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Foreword

Recent experiences, especially those during financial crises, have shown the importance of detecting sources of vulnerability early and taking timely corrective measures. One focus of the IMF's work in this area is on increasing the availability of key data. The IMF undertakes a range of activities for this purpose, including the IMF Statistics Department's work to prepare manuals describing methodologies that should be used to compile economic and financial statistics. In this regard, I am pleased to introduce the second edition of the *Government Finance Statistics Manual*. This manual takes its place alongside the other manuals prepared by the Statistics Department, including the *Balance of Payments Manual*, the *Monetary and Financial Statistics Manual*, and the *Quarterly National Accounts Manual*. Like the other manuals, this manual is harmonized with the *System of National Accounts 1993*.

This *Manual* represents a major step forward in the standards for compilation and presentation of fiscal statistics and thus takes its place as part of the worldwide effort to improve government accounting and transparency in operations. Government finance statistics are a key to fiscal analysis, and they play a vital role both in developing and monitoring sound financial programs and in conducting surveillance of economic policies. Of particular note is that the *Manual* introduces accrual accounting, balance sheets, and complete coverage of government economic and financial activities. Although only a few countries are currently capable of meeting the standards promulgated in this *Manual*, the number is increasing steadily and I hope that the trend continues. I commend the *Manual* to compilers and users as an important instrument in their work and urge member countries to adopt the guidelines of the *Manual* as the basis for compiling government finance statistics and for reporting this information to the Fund.

This *Manual* has been prepared by the Statistics Department in close consultation with experts in government financial statistics in member countries and international organizations. I would like to thank all of the experts involved for their invaluable assistance and for their collaborative and cooperative spirit.

Horst Köhler Managing Director International Monetary Fund

Preface

The Government Finance Statistics Manual is the latest in a series of international guidelines on statistical methodology that have been issued by the International Monetary Fund. The Manual, which updates the first edition published in 1986, is a major advance in the standards for compilation and presentation of fiscal statistics and part of a worldwide trend toward greater accountability and transparency in government finances, operations, and oversight. The Manual was produced by the IMF's Statistics Department in fulfillment of its mission to provide strong leadership for the development and application of sound statistical practices.

The *Manual* is designed for compilers of government finance statistics, fiscal analysts, and other users of fiscal data. It may also be useful to compilers and users of other macroeconomic statistics in understanding the relations between the various sets of statistics, in particular to compilers of the national accounts who may depend on government finance statistics as an input to their work. It is focused, however, on definitions, classifications, and guidelines for presenting government finance statistics. As such, it does not describe the methods to be used to compile the statistics. Practical guidance based on the *Manual* will be provided in a compilation guide and through technical assistance and training work with member countries. In addition to this English language version, the *Manual* will be published in Arabic, Chinese, French, Russian, and Spanish.

Fiscal analysis is rapidly evolving in response to the growing complexity of formulating and evaluating government fiscal policies. To meet these new requirements, the *Manual* introduces the accrual basis of recording economic events so that all resource flows are included, integrates balance sheets with transactions and other flows, and defines multiple balancing items so that a balancing item appropriate to a specific analytical need can be selected. Moreover, the concepts and principles set out in the *Manual* are harmonized with those of the *System of National Accounts 1993 (1993 SNA)* so that government finance statistics can be utilized jointly with other macroeconomic statistics.

The *Manual* is an ambitious step forward in statistical methodology. It is recognized that the implementation of the fully integrated system presented in this manual will take some time and will need to progress at a pace determined by the differing needs and circumstances of the country involved. In particular, many countries will need to revise their underlying accounting systems to reflect the accrual basis of recording and revised classifications.

The preparation of the *Manual* has been a long and complex endeavor involving a number of people with different skills who were able to build on each other's work over an extended period. The primary author of the *Manual* was Mr. John Pitzer, a consultant. The project was begun under the supervision of Mr. Thomas McLoughlin and completed under the guidance of Mr. Paul Cotterell, successive chiefs of the Government Finance Division in the IMF's Statistics Department. The drafting involved close consultation with experts in the IMF, member countries, and international organizations. Mr. Sean Culhane of the IMF's External Relations Department managed the production process of the final publication.

The publication of the 1993 SNA and growing recognition of deficiencies in the methodology of the 1986 manual provided the impetus for this revision. In March 1995, an issues note and questionnaire was sent to compilers in member countries to gather views on a number of methodological issues and ascertain the availability of source data. In October 1995, an internal paper was prepared by Mr. McLoughlin that gave shape to the new system. In July 1996, an IMF working paper The Case for Accrual Recording in the IMF's Government Finance Statistics System, by Mr. Don Efford, a consultant, was distributed. It was a key document in the debate over the shift from the cash basis of recording to the accrual basis. In August 1996, Government Finance Statistics: Annotated Outline was circulated for comment and the first draft of a manual was written by Mr. Efford throughout 1996 and 1997. Mr. Pitzer oversaw the finalization of the Manual through successive rounds of review and redrafting to take account of comments from experts in member countries and by IMF staff. A meeting of government finance statistics experts was convened in February 2001 to discuss the Manual and a final round of changes made to incorporate conclusions that were reached at the meeting.

Particular note should be made of the collaboration between the IMF's Statistics and Fiscal Affairs Departments. Ms. Adrienne Cheasty took the lead in drafting Chapter 4, The Analytic Framework, and she and her colleagues provided valuable consultation and advice with respect to the entire manual.

The IMF staff wishes to acknowledge, with thanks, the contributions of the following experts who participated in the February 2001 meeting.

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I. Introduction

This chapter describes the purpose of this manual, the uses of government finance statistics, the structure of the government finance statistics system, major methodological changes from the previous edition of this manual, and methods of implementing the revised system.

A. Purpose of the manual

- **1.1** This second edition of the *Government Finance Statistics Manual* (*GFS Manual* or revised *GFS Manual*)¹ describes a specialized macroeconomic statistical system (the GFS system) designed to support fiscal analysis. The manual provides the economic and accounting principles to be used in compiling the statistics and guidelines for the presentation of fiscal statistics within an analytic framework that includes appropriate balancing items.² The manual does not treat systematically the practical aspects of compiling the statistics. These aspects of the GFS system will be addressed in a compilation guide.
- 1.2 The primary purpose of the GFS Manual is to provide a comprehensive conceptual and accounting framework suitable for analyzing and evaluating fiscal policy, especially the performance of the general government sector and the broader public sector of any country. The concept of a sector is described in Chapter 2. In short, the general government sector consists of entities that implement public policy through the provision of primarily nonmarket services and the redistribution of income and wealth, with both activities supported mainly by compulsory levies on

- 1.3 Public finance analysts have traditionally used fiscal statistics to analyze the size of the public sector; its contribution to aggregate demand, investment, and saving; the impact of fiscal policy on the economy, including resource use, monetary conditions, and national indebtedness; the tax burden; tariff protection; and the social safety net (see Chapter 4, Box 1). In addition, analysts have become increasingly interested in assessing the effectiveness of spending on poverty alleviation, the sustainability of fiscal policies, net debt, net wealth, and contingent claims against government, including the obligations for social security pensions.
- 1.4 Achieving these analytic goals often requires the use of statistics for the public sector rather than the general government sector. Public corporations, nonfinancial as well as financial, can carry out government fiscal policies in a variety of ways, and analysis of their fiscal activities frequently requires statistics on all of their activities rather than isolated statistics on specific transactions. Even when statistics are compiled for only the general government sector, some information on public corporations is required to reflect the level and change in the level of equity ownership of public corporations held by units of the general government sector.
- 1.5 The basic concepts, classifications, and definitions employed in this manual depend on economic reasoning and principles that should be valid universally regardless of the circumstances in which they are applied. Therefore, the GFS system is applicable to all types of economies regardless of the institutional or legal structure of a country's government, the sophistication of its statistical development, the

other sectors. The public sector consists of the general government sector plus government-controlled entities, known as public corporations, whose primary activity is to engage in commercial activities.

The first edition was published in 1986 with the title A Manual on Government Finance Statistics. It will be referred to as the 1986 GFS Manual.

²Balancing items summarize the net value of the activities covered by a set of accounting entries, such as the net value of total revenue less total expense. Chapter 4 provides details on the analytic framework and its balancing items.

system of government financial accounting, or the extent of public ownership of for-profit entities. Nevertheless, the fact that countries differ greatly in their governmental and economic structures means that the various parts of this manual will not be equally relevant.

1.6 This edition of the *GFS Manual* updates the internationally recognized standards for the compilation of statistics required for fiscal analysis that were established by the *1986 GFS Manual*. The revised standards have been harmonized with the corresponding standards of other internationally recognized macroeconomic statistical systems to the extent consistent with the goal of supporting fiscal analysis. The other statistical systems are the overarching System of National Accounts (hereafter referred to as the *1993 SNA*) and two specialized systems that are focused on the balance of payments and monetary and financial statistics. This manual draws heavily on the text of the *1993 SNA* to avoid an inference that a different meaning is intended.

B. Uses of the GFS system

- 1.7 The GFS system is designed to provide statistics that enable policymakers and analysts to study developments in the financial operations, financial position, and liquidity situation of the general government sector or the public sector in a consistent and systematic manner. The GFS analytic framework can be used to analyze the operations of a specific level of government and transactions between levels of government as well as the entire general government or public sector.
- **1.8** One method used in the GFS system to produce summary information on the overall performance and financial position of the general government or public sector is through the use of a set of balancing

items, such as the net operating balance, net lending/borrowing, and the change in net worth. Such balancing items are most effectively defined and measured within an integrated and comprehensive accounting framework such as the GFS system.

- 1.9 In contrast to summary measures, the detailed data of the GFS system can be used to examine specific areas of government operations. For example, one might want information about particular forms of taxation, the level of expense incurred on a type of social service, or the amount of government borrowing from the banking system.
- 1.10 The harmonization of the GFS system with other macroeconomic statistical systems means that data from the GFS system can be combined with data from other systems to assess general government or public sector developments in relation to the rest of the economy. Similarly, the establishment of internationally recognized standards permits government finance statistics to be used in cross-country analyses of government operations, such as comparisons of ratios of taxes or expense to gross domestic product.

C. Structure and features of the GFS system

- 1.11 The GFS system pertains to the general government and public sectors as defined in the 1993 SNA and Chapter 2 of this manual. These sectors are defined in terms of institutional units, which are economic entities that are capable of owning assets, incurring liabilities, and engaging in economic activities and transactions with other entities in their own right. These characteristics render institutional units a subject of economic and statistical interest that can be satisfied by compilation of a full set of accounts for them, including balance sheets.
- **1.12** Two types of flows are recorded in the GFS system: transactions and other economic flows. For the most part, transactions are interactions between two institutional units that take place by mutual agreement. The *Statement of Government Operations* (see Chapter 4) records the results of all transactions during an accounting period. They are classified as revenue, expense, net acquisitions of nonfinancial

³Commission of the European Communities, International Monetary Fund, Organisation for Economic Co-operation and Development, United Nations, World Bank, *System of National Accounts 1993* (Brussels/Luxembourg, New York, Paris, Washington, 1993). International Monetary Fund, *Balance of Payments Manual, 5th ed.* (Washington, 1993). International Monetary Fund, *Monetary and Financial Statistics Manual* (Washington, 2000).

⁴This manual also draws heavily on United Nations, *Classifications of Expenditure According to Purpose* (New York, 2000) for the Classification of Functions of Government introduced in Chapter 6 and on the annual publication of the Organisation for Economic Cooperation and Development, *Revenue Statistics* (Paris), for the descriptions of tax categories in Chapter 5.

⁵Flows reflect the creation, transformation, exchange, transfer, or extinction of economic value. Transactions and other economic flows are defined and described in greater detail in Chapter 3.

assets, net acquisitions of financial assets, or net incurrences of liabilities. Transactions that generate revenue or expense result in a change in net worth. Other types of transactions result in equal changes to assets and/or liabilities and do not result in a change to net worth.

- **1.13** Other economic flows include price changes and a variety of other economic events that affect the holdings of assets and liabilities, such as debt write-offs and catastrophic losses. The *Statement of Other Economic Flows* (see Chapter 4) summarizes these changes in assets, liabilities, and net worth.
- **1.14** The *Balance Sheet* (see Chapter 4) for the general government or public sector is a statement of the stocks of financial and nonfinancial assets owned, the stock of claims of other units against the owners of those assets in the form of liabilities, and the sector's net worth, equal to the total value of all assets less the total value of all liabilities.
- 1.15 The comprehensive treatment of transactions and other economic flows in the GFS system enables the opening and closing balance sheets to be reconciled fully. That is, the stock of a given type of asset or liability at the beginning of an accounting period plus the changes in that stock indicated by transactions and other economic flows equals the stock at the end of the period. Such an integrated statistical system permits the effects of policies and specific economic events to be described and analyzed fully.
- 1.16 Various classifications are applied to the flows and stocks recorded in the GFS system. For example, each revenue transaction is classified according to whether it is a tax or another type of revenue; expense transactions are classified by purpose and by economic type; assets are classified according to whether they are financial or nonfinancial; and financial assets and liabilities are classified both by type of instrument and the sector of the unit that issued the asset held by government or that holds the liability issued by government.
- **1.17** Despite harmonization of the GFS system with the 1993 SNA, there are differences between the two statistical systems. The most important difference is that the focus of the GFS system is on financial transactions—taxing, spending, borrowing, and lending—while the 1993 SNA also focuses on the production and consumption of goods and services. As a result, the treatment of government productive activities in

the GFS system differs substantially from the treatment of those activities in the 1993 SNA. Significant differences relate to the treatment of own-account capital formation, retirement schemes for government employees, and the degree of consolidation (for more details, see Appendix 3).

- 1.18 In many cases, the compilation of government finance statistics will be the first step in the compilation of statistics for the general government sector of the national accounts. For this reason, some data that normally would not appear in a standard GFS presentation should be maintained in subsidiary records because they are needed for the national accounts. For example, the detailed estimates of retirement schemes for government employees should be maintained so that the different treatment of such schemes in the 1993 SNA can be accommodated.
- **1.19** Definitions of concepts in the GFS system are the same as in the 1993 SNA, but the coverage of a particular category of transactions may be slightly different. For example, compensation of employees recorded as an expense in the GFS system does not include the compensation of employees engaged in own-account capital formation, but compensation of employees in the 1993 SNA includes the compensation of all employees. The definition and composition of compensation of employees, however, is identical in both systems. Using the same name when the coverage is different could be misleading. To note where the coverage or some other aspect of a concept differs from the same concept in the 1993 SNA, the indicator "[GFS]" is added after the GFS title and an explanation of the difference is provided.
- 1.20 Contingencies, such as loan guarantees and implicit guarantees to provide social benefits when various needs arise, can have important economic influences on the general economy but do not result in transactions or other economic flows recorded in the GFS system until the event or condition referred to actually occurs. As a result, provision is made for recording contingencies as memorandum items.

D. Methodological changes from the 1986 GFS system

1.21 The methodology for compiling government finance statistics described in this manual differs substantially from the methodology of the *1986*

GFS Manual. The following paragraphs summarize the major differences. Details are provided in Appendix 1.

I. Coverage

1.22 The focus of the coverage of the revised GFS system is the general government sector as defined in the 1993 SNA, which is defined on the basis of institutional units. The coverage of the 1986 GFS Manual is defined on a functional basis and includes the relevant transactions of any unit carrying out a function of government. Frequently, units of the broader public sector carry out some functions of government. To capture the fiscal transactions and activities taking place outside the general government sector, the compilation of statistics of the public sector and identification of the transactions between units of the general government sector and public corporations are encouraged.

2. Basis of recording economic events

- **1.23** In the revised GFS system, flows are recorded on an accrual basis, which means that flows are recorded at the time economic value is created, transformed, exchanged, transferred, or extinguished. In the *1986 GFS Manual*, transactions are recorded when cash is received or paid.
- **1.24** Using the accrual basis also means that non-monetary transactions are fully integrated in the revised GFS system. In the *1986 GFS Manual* only selected nonmonetary transactions were recorded as memorandum items.

3. Valuation

1.25 Flows as well as assets, liabilities, and net worth are valued at current market prices in the revised *GFS Manual*, but with a provision for recording the nominal value of debt securities as a memorandum item. In the *1986 GFS Manual*, debt securities are valued at the amount the government is obligated to pay when the debt matures, which may differ from both the nominal value and the current market value.

4. Balance sheets

1.26 Complete balance sheets, which include all stocks of financial assets, nonfinancial assets, liabilities, and net worth, are included in the revised GFS

system. The 1986 GFS Manual includes only stocks of certain debt liabilities.

5. Integration of flows and stocks

1.27 The comprehensive recording of transactions and other economic flows permits a full integration of flows and stocks and the reconciliation of differences between the opening and closing balance sheets. Such a reconciliation of the stocks of the debt liabilities included in the *1986 GFS Manual* is not possible without the collection of additional information.

6. The analytic framework

- 1.28 In the revised GFS system several new balancing items are introduced. Associated with this change is the view that analysis of the general government sector or the public sector must include a variety of considerations and that no single measure is sufficient for all purposes. In the 1986 GFS Manual, the emphasis of the analytic framework is focused on a single balancing item, the overall deficit/surplus.
- **1.29** The revised definitions of revenue and expense as changes in net worth resulting from transactions lead to a revision of the treatment of transactions in nonfinancial assets from the *1986 GFS Manual* and the introduction of new balancing items. Previously, cash transactions in nonfinancial assets were treated as capital revenue and expenditure, which affected the overall deficit/surplus. Now the difference between revenue and expense is a balancing item, the net operating balance, that measures the change in net worth resulting from transactions.
- **1.30** All transactions involving the acquisition or disposal of financial assets are now treated as financial transactions, and net lending/borrowing is a balancing item defined as the net acquisition of all financial assets less the net incurrence of all liabilities from transactions. In the 1986 GFS Manual, the net acquisition of financial assets for policy purposes was designated as lending minus repayments and treated like expenditure in deriving the overall deficit/surplus. Provision is made in the revised system, however, for another balancing item, the overall balance, which allows the net acquisition of selected financial assets to be treated similarly to the net acquisition of financial assets for policy purposes in the 1986 GFS Manual (see Chapter 4).

E. Implementation of the revised GFS system

- 1.31 Some countries may be able, at least initially, to compile only a small part of the revised GFS system. It is not appropriate to lay down general priorities for data collection when economic circumstances may vary so much from one country to another. In practice, priorities usually are best established by national authorities that are familiar with the situation, needs, and problems of the individual countries in question.
- 1.32 It is recognized that the implementation of the fully integrated GFS system presented in this manual will take some time and will need to progress at a pace determined by the differing needs and circumstances of the country involved. In particular, many countries will need to revise their underlying accounting systems to reflect the accrual accounting principles and revised classifications of the GFS system.⁶
- **1.33** Nonetheless, it is likely that many countries will follow a similar path as they implement the system. For example, a possible first step on the migration path could be that countries would adopt the revised classification structure of the Statement of Government Operations or Statement of Sources and Uses of Cash and adjust their existing cash-based statistics to allow for known deficiencies, such as by incorporating information on revenue or expense arrears. Another step might be the assembly of balance sheet information on financial assets and liabilities that would enable estimates to be made of the other economic flows of the system as they relate to these financial items. A more difficult step is likely to be the collection of a complete set of information about the stocks of nonfinancial assets held at a given time and their valuation at current market prices. Finally, a fully developed accrual accounting system could be introduced that provides for complete balance sheets to be prepared.

- **1.34** The remainder of this manual can be divided into two general topics. Chapters 2 through 4 develop the concepts used in the system, and Chapters 5 through 10 describe the classifications used and the types of flows or stocks included in each classification category.
- 1.35 Chapter 2 describes the coverage of the general government sector, the division of the sector into subsectors, and its expansion to the public sector. Chapter 3 first summarizes the concepts of transactions, other economic flows, and stocks of assets and liabilities. It then describes the accounting rules governing their recording, including timing, valuation, and consolidation. Chapter 4 describes the analytic framework, which is the presentation of transactions, other economic flows, and balance sheets in a manner that permits the calculation of balancing items as summary measures of the activities of the general government sector.
- 1.36 Chapters 5 through 10 describe the classifications of transactions, other economic flows, and stocks of assets and liabilities. Chapter 5 is devoted to revenue transactions, which represent increases in net worth. Chapter 6 describes expense transactions, which decrease net worth. Chapter 7 describes the balance sheet and the classification of stocks of assets, liabilities, and net worth. Chapter 8 provides a classification of transactions in nonfinancial assets, and Chapter 9 provides a classification of transactions in financial assets and liabilities. Finally, Chapter 10 covers other economic flows.
- **1.37** The manual includes four appendixes. Appendix 1 describes the methodological changes from the *1986 GFS Manual*; Appendix 2 describes the treatment of various debt and debt-related transactions and other economic flows; Appendix 3 summarizes the relationships between the GFS system and the *1993 SNA*; and Appendix 4 lists all of the classification codes used in the GFS system. An annex to Chapter 2 describes social protection, while an annex to Chapter 6 reproduces the Classification of the Functions of Government.

F. Structure of the manual

⁶Although the GFS system is described in standard accounting terms, it is important to remember that it is a statistical reporting system that might differ in important ways from the underlying financial accounting system from which most of the GFS statistics will be derived.

2. Coverage of the GFS System

This chapter defines the concepts of sectors and institutional units and then uses those concepts to define the general government sector and the public sector.

A. Introduction

- **2.1** The government of a country consists of the public authorities and their agencies, which are entities established through political processes that exercise legislative, judicial, and executive authority within a territorial area. The principal economic functions of a government are (1) to assume responsibility for the provision of goods and services to the community on a nonmarket basis, either for collective or individual consumption, and (2) to redistribute income and wealth by means of transfer payments.² An additional characteristic of government is that these activities must be financed primarily by taxation or other compulsory transfers.³ A government may, of course, also finance a portion of its activities in a specific period by borrowing or by acquiring funds from sources other than compulsory transfers, such as interest revenue, incidental sales of goods and services, or the rent of subsoil assets.
- **2.2** The goods and services provided to the community for collective consumption normally consist of services such as public administration, defense,

and law enforcement. By definition, collective services are always provided free. Typical goods and services provided for individual consumption are education, health, housing, recreation, and cultural services. These services may be provided for free or the government may charge a fee. The goods and services provided to the community as a whole or to individuals may be produced by the government itself or the government may purchase them from a third party.

- 2.3 In principle, the GFS system covers all entities that materially affect fiscal policies. Normally, fiscal policies are implemented by entities wholly devoted to the economic functions of government, such as a government ministry. In addition to those entities, however, fiscal policy may be carried out by government-owned or controlled enterprises that engage primarily in commercial activities. These enterprises, such as the central bank or national railroad, which are referred to as public corporations, are not considered part of government, but statistics should be collected on them.
- **2.4** Determining the coverage of the entities included in the GFS system therefore requires consideration of two questions. First, what is the statistical unit from which it is feasible and meaningful to collect statistics? Second, which of those statistical units should be included in the GFS system?
- **2.5** Regarding the first question, the statistical unit employed in the GFS system is the institutional unit, the same unit that is the foundation of the *1993 SNA*. As explained later in this chapter, this type of unit can, in its own right, own assets, incur liabilities, and engage in economic activities and transactions with other entities. There are several reasons for choosing this unit:
- Statistics can be based on information from entities for which complete sets of accounts can be com-

¹The term "government" is used here as a collective of all entities in a country that satisfy this definition. More often, reference will be made to the various individual governments of a country. For example, a country may have one central government; several state, provincial, or regional governments; and many local governments.

²The concepts of market and nonmarket output are described in paragraphs 2.31 to 2.37. Briefly, nonmarket output consists of goods and services distributed for free or sold at very low prices.

³The requirement of financing activities by compulsory transfers is necessary to differentiate a government from a nonprofit institution, which may carry out the same functions as a government but obtains its funds from voluntary transfers, property income, or sales. The receipt of compulsory transfers may be indirect. For example, a local government may finance its activities with grants from the central government.

piled, including balance sheets. Such accounts permit the integration of flows and stocks. That is, all changes in the balance sheet during an accounting period can be traced to a transaction or other identified event recorded in the system.

- The data needed for the compilation of statistics are usually available in existing accounting records or can be made available.
- Statistics for government can be harmonized with statistics of the 1993 SNA because the entities for which statistics are compiled are defined identically.
- 2.6 An alternative to compiling GFS based on institutional units is to compile statistics from all units in the economy, but include only those statistics that relate directly to fiscal operations. Not only would it be impossible to construct balance sheets and explain changes in balance sheets with such statistics, but in practice, it is unlikely to be possible to separate the fiscal operations of public corporations from their normal commercial activities. For example, it is unlikely that loans issued by a public financial corporation with an interest rate deliberately set lower than the market rate can be separated from similar loans with a market rate.
- 2.7 With regard to the question of the institutional units for which statistics should be compiled, two principal constructs are developed in this manual. First, the general government sector is defined. It consists of all institutional units primarily engaged in nonmarket operations. Second, the public sector is defined to capture the impact on fiscal policy of the activities of public corporations. It includes all units of the general government sector plus all public corporations. In addition, a number of subsectors of the general government and public sectors are defined because of their likely analytic usefulness.
- **2.8** The remainder of this chapter first defines the concepts of sectors and institutional units in general. It then applies these concepts to the general government sector and the public sector. Finally, the other sectors mentioned in this manual and the concept of residency are described.

B. Sectors and institutional units⁴

I. Definition of a sector

- **2.9** The total economy of a country can be divided into *sectors*, with each sector consisting of a number of *institutional units*—defined in the following section—that are resident in the economy. This manual follows the *1993 SNA* by initially dividing the total economy into five mutually exclusive sectors. The units⁵ in each sector have similar objectives and these objectives are, in turn, different from those of units in other sectors. The five sectors are as follows:
- The nonfinancial corporations sector, which consists of entities created for the purpose of producing goods and nonfinancial services for the market;
- The financial corporations sector, which consists of entities engaged in providing financial services for the market;
- The general government sector, which consists of entities that fulfill the functions of government as their primary activity;
- The nonprofit institutions serving households sector, which consists of all resident nonprofit institutions, except those controlled and mainly financed by government, that provide nonmarket goods or services to households; and
- The *households sector*, which consists of small groups of persons who share the same living accommodation, pool some or all of their income and wealth, and consume certain types of goods and services collectively.
- **2.10** For analytic purposes each of these sectors may be divided into subsectors, and the subsectors can be combined in different ways to form other sectors. For example, the general government sector can be divided into central, state, and local government subsectors, and the nonfinancial corporations sector can be divided into public nonfinancial corporations and other nonfinancial corporations.

⁴The definitions and descriptions of sectors and institutional units are intended to be fully consistent with the equivalent definitions and descriptions in Chapter IV of the *1993 SNA*.

⁵Hereafter, "unit" will often be used as a short form for "institutional unit."

2. Definition of an institutional unit

- **2.11** An *institutional unit* is an economic entity that is capable, in its own right, of owning assets, incurring liabilities, and engaging in economic activities and in transactions with other entities. Some important features of institutional units follow:
- The ability of an institutional unit to own goods or assets in its own right means that it is also able to exchange the ownership of goods or assets in transactions with other institutional units.
- An institutional unit is able to take economic decisions and engage in economic activities for which it is itself held directly responsible and accountable at law.
- An institutional unit is able to incur liabilities on its own behalf, to take on other obligations or future commitments, and to enter into contracts.
- Either a complete set of accounts, including a balance sheet of assets, liabilities, and net worth, exists for an institutional unit, or it would be possible and meaningful, from both an economic and legal viewpoint, to compile a complete set of accounts if they were to be required.
- **2.12** There are two main types of entities that may qualify as institutional units: (1) persons or groups of persons in the form of households and (2) legal or social entities whose existence is recognized by law or society independently of the persons or other entities that may own or control them.
- **2.13** The four types of legal or social entities recognized in the *1993 SNA* and this manual as institutional units are corporations, quasi-corporations, nonprofit institutions, and government units.
- **2.14** *Corporations* are legal entities that are created for the purpose of producing goods or services for the market. They may be a source of profit or other financial gain to their owners. A corporation is collectively owned by shareholders who have the authority to appoint directors responsible for its general management. Institutional units owned or controlled by governments that qualify as corporations in the sense used here are known as public corporations. All corporations are members of the nonfinancial corporations sector or the financial corporations sector, depending on the nature of their primary activity.

- 2.15 The key to classifying a unit as a corporation is not its legal status but rather the characteristics of producing goods and services for the market and being a source of profit or other financial gain to the owners. Some nonprofit institutions and government units have the legal status of a corporation but are not considered corporations for the purposes of economic statistics because they do not produce for the market. Other nonprofit institutions are legal corporations that produce for the market but are not a source of financial gain to their owners. Conversely, some entities with different legal titles, such as joint-stock company, are considered corporations for economic statistics.
- **2.16** *Quasi-corporations* are entities that are not incorporated or otherwise legally established, but which function as if they were corporations, as defined in the previous two paragraphs. Quasi-corporations are also treated in the same way as corporations in the GFS system, which means that they are institutional units separate from the units to which they legally belong. They are classified as members of either the nonfinancial corporations sector or the financial corporations sector depending on the nature of their primary activity.
- **2.17** The concept of a quasi-corporation is intended to separate from their owners those unincorporated enterprises that are engaged in commercial activities and are sufficiently self-contained and independent that they behave in the same way as corporations. To be a quasi-corporation, there must be a complete set of accounts for the enterprise or it must be possible to construct such accounts, including any flows of income and capital between the quasi-corporation and its owner. A government printing office and an agency producing cultural services for sale to the public are examples of possible public quasi-corporations.
- 2.18 In order for a public quasi-corporation to exist, the government must allow the management of the enterprise considerable discretion with respect to the management of the production process and with the use of its funds. The quasi-corporation must be able to maintain its own working capital and be able to finance some or all of its capital formation, either from its own resources or by borrowing. The ability to distinguish flows of income and capital between a quasi-corporation and the government unit that owns it implies that the operating and financing activities of the quasi-corporation are not fully integrated with the parent's corresponding activities, despite the fact that the quasi-corporation is not a separate legal entity.

- 2.19 Nonprofit institutions (NPIs) are legal or social entities created for the purpose of producing or distributing goods and services, but they cannot be a source of income, profit, or other financial gain for the institutional units that established, control, or finance them. An NPI may engage in market or nonmarket production. If it engages in market production, such as a hospital that charges market prices or a university that charges tuition, then the NPI must either retain any surplus earned from its productive activities to support its future operations or distribute it to institutional units other than the units that established, control, or finance it. These market NPIs are, like corporations and quasi-corporations, members of either the nonfinancial corporations sector or the financial corporations sector. Other NPIs are members of either the nonprofit institutions serving households sector or the general government sector, depending on which units control and mainly finance the NPI.
- 2.20 Government units are institutional units that carry out the functions of government as their primary activity. That is, they have legislative, judicial, or executive authority over other institutional units within a given area; they assume responsibility for the provision of goods and services to the community as a whole or to individual households on a nonmarket basis; they make transfer payments to redistribute income and wealth; and they finance their activities, directly or indirectly, mainly by means of taxes and other compulsory transfers from units in other sectors. All government units are members of the general government sector.
- **2.21** A *social security fund* is a particular kind of government unit that is devoted to the operation of one or more social security schemes, which are defined in the annex to this chapter. A social security fund must satisfy the general requirements of an institutional unit. That is, it must be separately organized from the other activities of government units, hold its assets and liabilities separately, and engage in financial transactions on its own account.

3. Application of the definition of an institutional unit to government

2.22 Depending on the complexity of a government's organization, the identification of government units may be difficult. Most of the ministries, departments, agencies, boards, commissions, judicial authorities, legislative bodies, and other entities that

- make up a government are not institutional units because they generally do not have the authority to own assets, incur liabilities, or engage in transactions in their own right. In general, all entities funded by appropriations made in accordance with a budget controlled by the legislature must be amalgamated into a single institutional unit.
- **2.23** A government unit is not limited in its geographic location. For example, the individual ministries or departments of a particular government may be deliberately dispersed throughout the area of the government's jurisdiction. They remain, nevertheless, part of the same institutional unit. Similarly, a given ministry or department may maintain branch offices or agencies in many different locations to meet local needs. These offices and agencies are part of the same institutional unit.
- 2.24 There may, however, be government entities with a separate legal identity and substantial autonomy, including discretion over the volume and composition of their expenditures and a direct source of revenue, such as earmarked taxes. Such entities are often established to carry out specific functions, such as road construction or the nonmarket production of health or education services. These entities should be treated as separate government units if they maintain full sets of accounts, own goods or assets in their own right, engage in nonmarket activities for which they are held accountable at law, and are able to incur liabilities and enter into contracts.
- 2.25 Many governments allocate substantial volumes of resources to social protection through the provision of social benefits, which are payments in cash or in kind to protect the entire population or specific segments of it against certain social risks. A social risk is an event or circumstance that may adversely affect the welfare of the households concerned either by imposing additional demands on their resources or by reducing their incomes. Examples of social benefits are the provision of medical services, unemployment compensation, and social security pensions. Because of the large scale of social protection programs in many countries and the different organizational possibilities of such programs, an annex to this chapter describes the different types of programs and their effects on statistics of the general government sector.
- **2.26** When a government comprises two or more institutional units, there normally is one unit that con-

trols the other units. The controlling unit most likely includes the legislature, head of state, and judiciary. In contrast to corporations, one government unit controls another government unit by appointing its managers and/or determining the laws and regulations that provide its finance rather than through equity ownership. No government unit owns another government unit, and government units do not issue equity securities.

2.27 Public corporations, in contrast to government units, are potential sources of financial gain to the government units that own or control them. In some cases, the corporation issues equity securities so that the financial gain or loss is clearly allocated to the owner or owners. In other cases, no equity securities are issued, but it is clear that a specific government unit controls the corporation's activities and is financially responsible for it. In those cases, the responsible government unit is assumed to own implicitly issued equity securities.

C. The general government sector and its subsectors

I. The general government sector

2.28 The general government sector consists of all government units and all nonmarket NPIs that are controlled and mainly financed by government units. Hereafter the term *general government unit* will be used to refer to units of the general government sector.

2.29 Nonmarket NPIs that are both controlled and mainly financed by government units are legally nongovernment entities, but they are considered to be carrying out government policies and effectively are part of government. Governments may choose to use nonprofit institutions rather than government agencies to carry out certain government policies because NPIs may be seen as detached, objective, and not subject to political pressures. For example, research

2.30 A government unit controls a nonmarket NPI when it has the ability to determine the general policy or program of the NPI. A government unit can determine the general policy or program by having the right to appoint the officers managing the NPI or through financial means. The amount of control provided by the supply of finance depends on the timing and restrictions attached to the funds as well as the amount of financing. It is necessary, therefore, to apply judgment based on the individual facts and circumstances of each case. An NPI is mainly financed by a government unit when the main portion of the NPI's operating funds is provided by a government unit.⁸

2.31 The general government sector does not include public corporations or quasi-corporations. When a unit sells some or all of its output, it can be difficult to decide whether to classify the unit as either a government unit or a public corporation or to decide whether a public quasi-corporation exists. In general, the decision is based on whether the unit sells its output at market prices. Any unit that sells all or almost all of its output at market prices is a corporation or quasi-corporation and all other units are government units. With public units, however, market prices are not always easy to identify. The concept of economically significant prices underlies the determination of prices as market or nonmarket and, therefore, the classification of units.

2.32 Economically significant prices are prices that have a significant influence on the amounts the producers are willing to supply and on the amounts purchasers wish to buy. This definition can be implemented, however, only with a great deal of judgment after considering all of the facts and circumstances. Although no precise guidelines can be provided, it is clear that an economically significant price does not have to be so high that all costs of production are covered. At the other extreme, a price that is not economically significant is one that is not quantitatively significant from the point of view of either supply or demand. Such prices are likely to be charged in order to raise some revenue or achieve some reduction in the excess demand that may occur when services are

and development and the setting and maintenance of standards in fields such as health, safety, the environment, and education are areas in which NPIs may be more effective than government agencies.

⁶Only resident government units and NPIs are included in the general government sector, but it can be assumed that all government units and NPIs controlled by government are residents. The concept of residency is described in paragraphs 2.70 to.2.77.

⁷The term "general government unit" will generally be used in this manual, but in most cases the text is equally applicable to public corporations. In some cases, reference will be made to public corporations or public sector units for clarity. Otherwise an extension to the public sector can be assumed.

⁸In agreement with footnote 4, the assignment of NPIs to sectors should be identical to the assignment used in the national accounts.

provided completely free, but they are not intended to eliminate such excess demand. The price merely deters those units whose demands are the least pressing without greatly reducing the total level of demand.

- **2.33** *Market output* consists of goods and services that are sold at economically significant prices, otherwise disposed of on the market, or intended for sale or disposal on the market. *Nonmarket output* consists of goods and services that are supplied free or at prices that are not economically significant to other institutional units or the community as a whole.
- **2.34** A *market producer* is a unit that markets its entire output. In this context, market output includes output in the form of own-account fixed capital formation. A *nonmarket producer* is a unit that mainly supplies goods or services free or at prices that are not economically significant to households or the community as a whole. These producers may also have some sales of market output as a secondary activity.
- 2.35 Thus, when classifying units that sell some or all of their output, two questions must be considered. First, if a unit sells most or all of its output, are the prices economically significant? If they all are, then the unit is a public corporation. If none of the prices is economically significant, then the unit is a general government unit. Second, if only some of the prices are economically significant or if the unit sells only some of its output, is it possible to identify a quasicorporation within the unit? If it is possible, then the organizational components that sell their output at economically significant prices and have a complete set of accounts are treated as a quasi-corporation. The remaining components would form a general government unit. If it is not possible to form a quasi-corporation, then the components selling their output for economically significant prices remain an integral part of the general government unit and their sales are part of the unit's revenue.
- **2.36** If a general government unit sells some of its output for economically significant prices, then one or more *market establishments* may exist. An establishment is an enterprise ⁹ or a part of an enterprise situated in a single location at which only a single productive activity is carried out, or where the principal productive activity accounts for most of the value added. In practice, an establishment is usually identified with an individual workplace at which a particular kind of

productive activity is carried out. An institutional unit may be composed of one or more establishments.

- **2.37** A market establishment within a general government unit is an establishment that sells or otherwise disposes of all or most of its output at prices that are economically significant. 10 All other establishments are nonmarket establishments. A nonmarket producer, such as a general government unit, will have mostly nonmarket establishments, but it may have one or more market establishments. For example, a municipal swimming pool that charges entrance fees or a government publishing office that sells its publications might be a market establishment. The definition of a market establishment implies that complete accounting records about its production activities are available, including the value of its output and the cost of producing that output. It will not, however, have a complete balance sheet or be able to engage in financial transactions in its own name. If it had those qualities it would be treated as a quasi-corporation. The sales of market establishments are identified in Chapter 5 as a specific category of revenue. Sales by nonmarket establishments, whether at economically significant prices or not, are classified as a different category of revenue, incidental sales of goods and services.
- **2.38** There are two exceptions to these general rules about the classification of units. First, if the unit is an internal service organization that sells its output mainly to other government units, such as a transportation pool, a supply depot, or a munitions factory, then it is treated as an ancillary unit and its activities are consolidated with the other activities of the government unit that controls it. Second, in some cases a unit that appears to be a financial corporation is in fact a general government unit. Most typically, a government may establish a central borrowing authority that borrows on the market and then lends only to general government units, generally on commercial terms. Such organizations merely facilitate government borrowing and should be classified as general government units.11
- **2.39** An additional consequence of compiling statistics based on institutional units is that a part of the monetary authority may be included in the general government sector. Normally, the central bank is a

⁹An enterprise is an institutional unit engaged in production.

¹⁰A market establishment is the closest equivalent in this manual to the concept of a departmental enterprise in the *1986 GFS Manual*.

¹¹ If the unit mainly lends to public corporations, then it would be classified as a financial corporation.

separate institutional unit classified as a public corporation. In some countries, however, the central government may include units that engage in financial transactions that in other countries would be performed by central banks. In particular, government units may be responsible for the issue of currency, the maintenance of international reserves, the operation of exchange stabilization funds, or transactions with the IMF. When the units in question remain financially integrated with the government and under the direct control and supervision of the government, then they cannot be treated as separate institutional units and any monetary authority functions carried out by the government are recorded in the general government sector.

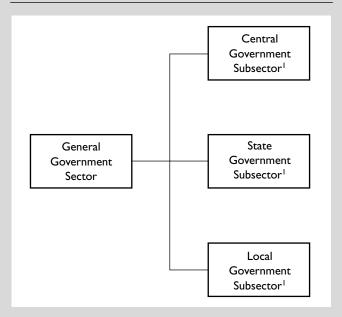
2. Subsectors of the general government sector

- **2.40** It is often necessary or desirable for analytic reasons to disaggregate the statistics of the general government sector. Two primary methods of constructing subsectors are presented. The difference between them is the result of alternative possible treatments of social security funds.
- 2.41 Depending on the administrative and legal arrangements, there may be more than one level of government within a country, and statistics should be compiled for each level. In the GFS system, provision is made for three levels of government: central; state, provincial, or regional; and local. Not all countries will have all three levels; some may have only a central government or a central government and one lower level. Other countries may have more than three levels. In that case, the various units should all be classified as one of the three levels suggested here. In addition to levels of government, the existence of social security funds and their role in fiscal policy may require that statistics for all social security funds be compiled as a separate subsector of the general government sector.
- **2.42** Classification problems may arise when government operations are carried out by a general government unit jointly responsible to two levels of government. This classification decision may be especially difficult if the agency has its own source of funding, such as earmarked taxes. Similarly, an NPI might be controlled and mainly financed by two or more government units at different levels of government. For example, a state government unit might have the right to appoint the majority of officers managing an NPI but the finance might be provided mainly by the central government.

General government units subject to dual control should be classified to the level of government that predominates in financing or controlling its operations, but no precise rules can be formulated that cover all possible arrangements.

- 2.43 The requirements to classify general government units according to their level of government and whether they are a social security fund can be accommodated in two alternative sets of subsectors. First, all social security funds could be classified according to the level of government that operates them and combined with other general government units at that level. Thus, the subsectors would be central, state, and local government, assuming that all three levels of government exist (Figure 2.1). Second, all social security funds could be combined into a separate subsector and all other general government units could be classified according to their level. In that case, the central, state, and local government subsectors would consist of all government units other than social security funds.
- **2.44** The alternative methods of subsectoring are designed to accommodate different analytic needs. The decision as to which method is more appropriate in a given country depends on how well organized and important social security funds are and on the extent to which they are managed independently of the government units with which they are associated. If the management of social security funds is so closely integrated with the short- or medium-term requirements of the government's general economic policy that contributions and benefits are deliberately adjusted in the interests of overall economic policy, it becomes difficult, at a conceptual level, to draw any clear distinction between the management of social security and the other economic functions of government. In other countries, social security funds may exist in only a very rudimentary form. In either of these circumstances it is difficult to justify treating social security funds as a separate subsector on a par with central, state, and local government.
- **2.45** In addition to subsectors based on the level of government and the existence of social security funds, it may be possible to create subsectors at each level of government based on whether the units are financed by the legislative budgets of that level of government or by extrabudgetary sources. It is often analytically desirable to classify these types of units separately because of their differing sources of finance and different types of public oversight of their operations.

Figure 2.1: The General Government Sector and Its Subsectors



¹Includes social security funds. Alternatively, social security funds can be combined into a seperate subsector.

- **2.46** In addition to the classification of units by level of government and by social security funds, some classifications of transactions are based on the other party to the transaction. In those instances, one grouping of units is "other general government units," which consists of all general government units other than the units for which the statistics are being compiled. For example, when statistics for the central government subsector are compiled, this grouping would include all general government units other than central government units.
- **2.47** The following sections define the levels of government. These definitions apply regardless of the selected treatment of social security funds.

a. Central government

2.48 The political authority of a country's central government extends over the entire territory of the country. The central government can impose taxes on all resident institutional units and on nonresident units engaged in economic activities within the country. The central government typically is responsible for providing collective services for the benefit of the community as a whole, such as national defense, rela-

tions with other countries, public order and safety, and the efficient operation of the social and economic system of the country. In addition, it may incur expenses on the provision of services, such as education or health, primarily for the benefit of individual households, and it may make transfers to other institutional units, including other levels of government.

- **2.49** The compilation of statistics for the central government is particularly important because of the special role it plays in monetary and economic analysis. It is mainly through central government finances that fiscal policy operates on inflationary or deflationary pressures within the economy. It is generally at the central government level alone that a decision-making body can formulate and carry out policies directed toward nationwide economic objectives. Other levels of government have neither national economic policies as their objective nor the central government's access to central bank credit.
- **2.50** The central government subsector is a large and complex subsector in most countries. It is generally composed of a central group of departments or ministries that make up a single institutional unit plus, in many countries, other units operating under the authority of the central government with a separate legal identity and enough autonomy to form additional government units.

b. State, provincial, or regional government

- **2.51** A state, province, or region is the largest geographical area into which the country as a whole may be divided for political or administrative purposes. These areas may be described by other terms, such as provinces, cantons, republics, prefectures, or administrative regions. For ease of expression and consistency with the *1993 SNA*, this level of government will be referred to hereafter as the state government.
- **2.52** The legislative, judicial, and executive authority of a state government extends over the entire area of an individual state, which usually includes numerous localities, but does not extend over other states. In some countries, individual states and state governments may not exist. In other countries, especially those with federal constitutions, considerable powers and responsibilities may be assigned to state governments.
- **2.53** A state government usually has the fiscal authority to levy taxes on institutional units that are resident in or engage in economic activities in its area

of competence. To be recognized as a government unit the entity must be able to own assets, raise funds, and incur liabilities on its own account, and it must also be entitled to spend or allocate at least some of the taxes or other income that it receives according to its own policies. The entity may, however, receive transfers from the central government that are tied to certain specified purposes. A state government should also be able to appoint its own officers independently of external administrative control. If a government entity operating in a state is entirely dependent on funds from the central government, and if the central government also dictates the ways in which those funds are to be spent, then the entity should be treated as an agency of the central government.

2.54 If a state government exists, then its principal departments and ministries will constitute a single institutional unit in a manner similar to the core unit of the central government. In addition, there may be agencies operating under the authority of a state government with a separate legal identity and enough autonomy to form additional institutional units. There may also be institutional units whose authority extends over two or more states, but which are responsible to the respective state governments. Such units should also be included in the state government subsector.

c. Local government

2.55 The legislative, judicial, and executive authority of local government units is restricted to the smallest geographic areas distinguished for administrative and political purposes. The scope of a local government's authority is generally much less than that of the central or state governments, and such governments may or may not be entitled to levy taxes on institutional units or economic activities taking place in their areas. They are often heavily dependent on grants from higher levels of government, and they may also act as agents of central or state governments to some extent. To be treated as institutional units, however, they must be entitled to own assets, raise funds, and incur liabilities by borrowing on their own account. They must also have some discretion over how such funds are spent, and they should be able to appoint their own officers independently of external administrative control.

2.56 Local governments typically provide a wide range of services to local residents, some of which may be financed out of grants from higher levels of government. Statistics for local government may cover a wide variety of governmental units, such as counties, munic-

ipalities, cities, towns, townships, boroughs, school districts, and water or sanitation districts. Often local government units with different functional responsibilities have authority over the same geographic areas. For example, separate government units representing a town, a county, and a school district may have authority over the same area. In addition, two or more contiguous local governments may organize a government unit with regional authority that is accountable to the local governments. Such units should also be included in the local government subsector.

2.57 Some of the most typical functions of local governments include (1) educational establishments to which users' fees are small in relation to the main costs borne by the local government; (2) hospitals and social welfare establishments, such as kindergartens, nurseries, and welfare homes; (3) public sanitation and related entities, such as water purification systems and plants, refuse collection and disposal agencies, cemeteries, and crematoria; and (4) culture, leisure, and sports facilities, such as theaters, concerts, music halls, museums, art galleries, libraries, parks, and open spaces.

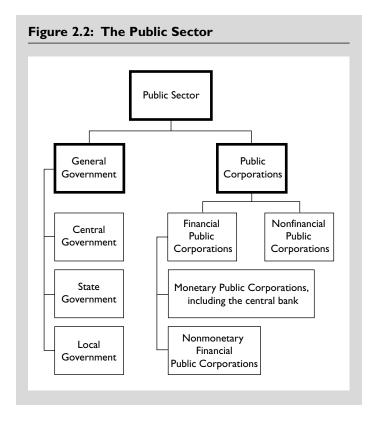
2.58 Government units serving both a state government and one or more local governments would be included with the level of government that predominates in its operations and finances. In some countries more than one level of government exists between the central government and the smallest governmental institutional units at a local level. In such cases, these intermediate levels of government are grouped together with the level of government, either state or local, with which they are most closely associated.

D. The public sector

2.59 Statistics should be compiled for the public sector as well as for the general government sector. For example, public corporations may carry out government operations at the behest of the government units that own them. Such activity can take place in a variety of forms. Most directly, a public corporation can engage in specific transactions to carry out a government operation, such as lending to particular parties at a lower-than-market interest rate or selling electric power to selected customers at reduced rates. More generally, however, a public corporation can carry out fiscal policy by employing more staff than required, purchasing extra inputs, paying above-market prices

for inputs, or selling a large share of its output for prices that are less than what the market price would be if only private producers were involved.

- **2.60** Statistics on public corporations are also likely to be necessary to compile comprehensive statistics for the general government sector. For example, changes in the net worth of public corporations are reflected in the value of the equity of those corporations owned by general government units. The accounts of public corporations will help explain the source of changes in these assets, and that information will be useful for an analysis of sustainability and other aspects of fiscal analysis.
- **2.61** When compiling statistics of public corporations, various groupings—or subsectors of the public sector—may be desirable for analytic purposes. Four groupings of public corporations will likely form the foundation from which other groupings can be created. These four groupings are (Figure 2.2):
- Nonfinancial public corporations—all resident nonfinancial corporations controlled by general government units.
- Nonmonetary financial public corporations—all resident financial corporations controlled by general government units except the central bank and other public depository corporations. Depository corporations are financial corporations, quasi-corporations, or market NPIs whose principal activity is financial intermediation and who have liabilities in the form of deposits or financial instruments that are close substitutes for deposits.
- Monetary public corporations other than the central bank—all resident depository corporations other than the central bank that are controlled by general government units.
- The central bank, which consists of the central bank itself, currency boards or independent currency authorities that issue national currency that is fully backed by foreign exchange reserves, and other government-affiliated agencies that are separate institutional units and primarily perform central bank activities.
- **2.62** Starting with the four groupings just listed and the subsectors of the general government sector, other subsectors of the public sector can be created, including:



- The nonfinancial public sector—the general government sector plus nonfinancial public corporations.
- The nonmonetary public sector—nonfinancial public corporations, nonmonetary financial public corporations, and the general government sector.
- Central government public sector—the central government subsector plus public corporations controlled by the central government.

E. Sectors other than the general government and public sectors

2.63 Certain transactions in the GFS system are classified by the sector of the other party to a financial instrument. For example, in Chapter 9 the incurrence of debt liabilities by the general government sector can be classified by the sectors in the rest of the economy or in other countries providing the finance. For this purpose, a classification of sectors other than the general government or the public sector is needed. This section summarizes the definitions of the sectors used in those classifications. In some cases, the sectors are identical to those defined in the *1993 SNA*. In

other cases, different groupings of institutional units are appropriate for use in the GFS system. In particular, the term "sector" is used in the 1993 SNA only in reference to resident institutional units. The aggregate of all nonresident institutional units is referred to as the rest of the world. In this manual, sector is used to refer to nonresident units in the same manner as it is used to refer to resident units.

- **2.64** The *financial corporations sector* consists of all corporations, quasi-corporations, and market NPIs principally engaged in financial intermediation or in auxiliary financial activities closely related to financial intermediation. In some cases, this sector is disaggregated into three subsectors: the central bank, other depository corporations, and financial corporations not elsewhere classified.
- **2.65** The *other depository corporations subsector* consists of all depository corporations, quasi-corporations, and market NPIs except the central bank.
- 2.66 The financial corporations not elsewhere classified subsector consists of all nondepository financial corporations, quasi-corporations, and market NPIs.¹² It includes units that raise funds on financial markets other than by deposits and use them to acquire other kinds of financial assets, such as investment corporations, corporations engaged in financial leasing, hire purchase corporations, other corporations engaged in the provision of personal finance or consumer credit, insurance corporations, and autonomous pension funds. It also includes corporations, quasi-corporations, and market NPIs engaged primarily in activities closely related to financial intermediation, such as public exchanges and securities markets, brokers and agents, foreign exchange companies, financial guarantee corporations, insurance and pension auxiliaries, and government-affiliated units established to regulate financial institutions.
- **2.67** The *other nonresidents* sector is an aggregation of all nonresident nonfinancial corporations, households, and NPIs serving households with which the general government sector had transactions.
- **2.68** The *international organizations sector* consists of all international organizations, all of which are nonresidents. As indicated in paragraph 2.76,

supranational organizations are considered a type of international organization.

2.69 As described earlier, transactions between general government units and public corporations can have an important impact on statistics of the general government. In such cases, the financial and nonfinancial corporations sectors and subsectors can be divided into a public corporations subsector and an other corporations subsector. The latter would include all foreign-controlled corporations.

F. Residency

- **2.70** The concept of residency is important for determining the coverage of the GFS system and the classification of transactions. The total economy of a country consists of the set of all resident institutional units, and the general government sector consists of all resident general government units. In addition, as described in later chapters, some types of transactions and stocks of assets and liabilities of the general government sector are classified in the GFS system on the basis of the other party to a financial instrument, and one of the classification criteria is the residency of the other party.
- **2.71** An institutional unit is resident in a country if it has a center of economic interest in the economic territory of that country. Residency in the GFS system is not based on nationality or legal criteria, although it may be similar to the concepts of residency used for exchange control, taxes, or other purposes in many countries.
- **2.72** The economic territory of a country consists of the geographic territory administered by a government. The economic territory need not be identical to its physical or political borders, but it will usually correspond closely with these borders. In particular, the economic territory of a country includes the following:
- The airspace, territorial waters, and continental shelf lying in international waters over which the country enjoys exclusive rights or over which it claims to have jurisdiction in respect of the right to fish or to exploit fuels or minerals below the sea bed.
- Territorial enclaves physically located in other countries that a government owns or rents with the formal political agreement of the government of the country in which they are physically located.

¹²This subsector is the combination of three subsectors in the *1993 SNA*: other financial intermediaries, except insurance corporations and pension funds; financial auxiliaries; and insurance corporations and pension funds.

These enclaves are used for embassies, consulates, military bases, scientific stations, information offices, immigration offices, and aid agencies. Conversely, the economic territory of a country does not include the territorial enclaves that are physically located within the geographical boundaries of that country that are used by foreign governments or international organizations.

- Any islands belonging to a country that are subject to exactly the same fiscal and monetary authorities as the mainland.
- Free zones and bonded warehouses or factories within the geographical boundaries of a country that are operated by offshore enterprises under customs control.
- 2.73 An institutional unit has a center of economic interest within a country when there exists some location—a dwelling, place of production, or other premises—within the country's economic territory on or from which it engages, and intends to continue to engage, in economic activities and transactions on a significant scale indefinitely or over a finite but long period of time. In most cases, a long period of time may be interpreted as one year or more. The location need not be fixed so long as it remains within the economic territory.
- 2.74 On the basis of this definition of residency, all general government units are considered to be residents in their own country regardless of their physical location. Public corporations, however, are considered to be residents of the economies in whose territories they operate. Thus, a general government unit resident in one country can own a corporation resident in a second country. In particular, when a resident public corporation maintains a branch, office, or production site in another country in order to engage in a significant amount of production over

a long period of time, the branch, office, or site is considered to be a quasi-corporation resident in the other country.

- 2.75 The economic territory of an international organization consists of the territorial enclaves over which it has jurisdiction. As a result, international organizations are not considered residents of any national economy, including the country in which they are located or conduct their affairs.
- 2.76 Supranational authorities are international organizations that have been endowed with the authority to raise taxes or other compulsory contributions within the territories of the countries that are members of the authority. Despite the fact that supranational authorities fulfill some of the functions of government within each member country, they are not resident units of any country. Thus, transactions between the supranational authority and resident institutional units outside the general government or public sectors are not included in the GFS system of an individual country. It is possible, however, to compile statistics for supranational authorities using the GFS framework as if they constituted a separate government. In doing so, the various categories of transactions and other economic flows should be classified according to the member country that is the counter party so that analytic measures can be compiled for individual countries that include the impact of supranationals.
- **2.77** A regional central bank is an international financial organization that acts as a common central bank for a group of member countries. Such a bank has its headquarters in one country and usually maintains national offices in each of the member countries. Each national office acts as the central bank for that country and is treated as a resident institutional unit in that country. The headquarters, however, is an international organization.

Annex to Chapter 2: Social Protection

This annex describes the various organizational structures used by government units to provide social benefits and the effects of those structures on statistics compiled for the general government sector or the public sector.

A. Introduction

1. Many governments devote considerable economic resources to *social protection schemes*, which consist of systematic interventions intended to relieve households and individuals of the burden of a defined set of social risks. *Social risks* are events or circumstances that may adversely affect the welfare of households either by imposing additional demands on their resources or by reducing their incomes. The relief is provided in the form of *social benefits*, which may be payable in cash or in kind. This annex describes the different ways in which the provision of social benefits can be organized and the effect of each type of organization on the statistics of the general government sector and the public sector.¹

B. The nature of social benefits

2. There is no universally accepted definition of the scope of social benefits, and the social risks covered are liable to vary from scheme to scheme and from government to government. The following list of typical social benefits illustrates their general nature:²

- Medical, dental, and other treatments and hospital, convalescent, and long-term care as a result of sickness, injuries, maternity needs, chronic invalidity, or old age. These social benefits are usually provided in kind directly or by reimbursing households or individuals.
- Support of spouses, children, elderly relatives, invalids, and other dependents. These social benefits are usually paid in cash in the form of regular dependents' or family allowances.
- Compensation for a reduction in income as a result of not being able to work, either full or part time. These social benefits are usually paid regularly in cash for the duration of the condition or for a maximum period. In some instances, a lump sum may be provided additionally or instead of the regular payment. Included in this category are retirement benefits, unemployment compensation, and income replacement because of sickness, injury, the birth of a child, or other forced reductions in work.
- Compensation for a reduction in income because of the death of the main income earner. These social benefits are usually paid in cash, often in the form of regular allowances.
- Housing benefits in cash and housing services, which may be provided free, at prices that are not economically significant, or by reimbursing expenditures made by households.
- Allowances to cover education expenses or, occasionally, education services in kind.
- **3.** Social benefits can be provided in cash or in kind. If provided in kind, the goods or services can be produced by the unit providing the benefits, they can be purchased by the unit providing the benefits from a market producer, or the households can purchase the

¹A more complete discussion of the issues involved in the organization and treatment of social protection schemes is in The European Commission, *ESSPROS Manual 1996* (Luxembourg, 1996). ESSPROS stands for European System of Integrated Social Protection Statistics. ²This list is adapted from paragraph 8.56 of *1993 SNA*. The Classification of Functions of Government (see Chapter 6) has a category labeled social protection, but its scope differs from the benefits listed here, notably by excluding health care.

goods and services and be reimbursed. Protection also can be provided indirectly, such as through preferential tax allowances and wage subsidies. Benefits provided in this manner are not considered social benefits in this manual or in 1993 SNA.

- **4.** A social benefit is always a transfer payment and is always provided in a collective arrangement. A transfer payment means that the benefits are provided without the recipients being required to provide something of equivalent value in return. Thus, allowances provided as compensation of employees or loans provided by employers to employees are not social benefits. Transfers are defined in more detail in paragraph 3.8 of Chapter 3.
- 5. The collective requirement means that social protection schemes exclude individual insurance policies taken out on the private initiative of individuals or households solely in their own interest. Some social protection schemes may permit or require participants to take out policies in their own names. In order for an individual policy to be treated as part of a social protection scheme, the risks against which the insured are protected must be social risks as described in paragraph 2 and at least one of the following conditions must be satisfied:
- Participation in the scheme is obligatory, either by law or under the terms and conditions of employment.
- The scheme is a collective one operated for the benefit of a designated group of people and participation is restricted to members of that group.
- An employer makes an actual or imputed contribution to the scheme on behalf of an employee.
- 6. When individuals take out insurance policies in their own names, on their own initiative, and independently of their employers or government, the claims receivable are not treated as social benefits even if the policies are taken out against the same kinds of risks as listed in paragraph 2. Saving arrangements that maintain the integrity of the participants' contributions and are restricted to protecting against social risks are not social protection schemes, even if participation is compulsory, because no insurance is involved. Under such arrangements, the contributions of the participants and/or their employers are kept in a separate account and are withdrawable under specified circumstances such as retirement, unemployment, invalidity, and death. In particular, defined-contribution retirement

schemes, as described in paragraph 21, are not social protection schemes.

C. Classification of social protection schemes

- **7.** Social protection schemes can be classified in several ways. For example, schemes may be classified as (1) contributory versus noncontributory, (2) compulsory versus voluntary, or (3) that of an employer providing coverage for its employees versus that of a government providing coverage for the general population.
- 8. Contributory schemes require the payment of social contributions by the protected persons or by other parties on their behalf in order to secure entitlement to the benefits. These schemes are referred to as social insurance schemes, and the benefits paid by them are social insurance benefits. Schemes operated on an unfunded basis by employers without actual contributions by employees are considered contributory schemes because employers are imputed to pay, as compensation of employees, the amounts necessary to secure coverage against the specified social risks, and the employees are imputed to pay the same amounts to the employer as social contributions. With noncontributory schemes, the eligibility to receive social benefits is not conditional on the payment of contributions by the protected persons or by other parties on their behalf. There may, however, be other eligibility criteria, such as a means test. These schemes are referred to as social assistance schemes and the benefits paid by them are social assistance benefits.
- **9.** Participation in social protection schemes is either compulsory or voluntary. Compulsory schemes may be established by law and/or regulation or by agreement between employer and employees. In some cases, a scheme may be mixed, where some people are required to participate and others are allowed a choice.
- 10. The individuals or households eligible to receive social benefits are either a group of employees or a segment of the general population. All social assistance benefits are provided to the general population, although possibly limited by eligibility criteria. Social insurance schemes that are imposed, controlled, and financed by government units and that cover the entire community or large sections of it are referred to as

social security schemes and the benefits paid by such schemes are social security benefits. Schemes in which employers provide social insurance benefits to their employees, former employees, or their beneficiaries are referred to as employer social insurance schemes, and the benefits paid by such schemes are referred to as employer social benefits.³

11. The classification of social benefits is based on the type of scheme supplying the benefits and not on the recipients. Thus any benefits received by government employees from social security and social assistance schemes are classified as social security and social assistance benefits even if the government employer has organized an employer social insurance scheme to provide other benefits to its employees. Indeed, employer social insurance schemes are often designed to cover only those risks not covered by social security and social assistance schemes.

D. The units involved in social protection schemes

12. As just described, social protection schemes can be organized as social assistance schemes, social security schemes, or employer social insurance schemes. The units involved in the organization and operation of schemes could be general government units, public corporations, or private corporations.

I. Social assistance schemes

13. All social assistance schemes are organized and operated by government units. The benefits are paid out of the unit's general resources according to the specified criteria. That is, no revenue is earmarked for social assistance schemes. The obligation to pay social assistance benefits is an expense in the period in which all eligibility requirements are fulfilled. Table 6.1 in Chapter 6 presents the GFS classification of expense, one category of which is social assistance benefits, which is further classified as benefits paid in cash or in kind. Some benefits may be payable over several accounting periods, such as disability payments, in which case a liability for the future payments has been incurred and the present value of those benefits should be recorded on the balance sheet as described in Chapter 7.

2. Social security schemes

- **14.** All social security schemes also are organized and operated only by government units. In many cases, however, entire institutional units are devoted to the operation of a social security scheme. Such units, referred to as *social security funds*, are special types of government units. All social security funds must be identified to implement the alternative methods of constructing subsectors of the general government sector.
- 15. The existence of a social security fund depends on its organization, not on any characteristics of the scheme, such as types of benefits provided or sources of finance. For a social security fund to exist, it must be separately organized from the other activities of government units, hold its assets and liabilities separately, and engage in financial transactions on its own account.
- 16. The existence of social security funds, however, does not ensure that all social security schemes are operated by social security funds. It is quite possible that some social security schemes, especially at differing levels of government, are operated by government units that are not social security funds. That is, statistics for a social security subsector may not include all social security schemes. If a social security scheme is not a separate institutional unit, however, there may be separate accounts to manage the scheme's finances, which would permit certain comprehensive statistics on social security to be compiled.
- 17. The primary receipts of social security schemes are social contributions. As shown in Table 5.1 in Chapter 5, social security contributions are classified according to their source, which may be employees, employers on behalf of their employees, self-employed, or nonemployed participants. In addition, social security schemes may receive transfers from general government resources and they may earn property income from the investment of their assets. For determination of a fiscal burden measure (see Box 4.1 of Chapter 4), it would be necessary to classify social contributions as voluntary or compulsory.
- 18. Social security benefits are one category of total social benefits and are further classified in Table 6.1 as being payable in cash or in kind. Some social benefits, particularly retirement benefits, will be paid years after the corresponding social contributions have been received. Because social security benefits can be varied at will by the government as part of its

³Employer social insurance schemes are termed "private social insurance schemes" in *1993 SNA*.

overall economic policy, there is uncertainty about the eventual payment or level of payment of retirement benefits. As a result, no liabilities are associated with social security schemes in the GFS system and an expense is recorded only when payment of the benefits is required. Because of the high expectation that retirement benefits will be paid, however, a memorandum item equal to the present value of the benefits that have already been accrued should be estimated as described in paragraph 7.145 of Chapter 7.

3. Employer social insurance schemes

- 19. There are several types of employer social insurance schemes, each with a different impact on the statistics of the general government sector or the public sector. Social insurance schemes are either funded or unfunded. A social insurance scheme is funded if there are identified reserves or accounts assigned for the payment of benefits. There are three types of funded employer schemes: those operated by insurance enterprises, those operated as autonomous pension funds, and those operated as nonautonomous pension funds. Unfunded social insurance schemes are operated by the employer without assigning specific accounts or otherwise creating special reserves for the payment of benefits. Instead, the benefits are paid from the employer's general resources.
- 20. If a public-sector employer organizes an employer social insurance scheme but contracts with an insurance enterprise for its operation, then the general government unit or public corporation that is the employer will pay the required social contributions to the enterprise on behalf of its employees, and all other transactions of the social insurance scheme will be the responsibility of the insurance enterprise. If the insurance enterprise is a private corporation, then its transactions, such as the payment of benefits and administrative expenses, investment of assets, and incurrence and liquidation of retirement and other liabilities, will not affect the statistics of the general government sector or the public sector. If the insurance enterprise is a public corporation, then statistics of the public sector will be affected by the operations of the scheme, but not the statistics of the general government sector.
- **21.** If a funded scheme is organized and operated by the employer, then the scheme may be structured as an autonomous or nonautonomous pension fund. A scheme that provides benefits other than for pensions and other retirement benefits is treated as an unfunded

- scheme because no reserves have to be established. In general, autonomous and nonautonomous pension funds may be organized as defined-benefit or definedcontribution schemes.⁴ In a defined-benefit scheme, the level of retirement benefits promised by the employer to participating employees is guaranteed and usually is determined by a formula based on participants' length of service and salary. The liability of a defined-benefit scheme is the present value of the promised benefits. In a defined-contribution scheme, the level of contributions to the fund by the employer is guaranteed, but the benefits that will be paid depend on the assets of the fund. The liability of a defined-contribution scheme is the current market value of the fund's assets. It should be noted, however, that defined-contribution schemes are not social protection schemes because no insurance is involved.
- 22. A pension fund is autonomous if it is a separate institutional unit, which means it must have its own assets and liabilities and it must engage in financial transactions in the market on its own account. All autonomous pension funds organized and managed by government units are public financial corporations, which are members of the public sector but not the general government sector. Similar to schemes managed by a private insurance enterprise, a government unit's primary responsibility with respect to the scheme is to pay the social contributions on behalf of its employees. The assets of the pension fund and the present value of the liability to pay retirement benefits are assets and liabilities of the public sector. The receipt of social contributions by the pension fund is treated as the incurrence of a liability to pay future benefits by the public sector as described in Chapter 9. The property income earned from the investment of the pension fund's assets is revenue of the public sector (see Chapter 5), and the property expense of the liability for future retirement benefits is an expense (see Chapter 6). The payment of the retirement benefits is a reduction in liabilities of the public sector (Chapter 9).
- 23. A pension fund is nonautonomous if the employer has established segregated reserves, but the organization and operations of the scheme do not qualify as an institutional unit. All of the assets, liabilities, transactions, and other events of the pension fund are combined with the corresponding items of the employer operating the scheme, which may be a general government unit or a public corporation. The treatment

⁴Defined-contribution schemes are also referred to as money-purchase schemes.

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of the assets, liabilities, transactions, and other events of the pension fund otherwise is the same as with an autonomous pension fund.

24. An employer social insurance scheme is unfunded when the employer pays social benefits to its employees, former employees, or their dependents out of its own resources without creating a special fund or segregated reserve for the purpose. An unfunded scheme can pay pensions and other retirement benefits that generate liabilities or it can pay other types of social benefits, such as health care. An unfunded scheme is similar to a nonautonomous pension fund except that

many transactions and assets cannot be specifically identified as being related to the scheme. For example, the income earned on the investment of government financial assets cannot be separated into income of the social insurance scheme and other income. In particular, there may be no record of the employer paying social contributions because there are no specialized reserves to which funds can be transferred. To maintain consistency of treatment with funded schemes, transactions reflecting the employer's expense for the payment of social contributions should be imputed as described in paragraph 6.18 of Chapter 6.

3. Flows, Stocks, and Accounting Rules

This chapter describes the flows and stocks of the GFS system and the accounting rules used to determine their time of recording, valuation, and other aspects of recording.

A. Introduction

- **3.1** All of the data recorded in the GFS system are either flows or stocks. Flows are monetary expressions of economic actions engaged in by units and other events affecting the economic status of units that occur within an accounting period. Stocks refer to a unit's holdings of assets and liabilities at a specific time and the unit's resulting net worth, equal to total assets less total liabilities.
- **3.2** The flows and stocks recorded in the GFS system are integrated, which means that all changes in stocks can be fully explained by the flows. In other words, the following relationship is valid for each stock:

$$\boldsymbol{S}_1 = \boldsymbol{S}_0 + \boldsymbol{F}$$

where S_0 and S_1 represent the values of a specific stock at the beginning and end of an accounting period, respectively, and F represents the net value of all flows during the period that affected that particular stock. More generally, the value of any stock held by a unit at a given time is the cumulative value of all flows affecting that stock that have occurred since the unit first acquired the stock.

3.3 A great diversity of flows needs to be recorded in the GFS system. This chapter first describes several important characteristics of flows that underlie their classification and treatment. It then describes in a general way the accounting rules used for recording flows and stocks in the GFS system. Descriptions of specific categories of flows and

stocks and the application of the general rules to their recording are discussed in later chapters.

B. Types of flows

3.4 Flows reflect the creation, transformation, exchange, transfer, or extinction of economic value. They involve changes in the volume, composition, or value of a unit's assets, liabilities, and net worth. A flow can be a single event, such as a cash payment for the purchase of goods, or the cumulative value of a set of events occurring during an accounting period, such as the continuous accrual of interest expense on a government bond. All flows are classified as transactions or as other economic flows. The following sections describe these two types of flows.

I. Transactions

- **3.5** A *transaction* is an interaction between two units by mutual agreement or an action within a unit that is analytically useful to treat as a transaction. Mutual agreement means that there was prior knowledge and consent by the units, but it does not mean that both units entered into the transaction voluntarily. Some transactions, such as the payment of taxes, are imposed by force of law. Although individual units are not free to fix the amounts of taxes they pay, there is collective recognition and acceptance by the community of the obligation to pay taxes. Thus, payments of taxes are considered transactions despite being compulsory. Similarly, the actions necessary to comply with judicial or administrative decisions may not be undertaken voluntarily, but they are taken with prior knowledge and consent of the parties involved.
- **3.6** Although most transactions take place between two units, in some cases a single unit acts in two different capacities and it is analytically useful to treat

this act as a transaction. Such an act is referred to as an internal transaction. The choice of which internal actions to treat as transactions is subjective. This manual follows the 1993 SNA by treating consumption of fixed capital, the transfer of materials and supplies from inventories to production, and other internal changes in inventories as transactions. This manual does not follow the 1993 SNA with regard to the treatment of assets produced by a unit for its own use and goods and services produced by a general government unit and distributed to individuals or to the community as a whole without charge or for prices that are not economically significant.¹

- **3.7** Every transaction is either an *exchange* or a *transfer*. A transaction is an exchange if one unit provides a good, service, asset, or labor to a second unit and receives a good, service, asset, or labor of the same value in return.² Compensation of employees, purchases of goods and services, the incurrence of interest expense, the sale of an office building, and all internal transactions are exchanges.
- **3.8** A transaction is a transfer if one unit provides a good, service, asset, or labor to a second unit without receiving simultaneously a good, service, asset, or labor of any value in return. Typically, general government units engage in a large number of transfers, which may be compulsory or voluntary. Taxes and most social security contributions are compulsory transfers imposed by government units on other units. Subsidies, grants, and social assistance benefits are voluntary transfers from general government units to other units.
- **3.9** Some transactions appear to be exchanges but are actually combinations of an exchange and a transfer. In such cases, the actual transaction should be partitioned into two transactions, one that is only an exchange and one that is only a transfer. For example, a general government unit might sell an asset at a price that is clearly less than the market value of the asset. The sale should be divided into an exchange at the asset's market value and a transfer equal in value

to the difference between the actual transaction value and the market value of the asset.³

- **3.10** Taxes are treated as transfers even though the units making these payments may receive some benefits from services provided by the government unit receiving the taxes. For example, no one can be excluded from sharing in the benefits provided by collective services such as public safety. In addition, a taxpayer may be able to consume certain individual services provided by government units. Usually, however, it is not possible to identify a direct link between the tax payments and the benefits received by individual units. Moreover, the value of the services received by a unit usually bears no relation to the amount of the taxes paid by the same unit.
- **3.11** Non-life insurance premiums and claims are also treated as transfers.⁴ The premiums for this type of insurance entitle the units making the payment to benefits only if one of the events specified in the policy occurs. That is, one unit pays a second unit to accept the risk that a specified event may occur to the first unit. These transactions are considered transfers because it is uncertain if the first unit will receive any benefits and, if it does receive benefits, they may bear no relation to the amount of the premiums previously paid. Non-life insurance includes social security schemes and employer social insurance schemes for government employees that do not provide retirement benefits. Thus, social security contributions received and social security benefits paid by government units are treated as transfers in the GFS system.
- **3.12** All transactions can also be classified as monetary or nonmonetary. A *monetary transaction* is one in which one unit makes a payment or incurs a liability stated in units of currency and the second unit receives the payment or another asset, also stated in units of currency. For example, goods are usually purchased at a given number of units of currency per unit of the good, and social security benefits are often paid in fixed amounts of cash.
- **3.13** All other transactions are *nonmonetary*, but they must be assigned a monetary value as the GFS system

¹The scope of internal transactions is described in paragraphs 3.44 through 3.49 of the *1993 SNA*. Actions that are treated as internal transactions in the *1993 SNA* but not in this manual are described further in paragraphs 3.23 and 3.24.

²The term "provides a good, service, asset..." is meant to include one unit allowing a second unit to use an asset owned by the first unit as well as a change in the ownership of the asset. Interest and other property income transactions are exchanges because one unit provides an asset, such as cash or other means of payment, and the second unit provides the use of one of its assets.

³See paragraph 3.21 for a general statement of partitioning transactions. ⁴More precisely, the payment of a premium is the acquisition of a financial asset. As the insurance enterprise earns the premium over the period covered by the policy, the premium is converted to a transfer payment. In *1993 SNA*, a portion of each actual non-life insurance premium is considered the purchase of a service rather than a transfer. In the GFS system, the entire premium is treated as a transfer because estimating the service component requires statistics for all sectors of the economy.

deals only with flows and stocks expressed in monetary terms. The values assigned to nonmonetary transactions have a different economic significance than do cash payments of the same amount, as they are not freely disposable sums of money. Nevertheless, to have a comprehensive and integrated system, it is necessary to assign the best estimate of market values to the items involved in nonmonetary transactions.

- **3.14** Nonmonetary transactions can be either two-party transactions or internal transactions, and they can be exchanges or transfers. Barter, remuneration in kind, and other payments in kind are nonmonetary exchanges. Transfers in kind are nonmonetary transfers. Internal transactions were described in paragraph 3.6.
- **3.15** In a *barter* transaction, two units exchange goods, services, or assets other than cash of equal value. For example, a government unit may agree to trade a parcel of land in an industrial area to a private corporation for a different parcel that the government will use as a national park.
- **3.16** *Remuneration in kind* occurs when a government employee is compensated with goods, services, or assets other than money. Types of compensation that employers commonly provide without charge or at reduced prices to their employees include meals and drinks, uniforms, housing services, transportation services, and child care services.
- **3.17** Other payments in kind occur when a payment to settle a liability is made in the form of goods, services, or noncash assets rather than money. For example, a government unit may agree to settle a claim for past-due taxes if the taxpayer transfers ownership of land or fixed assets to the government.
- **3.18** *Transfers in kind* may be used rather than cash for efficiency or to insure that the intended goods and services are consumed. For example, aid after a natural disaster may be more effective and be delivered faster if it is provided in the form of medicine, food, and shelter instead of money. Also, a general government unit might provide medical and educational services in kind to make sure that the need for the services is met.
- **3.19** Some transactions are not recorded in the form in which they appear to take place. Instead they are modified to bring out their underlying economic relationships more clearly. Rerouting, partitioning, and

reassignment are the three types of modifications employed in the GFS system.

- **3.20** *Rerouting* is required when a unit that is in fact a party to a transaction does not appear in the actual accounting records because of administrative arrangements. For example, if government employees are enrolled in a retirement scheme, accounting records may show the government unit making payments directly to the retirement scheme on behalf of its employees. In such a case it is necessary to reroute the payments so that the government is seen as paying the employees, who then are deemed to make payments of the same amount to the retirement scheme.
- **3.21** *Partitioning* is the division of a single transaction as viewed by the parties involved into two or more transactions for recording in the GFS system. For example, when a general government unit acquires a fixed asset under a financial lease, the periodic lease payments need to be partitioned into two transactions, a repayment of principal and a payment of interest. The division of actual transactions into an exchange and a transfer described in paragraph 3.9 is another example of partitioning.
- **3.22** *Reassignment* is required when a unit acts as an agent for another unit. For example, reassignment may occur when one government unit collects taxes and then transfers some or all of the taxes to another government unit. In some arrangements of this nature, the collecting unit retains a small portion of the tax collected in return for its collection efforts. The amount retained is treated as the sale of a service by the collecting unit. For guidelines on the reassignment or attribution of taxes to collecting or beneficiary governments, see paragraphs 5.24 to 5.28 of Chapter 5.
- **3.23** The treatment of some activities in the GFS system differs from the treatment of the same activities in the *1993 SNA*. For example, general government units are nonmarket producers, which means they normally consume economic resources in a production process, produce outputs of goods and services, and then distribute those goods and services without charge or for prices that are not economically significant to society collectively or to individual households. The production of the output and its distribution are both nonmonetary transactions that must be recorded in the *1993 SNA* to have a complete accounting of production. The GFS system, however,

is focused on the financial activities of government. Because the value of the output produced and the value of the distribution are equal by definition, there cannot be any change in the financial position of the general government unit involved. As a result, these transactions do not need to be recorded to meet the purposes of the GFS system. The transactions associated with the production process, such as compensation of employees and the purchase of goods and services for use in production, do affect the financial position of the general government unit and are recorded in the GFS system. Despite different treatments of some activities, both systems include all flows that change stocks so that all changes in the balance sheet can be explained by the flows recorded.

- **3.24** The exact scope of flows recorded in the GFS system is specified in later chapters. In general, however, the transactions of the *1993 SNA* that are not recorded in the GFS system are explained in Appendix 3 and include the following:
- The output and simultaneous distribution of nonmarket goods and services;
- The output of fixed assets constructed on own account and the costs of producing those assets;
- Certain transactions related to employer social insurance schemes providing retirement benefits managed by general government units;⁵ and
- Transactions reflecting the reinvestment of earnings on direct foreign investment.

2. Other economic flows

- **3.25** An *other economic flow* is a change in the volume or value of an asset or liability that does not result from a transaction. Volume changes are described as *other changes in the volume of assets* or, more simply, other volume changes, and value changes are described as *holding gains and losses*. In all cases, a reference to a change in the volume or value of an asset refers also to changes in liabilities as appropriate.
- **3.26** Other changes in the volume of assets cover a wide variety of events. For the purpose of description

here, these events are divided into three groups. The first group consists of events that involve the addition to or deletion from the balance sheet of an existing asset or liability with no changes in its quantity or quality. The second group consists of events that change the quantity or quality of assets. The final group is made up of changes in the classification of assets.

- **3.27** An entity may be known to exist but not be on the balance sheet of a general government unit because its market value is zero, such as a proven reserve of subsoil assets that is not economically exploitable given current technology and relative prices. If the market value becomes positive because of a change in technology or relative prices, then an other volume change is recorded to add the item to the balance sheet. Conversely, an asset may need to be removed from the balance sheet because a change in technology or relative prices makes the asset no longer economically exploitable.
- **3.28** There is a wide range of events that could trigger this type of flow. A few examples follow:
- A subsoil deposit of minerals may become economically exploitable as a result of technological progress or an increase in market prices.
- Improved access may make commercial harvesting of timber feasible in a particular forest.
- A construction project might lose its economic rationale before it is completed and the partially completed asset is abandoned.
- A government might grant patent protection to an invention.
- A creditor may determine that a financial claim can no longer be collected because of the debtor's bankruptcy.
- **3.29** The second group of other volume changes includes changes in the quantities or qualities of assets. Such changes arise because the assets have been discovered, created, destroyed, cancelled, or seized by one unit from another unit. Some examples of these types of events include:
- The partial or complete catastrophic destruction of an asset resulting from a large-scale event, such as a major earthquake or hurricane.

⁵These transactions are explained in Chapters 5 and 6 in the sections about social contributions and social benefits.

⁶Holding gains and loses are also referred to as revaluations in the 1993 SNA.

- An increase in the quantity of forests and fishstocks from natural growth.
- A depletion of the volume of mineral deposits and natural forests as a result of the physical removal of the assets.
- The exhaustion of a patent over time.
- A unilateral change by an employer in the benefit structure of a retirement scheme.
- The creation of land by reclaiming it from the sea with the use of dikes or other sea barriers.
- The discovery of a new deposit of minerals.
- The seizure of assets by a government unit without full compensation for reasons other than the failure to pay taxes, fines, or similar levies.
- A decrease in the quality of an asset resulting from environmental damage, erosion, deforestation, or unforeseen obsolescence.
- A change in the permitted or designated use of a parcel of land, such as from agricultural use to a commercial building site.
- **3.30** The third category relates to changes resulting from reclassifications of entire units from one sector to another or the reclassification of individual assets and liabilities from one category to another category. Net worth will not change as a result of a classification change.
- **3.31** Several events can cause a change in the classification of units. If a government unit begins to charge economically significant prices for its output, then it would become a public corporation. All of its assets and liabilities would be reclassified from the general government sector to either the nonfinancial or financial corporations sector. At the same time, a financial asset with a value equal to the net value of the assets and liabilities reclassified would be added to the balance sheet of the general government sector, leaving its net worth unchanged. Conversely, a public corporation might cease charging economically significant prices and become a government unit. It is also possible for two units to merge or a single unit to split into two units.
- **3.32** It is also possible for individual assets or groups of assets to be reclassified from one category to

another, usually because of a change in the purpose for which an asset is used. A conversion of gold from nonmonetary gold to monetary gold is one such event.

- **3.33** Holding gains and losses on assets and liabilities, together with the corresponding changes in net worth, arise as a result of changes in the prices of those assets and liabilities, including changes resulting from exchange rate movements. In concept, holding gains and losses are continuously recorded as prices change.
- **3.34** A holding gain or loss accrues purely as a result of holding an asset or liability over time without transforming it in any way. It can apply to virtually any type of asset, and it may accrue on an asset held for any length of time during the accounting period.

C. Accounting rules

3.35 Accounting rules for recording flows and stocks in the GFS system are designed to ensure that the data generated by the system conform with accepted standards for the compilation of economic statistics. With the exception of consolidation, as noted later in this chapter, the accounting rules of the GFS system are the same as those of the *1993 SNA*. There are also many similarities between the rules used in the GFS system and those applied by businesses and governments in their financial statements.⁷ The following sections describe the type of accounting system used, the rules governing the time of recording and the valuation of flows and stocks, and miscellaneous other topics.

I. Type of accounting system

3.36 *Double-entry accounting* is used for recording flows. In a double-entry system each flow gives rise to two equal-value entries, traditionally referred to as a credit entry and a debit entry. A debit is an increase in an asset, a decrease in a liability, or a decrease in net worth. A credit is a decrease in an asset, an increase in a liability, or an increase in net worth. Revenue entries, which represent an increase in net worth, are recorded

⁷The relationship between statistics of the GFS system and the *1993 SNA* are discussed in more detail in Appendix 3. There is not a similar comparison with financial accounting standards in this manual, but it is recommended that, where possible, the financial statements of government entities compiled in accordance with international accounting standards for governments be reconciled with the equivalent GFS statements.

as credits. Conversely, an expense refers to a decrease in net worth and is recorded as a debit.

3.37 A balance sheet is a compilation of a unit's or sector's assets, liabilities, and net worth. The fundamental identity of the balance sheet and of accounting in general is that the total value of the assets always equals the total value of the liabilities plus net worth. Use of the double-entry system ensures that this identity is correctly maintained. There are several possible combinations of debits and credits affecting assets, liabilities, and net worth. For example, the purchase of a service by a general government unit with payment to be made in 30 days would be recorded as an expense (debit) and an increase in the liability, accounts payable (credit). Thus, net worth, through the expense, decreases by the same amount that liabilities increase, and assets are not affected. The subsequent payment would be recorded as a decrease in cash (credit) and a decrease in accounts payable (debit). In this case, assets and liabilities both decrease by the same amount and net worth is unaffected.

2. Time of recording flows

- **3.38** Once a flow has been identified, the time at which it occurred must be determined so that the results of all flows within a given accounting period can be compiled. Although this section is concerned with the time assigned to flows, the integrated nature of the system means that the stocks recorded on the balance sheet are also influenced by the timing of flows.
- **3.39** One of the problems in determining the timing of transactions is the frequent existence of a long period between the initiation of an action and its final completion. For instance, many purchases of goods commence with the signing of a contract between a seller and a buyer, followed by the initiation of production of the item ordered, completion of production, shipment from the seller's location, arrival at the buyer's location, preparation and mailing the invoice, receipt of the invoice, approval of payment, the beginning of interest accruing on a late payment or the expiration of a discount for prompt payment, signing a check for payment, mailing of the check by the buyer, receipt of the check by the seller, deposit of the check in the seller's bank, and finally the check is paid by the buyer's bank. Even then, the transaction may not be complete as there may be rights of return or warranty claims. Each of these distinct moments is to some extent economically relevant and may result

in multiple transactions in the GFS system, but only one time can be attributed to each transaction.

a. Alternative recording bases

- **3.40** Broadly, the time of recording could be determined on four bases: the accrual basis, the due-for-payment basis, the commitments basis, and the cash basis.
- **3.41** With the *accrual basis*, flows are recorded at the time economic value is created, transformed, exchanged, transferred, or extinguished. In other words, the effects of economic events are recorded in the period in which they occur, irrespective of whether cash was received or paid or was due to be received or paid. Nevertheless, the time at which the economic events occur is not always clear. In general, the time attributed to events is the time at which ownership of goods changes, services are provided, the obligation to pay taxes is created, the claim to a social benefit payment is established, or other unconditional claims are established.
- **3.42** If an economic event requires a subsequent cash flow, such as purchases of goods and services on credit, then the length of time between the time attributed to an event with the accrual basis and the time of the cash flow is bridged by recording a receivable or a payable. For example, when a general government unit purchases goods on credit, it records a debit to an inventory account and a credit to accounts payable when ownership of the goods shifts. When the cash payment is made, the general government unit records a debit to accounts payable and a credit to cash.
- **3.43** All events that result in the creation, transformation, exchange, transfer, or extinguishment of economic value are recorded with the accrual basis in the GFS system. Thus, all nonmonetary transactions are included in statistics compiled on the accrual basis.
- **3.44** With the *due-for-payment basis*, flows that give rise to cash payments are recorded at the latest times they can be paid without incurring additional charges or penalties or, if sooner, when the cash payment is made. If a payment is made after it is due to be paid, then the gap is bridged by recording a receivable, just as with the accrual basis. If a payment is made before it is due, then no receivable is necessary. Depending on the goals of the accounting system, nonmonetary flows may or may not be recorded.
- **3.45** With the *commitments basis*, flows are recorded when a general government unit has committed itself to

a transaction. Normally, this basis applies only to purchases of assets, goods, and services, including compensation of employees. The time of recording generally is when a purchase order is issued by the general government unit. Flows for which the commitments basis is not applicable must be recorded on one of the other three bases. In-kind transactions may or may not be recorded.

3.46 With the *cash basis*, flows are recorded when cash is received or disbursed. Although nonmonetary flows can be recorded, most accounting systems using the cash basis do not record nonmonetary flows because the focus is on cash management rather than resource flows.

b. The reasons for using the accrual basis in the GFS system

- **3.47** The GFS system uses the accrual basis, primarily because the time of recording matches the time of the actual resource flows. As a result, the accrual basis provides the best estimate of the macroeconomic impact of government fiscal policy. With the cash basis, the time of recording may diverge significantly from the time of the economic activities and transactions to which they relate. For example, the interest paid on a zero-coupon bond would not be recorded until the bond matures, which could be many years after the expense was incurred. The due-for-payment basis will frequently record transactions after the resource flows have taken place, although the very long delays permitted by the cash basis would, in most cases, be reduced. The timing of the commitments basis will precede the actual resource flow.
- **3.48** The accrual basis provides the most comprehensive information because all resource flows are recorded, including internal transactions, in-kind transactions, and other economic flows. Moreover, this comprehensive recording permits the integration of flows with changes in the balance sheet. In general, accounts using the due-for-payment, commitments, or cash basis are restricted to monetary transactions.
- **3.49** Payment arrears arise when an obligatory payment is not made by its due-for-payment date. Because this date is always the same or later than the date attributed to a flow under the accrual basis, all arrears will be included in statistics compiled with the accrual basis. Without supplementary information, however, it may be difficult to estimate the share of total accounts payable that is in arrears as opposed

to the share that exists because of normal payment delays. By definition, the due-for-payment basis will show clearly the arrears arising from purchases on credit, but arrears from the failure to repay debt obligations, such as loans and securities other than shares, as scheduled will not be apparent without supplemental information. With the commitments basis, the availability of information on arrears will be the same as with the accrual basis. With the cash basis, there is no impact on the accounts when a general government unit does not pay for its purchases made on credit or comply with the terms for the repayment of debt. Thus, there will be no information on arrears unless a special compilation is made.

- **3.50** Managing liquidity is crucial for the operation of any unit. It is not necessary to use the cash basis to meet this need, however, as information on cash flows is not lost with the accrual basis. Normally a separate statement of cash flows is prepared. Moreover, it may be difficult to assess solvency and future cash flows with the cash basis because information on arrears is missing.
- **3.51** Accounts using the due-for-payment, commitments, or cash basis normally do not differentiate between expenses and acquisitions of nonfinancial assets. With the accrual basis, acquisitions of nonfinancial assets are recorded separately and the expense of using those assets in operating activities is matched with the period of their use rather than the period of their acquisition.
- **3.52** Additionally, the other major macroeconomic statistical systems (national accounts, balance of payments, and monetary and financial statistics) use the accrual basis. Thus, the joint use of statistics from two different systems is facilitated greatly by the use of the accrual basis in the GFS system.
- **3.53** Despite the advantages of the accrual basis, its implementation is likely to be more difficult than the other bases and will require more estimates. For example, it may be difficult for a government unit to know the full amount of tax revenue to which it is entitled because these amounts may depend on transactions and other events in which the government is not a party.

c. Implementation of the accrual basis

3.54 As a general rule, a flow is recorded under the accrual basis when the economic benefit associated with an event has flowed to or from the unit involved,

or it is probable that a future benefit will flow to or from the unit and the monetary value of the event can be measured reliably. More specific guidelines for the application of the accrual recording basis are described in the following paragraphs.

- **3.55** Taxes and other compulsory transfers should be recorded when the activities, transactions, or other events occur that create the government's claim to the taxes or other payments. This time is not necessarily the time at which the event being taxed occurred. For example, the obligation to pay tax on capital gains normally occurs when an asset is sold, not when the asset's value appreciated.
- **3.56** Estimating the revenue from taxes and compulsory social insurance contributions must take many uncertainties into account. The primary uncertainty is that the government unit receiving the revenue is usually not a party to the transaction or other event that creates the obligation to pay the taxes or compulsory social security contributions. Consequently, many of these transactions and events permanently escape the attention of the tax authorities. The amount of revenue from taxes and social insurance contributions should exclude the amounts that possibly could have been received from such unreported events had the government learned about them. In other words, only those taxes and social security contributions that are evidenced by tax assessments and declarations, customs declarations, and similar documents are considered to create revenue for government units.
- **3.57** In addition, it is typical that some of the taxes and social insurance contributions that have been assessed will never be collected. It would be inappropriate to accrue revenue for an amount that the government unit does not realistically expect to collect. Thus, the difference between assessments and expected collections represents a claim that has no real value and should not be recorded as revenue. The amount of taxes and social security contributions that is recorded as revenue should be the amount that is realistically expected to be collected. The actual collection, however, may be in a later period, possibly much later.
- **3.58** If taxes are imposed on specific transactions or events, they are recorded at the times the underlying transaction or event occurs, even though these times may not coincide with the actual payment of the tax to the government. Examples include sales taxes, value-added taxes, import duties, and estate and gift taxes.

- 3.59 In principle, income taxes and social contributions based on income should be attributed to the period in which the income is earned, even though there may be a significant delay between the end of the accounting period and the time at which it is feasible to determine the actual liability. In practice, however, some flexibility is permitted. In particular, as a practical deviation from the general principle, income taxes deducted at source, such as pay-as-you-earn taxes, and regular prepayments of income taxes may be recorded in the periods in which they are paid, and any final tax liability on income may be recorded in the period in which it is determined.
- **3.60** Income taxes are normally imposed on the income earned during an entire year. If monthly or quarterly statistics are compiled, indicators of seasonal activity or other appropriate indicators may be utilized to allocate the annual totals.
- **3.61** Taxes on the ownership of specific types of property often are based on the value of the property at a particular time but are deemed to accrue continuously over the entire year or the portion of the year that the property was owned, if less than the entire year. Similarly, taxes on the use of goods or the permission to use goods or perform activities usually relate to a specific time period, such as a license to operate a business during a specific period.
- **3.62** Some compulsory transfers, such as fines, penalties, and property forfeitures, are determined at a specific time. These transfers are recorded when the government has a legal claim to the funds, which may be when a court renders judgment or an administrative ruling is published.
- 3.63 Determining the time of recording for grants and other voluntary transfers can be complex because there is a wide variety of eligibility conditions that have varying legal powers. In some cases, a potential grant recipient has a legal claim when it has satisfied certain conditions, such as the prior incurrence of expenses for a specific purpose or the passage of legislation. These transfers are recorded when all requirements and conditions are satisfied. In other cases, the grant recipient never has a claim on the donor, and the transfer should be attributed to the time at which the cash payment is made.
- **3.64** Dividends and withdrawals from income of quasi-corporations are recorded as of the date on

which they are declared payable or actually take place if no prior declaration occurs.

- **3.65** Transactions in goods and nonfinancial assets are recorded when legal ownership changes, which may depend on the provisions in the sales contract. If that time cannot be determined precisely, recording may take place when there is a change in physical ownership or control. For example, a change of ownership is imputed to have taken place under a financial lease when the lessee takes control of the asset.
- **3.66** Transactions in services normally should be recorded when the services are provided. If a service, such as transportation, is delivered at a specific time, then the transaction is recorded at that time. Other services are supplied or take place on a continuous basis. For example, operating leasing, insurance, and housing services are continuous flows and, in concept, are recorded continuously as long as they are being provided. More practically, the value of the services attributed to a period is based on the quantity supplied during the period rather than the payments required.
- **3.67** Several other transactions also relate to flows that take place continuously or over extended periods. For example, consumption of fixed capital accrues continuously over the whole period a fixed asset is available for productive purposes and interest accrues continuously over the period that the financial claim exists. Often an interest-bearing financial claim calls for periodic interest payments. These payments, however, reduce the liability that has already accrued over the previous period and are not expense transactions.
- **3.68** Additions to inventories are recorded when products are purchased, produced, or otherwise acquired. Withdrawals from inventories are recorded when products are sold, used up in production, or otherwise relinquished. Additions to work-in-progress inventory are recorded continuously as work proceeds. When production is completed, the production costs accumulated to that point are transferred to finished-goods inventory.
- **3.69** A transaction in the use of goods or services is recorded when the good or service enters the production process. For goods, this time may be quite different from the time they were acquired. In the meantime, they are classified as inventories.
- **3.70** Transactions in many types of financial assets, such as securities, loans, currency, and deposits, are

recorded when legal ownership changes. In some cases, the parties to a transaction may perceive ownership to change on different dates because they acquire the documents evidencing the transaction at different times. This variation usually is caused by the process of clearing, or the time checks are in the mail. The amounts involved in such "float" may be substantial in the case of transferable deposits and other accounts receivable or payable. If there is disagreement on a transaction between two general government units, the date on which the creditor records the transaction is the date of record.

- **3.71** The various types of accounts payable and receivable, such as general accounts payable, interest payable, and wages payable, are created by a counterpart transaction, such as the purchase of a good on credit, interest expense, and compensation of employees. These financial claims are deemed to arise when the counterpart flow occurs.
- **3.72** As indicated previously, there is a wide variety of other economic flows. Depending on the nature of the flow, they may take place at a specific time or continuously over a period. For example, the destruction of an asset by fire happens at a specific time, and holding gains and losses occur continuously as prices change.

3. Valuation

- **3.73** All flows and stocks should be valued at the amounts for which goods, assets other than cash, services, labor, or the provision of capital are in fact exchanged or could be exchanged for cash. These values are referred to as *current market prices* or values. Flows should be valued at the prices current on the dates for which they are recorded in accordance with the guidelines of the previous section. Stocks should be valued at the prices current on the balance sheet date.
- 3.74 In general, flows expressed in monetary terms when they occur can be recorded at their actual value because that value is presumed to be the current market value. Some transactions expressed in monetary terms need to be partitioned into two transactions, as described in paragraphs 3.9 and 3.21. In that case, the total value of the two transactions must equal the monetary value of the single transaction that actually occurred. If a government unit sells an asset for less than its market value or purchases an asset for more than its market value, the sale or purchase should be valued at the true market price and a transfer for the remaining amount

should be imputed. Often transactions of this nature are structured so that the true market values are impossible to estimate accurately. Nevertheless, estimates should be made whenever possible.

- **3.75** Current market values of stocks are available for assets and liabilities that are traded in active markets, most commonly certain financial assets and their corresponding liabilities. Current market values of other assets and liabilities need to be estimated in a manner similar to nonmonetary flows, as described in paragraph 3.79.
- **3.76** Some financial assets and liabilities, such as bonds, have a nominal value as well as a current market value, and for some purposes supplemental data on the nominal values of stocks may be helpful.⁸ Transactions in these assets and liabilities, however, should be valued at the prices actually paid and not at their nominal value. Similarly, the stocks of such assets and liabilities should be valued at their current market value when recorded on the balance sheet.
- **3.77** Another type of actual transaction that may require a valuation adjustment occurs when a unit sells an item and does not receive the corresponding payment for an unusually long time. If the amount of trade credit extended in this way is large, then value of the sale should be reduced by means of an appropriate discount rate and interest should be accrued until the actual payment is made.
- 3.78 Flows expressed in a foreign currency are converted to their value in the national currency at the rate prevailing when they take place, and stocks are converted at the rate prevailing on the balance sheet date. The midpoint between the buying and selling rates should be used. The valuation in the national currency of a purchase or sale on credit expressed in a foreign currency may differ from the value of the subsequent cash payment because the exchange rate changed in the interim. Both transactions should be valued at their current market values as of the dates they actually occurred, and a holding gain or loss resulting from the change in the exchange rate should be recorded for the period or periods in which it occurs.

- **3.79** The values of flows that are not already expressed at their current market value, such as barter transactions, must be estimated. In addition, current market values for many stocks will not be readily available and must be estimated. The following list suggests several estimation possibilities. The choice of which method to use in a given circumstance depends on the information available.
- It may be possible to estimate the values of transactions based on values taken from markets in which similar transactions take place under similar conditions. The value of certain stocks, primarily financial assets, may also be estimated using market transactions involving similar assets that take place at the end of the accounting period.
- Flows and stocks involving existing fixed assets can be valued using the market price for similar new goods, properly adjusted for consumption of fixed capital and other events that may have occurred since they were produced.
- If there is no appropriate market in which a particular good or service is currently traded, the valuation of a flow involving that good or service may be derivable from the market prices of similar goods and services by making adjustments for quality and other differences.
- The value of flows and stocks of assets may be able to be estimated on the basis of the historical or acquisition cost of the item, adjusted for all changes that have occurred since it was purchased or produced, such as consumption of fixed capital, holding gains or losses, depletion, exhaustion, degradation, unforeseen obsolescence, and exceptional losses.
- Goods and services can be valued by the amount that it would cost to produce them currently.
- Assets can be valued at the discounted present value of their expected future returns. This method is particularly prominent for a number of financial assets, natural assets, and intangible assets.

4. Derived measures

3.80 Derived measures consist of aggregates and balancing items. They are important analytic tools that summarize the values of selected flows or stocks that have been individually recorded in the GFS system.

⁸The nominal value is the amount that the debtor owes to the creditor at any moment. It reflects the value of the instrument at creation and subsequent economic flows, such as transactions, valuation changes (excluding market price changes), and other changes, such as debt forgiveness. Conceptually, the nominal value is equal to the required future payments of principal and interest discounted at the existing contractual interest rate. Nominal value is not necessarily face value, which is the undiscounted amount of principal to be repaid.

- **3.81** Aggregates are summations of elements in a class of flows or stocks. For example, tax revenue is the sum of all flows that are classified as taxes. Aggregates and classifications are closely linked in that classifications are designed to produce the aggregates thought to be most useful.
- **3.82** *Balancing items* are economic constructs obtained by subtracting one aggregate from a second aggregate. For example, the net operating balance is obtained by subtracting the total expense aggregate from the total revenue aggregate. Net worth is equal to total assets less total liabilities.

5. Netting of flows and stocks

- **3.83** It is feasible to present many categories of flows and stocks on a gross or net basis. An item presented on a net basis is calculated as the sum of one set of flows or stocks less the sum of a second set. For example, total tax revenue could be presented on a gross basis as the total amount of all taxes accrued, or on a net basis as the gross amount less taxes refunded for one reason or another. The choice depends on the category of flows or stocks, the nature of the items that might be subtracted to obtain the net value, and the analytic utility of the gross and net values. The following choices are used in the GFS system.
- **3.84** Revenue categories are presented gross of expense categories for the same or related category and likewise for expense categories. In particular, interest revenue and interest expense are both presented gross rather than only net interest expense or revenue. Similarly, social benefits and social contributions, grant revenue and expense, and rent revenue and expense are presented gross. Also, sales of goods and services are presented gross of the expenses incurred in their production.
- **3.85** Revenue categories are presented net of refunds of the relevant revenue, and expense categories are presented net of inflows of the same expense arising from erroneous or unauthorized transactions. For example, refunds of income taxes may be paid when the amount of taxes withheld or otherwise paid in advance of the final determination exceeds the actual tax due. Such refunds are recorded as negative tax revenue. Similarly, if social benefits that were paid in error are recovered, then such recoveries are recorded as a negative expense.
- **3.86** Acquisitions and disposals of nonfinancial assets other than inventories are presented gross. For exam-

- ple, acquisitions of land are presented separately from disposals of land. For analytic presentations, the net acquisition of each category of nonfinancial asset may be preferable and can be derived easily.
- **3.87** Changes in each type inventory are presented net. That is, the change in materials and supplies is presented as the net value of additions less withdrawals.
- **3.88** Acquisitions and disposals of each category of financial assets are presented net. For example, only the net change in the holding of cash is presented, not gross receipts and disbursements of cash. Similarly, additions to liabilities are presented net of repayments.
- **3.89** Other economic flows are presented net. That is, the net holding gain for each asset and liability is presented, not gross holding gains and gross holding losses.
- **3.90** Stocks of the same type of financial instrument held both as a financial asset and a liability are presented gross. For example, a unit's holding of bonds as assets is presented separately from its liability for bonds.

6. Consolidation

- **3.91** Consolidation is a method of presenting statistics for a set of units as if they constituted a single unit. In the GFS system, the data presented for a group of units normally are consolidated. In particular, statistics for the general government sector and each of its subsectors are presented on a consolidated basis. When units of the public sector are included in a presentation, the data for public corporations should be presented in two ways, as a separate sector and together with general government units. In both cases, the statistics should be presented on a consolidated basis within each group.
- 3.92 Consolidation involves the elimination of all transactions and debtor-creditor relationships that occur among the units being consolidated. In other words, a transaction of one unit is paired with the same transaction as recorded for the second unit and both transactions are eliminated. For example, if one general government unit owns a bond issued by a second general government unit and data for the two units are being consolidated, then the stocks of bonds held as assets and liabilities are reported as if the bond did not exist. At the same time, consolidated interest revenue and expense exclude the interest paid by the debtor general government unit to the

creditor. Similarly, sales of goods and services between consolidated units are also eliminated.

3.93 The 1993 SNA recommends that statistics of institutional units should not be consolidated and, in addition, sales of one establishment of an institutional unit to a second establishment of the same institutional unit also should not be consolidated. The difference between the 1993 SNA and this manual reflects the different uses of the statistics. The GFS system is designed to produce statistics suitable for use in the analysis of the impact of government operations, either the entire general government sector or a specific subsector. In particular, assessing the overall impact of government operations on the total economy or the sustainability of government operations is more effective when the measure of government operations is a set of consolidated statistics rather than unconsolidated statistics. The GFS system also is not intended to produce a measure of production taking place in the general government sector. The 1993 SNA, on the other hand, serves a much wider range of uses, including a comprehensive measure of production and relations among sectors.

3.94 In financial accounting reports, statistics are often presented on a consolidated basis for the reporting entity and all of its controlled entities without regard to whether the controlled entities are general government units or public corporations, as those terms are used in the manual. This use of consolidation attempts to portray the operations and financial position of a parent and its subsidiaries as though the group of enterprises were a single unit. For example, a financial report for a state government would include all public corporations controlled by that government but would not include the statistics of any other state government. In contrast, the consolidated statistics of the state government subsector in the GFS system would include all state government units but would exclude all public corporations owned or controlled by state governments.

7. Contingencies

3.95 Contingencies are conditions or situations that may affect the financial performance or position of the general government sector depending on the occurrence or nonoccurrence of one or more future events. For example, a general government unit's guarantee of a loan may result in an expense if the debtor defaults, but it will not be known whether the expense will be incurred or, if it is incurred, how much the expense will be until a default occurs or the loan is repaid fully. In another example, a government unit's tax assessment may be contested in court by the unit assessed. This contingent revenue will not be resolved until an agreement is reached by the two parties or a court issues a ruling and no further appeals are possible or planned.

3.96 This manual follows the *1993 SNA* by not treating any contingencies as financial assets or liabilities because they are not unconditional claims or obligations. Nevertheless, contingencies, especially those that may result in an expense, can be particularly significant for the general government sector. Aggregate data on all important contingencies should be recorded as memorandum items. In addition to the gross amount of possible revenue or expense, estimates of expected revenue or expense should be presented. This position is somewhat different from that of financial accounting standards, which recognize contingent liabilities when it is probable that future events will confirm that an asset has been impaired or a liability incurred and that a reasonable estimate of the amount can be made.

3.97 When a contingency is recognized as a liability of a general government unit, a flow is recorded with an expense as the debit and an increase in a liability as the credit. For example, if a loan guarantee has been called and the general government unit has no claim on the defaulter, then the general government unit would record a transfer to the defaulter and an incurrence of a liability to the creditor.

4. The Analytic Framework

This chapter introduces the analytic framework of the GFS system and describes the relationships among its elements.

A. Introduction

- **4.1** A government and its public enterprises carry out a multitude of transactions. To manage the internal operations of government and assess the government's impact on the economy, these transactions must be organized into a framework within which they can be summarized and analyzed. For accountability purposes, transactions may be organized according to the government unit that carries them out. For detailed purchasing or planning purposes, transactions may be organized by the kind of item purchased or service provided. For billing or control purposes, transactions may be organized by the particular transactors with whom the government deals. The government finance statistics framework, on the other hand, is designed to facilitate macroeconomic analysis. While there is clearly a close link between accounting data and economic statistics, they do not serve the same objectives and may differ in the treatment of particular items.
- **4.2** Traditionally, governments have kept their accounts on a cash basis; this is reflected in the analytic framework of the *1986 GFS Manual*. Including only cash revenues and expenditures has the advantage of focusing the government's attention on its financing constraint, which has traditionally been viewed as its most binding priority. However, governments have become less liquidity constrained in carrying out fiscal policy and have become more adept at separating the time of a fiscal action from the time it is paid for, so that cash transactions do not adequately capture either the timing of the action or its impact on the economy. In consequence, there has been increasing dissatis-

faction with cash transactions as the basis for assessing fiscal policy, and a worldwide shift is under way toward resource-based accounting.¹

4.3 The analytic framework in this manual reflects these developments and is presented in the form of a set of interrelated statements derived from the 1993 SNA that integrate flows and stocks. This framework differs considerably from the cash-based framework of the 1986 GFS Manual, which focused on selected stocks and flows and did not integrate them. The new framework facilitates a more comprehensive assessment of the economic impact of government activity and the sustainability of fiscal policy. More specifically, the introduction of the accrual basis and the integration of balance sheets with flows for government are consistent with the need for government behavior to be determined in the context of its intertemporal budget constraint. For example, a government's policies will not be sustainable if they reduce its net worth too much. The framework also provides an improved basis for monitoring efficiency in the allocation and use of government resources.

B. Analytic objectives

- **4.4** The GFS system is a quantitative tool that supports fiscal analysis. To permit effective analysis of fiscal policy, the statistical output of the system must facilitate the identification, measurement, monitoring, and assessment of the impact on the economy of a government's economic policies and other activities, as well as the sustainability of those policies and activities.
- **4.5** To achieve the analytic objectives, the GFS statistical framework should generate data that (1)

¹For example, see Part III of International Federation of Accountants, *Government Financial Reporting: Accounting Issues and Practices* (New York, 2000).

are closely linked to other macroeconomic statistical systems (national accounts, balance of payments, and monetary and financial statistics) and (2) enable the analyst to assess the financial soundness of the general government sector in ways commonly applied to other organizations in the economy.²

C. Construction of the framework: Relation to the previous GFS system

- **4.6** The analytic framework builds on the 1986 GFS system and extends it by incorporating additional elements that are useful in assessing fiscal policy. Three types of changes have been made:
- The definitions of individual statistical variables have been aligned more closely with economic concepts. An important example is the treatment of nonfinancial assets, where the sale of such assets is no longer included in revenue and their purchase is no longer included in expense.
- A number of conceptual modifications have been made to harmonize the GFS system with the 1993 SNA. Important changes include the shift from a functional-based definition of government to one built on institutional units (see Chapter 2), a switch from cash to accrual accounting (see Chapter 3), and the complete integration of flows and stocks.
- The previous GFS analytic framework has been extended to include nonmonetary transactions, flows other than transactions, and balance sheets.
- **4.7** The central coverage of the GFS system encompasses the general government sector. Once an institutional unit has been classified to a sector (as defined in Chapter 2), then all its stocks and flows are recorded in that sector.³ Some types of analysis may be more effectively carried out if they are based on statistics that include the operations of public corporations. Thus, statistics for the public sector as well as for the general government sector should be compiled. The analytic framework described in this

chapter can be applied to both sectors regardless of the coverage selected.

D. Components and concepts of the analytic framework

- **4.8** The core of the analytic framework is a set of four financial statements. Three of the statements can be combined to demonstrate that all changes in stocks result from flows (see Figure 4.1). These are (1) the Statement of Government Operations; (2) the Statement of Other Economic Flows; and (3) the Balance Sheet. In addition, the framework includes a Statement of Sources and Uses of Cash to provide key information on liquidity.
- **4.9** The Statement of Government Operations is a summary of the transactions of the general government sector in a given accounting period. In essence, transactions represent changes to stocks that arise from mutually agreed interactions between institutional units, such as the sale of a good or service by one unit and its purchase by another. The framework also recognizes that a unit can act in two capacities of economic interest and includes as transactions some items that do not involve another institutional unit. For example, consumption of fixed capital recognizes that a unit is both the owner of a fixed asset and the consumer of the services provided by the asset. Taken together, transactions constitute the largest share of the implementation of fiscal policy. As described in the following section, the transactions are classified to demonstrate the effect of fiscal policy on the net worth of the general government sector, on its demand for credit, and on its holdings of assets and liabilities.
- **4.10** The *Statement of Other Economic Flows* tabulates changes to stocks of assets, liabilities, and net worth that come about from sources other than transactions. More specifically, *holding gains* represent changes to stocks that arise from price movements, including exchange rate movements.⁴ *Other changes in the volume of assets* relate to changes to stocks arising from events such as the discovery of new assets (e.g., mineral deposits) and depletion or destruction of assets.

²Organizations in other sectors of the economy record their operations in the form of integrated accounting systems that include income statements, balance sheets, and cash flow statements.

³As described in Chapter 2, the central bank and other public financial and nonfinancial corporations belong to the public sector but not to the general government sector.

^{4&}quot;Holding gains" is used as a short form of the more general term, "holding gains and losses."

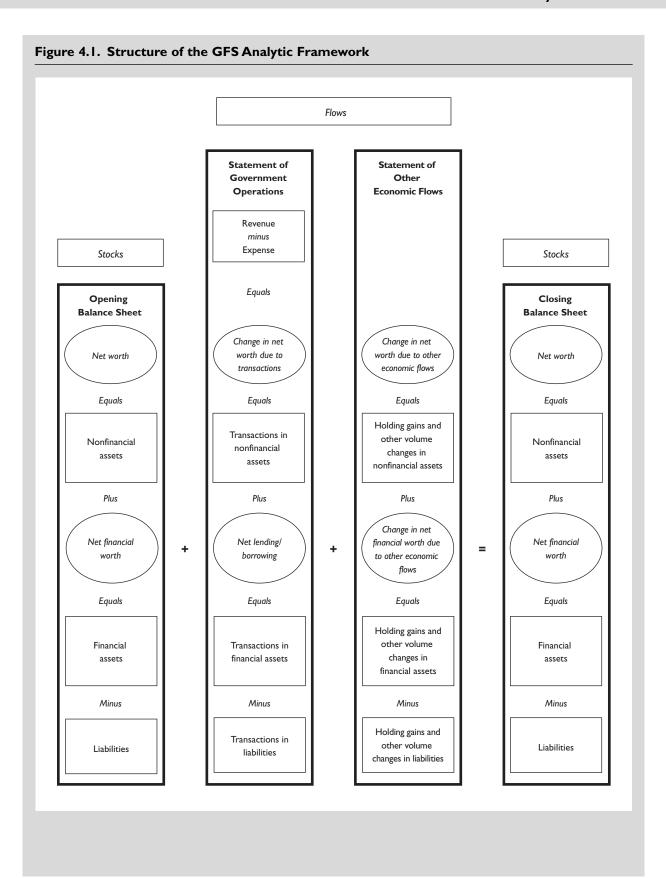


Table 4.1: Statement of Government Operations

TRANSACTIONS AFFECTING NET WORTH:

REVENUE

Taxes

Social contributions [GFS]

Grants

Other revenue

EXPENSE

Compensation of employees [GFS]

Use of goods and services

Consumption of fixed capital [GFS]

Interest [GFS]

Subsidies

Grants

Social benefits [GFS]

Other expense

NET/GROSS OPERATING BALANCE!

TRANSACTIONS IN NONFINANCIAL ASSETS:

NET ACQUISITION OF NONFINANCIAL ASSETS²

Fixed assets

Change in inventories

Valuables

Nonproduced assets

NET LENDING/BORROWING [GFS]3

TRANSACTIONS IN FINANCIAL ASSETS AND LIABILITIES (FINANCING):

NET ACQUISITION OF FINANCIAL ASSETS

Domestic

Foreign

NET INCURRENCE OF LIABILITIES

Domestic

Foreign

¹The net operating balance equals revenue minus expense. The gross operating balance equals revenue minus expense other than consumption of fixed capital.
²Acquisitions minus disposals and consumption of fixed capital.

³Net lending/borrowing equals the net operating balance minus the net acquisition of nonfinancial assets. It is also equal to the net acquisition of financial assets minus the net incurrence of liabilities.

- **4.11** The *Balance Sheet* records the stocks of assets, liabilities, and net worth of the general government sector at the end of each accounting period.
- **4.12** By breaking down the total assets and total liabilities into their constituents and establishing the sources of changes in them from one period to another in terms of transactions and other economic flows as defined above, the framework provides a strong statistical explanation of the factors causing the change in the net worth of government.

4.13 The *Statement of Sources and Uses of Cash* records cash inflows and outflows using a classification similar to that of the Statement of Government Operations.

E. The Statement of Government Operations

- **4.14** The Statement of Government Operations (Table 4.1) presents details of transactions in revenue, expense, the net acquisition of nonfinancial assets, the net acquisition of financial assets, and the net incurrence of liabilities.⁵ Revenue is defined as the increase in net worth resulting from transactions, and expense as the decrease in net worth resulting from transactions. The net acquisition of nonfinancial assets equals gross fixed capital plus changes in inventories and transactions in other nonfinancial assets.
- **4.15** Two important analytic balances are derived in the Statement of Government Operations. Revenue less expense equals the *net operating balance*. The subsequent deduction of the net acquisition of nonfinancial assets results in *net lending* (+)/borrowing (-), which is also equal to the net result of transactions in financial assets and liabilities. In addition, Box 4.1 describes a number of other important variables used in fiscal analysis.⁶
- **4.16** The net operating balance is a summary measure of the ongoing sustainability of government operations. It is comparable to the national accounting concept of saving plus net capital transfers receivable. It should be noted that the net operating balance (and the equivalent change in net worth due to transactions) as defined here excludes gains and

⁵As explained in Chapter 3, government finance statistics are intended to be compiled using the accrual basis of recording transactions. It is recognized, however, that many governments may be able to compile statistics only on a cash or partial accrual basis for some time. If only cash data are available, the classification of cash flows shown in Table 4.2 should be used. Otherwise, with accrual or partial accrual data, the classification of transactions shown in Table 4.1 should be used. With the exception of consumption of fixed capital and accounts receivable/payable, all of the line items in the table can be applied to both cash and accrual data. However, the benefits of the fully integrated system can only be derived from using accrual data.

⁶The European Central Bank (ECB) defines revenue in the same way as this manual and expenditure as the sum of expense and the net acquisition of nonfinancial assets. The ECB deficit/surplus is defined as revenue minus expenditure and is equivalent to net lending/borrowing. Expenditure is one of the fiscal variables included in Box 4.1.

losses resulting from changes in price levels and other changes in the volume of assets. The component of the change in net worth that is due to transactions can be attributed directly to government policies since governments have control over their transactions. The same cannot be said for the other components of the total change in net worth, as governments do not directly control them.

- **4.17** Net lending (+)/borrowing (-) is a summary measure indicating the extent to which government is either putting financial resources at the disposal of other sectors in the economy or utilizing the financial resources generated by other sectors. It may therefore be viewed as an indicator of the financial impact of government activity on the rest of the economy. It differs from the *1993 SNA* concept of net lending/borrowing to the extent that a government maintains an unfunded retirement scheme for its employees. In the GFS system, the present value of the obligations to pay retirement benefits is recognized as a liability, while in *1993 SNA* it is not recognized.⁷
- **4.18** In addition, the *gross operating balance* is presented in Table 4.1. It differs from the net operating balance in that it does not include consumption of fixed capital as an expense. Consumption of fixed capital can be difficult to measure in practice and a satisfactory estimate may not be possible. If so, the gross operating balance may be more practical for analysis than the net operating balance. The net operating balance is, however, preferred because it captures all current costs of government operations.
- **4.19** Table 4.1 is divided into three sections: (1) revenue and expense transactions, (2) transactions in nonfinancial assets, and (3) transactions in financial assets and liabilities. The following paragraphs follow that structure in summarizing the various categories of transaction. These definitions and descriptions are not intended to be comprehensive. In each section, reference is made to the chapter that contains more detailed information.

I. Revenue

4.20 All transactions that increase the net worth of the general government sector are classified as

revenue.⁸ Governments receive three major types of revenue from their fiscal operations: taxes, social contributions, and other revenue. For many governments, the revenue from these sources is supplemented by grants. It should be noted that the sale of a nonfinancial asset is not revenue because it has no effect on net worth. Rather, it changes the composition of the balance sheet by exchanging one asset (the nonfinancial asset) for another (the proceeds of the sale). (The detailed classification of revenue is described in Chapter 5.)

- **4.21** *Taxes* are compulsory transfers received by the general government sector. They include fees that are clearly out of all proportion to the costs of providing services, but exclude compulsory social contributions, fines, and penalties.
- **4.22** Social contributions [GFS]⁹ include receipts of social security schemes and employer social insurance schemes that provide benefits other than retirement benefits. Social security contributions may be compulsory or voluntary and may be made by employees, employers on behalf of employees, self-employed persons, or nonemployed persons. Compulsory social security contributions differ from taxes in that the payments entitle the contributors and other beneficiaries to certain social benefits if specified events should take place, such as sickness and old age. Compulsory payments assessed on a basis other than pay, payroll, or the number of employees but earmarked for social security schemes are taxes. Also, contributions to employer retirement schemes are not treated as social contributions in the GFS system.
- **4.23** *Grants* are noncompulsory transfers received from other governments or from international organizations. They supplement the revenue from a government's own resources. They may be received in cash or in kind. ¹⁰

⁷Net lending/borrowing in the GFS system also differs from the comparable concept in *1993 SNA* because of a different treatment of reinvested earnings on direct foreign investment, as described in Chapter 5.

⁸ In general, transactions that increase net worth result from current operations. Capital transfers receivable is a possible exception. As defined in the *1993 SNA*, a capital transfer is a transfer of a noncash asset, the cancellation of a liability by a creditor, the transfer of cash that was raised by disposing of an asset, or the transfer of cash that the recipient is expected or required to use for the acquisition of an asset. (In each case inventories are excluded.) In the GFS system, capital transfers receivable are classified as revenue because they increase government's net worth and they are often indistinguishable from current transfers in their effect on government operations.

⁹ [GFS] indicates that this item has the same name in 1993 SNA but different coverage.

¹⁰In the 1986 GFS Manual, grants were treated as an inflow separately from revenue. They have been included as part of revenue in this manual because they meet the criterion of increasing net worth.

4.24 *Other revenue* includes all revenue transactions not classified as taxes, social contributions, or grants. The major items are sales of goods and services, ¹¹ interest and other types of property income, voluntary transfers in cash or in kind other than grants, and fines and penalties.

2. Expense

- **4.25** All transactions that decrease the net worth of the general government sector are classified as expense. ¹² The purchase of a nonfinancial asset is not an expense because it has no effect on net worth. Rather, it changes the composition of the balance sheet by exchanging one asset (the nonfinancial asset) for another or a liability (the payment for the asset). The major types of expense are compensation of employees, use of goods and services, consumption of fixed capital, interest, subsidies, grants, social benefits, and other expense. In addition, expense can be classified according to functional purpose, such as health or social protection. (Both classifications of expense are described in Chapter 6.)
- **4.26** *Compensation of employees [GFS]* is the remuneration, in cash or in kind, payable to an employee in return for work done. In addition to wages and salaries, compensation of employees includes social insurance contributions made by a general government unit on behalf of its employees. Excluded is any compensation of employees related to own-account capital formation. ¹³ As a result, total compensation of employees in *1993 SNA* is larger by this amount than compensation of employees shown in Table 4.1.
- **4.27** Use of goods and services is the total value of goods and services purchased by the general government sector for use in a production process or acquired for resale less the net change in inventories of those goods and services.¹⁴ Goods and services acquired for use as in-kind transfers to households or as grants without being used in a production process are excluded. Parallel to compensation of employees, any goods and

¹¹In the *1986 GFS Manual*, the net value of sales of market establishments less their operating costs is shown as revenue (or as expense if the operating costs exceed revenue). In this manual, the gross amount of sales is to be shown as revenue and the various operating costs are to be distributed among each category of expense as appropriate.

services used in own-account capital formation are treated as acquisitions of nonfinancial assets.

- **4.28** Consumption of fixed capital [GFS] is the decline in the value of the stock of fixed assets during the accounting period as a result of physical deterioration, normal obsolescence, and normal accidental damage. It is always a noncash expense. Because of the difficulty in estimating this expense, the gross operating balance, as shown in Table 4.1, is sometimes computed in place of, or in addition to, the net operating balance.
- **4.29** *Interest* [*GFS*] is an expense incurred by a debtor for the use of another unit's funds. An interest-bearing financial instrument can be classified as deposits, securities other than shares, loans, or accounts receivable/payable.
- **4.30** *Subsidies* are current transfers that government units pay to enterprises either on the basis of the levels of their production activities or on the basis of the quantities or values of the goods or services that they produce, sell, or import. Included are transfers to public corporations and other enterprises that are intended to compensate for operating losses.
- **4.31** *Grants* are noncompulsory transfers, in cash or in kind, paid to another general government unit or an international organization.
- **4.32** *Social benefits [GFS]* are current transfers to households to provide for needs arising from events such as sickness, unemployment, retirement, housing, or family circumstances. The benefits may be paid in cash or in kind. The costs of social benefits in kind produced by a general government unit are recorded against the relevant expenses that were incurred to produce the goods and services rather than included in this category.¹⁶
- **4.33** *Other expense* includes all expense transactions not elsewhere classified. Transactions recorded here include property expense other than interest; taxes, fines, and penalties imposed by one government on another; current transfers to nonprofit institutions serving households; capital transfers other than capital grants, and non-life insurance premiums and claims.

¹²As with revenue, capital transfers paid or otherwise obligated are classified as expense. See footnote 8.

¹³These transactions are classified as acquisitions of nonfinancial assets.
¹⁴For example, goods purchased but not used in the same period would be shown as an increase in inventories and not as use of goods and services, while goods withdrawn from inventories would be shown as a reduction in inventories and an addition to use of goods and services.

¹⁵Consumption of fixed capital related to fixed assets used in ownaccount capital formation is excluded from this category and included as part of the value of the asset produced.

¹⁶Pensions and other retirement benefits are also classified as social benefits in 1993 SNA, but in the GFS system they are classified as reductions in liabilities.

3. Treatment of social security and unfunded government employer retirement schemes

4.34 In the GFS system, social security contributions are treated as revenue (and therefore as an increase in net worth), and social security benefits as expense (a decrease in net worth). This treatment is in line with conventional fiscal analysis. Some analysts argue that, in a full intertemporal framework, social security contributions may be seen more appropriately as a buildup of assets associated with future liabilities. Likewise, many social security benefits may be seen as the extinction of previously incurred government liabilities. This approach is not taken in this manual because it is considered that social security schemes do not result in a contractual liability for the government, i.e., there is no direct link between the contributions made and the benefits eventually paid. Indeed, it is not uncommon for governments to change unilaterally the structure of benefits (e.g., by changing the circumstances under which the benefits become payable or the amount of the benefit). Nonetheless, it is important for a government to be aware of the contingent liability that arises from its social security program. As a result, a memorandum item is included in Chapter 7 to recognize the net present value of future benefits that have already been earned according to the existing laws and regulations.

4.35 Contrary to the *1993 SNA*, transactions in unfunded government employer retirement schemes are considered in this manual to involve a contractual liability for a government to its employees. As a result, the receipt of contributions to such schemes is considered to be an incurrence of a liability, and the payment of retirement benefits is considered to be a reduction of the same liability.

4. Transactions in nonfinancial assets 17

4.36 The second section of Table 4.1 records transactions that change a government's holdings of non-financial assets. These assets are classified as fixed assets, inventories, valuables, and nonproduced assets. (Transactions in nonfinancial assets are described further in Chapter 8.)

- **4.37** *Fixed assets* are produced assets that are used repeatedly or continuously in processes of production for more than one year. Transactions in fixed assets can refer to acquisitions of new assets, construction of new assets on own account, acquisitions and disposals of existing assets, and major improvements to fixed assets and nonproduced assets. Assets can be acquired or disposed of by purchase, sale, barter, or transfer.
- **4.38** *Inventories* are stocks of goods held by general government units that are intended for sale, use in production, or other use at a later date. They can be strategic stocks, materials and supplies, work in progress, finished goods, or goods held for resale. Withdrawals from inventories are valued at current market prices rather than their acquisition prices. Any change in the value of inventories between the time of acquisition and withdrawal should be shown as a holding gain in the Statement of Other Economic Flows and not as revenue (gain) or expense (loss).
- **4.39** *Valuables* are produced assets that are not used primarily for purposes of production or consumption but are held as stores of value over time.
- **4.40** *Nonproduced assets* are assets needed for production that have not themselves been produced, such as land, subsoil assets, and certain intangible assets.

5. Transactions in financial assets and liabilities

- **4.41** The third section of Table 4.1 records financial transactions, which are transactions that change a government's holdings of financial assets and liabilities. Financial assets are mainly claims on other institutional units and therefore have counterpart liabilities. ¹⁸ (Transactions in financial assets and liabilities are described in Chapter 9.)
- **4.42** Transactions in financial assets can be classified in multiple ways; for ease of presentation, Table 4.1 indicates only a classification of financial assets according to whether the counterpart liability was incurred by a resident (indicated by "domestic" in the table) or a nonresident (foreign) and vice versa for the classification of liabilities.
- **4.43** There are two other classifications of financial transactions in the GFS system. The first classification is based on the type of financial instruments involved

¹⁷This section deals only with direct acquisitions and disposals of nonfinancial assets (including consumption of fixed capital). Government units may facilitate public capital formation by transferring funds to other governments or to public corporations with a requirement that the funds be used to acquire nonfinancial assets. These transactions are included in capital grants or other expense as relevant.

¹⁸ Monetary gold and SDRs are exceptions in that they are financial assets that are not claims on other units.

in the transactions. The categories are monetary gold and SDRs, currency and deposits, loans, securities other than shares, shares and other equity, insurance technical reserves, financial derivatives, and other accounts receivable/payable (see Table 9.1 in Chapter 9). The second classification is based on the sector of the counterparty of the financial instrument. That is, liabilities are classified according to whether the current holder of the counterpart financial asset is a financial corporation, nonfinancial corporation, household, and so forth (see Table 9.2 in Chapter 9).

4.44 In general, transactions in liabilities can be classified in the same way as transactions in financial assets. One additional classification that could be employed is whether a liability has become past due for payment and is in arrears. By showing a reduction in a liability when it is due for payment and a corresponding increase in a separate liability, the accumulation of debt amortization arrears can be indicated as a source of financing. Such treatment is explained in more detail in Appendix 2.

4.45 An additional possible classification of a financial asset is whether it was acquired or disposed of for the purpose of public policy or liquidity management. This distinction is not included in the Statement of Government Operations, but is used to define the overall balance in Box 4.1. Policy-related assets may be acquired for a variety of reasons, such as fostering new industries, assisting ailing government corporations, or helping particular businesses suffering economic adversity. Such transactions can take a variety of forms, including loans, equity securities, and debt securities. Given that there is often a subsidy component of such transactions, it is useful to identify them in a separate category so that for some analyses they can be treated as flows with characteristics similar to revenue and expense.¹⁹ All other transactions in financial assets are assumed to be for liquidity management purposes. That is, the assets are acquired to earn a market rate of return while keeping sufficient funds on hand to finance day-to-day operations.

F. Government cash operations

4.46 While it is desirable to record flows on an accrual basis, information on the sources and uses of

Table 4.2: Statement of Sources and Uses of Cash

CASH FLOWS FROM OPERATING ACTIVITIES:

CASH RECEIPTS FROM OPERATING ACTIVITIES

Taxes

Social contributions

Grants

Other receipts

CASH PAYMENTS FOR OPERATING ACTIVITIES

Compensation of employees

Purchases of goods and services

Interest

Subsidies

Grants

Social benefits

Other payments

Net cash inflow from operating activities

CASH FLOWS FROM INVESTMENTS IN NONFINANCIAL ASSETS:

PURCHASES OF NONFINANCIAL ASSETS

Fixed assets

Strategic stocks

Valuables

Nonproduced assets

SALES OF NONFINANCIAL ASSETS

Fixed assets

Strategic stocks

Valuables

Nonproduced assets

Net cash outflow from investments in nonfinancial assets

CASH SURPLUS/DEFICIT¹

CASH FLOWS FROM FINANCING ACTIVITIES:

NET ACQUISITION OF FINANCIAL ASSETS OTHER THAN CASH

ASIT

Domestic

Foreign

NET INCURRENCE OF LIABILITIES

Domestic

Foreign

Net cash inflow from financing activities

NET CHANGE IN THE STOCK OF CASH²

cash is important for assessing the liquidity of the general government sector. The *Statement of Sources and Uses of Cash* (Table 4.2) shows the total amount of cash generated or absorbed by (1) current operations, (2) transactions in nonfinancial assets, and (3) transactions involving financial assets and liabilities other than cash itself. The net change

¹⁹The net acquisition of financial assets for policy purposes was called "lending minus repayments" in the *1986 GFS Manual* and was often referred to as "net lending." These terms should not be confused with the term "net lending/borrowing" used in this manual.

 $^{^{\}rm I}$ Net cash inflow from operating activities minus the net cash outflow from investments in nonfinancial assets.

 $^{^2\,\}mbox{\sc Cash}$ surplus/deficit plus the net cash inflow from financing activities.

in the government's cash position is the sum of the net cash received from these three sources.

- **4.47** Cash refers to cash on hand and cash equivalents. Cash on hand refers to notes and coins held and deposits held on demand with a bank or other financial institution. Cash equivalents are highly liquid investments that are readily convertible to cash on hand at the government's option and overdrafts considered integral to the cash management function.
- **4.48** Unlike the accrual-based Statement of Government Operations (Table 4.1), the Statement of Sources and Uses of Cash (Table 4.2) reflects a cash basis of recording. This in effect means that transactions are captured when cash is received or when cash payments are made. Additional useful information is obtained from an analysis of the differences between Tables 4.1 and 4.2. There are two broad categories of transactions that are recorded in Table 4.1 but not in Table 4.2:
- Transactions that will be settled in cash in the future. With accrual recording, a purchase of goods and services is recognized when the ownership of goods changes hands or services are provided. The associated cash payment may not take place until a subsequent accounting period, in which case it would not be included in Table 4.2 in the same period as it appears in Table 4.1. Similarly, revenue can be received in cash before it is earned by the delivery of goods or provision of services to the purchaser. There may also be transactions in assets and liabilities that will be settled in cash in future periods, such as the interest accruing from the amortization of the discount on a zero-coupon or other discounted bond.
- Transactions that are not in cash by their nature. Consumption of fixed capital, imputed transactions, barter, and other transactions in kind can only be noncash transactions.

G. The Statement of Other Economic Flows

4.49 Table 4.3, the Statement of Other Economic Flows, presents influences on the government's net worth that are not the result of government transactions. They are classified as changes either in the value or volume of assets, liabilities, and net worth. The balancing item of this statement is the *change in*

Table 4.3: Statement of Other Economic Flows

CHANGE IN NET WORTH RESULTING FROM OTHER ECONOMIC FLOWS

NONFINANCIAL ASSETS

Holding gains

Other volume changes

FINANCIAL ASSETS

Holding gains

Other volume changes

LIABILITIES

Holding gains

Other volume changes

net worth resulting from other economic flows. (Other economic flows are described in Chapter 10.)

- **4.50** Changes in the value of assets, liabilities, and net worth due solely to price effects are called holding gains. They can result from changes in the general price level or in relative prices. Changes in the exchange rate will also cause holding gains of financial assets and liabilities denominated in a foreign currency.
- **4.51** Changes in the volume of assets and liabilities other than from transactions may arise for a variety of reasons. They can be described as resulting from exceptional or unexpected events, from normal events, or from reclassifications.
- Exceptional or unexpected events include losses from earthquakes, floods, fires, wind, wars, and other catastrophes. They also include bad debts written off by creditors, uncompensated seizures, abandonment of production facilities before construction is completed, unforeseen obsolescence of assets, unforeseen degradation of fixed assets from pollution, and exceptional losses of inventories.
- Normal events include the discovery of a subsoil asset, the depletion of subsoil assets through extraction, the registration of a patent, a change in the liability of a defined benefit pension plan resulting from a change in the benefits covered, the designation of a structure as a historic monument, and the natural growth of noncultivated biological resources.
- Reclassifications occur when a part of a general government unit begins to operate with sufficient independence that it is classified as a quasicorporation, when a general government unit is

converted to a public corporation or vice versa because of a change in its operations or the prices that it charges for its services, and when there is a restructuring or merger of general government units and public corporations. In these cases, assets and liabilities may be added to or removed from the balance sheet of the general government sector.

H. The Balance Sheet

- **4.52** The *Balance Sheet* is shown in Table 4.4. It presents the stocks of assets and liabilities at the end of the accounting period. Also included is *net worth*, defined as total assets less total liabilities. The change in net worth is the preferred measure for assessing the sustainability of fiscal activities.
- **4.53** It may be difficult to attach market values to some government nonfinancial assets, and certain analyses are focused only on the financial assets of the general government sector rather than its total assets. As a result, *net financial worth*, also shown in Table 4.4, is defined as total financial assets less total liabilities.

I. Government assets

4.54 The assets included in the Balance Sheet of the general government sector are assets over which general government units enforce ownership rights and from which they may derive economic benefits by holding or using them over a period of time. Assets not

owned and controlled by a general government unit and assets that have no economic value are excluded.

4.55 As shown in Table 4.4, assets are classified in the same way that transactions in assets are classified. Assets are either nonfinancial or financial. Nonfinancial assets are further classified as fixed assets, inventories, valuables, or nonproduced assets. Financial assets are classified by residency of the counterparty and by type of instrument. Financial assets can also be classified by sector of the counterparty. (The classification of assets is described in Chapter 7.)

2. Government liabilities

4.56 Liabilities are obligations to provide economic value to another institutional unit. Most classifications that apply to financial assets also apply to liabilities. Table 4.4 shows a classification first by the residency and then by type of instrument. (The classification of liabilities is described in Chapter 7.)

I. Additional summary measures for fiscal policy

4.57 Depending on the objectives of the analysis being undertaken, it is likely that variables and balances other than those included in the main tables of the GFS framework will be useful. Some of the most important indicators that are likely to be employed are described in Box 4.1.

Table 4.4: Balance Sheet

	Opening balance sheet	Closing balance sheet
NET WORTH		
NONFINANCIAL ASSETS		
Fixed assets		
Inventories		
Valuables		
Nonproduced assets		
FINANCIAL ASSETS		
Domestic		
Currency and deposits		
Securities other than shares		
Loans		
Shares and other equity		
Insurance technical reserves		
Financial derivatives		
Other accounts receivable		
Foreign		
Currency and deposits		
Securities other than shares		
Loans		
Shares and other equity		
Insurance technical reserves		
Financial derivatives		
Other accounts receivable		
0.000 0.000 0.000 0.000		
Monetary gold and SDRs		
LIABILITIES		
Domestic		
Currency and deposits		
Securities other than shares		
Loans		
Shares and other equity (public corporations only)		
Insurance technical reserves [GFS]		
Financial derivatives		
Other accounts payable		
Foreign		
Currency and deposits		
Securities other than shares		
Loans		
Shares and other equity (public corporations only)		
Insurance technical reserves [GFS]		
Financial derivatives		
Other accounts payable		

Box 4.1: Analytical Measures for Fiscal Policy

For macroeconomic analysis, fiscal policy measures include the three core balances in the GFS system, other balances used by various institutions (including the IMF), and other important macroeconomic measures of flows and stocks. These variables could apply to the different levels of government, the general government sector or to the public sector.

Core GFS balances

Net/gross operating balance the net operating balance equals revenue minus expense. The gross operating balance

equals revenue minus expense other than consumption of fixed capital

Net lending/borrowing net operating balance minus the net acquisition of nonfinancial assets (or the gross oper-

ating balance minus the net acquisition of nonfinancial assets that also excludes consumption of fixed capital). Net lending/borrowing is also equal to the net acquisition of

financial assets minus the net incurrence of liabilities

Cash surplus/deficit net cash inflow from operating activities minus the net cash outflow from investments in

nonfinancial assets

Other balances

Overall fiscal balance net lending/borrowing adjusted through the rearrangement of transactions in assets and

liabilities that are deemed to be for public policy purposes. Notably, all proceeds under privatization (including fixed asset sales) would be included as financial items; and subsi-

dies given in the form of loans would be recognized as an expense¹

Adjusted overall fiscal balance overall fiscal balance (or net lending/borrowing) adjusted to exclude some or all revenue

grants, certain enclave activities such as the oil sector, and/or large and infrequent trans-

actions that could distort the fiscal analysis1

Overall primary balance overall fiscal balance plus net interest expense

Primary operating balance net operating balance plus net interest expense

Gross saving gross operating balance minus net capital transfers receivable, including net capital grants

and capital taxes (GFS codes 1133 and 1135)

Other macroeconomic variables

Fiscal burden tax revenue plus compulsory social security contributions (as a percent of GDP)

Total expenditure expense plus the net acquisition of nonfinancial assets (excluding valuables, if possible)

Total expenditure composition disaggregation of total expenditure through the functional classification (COFOG, see

Chapter 6)

Government final consumption expenditure approximated by compensation of employees, plus the use of goods and services, plus

consumption of fixed capital, minus the sales of goods and services, plus purchases for

direct transfer to households (mainly social benefits in kind)

Gross investment acquisition less disposal of nonfinancial assets (excluding valuables, if possible)

Wealth and Debt

Net wealth position net worth, which equals the total stock of assets minus liabilities

Net financial wealth position total stock of financial assets minus liabilities

Gross debt position stock of all liabilities except shares and other equity and financial derivatives

Contingent liabilities stock of explicit government (public sector) guarantees plus the net present value of the

obligations of social security schemes

¹ The net operating balance, the cash surplus/deficit, and other balances could be adjusted similarly.

5. Revenue

This chapter defines the concept of revenue and describes its classification.

A. Revenue and its components

- **5.1** *Revenue* is an increase in net worth resulting from a transaction. For general government units, there are four main sources of revenue: taxes and other compulsory transfers imposed by government units, property income derived from the ownership of assets, sales of goods and services, and voluntary transfers received from other units.
- **5.2** *Tax revenue*, which forms the dominant share of revenue for many government units, is composed of compulsory transfers to the general government sector. Certain compulsory transfers, such as fines, penalties, and most social security contributions, are excluded from tax revenue. Refunds and corrections of erroneously collected tax revenue have the appearance of transactions that decrease the net worth of the government unit imposing the tax. More accurately, they are adjustments that allow the excessive increase in net worth previously recorded to be corrected. As such, these transactions are treated as negative revenue.
- **5.3** All other types of revenue are frequently combined into a heterogeneous category of nontax revenue. In this manual, however, the various other types of revenue are separately identified and include social contributions, grants, property income, sales of goods and services, and miscellaneous other revenue.
- **5.4** *Social contributions [GFS]*¹ are actual or imputed receipts from either employers on behalf of

¹[GFS] indicates that this item has the same name but different coverage in the *1993 SNA*.

their employees or from employees, self-employed, or nonemployed persons on their own behalf that secure entitlement to social benefits for the contributors, their dependents, or their survivors. The contributions may be compulsory or voluntary.

- **5.5** *Grants* are noncompulsory transfers received by government units from other government units or international organizations. When statistics are compiled for the general government sector, grants from other domestic government units would be eliminated in consolidation so that only grants from foreign governments and international organizations would appear. Grants may be classified as capital or current and can be received in cash or in kind.
- **5.6** *Property income* [*GFS*] is received when general government units place financial assets and/or nonproduced assets at the disposal of other units. Interest, dividends, and rent are the major components of this category.
- **5.7** Sales of goods and services include sales by market establishments, administrative fees, incidental sales by nonmarket establishments, and imputed sales of goods and services. Some administrative fees are so high that they are clearly out of proportion to the cost of the services provided. Such fees are classified as taxes.
- **5.8** Sales of goods and services are recorded as revenue without deduction of the expenses incurred in generating that revenue. It is quite possible for general government units to sell their output at prices that are less than the cost of production. Indeed, as nonmarket producers, most general government units distribute their output without charge or for prices that are not economically significant. In these cases, the net worth of the unit has decreased because the expense from production is higher than the revenue from the sale of the goods and services

in question. In a broader perspective, however, the general government unit is seen as having decided to produce the goods or services as a matter of public policy and to impose some fees or sell some items, rather than give them away, to defray some of the costs or to eliminate some of the excess demand that otherwise would exist. In this view, the resources have already been committed and the fees or sales receipts are an increase in the unit's net worth.

- **5.9** Other types of nontax revenue that might be received are fines, penalties, forfeits, settlements arising from judicial processes, voluntary transfers other than grants, and sales of existing goods, including used military items.
- **5.10** The disposal of a nonfinancial asset other than inventory by sale or barter does not affect net worth and these transactions are not revenue. They are transactions in nonfinancial assets as described in Chapter 8.
- **5.11** Fiscal analysis often makes use of the concept of "fiscal burden," which is the amount of compulsory transfers imposed by units of the general government sector on the rest of the economy. While not a part of the revenue classification, it can be approximated by the sum of tax revenue and social security contributions. Depending on the analytic purpose, if a supranational organization also imposes compulsory transfers, they may need to be added. To the extent that voluntary social security contributions exist, they should be subtracted. Fines, penalties, and forfeits are compulsory transfers but are not normally part of the fiscal burden.

B. Classification and recording of revenue

- **5.12** Revenue is composed of heterogeneous elements. Accordingly, the elements are classified according to different characteristics depending on the type of revenue. For taxes the classification scheme is determined mainly by the base on which the tax is levied. Grants are classified by the source from which the revenue is derived, and property income is classified by type of income. The complete classification system is shown in Table 5.1.
- **5.13** Revenue should be recorded according to the accrual basis, which is when the activities, transactions, or other events occur that create the claims to receive the taxes or other types of revenue. The application of

the general rule to the various types of revenue is indicated in each section of the classification as necessary.

- **5.14** With the exception of taxes and social contributions, the amount of revenue to be recorded is the entire amount to which the general government unit has an unconditional claim. As indicated in Chapter 3, the amount of taxes and social contributions recorded must take into account the fact that the government unit receiving the revenue is usually not a party to the transaction or other event that creates the obligation to pay the taxes or social insurance contributions. Consequently, many of these transactions and events permanently escape the attention of the tax authorities. The amount of revenue from taxes and social insurance contributions should exclude the amounts that possibly could have been received from such unreported events had the government learned about them. In other words, only those taxes and social insurance contributions that are evidenced by tax assessments and declarations, customs declarations, and similar documents are considered to create revenue for government units.
- **5.15** In addition, it is typical that some of the taxes and social insurance contributions that have been assessed will never be collected. It would be inappropriate to accrue revenue for an amount that the government unit does not realistically expect to collect. Thus, the difference between assessments and expected collections represents a claim that has no real value and should not be recorded as revenue. The amount of taxes and social insurance contributions that is recorded as revenue should be the amount that is realistically expected to be collected. The actual collection, however, may be in a later period, possibly much later.
- **5.16** It is not always clear whether a compulsory transfer is a tax or a social security contribution. Social security contributions include all compulsory payments made by insured persons, or their employers, to government units providing social security benefits in order to secure entitlement to those benefits, provided the contributions are levied as a function of earnings, payroll, or the number of employees. When income is used as a proxy for gross wages, as for the self-employed, the receipts are included as social security contributions. Voluntary contributions also may be made to secure the entitlement.
- **5.17** Compulsory transfers levied on other bases and earmarked for social security expenditures are taxes and are classified according to their respective tax

Table 5.1: Classification of Revenue

I Revenue		12	Social contributions [GFS]
П	Taxes	121	Social security contributions
Ш	Taxes on income, profits, and capital gains	1211	Employee contributions
Ш	Payable by individuals	1212	Employer contributions
1112	Payable by corporations and other enterprises	1213	Self-employed or nonemployed contributions
1113	Unallocable	1214	Unallocable contributions
112	Taxes on payroll and workforce	122	Other social contributions
113	Taxes on property	1221	Employee contributions
1131	Recurrent taxes on immovable property	1222	Employer contributions
1132	Recurrent taxes on net wealth	1223	Imputed contributions
1133	Estate, inheritance, and gift taxes	13	Grants
1134	Taxes on financial and capital transactions	131	From foreign governments
1135	Other nonrecurrent taxes on property	1311	Current
1136	Other recurrent taxes on property	1312	Capital
114	Taxes on goods and services	132	From international organizations
1141	General taxes on goods and services	1321	Current
11411	Value-added taxes	1322	Capital
11412	Sales taxes	133	From other general government units
11413	Turnover and other general taxes on goods and	1331	Current
	services	1332	Capital
1142	Excises	14	Other revenue
1143	Profits of fiscal monopolies	141	Property income [GFS]
1144	Taxes on specific services	1411	Interest [GFS]
1145	Taxes on use of goods and on permission to use	1412	Dividends
	goods or perform activities	1413	Withdrawals from income of quasi-corporations
11451	Motor vehicle taxes	1414	Property income attributed to insurance
11452	Other taxes on use of goods and on permission		policyholders
	to use goods or perform activities	1415	Rent
1146	Other taxes on goods and services	142	Sales of goods and services
115	Taxes on international trade and transactions	1421	Sales by market establishments
1151	Customs and other import duties	1422	Administrative fees
1152	Taxes on exports	1423	Incidental sales by nonmarket establishments
1153	Profits of export or import monopolies	1424	Imputed sales of goods and services
1154	Exchange profits	143	Fines, penalties, and forfeits
1155	Exchange taxes	144	Voluntary transfers other than grants
1156	Other taxes on international trade and transactions	1441	Current
116	Other taxes	1442	Capital
1161	Payable solely by business	145	Miscellaneous and unidentified revenue
1162	Payable by other than business or unidentifiable		

base. In particular, receipts based on net income personalized by adjustments for personal deductions and exemptions are classified as income taxes, even if earmarked for the payment of social security benefits. Compulsory payments levied as a function of earnings, payroll, or the number of employees that do not secure entitlement to social security benefits are classified as taxes on payroll or workforce.

I. Taxes (II)²

5.18 The coverage, timing, and valuation of tax revenue in the GFS system and *1993 SNA* are identical, but the classification systems differ. The *1993 SNA*

has provisions for compilation of (i) taxes on production and imports; (ii) current taxes on income, wealth, etc.; and (iii) capital taxes. The approach adopted in the GFS system is to classify taxes mainly by the base on which the tax is levied. Taxes are grouped into six major categories: (i) taxes on income, profits, and capital gains; (ii) taxes on payroll and workforce; (iii) taxes on property; (iv) taxes on goods and services; (v) taxes on international trade and transactions; and (vi) other taxes. The borderlines between these categories are not always clear, and the text provides additional commentary in questionable cases.

5.19 Normally, designating a tax for a particular use does not affect its classification. An exception is the distinction between taxes on payroll and workforce

²The numbers in parentheses after each classification category are the GFS classification codes. Appendix 4 provides all classification codes used in the GFS system.

and social security contributions. If the revenue is designated for use in a social security scheme, then it is a social security contribution. Otherwise, it is a tax on payroll and workforce.

- **5.20** The classification of taxes in this manual is quite similar to the classification employed in *Revenue Statistics*, which is published annually by the Organisation for Economic Co-operation and Development. The two primary differences are that in *Revenue Statistics* compulsory social security contributions are treated as taxes and the categories of taxes on goods and services and taxes on international trade and transactions are combined into a single category.
- **5.21** Taxes and other compulsory transfers should be recorded when the activities, transactions, or other events occur that create government claims to the taxes or other payments. This time is not necessarily the time at which the event being taxed occurred. For example, the obligation to pay tax on capital gains normally occurs when an asset is sold, not when its value appreciates.
- **5.22** Tax refunds generally are treated as negative taxes. Refunds are adjustments for overpayments. They are attributed to the period in which the event occurred that generated the overpayment. In the case of a value-added-type tax, taxpayers other than final consumers normally are allowed a refund of taxes paid on purchases. If this refund exceeds the taxes paid by that taxpayer, the net refund is treated as a negative tax.
- **5.23** Tax credits are amounts deductible from the tax that otherwise would be payable. Some types of credits can result in a government unit making a net payment to the taxpayer. Such net payments are treated as an expense rather than a negative tax.
- **5.24** In some cases, one government unit collects taxes and then transfers some or all of them to another government unit. Depending on the arrangement, the taxes passed on to the second government unit may be reassigned as tax revenue of that unit or they can be recorded as tax revenue of the collecting unit and a grant from that unit to the second government unit.
- **5.25** In general, a tax is attributed to the government unit that (a) exercises the authority to impose the tax (either as a principal or through the delegated authority of the principal), (b) has final discretion to set and

vary the rate of the tax, and (c) has final discretion over the use of the funds.

- **5.26** Where an amount is collected by one government for and on behalf of another government, and the latter government has the authority to impose the tax, set and vary its rate, and determine the use of the proceeds, then the former is acting as an agent for the latter and the tax is reassigned. Any amount retained by the collecting government as a collection charge should be treated as a payment for a service. Any other amount retained by the collecting government, such as under a tax-sharing arrangement, should be treated as a current grant. If the collecting government was delegated the authority to set and vary the rate as well as decide on the ultimate use of the proceeds, then the amount collected should be treated as tax revenue of this government.
- **5.27** Where different governments jointly and equally set the rate of a tax and jointly and equally decide on the distribution of the proceeds, with no individual government having ultimate overriding authority, then the tax revenues are attributed to each government according to its respective share of the proceeds. If an arrangement allows one government unit to exercise ultimate overriding authority, then all of the tax revenue is attributed to that unit.
- **5.28** There may also be the circumstance where a tax is imposed under the constitutional or other authority of one government, but other governments individually set the tax rate in their jurisdictions and individually decide on the use of the proceeds of the tax generated in their jurisdictions. The proceeds of the tax generated in each respective government's jurisdiction are attributed as tax revenues of that government.

a. Taxes on income, profits, and capital gains (111)

5.29 Taxes on income, profits, and capital gains generally are levied on (i) wages, salaries, tips, fees, commissions, fringe benefits, and other compensation for labor services; (ii) interest, dividends, rent, and royalty incomes; (iii) capital gains and losses, including capital gain distributions of investment funds; (iv) profits of corporations, partnerships, sole proprietorships, estates, and trusts; (v) taxable portions of social security, pension, annuity, life insurance, and other retirement account distributions; and (vi) miscellaneous other income items.

- **5.30** Taxes on income, profits, and capital gains are attributed either to *individuals* (1111) or to *corporations and other enterprises* (1112). When the information needed to determine whether taxes should be attributed to either of these categories is not available, the taxes are treated as *unallocable* (1113). Income taxes on estates are treated as taxes on individuals. Income taxes on nonprofit units are treated as taxes on corporations. Income taxes on trusts are treated as taxes on individuals when the beneficiaries are individuals, and as taxes on corporations otherwise.
- **5.31** These taxes may be levied on actual or estimated income and profits and on realized or unrealized capital gains. The amount of income subject to tax is usually less than gross income because various deductions are permitted. A profits tax is levied on revenue less allowable deductions.
- **5.32** In principle, income taxes and social contributions based on income should be attributed to the period in which the income is earned, even though there may be a significant delay between the end of the accounting period and the time at which it is feasible to determine the actual liability of the taxpayer. In practice, however, some flexibility is permitted. In particular, as a practical deviation from the general principle, income taxes deducted at source, such as pay-as-you-earn taxes, and regular prepayments of income taxes may be recorded in the periods in which they are paid and any final tax liability on income may be recorded in the period in which the liability is determined.
- **5.33** Income taxes are normally imposed on the income earned during an entire year. If monthly or quarterly statistics are compiled, indicators of seasonal activity or other appropriate indicators may be used to allocate the annual totals.
- **5.34** Under imputation systems of corporate income tax, shareholders are wholly or partly relieved on their liability for an income tax on dividends paid by the corporation out of income or profits liable to corporate income tax. The relief is usually called a tax credit although it actually is a means of allocating a tax among taxpayers. If the relief exceeds a shareholder's total tax liability, the excess may be payable to the shareholder. Because this "tax credit" is an integral part of the imputation system of corporate income tax, any net payment to shareholders is treated as a negative tax rather than expense. This treatment differs from the general treatment of tax cred-

its described in paragraph 5.23. The total tax paid by the corporation is attributed to corporations (1112) and the credits are attributed to the shareholders.

b. Taxes on payroll and workforce (112)

5.35 This category consists of taxes that are collected from employers or the self-employed either as a proportion of payroll size or as a fixed amount per person and that are not earmarked for social security schemes. Payments earmarked for social security schemes are classified as *social security contributions* (121).

c. Taxes on property (113)

- **5.36** This item includes taxes on the use, ownership, or transfer of wealth. The taxes may be levied at regular intervals, one time only, or on a change in ownership.
- **5.37** Taxes on the ownership or use of specific types of property often are based on the value of the property at a particular time but are deemed to accrue continuously over the entire year or the portion of the year that the property was owned, if less than the entire year. Taxes on the transfer of wealth are recorded at the time of the transfer, and some taxes on the ownership or use of property are recorded at a specific time, such as a one-time tax on net wealth.
- **5.38** The following taxes are similar to taxes on property but are classified elsewhere: Taxes on immovable property that are levied on the basis of a presumed net income are recorded as *taxes on income, profits, and capital gains* (111).
- Taxes on the use of property for residence, where the tax is payable by either proprietor or tenant and the amount payable is a function of the user's personal circumstances, such as pay or the number of dependents, are treated as *taxes on income*, *profits*, and capital gains (111).
- Taxes on construction, enlargement, or alteration of all buildings, or those whose value or use density exceeds a certain threshold, are included in taxes on use of goods and on permission to use goods or perform activities (1145).
- Taxes on use of one's own property for special trading purposes, such as selling alcohol, tobacco, or meat, are recorded under *taxes on use of goods* and on permission to use goods or perform activities (1145).

- Taxes on exploitation of land and subsoil assets not owned by government units, including taxes on extraction and exploitation of minerals and other resources, are recorded in *other taxes on goods and services* (1146). Payments to a government unit as the owner of land and subsoil assets are recorded in *rent* (1415). Payments for licenses for the permission to exploit land and subsoil assets are classified in *taxes on use of goods and on permission to use goods or perform activities* (1145).
- Taxes on capital gains resulting from the sale of property are included in *taxes on income*, *profits*, and capital gains (111).
- **5.39** Taxes on property are divided into six categories: recurrent taxes on immovable property; recurrent taxes on net wealth; estate, inheritance, and gift taxes; taxes on financial and capital transactions; other nonrecurrent taxes on property; and other recurrent taxes on property.
- **5.40** Recurrent taxes on immovable property (1131). This item covers taxes levied regularly on the use or ownership of immovable property, which includes land, buildings, and other structures. The taxes can be levied on proprietors, tenants, or both. The amount of the taxes is usually a percentage of an assessed property value that is based on a notional rental income, sales price, capitalized yield, or other characteristics such as size or location. Unlike recurrent taxes on net wealth (1132), liabilities incurred on the property are usually not taken into account in assessment of these taxes.
- **5.41** Recurrent taxes on net wealth (1132). This item covers taxes levied regularly on net wealth, which is usually defined as the value of a wide range of movable and immovable property less liabilities incurred on that property.
- **5.42** Estate, inheritance, and gift taxes (1133).³ This item covers taxes on transfers of property at death and on gifts. Taxes on the transfer of property at death include estate taxes, which are usually based on the size of the total estate, and inheritance taxes, which

may be determined by the amount received by beneficiaries and/or their relationship to the deceased.

5.43 Taxes on financial and capital transactions (1134). This item includes taxes on change of ownership of property, except those classified as gifts, inheritance, or estate transactions. Included are taxes on the issue, purchase, and sale of securities, taxes on checks and other forms of payment, and taxes levied on specific legal transactions, such as the validation of contracts and the sale of immovable property. This category does not include taxes on the use of goods (part of 1145); taxes on capital gains (part of 111); recurrent taxes on net wealth (1132); other nonrecurrent taxes on property (1135); fees paid to cover court charges or for birth, marriage, or death certificates (part of 1422); sales taxes (11412); or general stamp taxes (part of 116).

5.44 Other nonrecurrent taxes on property (1135).⁴ This item covers taxes on net wealth and property that are levied on a one-time basis or at irregular intervals. It includes taxes on net wealth levied to meet emergency expenditures or to effect a redistribution of wealth; taxes on property, such as betterment levies, that take account of increases in land values due to government permission to develop the land or the provision by government of additional local facilities; taxes on the revaluation of capital; and any other exceptional taxes on particular items of property.

5.45 Other recurrent taxes on property (1136). This item includes any recurrent taxes on property not included in categories 1131, 1132, or 1134, such as recurrent gross taxes on personal property, jewelry, cattle, other livestock, other particular items of property, and external signs of wealth. Taxes on the use of particular types of movable property, such as motor vehicles and guns, are classified in taxes on use of goods and on permission to use goods or perform activities (1145).

d. Taxes on goods and services (114)

5.46 Included in this item are all taxes levied on the production, extraction, sale, transfer, leasing, or delivery of goods and rendering of services. Also included are taxes on the use of goods and on permission to use goods or perform activities. Taxes on goods and services include

³This category is one of the two categories of taxes that are considered to be capital taxes in the *1993 SNA*. The other category is *other nonre-current taxes on property* (1135). Capital taxes are taxes levied at irregular and very infrequent intervals on the values of the assets or net worth owned by institutional units or on the values of assets transferred between institutional units as a result of legacies, gifts *inter vivos*, or other transfers. The identification of capital taxes is necessary to calculate gross and net saving, which are two of the supplemental balances described in Chapter 4 and are also balances in the *1993 SNA*.

⁴This category is classified as capital taxes in the *1993 SNA*, which are described in footnote 3.

- · Value-added taxes.
- General sales taxes, whether levied at manufacturer/production, wholesale, or retail level.
- Single-stage taxes and cumulative multistage taxes, where "stage" refers to stage of production or distribution.
- · Excises.
- Taxes levied on the use of motor vehicles or other goods.
- Taxes levied on permission to use goods or perform certain activities.
- Taxes on the extraction, processing, or production of minerals and other products.
- **5.47** This category does not include *taxes levied on international trade and transactions* (115) but does include taxes levied upon importation or at the border if the liability does not result solely from the fact that the goods have crossed the border and is applicable to domestic goods or transactions as well. Taxes on goods and services are divided into six categories as described in the following paragraphs.
- 5.48 General taxes on goods and services (1141). This item includes all taxes, other than customs and other import duties (1151) and taxes on exports (1152), levied on the production, leasing, delivery, sale, purchase, or other change of ownership of a wide range of goods and the rendering of a wide range of services. Such taxes may be levied regardless of whether the goods or services are produced domestically or imported, and they may be imposed at any stage of production or distribution. Receipts from adjustments made in connection with these taxes when goods cross a border are included. Conversely, refunds of these taxes when goods are exported are treated as negative taxes within this category. When taxes are levied on a limited range of goods rather than a wide range, they are included in excises (1142). Borderline cases are resolved on the basis of the predominant character of the tax. This item is subdivided into the following categories.
- Value-added taxes (11411). A value-added tax (VAT) is a tax on goods or services collected in stages by enterprises but which is ultimately charged in full to the final purchasers. It is described as a

- deductible tax because producers are not usually required to pay the government the full amount of the tax they invoice to their customers, as they are permitted to deduct the amount of tax they have been invoiced on their own purchases of goods or services intended for intermediate consumption or fixed capital formation. VAT is usually calculated on the price of the good or service, including any other tax on the product. VAT may also be payable on imports of goods or services in addition to any import duties or other taxes on the imports.
- Sales taxes (11412). This category includes all general taxes levied at one stage only, whether at manufacturing or production stages or on wholesale or retail trade.
- Turnover and other general taxes on goods and services (11413). This category includes multistage cumulative taxes, which include a tax each time a transaction takes place without deduction for taxes paid on inputs and all general consumption taxes where elements of value-added, sales, or multistage taxes are combined.
- 5.49 Excises (1142). Excises are taxes levied on particular products, or on a limited range of products, that are not classifiable under general taxes on goods and services (1141); profits of fiscal monopolies (1143); customs and other import duties (1151); or taxes on exports (1152). Excises may be imposed at any stage of production or distribution and are usually assessed by reference to the value, weight, strength, or quantity of the product. Included are special taxes on individual products such as sugar, beetroot, matches, and chocolates; taxes levied at varying rates on a certain range of goods; and taxes levied on tobacco goods, alcoholic drinks, motor fuels, and hydrocarbon oils. If a tax collected principally on imported goods also applies, or would apply, under the same law to comparable domestically produced goods, then the revenue therefrom is classified as arising from excises rather than from import duties. This principle applies even if there is no comparable domestic production or no possibility of such production. Taxes on electricity, gas, and energy are regarded as taxes on goods and are included under excises rather than taxes on specific services (1144).
- **5.50** *Profits of fiscal monopolies* (1143). This item covers that part of the profits of fiscal monopolies that is transferred to the government. Fiscal monopolies are public corporations or public quasi-corporations that exercise the taxing power of government by the use of

monopoly powers over the production or distribution of a particular kind of good or service. The monopolies are created to raise government revenues that could otherwise be gathered through taxes on private sector production or distribution of the commodities concerned. Typical commodities subject to fiscal monopolies are tobacco products, alcoholic beverages, salt, matches, petroleum products, and agricultural products.

- **5.51** Fiscal monopolies are distinguished from public enterprises such as rail transport, electricity, post offices, and other communications services. Such enterprises may enjoy a monopoly or quasi-monopoly but normally exist primarily to further the interests of public economic or social policy rather than to raise revenue for government. Transfers to government from such public enterprises are treated as dividends (1412) or withdrawals of income from quasi-corporations (1413). The concept of fiscal monopoly does not extend to state lotteries, the profits of which are also regarded as dividends (1412) or withdrawals of income from quasi-corporations (1413). Export and import monopoly profits transferred from marketing boards or other enterprises dealing with international trade are similar to fiscal monopoly profits, but are classified as profits of export or import monopolies (1153).
- **5.52** While in principle only the excess of the monopoly profits over some notional "normal" profits should be treated as taxes, it is difficult to estimate this amount, and, in practice, the value of the taxes should be taken as equal to the amount of the profits actually transferred from fiscal monopolies to government. Any reserves retained by fiscal monopolies are excluded. The taxes are recorded when the transfer takes place rather than when the profits were earned.
- 5.53 Taxes on specific services (1144). All taxes levied on payments for specific services, such as taxes on transport charges, insurance premiums, banking services, entertainment, restaurants, and advertising charges, are included here. Also included in this item are taxes levied on gambling and betting stakes for horse races, football pools, lotteries, and so forth. Taxes on entry to casinos, races, etc. are also classified as selective taxes on services. If, however, the taxes form part of a general tax on goods and services, the revenue is recorded under category 1141. Taxes on individual gains from football pools or other gambling proceeds are classified in taxes on income, profits, and capital gains (111). Profits transferred to government from state lotteries are regarded as dividends (1412) or withdrawals of income from quasi-

corporations (1413). Taxes on checks and on the issue, transfer, or redemption of securities are classified as taxes on financial and capital transactions (1134). Stamp tax revenues that cannot be assigned to taxes on services or other transactions are classified as other taxes (116). Taxes on electricity, gas, and energy are included under excises (1142).

- 5.54 Taxes on use of goods and on permission to use goods or perform activities (1145). One of the regulatory functions of government is to forbid the ownership or use of certain goods or the pursuit of certain activities unless specific permission is granted by issuing a license or other certificate for which a fee is demanded. If the issue of such licenses involves little or no work on the part of government, the licenses being granted automatically on payment of the amounts due, it is likely that they are simply a device to raise taxes, even though the government may provide some kind of certificate, or authorization, in return. However, if the government uses the issue of licenses to exercise a regulatory function—for example, checking the competence or qualifications of the person concerned, checking the efficient and safe functioning of the equipment in question, or carrying out some other form of control that it would otherwise not be obliged to do-the receipts should be treated as sales of services rather than receipts of taxes, unless the receipts are clearly out of all proportion to the costs of providing the services. The borderline between taxes and administrative fees (1422) is not always clear-cut in practice.
- **5.55** More specifically, the following types of fees are considered taxes: (a) fees where the payer of the levy is not the receiver of the benefit, such as a fee collected from slaughterhouses to finance a service provided to farmers; (b) fees where government is not providing a specific service in return for the levy even though a license may be issued to the payer, such as a hunting, fishing, or shooting license that is not accompanied by the right to use a specific area of government land; and (c) fees where benefits are received only by those paying the fee but the benefits received by each individual are not necessarily in proportion to the payments, such as a milk marketing levy paid by dairy farmers and used to promote the consumption of milk.
- **5.56** Although taxes in this category are levied on the use of goods rather than on the ownership or transfer of goods, registration of the ownership of goods may generate the tax claim. For example, registration of the ownership of animals or motor vehicles may be the event that causes a tax on the use of

these items to be assessed. Taxes on the use of goods may apply even to functionally unusable goods, such as antique motor vehicles or guns.

5.57 Borderline cases arise with taxes on the permission to perform business activities, which are levied on a combined income, payroll, or turnover base. If it is possible to estimate receipts related to each base, then the total should be allocated among the bases. If separate amounts cannot be estimated, but it is known that most of the receipts are derived from one base, then the whole of the receipts are classified according to that base. Borderline cases also arise with taxes on the ownership or use of property that could be classified as recurrent taxes on immovable property (1131), recurrent taxes on net wealth (1132), or other recurrent taxes on property (1136). Unlike the taxes under this item, category 1131 is confined to taxes on the ownership or tenancy of immovable property and such taxes normally are related to the value of the property. The taxes included in 1132 and 1136 are confined to ownership rather than use of assets, apply to groups of assets rather than particular goods, and are based on the value of assets.

5.58 This category is subdivided into motor vehicle taxes and other taxes on the use of goods and on the permission to use goods or perform services:

- Motor vehicle taxes (11451). This category
 includes taxes on the use of motor vehicles or permission to use motor vehicles. It does not include
 taxes on motor vehicles as property or net wealth or
 tolls for use of roads, bridges, and tunnels.
- Other taxes on use of goods and on permission to use goods or perform services (11452). Business and professional licenses are included in this category. Such licenses can take the form of taxes on permission to carry on a business in general or a particular business or profession. General business taxes or licenses levied in a fixed amount, on a schedule according to the kind of business, or on the basis of various indicators such as floor space, installed horsepower, capital, or shipping tonnage would be included. It would not cover business taxes levied on gross sales, which would be classified under general taxes on goods and services (1141). Taxes or licenses for particular kinds of businesses would include permission to sell goods or provide services. These taxes may be levied at regular intervals, on a one-time basis, or each time goods are used. Also included in this category are

pollution taxes levied on the emission or discharge into the environment of noxious gases, liquids, or other harmful substances.

Taxes in this category other than business and professional licenses include taxes on permission to hunt, shoot, or fish, and taxes on the ownership of pets when the right to carry out these activities is not granted as part of a normal commercial transaction. They also include radio and television licenses, unless the public authorities provide general broadcasting services, in which case a service payment, rather than a tax, is involved.

5.59 Other taxes on goods and services (1146). This item includes taxes on the extraction of minerals, fossil fuels, and other exhaustible resources from deposits owned privately or by another government and any other taxes on goods or services not included in categories 1141 through 1145. Taxes on the extraction of exhaustible resources usually are a fixed amount per unit of quantity or weight, but can be a percentage of value. The taxes are recorded when the resources are extracted. Payments for the extraction of exhaustible resources from deposits owned by the government unit receiving the payment are classified as *rent* (1415).

e. Taxes on international trade and transactions (115)

5.60 Customs and other import duties (1151). This item covers revenue from all levies collected on goods because they are entering the country or services because they are delivered by nonresidents to residents. The levies may be imposed for revenue or protection purposes and may be determined on a specific or ad valorem basis, but they must be restricted by law to imported products. Included are duties levied under the customs tariff schedule and its annexes, including surtaxes that are based on the tariff schedule, consular fees, tonnage charges, statistical taxes, fiscal duties, and surtaxes not based on the customs tariff schedule. Taxes that fall on imports only because the imports fall into a wider category of goods that are subject to the tax are recorded under general taxes on goods and services (1141) or excises (1142).

5.61 *Taxes on exports* (1152). This category includes all levies based on the fact that goods are being transported out of the country or services are being delivered to nonresidents by residents. Rebates on exported goods that are repayments of previously paid general consumption taxes, excises, or import

duties are deducted from the gross amounts receivable from the respective taxes, not from amounts receivable in this category.

5.62 Profits of export or import monopolies (1153). Governments may establish enterprises with the monopoly right to export or import particular goods and/or control services provided to or received from nonresidents to raise revenue that could be gathered through taxes on exports, imports, or dealings in foreign exchange. When such monopolies exist, the profits remitted to government by the monopolistic enterprises or marketing boards are considered to be taxes. Such profits are recorded as tax revenue when transferred to the government and do not include the retained reserves of the enterprises or marketing boards.5 Profits received from export or import enterprises or marketing boards that do not represent monopoly profits are recorded as property income (141). Profits transferred to the government from public enterprises or marketing boards dealing in commodities domestically, outside of international trade, are recorded under property income (141) or profits of fiscal monopolies (1143).

5.63 Exchange profits (1154). When the monopoly powers of government or monetary authorities are exercised to extract a margin between the purchase and sale prices of foreign exchange, other than to cover administrative costs, the revenue derived constitutes a compulsory levy exacted from both purchaser and seller of foreign exchange. It is the common equivalent of an import duty and export duty levied in a single exchange rate system or of a tax on the sale or purchase of foreign exchange. Like the profits of export or import monopolies, the revenue represents the exercise of monopoly powers for tax purposes and is included in tax revenues when received by government. This category does not include any transfer to government of exchange profits realized other than as a result of maintenance of an exchange rate differential.

5.64 Exchange taxes (1155). This item covers taxes that are levied upon the sale or purchase of foreign exchange, whether at a unified exchange rate or at different exchange rates. Included are taxes on remittances abroad if the taxes are levied on the purchase of foreign exchange that is to be remitted. Remittance

taxes that are not levied on the purchase of foreign exchange are recorded under *other taxes on international trade and transactions* (1156).

5.65 Other taxes on international trade and transactions (1156). This item includes other taxes levied on various aspects of international trade and transactions, such as taxes levied exclusively or predominantly on travel abroad, taxes on insurance or investment abroad, and taxes on remittances abroad, excluding taxes levied on the purchase of foreign exchange to be remitted abroad, which are included in *exchange taxes* (1155).

f. Other taxes (116)

5.66 This item covers revenue from taxes levied predominantly on a base or bases other than those described under the preceding tax headings. Also included is revenue from unidentified taxes and interest and penalties collected for late payment or nonpayment of taxes but not identifiable by tax category. The item is subdivided into other taxes paid solely by business (1161) and other taxes paid by other than business or unidentifiable (1162). The item includes taxes on persons that are not based on income or presumptive income, sometimes referred to as poll taxes, head taxes, or capitation taxes. Personal taxes based on actual or presumptive income are recorded as taxes on income, profits, and capital gains (111). Also included are stamp taxes that do not fall exclusively or predominantly on a single class of transactions or activities covered by other taxes. Examples would be revenues from the sale of stamps required to be affixed to contracts and checks. Revenues from the sale of stamps assignable to a single category, such as liquor and cigarettes, would be shown as taxes on those products, either excises (1142) or taxes on specific services (1144). Also included would be an expenditure tax that is levied on purchases but is personalized by the application of personal deductions and exemptions and revenue from taxes levied on a combination of several tax bases, where the revenue cannot be readily allocated to each tax base or to one predominant tax base.

2. Social contributions [GFS] (12)

5.67 As defined in paragraph 5.4, social contributions are actual or imputed receipts either from employers on behalf of their employees or from employees, self-employed, or nonemployed persons on their own behalf that secure entitlement to social benefits for the

⁵If an enterprise of this type both obtains profits from its exports or imports of some products and provides a subsidy on other products, then the taxes and subsidies should be separately recorded to the extent possible rather than recording only the net value of taxes less subsidies.

contributors, their dependents, or their survivors. The contributions may be compulsory or voluntary. Social contributions are classified as social security contributions (121) or other social contributions (122) depending on the type of scheme receiving them.

5.68 The coverage of social contributions in the GFS system is more restricted than in the *1993 SNA*. In the GFS system, social contributions consist of all social security contributions and all contributions to unfunded employer social insurance schemes that provide benefits other than retirement benefits. In the *1993 SNA*, social contributions also include contributions to autonomous and nonautonomous pension funds and to unfunded schemes that provide retirement benefits. The transactions that are treated as social contributions in the *1993 SNA* but not in the GFS system are treated as incurrences of liabilities in the GFS system.

5.69 Social contributions are levied as a function of earnings, payroll, or the number of employees. When income is used as a proxy for gross wages, however, as for the self-employed, the receipts are included here. Compulsory payments assessed on a different base but earmarked for social insurance schemes are treated as taxes.

5.70 As discussed in paragraphs 5.14 and 5.15, the amount of social contributions recorded as revenue should only be the amount that is realistically expected to be collected. The actual collection, however, may be in a later period, perhaps much later.

a. Social security contributions (121)

5.71 Contributions to social security schemes are classified by the source of the contribution. Employee contributions (1211) are either paid directly by employees or are deducted from employees' wages and salaries and transferred on their behalf by the employer. Employer contributions (1212) are paid directly by employers on behalf of their employees. Amounts paid by general government employers are not eliminated by consolidation when the paying and receiving units are in the same sector or subsector because the contributions are considered to be rerouted as described in paragraph 3.20 of Chapter 3 and then paid by the employees. Self-employed or nonemployed contributions (1213) are paid by contributors who are not employees. Unallocable contributions (1214) are those contributions whose source cannot be determined. If any contributions were voluntary, a memorandum item of their total amount would be useful for computing the fiscal burden and other uses.

b. Other social contributions (122)

5.72 Other social contributions include actual and imputed contributions to social insurance schemes operated by governments as employers on behalf of their employees that do not provide retirement benefits. Unlike social security schemes, social insurance schemes for government employees generally tie the level of benefits directly to the level of contributions. Such schemes usually are operated by a government only for its own employees, but they can be operated by one government on behalf of the employees of many governments.

5.73 *Employee contributions* (1221) include amounts paid directly by employees or transferred from wages and salaries and other compensation by employers on behalf of employees. *Employer contributions* (1222) include amounts paid by employers on behalf of their employees. As with employer contributions to social security schemes, these contributions are not eliminated by consolidation when the paying and receiving governments are in the same sector or subsector.

5.74 *Imputed contributions* (1223) arise when government employers provide social benefits directly to their employees, former employees, or dependents out of their own resources without involving an insurance enterprise or an autonomous or nonautonomous pension fund. In this situation, existing employees are considered protected against various specified social risks, even though no payments are being made to cover them. The amount of revenue accrued in this category is the value of employer social contributions that would be needed to secure the de facto entitlements to the social benefits.

3. Grants (13)

5.75 Grants are noncompulsory current or capital transfers received by a government unit from either another government unit or an international organization. Grants are classified first by the type of unit paying the grant and then by whether the grant is current or capital.

5.76 Three sources of grants are recognized in the GFS system: grants from foreign governments (131), grants from international organizations

⁶The coverage of social benefits is described in Chapter 6.

(132), and grants from other general government units (133). The last category, grants from other general government units, is required only when statistics are compiled for a subsector of the general government sector. Otherwise these transactions are eliminated in consolidation.

5.77 Current grants are those made for purposes of current expenditure and are not linked to or conditional on the acquisition of an asset by the recipient. Capital grants involve the acquisition of assets by the recipient and may consist of a transfer of cash that the recipient is expected or required to use for the acquisition of an asset or assets (other than inventories), the transfer of an asset (other than inventories and cash), or the cancellation of a liability by mutual agreement between the creditor and debtor.⁷ If doubt exists regarding the character of a grant, it should be classified as current.⁸

5.78 Grants in kind should be valued at current market prices. If market prices are not available then the value should be the explicit costs incurred in providing the resources or the amounts that would be received if the resources were sold. In some cases, the donor and the recipient may view the value quite differently. In this case, the valuation from the viewpoint of the donor should be used.

5.79 Grants are recorded when all requirements and conditions for receiving them are satisfied and the receiving unit has an unconditional claim. Determining this time can be complex because there is a wide variety of eligibility conditions that have varying legal powers. In some cases, a potential grant recipient has a legal claim when it has satisfied certain conditions, such as the prior incurrence of expenses for a specific purpose or the passage of legislation. In many cases, the grant recipient never has a claim on the donor and it should be attributed to the time at which the cash payment is made.

4. Other revenue (14)

5.80 In addition to taxes, social contributions, and grants, revenue includes property income, sales of goods and services, and miscellaneous other types of revenue.

a. Property income [GFS] (141)

5.81 Property income includes a variety of forms of revenue earned by a general government unit when it places financial and/or nonproduced assets that it owns at the disposal of other units. Revenue in this category may take the form of interest, dividends, withdrawals from income of quasi-corporations, property income attributed to insurance policyholders, or rent.⁹

5.82 *Interest [GFS]* (**1411**) is receivable by general government units that own certain kinds of financial assets, namely deposits, securities other than shares, loans, and accounts receivable. These types of financial assets are created when a general government unit lends funds to another unit. Interest is the revenue earned by the creditor for permitting the debtor to use its funds. Interest revenue accrues continuously over the period that the financial asset exists. The rate at which interest accrues may be stated as a percentage of the outstanding principal, a predetermined sum of money, or both.

5.83 The contract between creditor and debtor may call for periodic payments equal to the amount of interest that has accrued but not yet been paid, but in other cases there may be no such requirement so that the interest accrued is not due to be paid until the end of the contract. Combinations of these methods are also possible. To the extent that interest has accrued without being paid, the debtor's total liability to the creditor has increased. Any periodic or other payments reduce the total liability but are not revenue transactions.

5.84 Many considerations must be taken into account when determining the amount of interest revenue to record. To avoid repetition, interest is described in more detail in paragraphs 6.39 to 55 of Chapter 6.

⁷Appendix 2 provides details on this and other types of government debt operations.

⁸The identification of capital grants is necessary to calculate gross and net saving.

⁹In the 1993 SNA, reinvested earnings on direct foreign investment is another type of property income. Briefly, a direct foreign investment enterprise is either an unincorporated branch of a nonresident enterprise or a corporation in which at least one foreign investor owns sufficient shares to have an effective voice in its management. An increase in retained earnings of a direct foreign investment enterprise is treated as if it were remitted to the foreign direct investors in proportion to their ownership of the equity of the enterprise and then reinvested in additional equity. The imputed remittance of these retained earnings is treated as property income in the 1993 SNA but not in the GFS system. Such an increase in the value of the equity held by a government unit that is a direct foreign investor is accounted for as a holding gain in the same way as it is for other equity holdings (see Chapter 10). This different treatment causes net lending/borrowing in the two systems to differ. Reinvested earnings on direct foreign investment are described in paragraphs 7.119 to 7.122 of the 1993 SNA.

¹⁰Financial assets and their classification are defined in Chapter 7.

5.85 *Dividends* (1412). General government units, in their capacity as shareholders and owners of a corporation, become entitled to receive dividends as a result of placing equity funds at the disposal of that corporation. Equity funds do not entitle shareholders to a fixed or predetermined income. Instead, the board of directors or other managers of the corporation must declare a dividend payable on their own volition. Dividends are recorded either on the date they are declared payable or, if no prior declaration occurs, on the date the payment is made.

5.86 General government units may receive dividends from private or public corporations. Distributions of profits by public corporations may take place irregularly and may not be explicitly labeled as dividends. Nevertheless, except for the distributions noted below, dividends include all distributions of profits by corporations to their shareholders or owners, including profits of central banks transferred to government units, profits derived from the operation of monetary authority functions outside the central bank, and profits transferred by state lotteries. Distributions of *profits of fiscal monopolies* (1143) and *profits of export or import monopolies* (1153), however, are classified as taxes, as described in paragraphs 5.50 and 5.62.

5.87 When payments are received from public corporations, it can be difficult to decide whether they are dividends or withdrawals of equity. Dividends are payments a corporation makes out of its current income, which is derived from its ongoing productive activities. A corporation may, however, smooth the dividends its pays from one period to the next so that in some periods it pays more in dividends than it earns from its productive activities. Such payments are still dividends. Distributions by corporations to shareholders of proceeds from privatization receipts and other sales of assets and large and exceptional one-off payments based on accumulated reserves or holding gains are withdrawals of equity rather than dividends.

5.88 Withdrawals from income of quasi-corporations (1413). By definition, quasi-corporations cannot distribute income in the form of dividends, but the owner may choose to withdraw some or all of the income. Conceptually, the withdrawal of such income is equivalent to the distribution of corporate income through dividends and is treated the same way. The amount of income that the owner of a quasi-corporation chooses to withdraw will depend largely on the size of its net income. All such withdrawals are recorded on the date the payment actually occurs.

5.89 As with dividends, withdrawals from income of quasi-corporations do not include withdrawals of funds realized from the sale or other disposal of the quasi-corporation's assets. The transfer of funds resulting from such disposals is recorded as a reduction of the equity of quasi-corporations owned by government. Similarly, funds withdrawn by liquidating large amounts of accumulated retained earnings or other reserves of the quasi-corporation are treated as withdrawals from equity.

5.90 Property income attributed to insurance policyholders (1414). Insurance enterprises hold technical reserves in the form of prepayments of premiums, reserves against outstanding claims, and actuarial reserves against outstanding risks in respect of life insurance policies. These reserves are considered to be assets of the policyholders or beneficiaries, including any general government units that are policyholders, and liabilities of the insurance enterprises. Any income received from the investment of insurance technical reserves is also considered to be the property of the policyholders or beneficiaries and is described as property income attributed to insurance policyholders. This type of property income, which is likely to be rare and/or small for general government units, is described in greater detail in paragraphs 6.76 to 6.80 of Chapter 6.

5.91 *Rent* **(1415).** Rent is the property income received from certain leases of land, subsoil assets, and other naturally occurring assets. Other leases of these types of assets, especially leases of the electromagnetic spectrum, may be considered the sale of an intangible nonproduced asset. The terms and conditions governing the classification of leases of naturally occurring assets were still under discussion at the time of publication of this manual. The remainder of this section concerns only those leases classified as rent.

5.92 As with interest, rent accrues continuously to the asset's owner throughout the period of the contract. The rent recorded for a particular accounting period is, therefore, equal to the value of the accumulated rent that becomes payable over the accounting period and may differ from the amount of rent that becomes due for payment or is actually paid during the period.

5.93 General government units may own subsoil assets in the form of deposits of minerals or fossil fuels and may grant leases that permit other units to extract these deposits over a specified period of time in return for a payment or series of payments. These payments

are often described as "royalties," but they are rents that accrue to owners of assets in return for putting the assets at the disposal of other units for specified periods of time. The rents may take the form of periodic payments of fixed amounts, irrespective of the rate of extraction, or, more usually, will be derived according to the quantity, volume, or value of the asset extracted. Enterprises engaged in exploration on government land may make payments to general government units in exchange for the right to undertake test drilling or otherwise investigate the existence and location of subsoil assets. Such payments are also treated as rents even though no extraction may take place.

5.94 Other types of rent include payments for the right to cut timber on noncultivated government land, to exploit bodies of unmanaged water for recreational or commercial purposes, including fishing, to use water for irrigation, and to graze animals on government land.

5.95 Rent should not be confused with severance taxes, business licenses, or other taxes. Severance taxes are imposed on the extraction of minerals and fossil fuels from land owned privately or by another government. If the payment counts toward the taxes on profits, then it should be classified as *taxes on income*, *profits*, *and capital gains* (111). Payments counted toward a tax on the gross value of production should be classified as *other taxes on goods and services* (1146). Payments for a license or permit to conduct extraction operations should be classified as *taxes on use of goods and on permission to use goods or perform activities* (1145).

5.96 Rent should also not be confused with the rental of produced assets, which is treated as *sales of goods and services* (142). The difference in treatment arises because lessors of produced assets are engaged in a production process whereby they provide services to the lessees, such as maintaining inventories of fixed assets available for lease at short notice and repairing and maintaining the leased assets. General government units that own land, subsoil assets, or the electromagnetic spectrum and merely place these assets at the disposal of other units are not considered to be engaged in productive activity. The rentals paid by tenants are treated as payments for the provision of building or housing services.

5.97 A single transaction may comprise both rent and sales of goods and services. Such an event can occur, for instance, when a general government unit,

in a single contract, leases land and buildings situated on the land, and the contract does not separately identify the rent on the land from rental of the buildings. If there is no objective basis on which to apportion the payment between rent on land and rental on the buildings, the whole amount is recorded as a rental if the value of the building is greater than the value of the land and vice versa.

b. Sales of goods and services (142)

5.98 Sales by market establishments (1421). As defined in Chapter 2, an establishment is a part of an enterprise situated in a single location and at which only a single productive activity is carried out or the principal productive activity accounts for most of the value added. A market establishment within a government unit is an establishment that sells or otherwise disposes of all or most of its output at prices that are economically significant. This category consists of the sales of all market establishments that are part of the units for which statistics are being compiled. Because all establishments of public corporations are market establishments, all sales of public corporations are included here. Rentals of produced assets are treated as sales of services and are included in this category. Sales of nonfinancial assets are disposals of nonfinancial assets as described in Chapter 8 and are not sales of goods and services.

5.99 Administrative fees (1422). This item includes fees for compulsory licenses and other administrative fees that are sales of services. Examples are drivers' licenses, passports, court fees, and radio and television licenses when public authorities provide general broadcasting services. For these fees to be considered a sale of a service, the general government unit must exercise some regulatory function for example, checking the competence or qualifications of the person concerned, checking the efficient and safe functioning of the equipment in question, or carrying out some other form of control that it would otherwise not be obliged to do. If a payment is clearly out of all proportion to the cost of providing the service, then the fee is classified as taxes on use of goods and on permission to use goods or perform activities (1145).

5.100 *Incidental sales by nonmarket establishments* (1423). This item covers sales of goods and services by nonmarket establishments of general government units other than administrative fees.

Included are sales incidental to the usual social or community activities of government departments and agencies, such as sales of products made at vocational schools, seeds from experimental farms, postcards and art reproductions by museums, fees at government hospitals and clinics, tuition fees at government schools, and admission fees to government museums, parks, and cultural and recreational facilities that are not organized as public corporations.

5.101 Imputed sales of goods and services (1424).

When a unit produces goods and services for the purpose of using them as compensation of employees in kind, the unit is acting in two capacities: as an employer and as a general producer of goods and services. In order to indicate the total amount paid as compensation of employees, it is necessary to treat the amount paid in kind as if it had been paid in cash as wages and salaries and then the employees had used the cash to purchase the goods and services. This category includes the total value of these imputed sales.

5.102 Sales of goods are recorded when legal ownership changes. If that time cannot be determined precisely, recording may take place when there is a change in physical ownership or control. Transactions in services normally are recorded when the services are provided. Some services are supplied or take place on a continuous basis. For example, operating leasing, and housing services are continuous flows and, in concept, are recorded continuously as long as they are being provided.

c. Fines, penalties, and forfeits (143)

5.103 Fines and penalties are compulsory current transfers imposed on units by courts of law or quasijudicial bodies for violations of laws or administrative rules. Out-of-court agreements are also included. Forfeits are amounts that were deposited with a general government unit pending a legal or administrative proceeding and that have been transferred to the general government unit as part of the resolution of that proceeding.

5.104 Fines and penalties assessed for infringement of regulations identified as relating to a particular tax are recorded together with that tax. Other fines and penalties identifiable as relating to tax offenses are classified as *other taxes* (116).

5.105 Most fines, penalties, and forfeits are determined at a specific time. These transfers are recorded when the general government unit has a legal claim to the funds, which may be when a court renders judgment or an administrative ruling is published, or it may be when a late payment or other infringement automatically causes a fine or penalty.

d. Voluntary transfers other than grants (144)

5.106 This category includes gifts and voluntary donations from individuals, private nonprofit institutions, nongovernmental foundations, corporations, and any other source other than governments and international organizations. *Current voluntary transfers other than grants* (1441) include, for example, contributions to government of food, blankets, and medical supplies for relief purposes. *Capital voluntary transfers other than grants* (1442) include transfers for the construction or purchase of hospitals, schools, museums, theaters, and cultural centers and gifts of land, buildings, or intangible assets such as patents and copyrights. If it is not clear whether the transfer is current or capital, it is classified as current.¹¹

e. Miscellaneous and unidentified revenue (145)

5.107 Included in this category are all revenues that do not fit into any other category. Items that might appear here are sales of used military and other goods that were not classified as assets, sales of scrap, non-life insurance claims against insurance corporations, non-life insurance premiums of government-operated insurance schemes, payments received for damage to government property other than payments from a judicial process, and any revenues for which adequate information is not available to permit their classification elsewhere.

¹¹The identification of capital transfers is necessary to calculate gross and net saving.

6. Expense

This chapter defines the concept of expense and describes the manner in which expense is classified.

A. Classifications of expense

- **6.1** *Expense* is a decrease in net worth resulting from a transaction. Governments have two broad economic responsibilities: to assume responsibility for the provision of selected goods and services to the community on a nonmarket basis and to redistribute income and wealth by means of transfer payments. These responsibilities are largely fulfilled through expense transactions, which are classified in two ways in the GFS system: an economic classification and a functional classification.
- **6.2** When supplying nonmarket goods and services to the community, a government unit may produce the goods and services itself and distribute them, purchase them from a third party and distribute them, or transfer cash to households so they can purchase the goods and services directly. The economic classification identifies the types of expense incurred for these activities. Compensation of employees, use of goods and services, and consumption of fixed capital all relate to the costs of production undertaken by government itself. Subsidies, grants, social benefits, and miscellaneous other expense relate to transfers in cash or in kind and purchases from third parties of goods and services for delivery to other units. The functional classification provides information on the purpose for which an expense was incurred. Examples of functions are education and environmental protection.
- **6.3** The functional classification described in this chapter is not limited to expense transactions. Acquisitions of nonfinancial assets can also be classified using the functional classification. The term "outlays" is used in connection with the functional classification to include these acquisitions of assets

- as well as expense. In addition, the economic and functional classifications can be cross-classified to show the types of transactions engaged in to carry out a given function.
- **6.4** Two types of transactions are treated as expense despite a surface impression that they may increase net worth. First, refunds, recoveries of overpayments and erroneous payments, and similar transactions appear to increase net worth. More accurately, they are adjustments that correct the excessive decrease in net worth previously recorded. As such, these transactions are treated as negative expense. Second, the costs incurred in the production of goods and services are recorded as expense despite the fact that the goods and services may have been sold for a price that exceeded the cost of production, thereby increasing net worth.
- **6.5** The acquisition of a nonfinancial asset by purchase or barter does not affect net worth, and the transaction is not an expense. It is a transaction in nonfinancial assets as described in Chapter 8. When ownership of an asset is given up without receiving anything of value in return, the net worth of the unit has decreased and the expense is recorded as a type of capital transfer, such as a capital grant.
- 6.6 The time at which expense transactions should be recorded is determined according to the accrual basis, which is when the activities, transactions, or other events occur that create the unconditional obligation of general government units to make payments or otherwise give up resources. Complications arise, however, in regard to the acquisition and subsequent use of goods. In concept, the purchase of goods that are not immediately used in some manner is an addition to inventories rather than an expense. When the goods are consumed in production or otherwise utilized, a transaction must be recorded to reduce inventories and increase an expense or other category depending on the use made of the goods.

Other applications of the accrual basis to expense transactions are indicated in each section of the economic classification as necessary.

B. The economic classification of expense

6.7 Table 6.1 shows the economic classification of expense, and the following paragraphs describe each category in detail.

I. Compensation of employees [GFS] (21)2

6.8 Compensation of employees is the total remuneration, in cash or in kind, payable to a government employee in return for work done during the accounting period, except for work connected with ownaccount capital formation. (The same exception applies to each subcategory of compensation of employees.) It includes both wages and salaries (211) and social contributions (212) made on behalf of employees to social insurance schemes. Excluded are amounts payable to contractors, self-employed outworkers, and other workers who are not employees of general government units. Any such amounts are recorded under use of goods and services (22). Compensation of employees engaged in ownaccount capital formation, which is the production of nonfinancial assets for own use, is recorded as the acquisition of nonfinancial assets (see Chapter 8).

6.9 Compensation of employees is measured by the value of the remuneration in cash or in kind an employee becomes entitled to receive from an employer for work done during the relevant period, whether paid in advance, simultaneously, or in arrears of the work itself. To the extent that payment has not been made for work performed, the general government unit must record an entry in accounts payable (see Chapter 7).

a. Wages and salaries [GFS] (211)

6.10 Wages and salaries consist of all compensation of government employees except for *social contributions* (212) by employers. It includes pay in cash or in kind.

Table 6.1: Economic Classification of Expense

	Expense
21	Compensation of employees [GFS]
211	Wages and salaries [GFS]
2111	Wages and salaries in cash [GFS]
2112	Wages and salaries in kind [GFS]
212	Social contributions [GFS]
2121	Actual social contributions [GFS]
2122	Imputed social contributions [GFS]
22	Use of goods and services
23	Consumption of fixed capital [GFS]
24	Interest [GFS]
241	To nonresidents
242	To residents other than general government
243	To other general government units
25	Subsidies
251	To public corporations
2511	To nonfinancial public corporations
2512	To financial public corporations
252	To private enterprises
2521	To nonfinancial private enterprises
2522	To financial private enterprises
26	Grants
261	To foreign governments
2611	Current
2612	Capital
262	To international organizations
2621	Current
2622	Capital
263	To other general government units
2631	Current
2632	Capital
27	Social benefits [GFS]
<u></u> 271	Social security benefits
2711	Social security benefits in cash
2712	Social security benefits in kind
272	Social assistance benefits
2721	Social assistance benefits in cash
2722	Social assistance benefits in kind [GFS]
273	Employer social benefits
2731	Employer social benefits in cash
2732	Employer social benefits in kind
2/32	Other expense
28 I	•
	Property expense other than interest
2811	Dividends (public corporations only)
2812	Withdrawals from income of quasi-corporations
20:2	(public corporations only)
2813	Property expense attributed to insurance
	policyholders [GFS]
2814	Rent
282	Miscellaneous other expense
2821	Current
2822	Capital

¹[GFS] indicates that this item has the same name but different coverage in the 1993 SNA.

²The numbers in parentheses after each classification category are the GFS classification codes. Appendix 4 provides all classification codes used in the GFS system.

Social contributions paid by deduction from employees' wages and salaries are included in this category.

- **6.11** Wages and salaries exclude the reimbursement of expenditures made by employees in order to enable them to take up their jobs or to carry out their work. For example, the reimbursement of travel, removal, or related expenses incurred by employees when they take up new jobs or are required by their employers to move their homes are classified as *use of goods and services* (22) rather than wages and salaries. Also excluded are reimbursements of expenditures by employees on tools, equipment, special clothing, or other items that are needed exclusively or primarily to enable them to carry out their work. The amounts reimbursed are treated as *use of goods and services* (22).
- **6.12** Wages and salaries also exclude social benefits paid by employers in the form of children's, spouse's, family, education, or other allowances in respect of dependents; payments made at full or reduced wage or salary rates to workers absent from work because of illness, accidental injury, or maternity leave; and severance payments to workers, or their survivors, who lose their jobs because of redundancy, incapacity, or accidental death. These social benefits are included in *employer social benefits* (273).
- **6.13** Wages and salaries in cash [GFS] (2111). This category consists of payments in cash to employees in return for services rendered, before deduction of withholding taxes and employees' contributions to social insurance schemes. Included are basic wages and salaries; extra pay for overtime, night work, and weekend work; cost of living allowances, local allowances, and expatriation allowances; bonuses; annual supplementary pay, such as "13th month" pay; allowances for transportation to and from work; holiday pay for official holidays or annual holidays; and housing allowances.
- **6.14** Wages and salaries in kind [GFS] (2112). This category consists of payments in kind to employees in return for services rendered. Examples are meals and drinks, including those consumed when traveling on business; housing services or accommodation of a type that can be used by all members of the household to which the employee belongs; uniforms or other forms of special clothing that employees choose to wear frequently outside of the workplace as well as at work; the services of vehicles or other durables provided for the personal use of employees;

goods and services produced by the employer, such as free travel on government airplanes; sports, recreation, or holiday facilities for employees and their families; transportation to and from work; car parking; and day care for the children of employees. Also included is the value of interest foregone when loans are provided to employees at reduced or zero rates of interest. If goods and services are provided to employees at reduced cost, then only the net cost to the employer is recorded in this category.

b. Social contributions [GFS] (212)

- **6.15** Social contributions are payments, actual or imputed, made by general government units to social insurance schemes to obtain entitlement to social benefits for their employees, including pensions and other retirement benefits. Social benefits are described in the annex to Chapter 2.
- **6.16** Some social contributions are paid directly by the general government unit that is the employer to a second general government unit, usually a social security fund. These transactions are not eliminated in consolidation because they are rerouted, as described in paragraph 3.20 of Chapter 3, first to the employees and then from the employees to the social insurance schemes.
- **6.17** Actual social contributions [GFS] (2121). This category consists of contributions payable to insurance enterprises, social security funds, or other institutional units responsible for the administration and management of social insurance schemes, including general government units operating nonautonomous pension funds.
- **6.18** *Imputed social contributions [GFS]* (2122). Some governments provide social benefits directly to their employees, former employees, or dependents out of their own resources without involving an insurance enterprise or an autonomous or nonautonomous pension fund. In this situation, social contributions equal in value to the amount of social contributions that would be needed to secure the de facto entitlements should be imputed.

2. Use of goods and services (22)

6.19 This category consists of goods and services used for the production of market and nonmarket goods and services—except for own-account capital formation—plus goods purchased for resale less the

net change in inventories of work in progress, finished goods, and goods held for resale.³ General government units may engage in a number of transactions in goods and services that are not classified as use of goods and services. In particular:

- Goods acquired for use as fixed assets or valuables or for use in own-account capital formation are classified as acquisitions of fixed assets or valuables. Expenditures on inexpensive durable goods, such as hand tools, are treated as use of goods and services when such expenditures are made regularly and are small compared with expenditures on machinery and equipment.
- Goods and services acquired to increase inventories of strategic stocks or of materials and supplies are classified as *changes in inventories*, a type of acquisition of nonfinancial assets (see Chapter 8).
- Goods and services used as compensation of employees in kind are classified as compensation of employees (21).
- Goods and services acquired and transferred in kind without being used by the general government unit in a production process are classified as transfer payments, such as *subsidies* (25), *grants* (26), *social benefits* (27), or *other expense* (28), depending on the reason for the transfer.
- Reimbursements by a general government unit for purchases of goods and services by households in connection with social assistance or social insurance schemes are classified as social benefits (27).
- **6.20** Fees and charges collected for goods and services provided by general government units, such as for certain types of social benefits or grants, should be shown as revenue rather than deducted from expense.
- **6.21** The value of goods and services used in production is recorded when the goods or services are actually used rather than when they were acquired. In practice, the two times coincide for inputs of services but not for goods, which may be acquired some time in advance of their use. The value of goods purchased and held for resale is recorded as use of goods and services when they are sold. Sales of goods acquired and held as strategic stocks are recorded as disposals of nonfinan-

cial assets rather than as sales revenue. Therefore, the transaction has no effect on use of goods and services.

- **6.22** In practice, units do not usually record the actual use of goods in production directly. Instead, they keep records of purchases of materials and supplies intended to be used as inputs and also of any changes in the amounts of such goods held in inventory. An estimate of use of goods and services during a given accounting period can then be derived by subtracting the value of changes in inventories of materials and supplies from the value of purchases made.
- **6.23** Goods and services consumed for the maintenance and repair of fixed assets constitute use of goods and services. Major renovations, reconstructions, or enlargements of existing fixed assets are treated as acquisitions of fixed assets. Maintenance and repairs are distinguished by two features: (a) they are activities that owners or users of fixed assets are obliged to undertake periodically in order to be able to utilize such assets over their expected service lives and (b) they do not change the fixed asset or its performance, but simply maintain it in good working order or restore it to its previous condition in the event of a breakdown. In contrast, major improvements to fixed assets are distinguished by the following features: (a) the decision to renovate, reconstruct, or enlarge a fixed asset is a deliberate investment decision that may be undertaken at any time and is not dictated by the condition of the asset and (b) renovations or enlargements increase the performance or capacity of existing fixed assets or significantly extend their previously expected service lives.
- **6.24** Goods and services used for research and development, staff training, market research, and similar activities are treated as use of goods and services rather than acquisitions of intangible fixed assets even though some of them may bring benefits for more than one year.
- **6.25** Materials to produce coins or notes of the national currency or amounts payable to contractors to produce the currency are included as use of goods and services. The issuance of the coins or notes is a financial transaction that does not involve revenue or expense.
- **6.26** Use of goods and services includes purchases of weapons (for example, rockets, missiles, and the associated warheads) and equipment used to deliver those weapons (for example, rocket launchers, warships, submarines, and tanks). Purchases of items that

³Use of goods and services is closely related to intermediate consumption in the *1993 SNA*. The relationship between the two concepts is explained in Appendix 3.

can be used for civilian purposes in the same way as they are used for military purposes, such as military airfields, docks, colleges, hospitals, and office machinery, are treated as acquisitions of fixed assets. Weapons or armored vehicles acquired by police and internal security services, however, are treated as acquisitions of fixed assets even though expenditures on the same kind of equipment by the military would be treated as use of goods and services.

6.27 Depending on the purpose made of them, goods and services purchased by government units and consumed by their employees could be use of goods and services or compensation of employees in kind. In general, when employees are obliged to use the goods or services in order to enable them to carry out their work, that constitutes use of goods and services. On the other hand, when the goods or services are used by employees in their own time and at their own discretion for the direct satisfaction of their needs or wants, that constitutes compensation of employees. The following types of goods and services provided to employees are treated as use of goods and services: (a) tools or equipment used exclusively or mainly at work; (b) clothing or footwear worn exclusively or mainly at work, such as protective clothing, overalls, or uniforms; (c) accommodation services at the place of work that cannot be used by the households to which the employees belong, such as barracks, cabins, dormitories, and huts; (d) special meals or drinks necessitated by exceptional working conditions, and meals or drinks provided to servicemen or others while on active duty; (e) transportation and hotel services provided while the employee is traveling on business; (f) changing facilities, washrooms, showers, and baths necessitated by the nature of the work; and (g) first aid facilities, medical examinations, or other health checks required because of the nature of the work. Employees may sometimes be responsible for purchasing the kinds of goods or services listed above and are subsequently reimbursed by the employer. Such reimbursements are treated as use of goods and services rather than as wages and salaries.

6.28 All transfers of goods and services to other governments or international organizations other than goods and services produced by the donor government unit are treated as *grants* (26). Such grants may entail the transfer of government-owned fixed assets, the transfer of goods held in inventory, the construction of fixed assets, or the purchase and simultaneous transfer of either fixed assets or goods and services for current consumption. Examples are

transfers of food, clothing, blankets, and medicines as emergency aid after natural disasters; transfers of machinery and other equipment; the direct provision of the construction of buildings or other structures; and transfers of military equipment of all types. Goods and services used to produce nonmarket goods and services consumed by other governments and international organizations are included in use of goods and services. An example would be the goods and services acquired so that government employees can conduct relief operations in a foreign country after a natural disaster.

6.29 Use of goods and services includes all goods and services consumed by a general government unit to produce nonmarket goods and services that are distributed either as social benefits in kind or distributed to households in particular circumstances, such as following a natural disaster. Such social benefits can be distributed through social security schemes; social insurance schemes operated for the benefit of government employees, their dependents, or survivors; or social assistance schemes. A common type of social benefit likely to be produced by general government units and distributed in kind is related to health care, such as medical or dental treatments, surgery, hospital accommodation, home care, and similar services. Benefits for government employees and dependents typically include general medical services not related to the employee's work, convalescent and retirement homes, education services, and access to recreation or holiday facilities. Any nominal payments made by the households should be deducted from use of goods and services expense.

6.30 Goods and services that were not produced by the donor government unit, but are distributed as social benefits in kind or distributed to households in particular circumstances, are classified as *social benefits* (27) rather than use of goods and services. Such distributions include transfers of goods held in inventory, the purchase and simultaneous transfer of goods and services from market producers, and the reimbursement of expenditures by households on specified goods or services, such as expenditures on medicines, medical or dental treatments, hospital bills, and optometrists' bills.

6.31 Use of goods and services includes payments for the rental of produced assets, especially buildings, transport equipment, and machinery. Payment for the rent of nonproduced naturally occurring assets, such as land, is classified as *rent* (2814). The

difference in treatment arises because lessors of produced assets are engaged in a production process whereby they provide services to the lessees, such as maintaining inventories of fixed assets available for lease at short notice and repairing and maintaining the leased assets. Owners of land and other nonproduced assets, however, merely place these assets at the disposal of other units. Hence, they are not considered to be engaged in productive activity.

6.32 On occasion, government units engage in transfer payments by purchasing goods and services for prices that greatly exceed their market value. As described in paragraph 3.9 of Chapter 3, when such transactions can be detected, they should be partitioned into a purchase of goods and services at their true market value and a transfer payment of the appropriate category.

3. Consumption of fixed capital [GFS] (23)

6.33 Consumption of fixed capital is the decline during the course of an accounting period in the value of fixed assets owned and used by a general government unit as a result of physical deterioration, normal obsolescence, or normal accidental damage.⁴ It is valued in the average prices of the period. Consumption of fixed capital may deviate considerably from depreciation as recorded in government financial records, which is normally calculated using the original costs of fixed assets.

6.34 Consumption of fixed capital is a forward-looking measure because its value is based on future events rather than past events. The value of a fixed asset is the present discounted value of the stream of rentals that the owner of a fixed asset could expect if it were rented out over the remainder of its service life. The rentals, in turn, depend upon the benefits that units expect to derive from using the asset. Thus, consumption of fixed capital is the decrease in the present value of the remaining sequence of rentals, with the rentals valued at the average prices of the period. The extent of the decrease will be influenced not only by the decrease in the benefits derived from the asset, or its efficiency, during the

current period, but also by the shortening of its service life and the rate at which its efficiency is expected to decline over its remaining service life. Furthermore, changes in the price of the asset must be excluded from consumption of fixed capital. Price changes are recorded as holding gains, as described in Chapter 10.

6.35 Consumption of fixed capital is estimated with respect to all tangible and intangible fixed assets, including infrastructure assets, major improvements to land, and the costs of ownership transfer incurred on the acquisition of valuables and nonproduced assets. Although some fixed assets, such as roads or railway tracks, may appear to have infinite service lives if properly maintained, their value may nevertheless decline because of a decrease in the demand for their services as a result of technical progress and the appearance of substitutes. Many fixed assets are scrapped or demolished only because they have become obsolete. Consequently, consumption of fixed capital must include an allowance for anticipated obsolescence.

6.36 If a general government unit engages in own-account capital formation, then this category of expense does not include the consumption of fixed capital related to the fixed assets used in that production process. As described in the previous sections on compensation of employees and use of goods and services, the costs incurred in own-account capital formation, including consumption of fixed capital, are classified as acquisitions of fixed assets.

6.37 Consumption of fixed capital also excludes the loss of value when fixed assets are destroyed by acts of war, natural disasters, and other exceptional events. Similarly, it excludes losses due to unexpected technological developments that may significantly shorten the service life of an existing fixed asset and the depletion or degradation of nonproduced assets such as land and subsoil assets. These events are treated as other economic flows, as described in Chapter 10.

6.38 To compute consumption of fixed capital, the fixed assets purchased in the past and still in use have to be revalued at the average prices of the current period and assumptions have to be made regarding the remaining service lives of each asset and the rate at which their efficiency is expected to diminish. Linear or geometric patterns of decline, or some combination of them, are the patterns most

⁴The concept of consumption of fixed capital is identical to the concept used in the *1993 SNA*. The coverage of consumption of fixed capital expense may differ from the amount recorded in the production account of the *1993 SNA* because of the GFS treatment of own-account capital formation. When nonfinancial assets are produced on own account, some consumption of fixed capital is recorded in the GFS system as acquisitions of fixed assets rather than expense (see paragraph 6.36). Consumption of fixed capital is described in the *1993 SNA* in paragraphs 6.179 through 6.203.

commonly assumed.⁵ In limited cases, it may be possible to estimate consumption of fixed capital from observations of used asset prices in markets.

4. Interest [GFS] (24)

6.39 Interest is payable by units that incur certain kinds of liabilities, namely deposits, securities other than shares, loans, and accounts payable. These liabilities are created when a general government unit borrows funds from another unit. Interest is the expense that the general government unit (the debtor) incurs for the use of the principal outstanding, which is the economic value that has been provided by the creditor.

6.40 Interest expense accrues continuously over the period that the liability exists. The rate at which interest accrues may be stated as a percentage of the outstanding principal per time period, a predetermined sum of money, a variable sum of money dependent on a defined indicator, or some combination of these methods. Interest normally is not paid until the expense has accrued. That is, if interest on a loan is paid monthly, the amount paid is usually the expense that has accrued during the previous month. Until a payment takes place, the debtor's total liability to the creditor has increased by the amount of interest expense incurred but not paid. What are commonly referred to as interest payments, therefore, are reductions of the debtor's existing liability, part of which was created by the already incurred interest expense.

6.41 This manual recommends that accrued but unpaid interest be added to the principal of the underlying instrument. That is, as interest accrues on a government bond, the principal of the bond would increase. It is recognized, however, that interest accruing on deposits and loans may have to follow national practices and be classified under accounts payable.

6.42 With the exception of index-linked securities, including floating-rate notes, the rate at which interest expense accrues is determined when the contract is established and the funds have been borrowed.⁷ In the simplest case, a sum of money is borrowed, periodic

payments are made equal to the interest expense incurred during the previous period, and at the end of the contract a final interest payment is made together with the original amount borrowed. The amount of interest expense incurred each period is equal to the interest rate stated in the contract multiplied by the amount borrowed. As each period passes, the amount of principal outstanding increases as interest expense is incurred. At the end of the period, the payment reduces the principal to the amount originally borrowed. Unless the end of the accounting period coincides with a periodic payment, the total liability at the end of the period will include some amount of interest incurred but not yet paid.

6.43 Certain financial instruments, such as bills and zero-coupon bonds, are such that the debtor is under no obligation to make any payments to the creditor until the liability matures. In effect, no interest is due for payment until the liability matures, at which point the debtor's liability is discharged by a single payment covering both the amount of the funds originally borrowed and the interest accrued and accumulated over the entire life of the liability. Instruments of this type are said to be discounted because the amount initially borrowed is less than the amount to be repaid. The difference between the amount repaid at the end of the contract and the amount originally borrowed is interest that must be allocated over the accounting periods between the beginning and end of the contract. The interest accruing each period is treated as being paid by the debtor and then borrowed as an additional amount of the same liability. Thus, interest expense and an increase in the liability are recorded each period. When more than one accounting period is involved, there is a number of ways to allocate the total amount of interest among the periods involved. The most common and among the simplest is to assume that the interest rate is constant throughout the contract period.

6.44 A slightly more complicated case consists of a discounted instrument that also requires periodic payments. In such cases, the interest expense is the amount of the money income payable periodically plus the amount of interest accruing each period attributable to the difference between the redemption price and the issue price. Again, the most common assumption is that the interest rate is constant over the entire period of the contract. This interest rate is the one that makes the sum of all future payments equal to the amount initially borrowed when the future payments are discounted by the interest rate.

⁵Organisation for Economic Co-operation and Development, Measuring Capital—OECD Manual: Measurement of Capital Stocks, Consumption of Fixed Capital and Capital Services (Paris, 2001) contains an extensive discussion of the methods for estimating consumption of fixed capital.

⁶Financial assets and their classification are defined in Chapter 7.

⁷An alternative view of the computation of interest is explained in paragraphs 6.48 to 6.50.

- **6.45** In some cases, securities other than shares are issued at a premium rather than a discount. The method of determining the interest expense is identical to the case of a discounted instrument except that the premium (the difference between the redemption price and the issue price) is treated as negative interest expense.
- **6.46** Loans are often structured with periodic payments that incorporate both interest and principal payments. The excess of the periodic payment over the interest accrued reduces the original principal. Over time, the share of the payment allocated to the payment of accrued interest decreases and the share allocated to reducing the original principal increases.
- **6.47** Index-linked securities are financial instruments for which the amounts of the periodic payments and/or the principal outstanding are linked to a price index or an exchange rate index. When the periodic payments are index linked, as with floating-rate notes, the full amounts of such payments are treated as interest. When the value of the principal is index linked, the difference between the eventual redemption price and the issue price is treated as interest accruing over the life of the asset in the same way as for a discounted security whose redemption price is fixed in advance. In practice, the change in the value of the principal outstanding between the beginning and end of a particular accounting period due to the movement in the relevant index may be treated as interest accruing in that period in addition to any interest due for payment in that period. As with discounted instruments, the interest accruing as a result of the indexation is treated as being paid by the debtor and then borrowed as an additional amount of the same liability.
- **6.48** In some cases the value of a liability and the current market interest rate are interrelated. When the future cash flows associated with a financial instrument are fixed, then the market value of the instrument is the sum of the future flows discounted by the current market interest rate. An example is a bond that calls for fixed periodic monetary payments and a final repayment of principal when the bond matures. If the market interest rate increases, then the market value of the bond decreases because the future cash flows are discounted by a larger amount. When the current market interest changes, therefore, a holding gain or loss occurs with respect to many financial assets and liabilities. The change in interest rates also raises the question of how to determine interest expense from that point forward.

- **6.49** There are three general possibilities, which are referred to as the debtor, creditor, and acquisition approaches. The debtor approach assumes that interest expense is determined for the entire life of a financial instrument when it is created, except for changes in index-linked securities. If interest rates change, for example increase, then the market value of the instrument will change, in this case decrease. The decrease in the debtor's liability is treated as a holding gain. If there are no further changes in the interest rate, then over the remaining period of the contract, the market value of the instrument will increase gradually until at maturity it equals the amount the debtor is obligated to pay. These increases in the market value are treated as holding losses. The debtor approach is the one that is generally understood to be embedded in the 1993 SNA and is the approach followed in this manual.
- **6.50** With the creditor approach, it is assumed that future interest expense is recalculated each time there is a change in the interest rate. To use the same example, an increase in the interest rate leads to a decrease in the market value of the instrument and there has been a holding gain for the debtor. At this point, the instrument is treated as a new instrument that was issued at a discount. If there are no further changes in the interest rate, then the gradual increases in the market value of the instrument over the remaining period will be treated as interest expense. The acquisition approach is the same as the debtor approach except that changes in the interest rate are acknowledged when there is a change in the ownership of the instrument, usually from trading in a secondary market.
- **6.51** The interest expense payable to financial intermediaries recorded in this manual differs from the amount recorded in 1993 SNA. A financial intermediary sets its interest rates for depositors and borrowers at levels that will provide a margin large enough to defray the costs of providing its services to its depositors and borrowers without explicit fees. In concept, the value of the services provided by financial intermediaries to a borrowing general government unit should be treated as a use of goods and services expense. To accomplish this treatment, the actual interest expense payable to financial intermediaries would need to be decreased by the value of the services. The value of the financial services, however, can be estimated only indirectly by compilers of the national accounts because data for all depositors and borrowers of financial intermediaries are required. Thus, in this manual, no adjustment is made for financial services indirectly measured.

6.52 Government units may make interest payments on loans and other interest-bearing liabilities of other units for which they act as guarantors. These payments should not be classified as interest until the government unit has assumed the debt. If the government unit has not assumed the debt, then two transactions are possible. First, if the government unit does not receive a financial claim on the other unit or receives a financial claim that is not likely to be paid, then the transaction should be recorded as a *subsidy* (25) if the other unit is a corporation, as a grant (26) if the other unit is another general government unit, or as other expense (28) if the other unit is a household or a nonprofit institution serving households. If the government unit receives a financial claim on the other unit for the amount paid and the claim is likely to be paid, then the transaction should be recorded by the government unit as an acquisition of a financial asset. 8

6.53 In the *1993 SNA* as originally published, payments related to certain derivatives were treated as interest expense. Subsequently, the *1993 SNA* was amended so that no payments related to derivatives are considered to be interest. This manual follows that amendment.⁹

6.54 As noted in Chapter 5, interest assessed on the late payment of taxes or that is otherwise related to an infringement of tax regulations is treated as tax revenue by the receiving government unit. If this interest is paid by a general government unit, then it is classified as a tax payment, a component of *miscellaneous other expense* (282).

6.55 Total interest payable is subdivided into *interest* payable to nonresidents (241), interest payable to residents other than general government (242), and interest payable to other general government units (243). Interest payable to other general government units is required only when statistics are compiled for a subsector of the general government sector. Otherwise all such transactions are eliminated in consolidation.

5. Subsidies (25)

6.56 Subsidies are current unrequited payments that government units make to enterprises on the basis of the levels of their production activities or the quantities or values of the goods or services they produce, sell,

export, or import. Subsidies may be designed to influence levels of production, the prices at which outputs are sold, or the remuneration of the enterprises.

6.57 Subsidies are payable to producers only, not to final consumers, and are current transfers only, not capital transfers. Transfers that government units make directly to households as consumers and most transfers to nonprofit institutions serving households are treated as either *social benefits* (27) or *miscellaneous other expense* (282) depending on the reason for the payment. Most transfers made to general government units are included in *grants* (26). Payments to enterprises to finance their capital formation, to compensate them for damage to nonfinancial assets, or to cover large operating deficits accumulated over two or more years are *miscellaneous other capital expense* (2822).

6.58 Subsidies can be payable on specific products or on production in general. A subsidy on a product is a subsidy payable per unit of a good or service. The subsidy may be a specific amount of money per unit of quantity of a good or service, or it may be calculated ad valorem as a specified percentage of the price per unit. A subsidy may also be calculated as the difference between a specified target price and the market price actually paid by a buyer. A subsidy on a product usually becomes payable when the good or service is produced, sold, exported, or imported, but it may also be payable in other circumstances, such as when a good is transferred, leased, delivered, or used for own consumption or own capital formation.

6.59 Subsidies on production consist of subsidies that enterprises receive as a consequence of engaging in production but that are not related to specific products. Included are subsidies on payroll or workforce, which are payable on the total wage or salary bill, the size of the total workforce, or the employment of particular types of persons; subsidies to reduce pollution; and payments of interest on behalf of corporations.

6.60 Subsidies also include transfers to public corporations and quasi-corporations to compensate for losses they incur on their productive activities as a result of charging prices that are lower than their

⁸Additional information on debt operations is provided in Appendix 2. ⁹International Monetary Fund, *The New International Standards for the Statistical Measurement of Financial Derivatives: Changes to the Text of the 1993 SNA* (Washington, 2000).

¹⁰In rare cases payments to general government units and nonprofit institutions serving households can be classified as subsidies. The payments must depend on general regulations applicable to all producers, nonmarket as well as market. For example, a government may pay a subsidy to all employers that employ members of a specified profession or people with a specified disability.

average costs of production as a matter of deliberate government economic and social policy. If such losses have been accumulated over two or more years, the payments are classified as *miscellaneous* other capital expense (2822).

6.61 Subsidies are classified first by whether the recipient is a public or private producer and then by whether the producer is a nonfinancial or financial enterprise. The four possibilities are public nonfinancial corporations (2511), public financial corporations (2512), private nonfinancial enterprises (2521), and private financial enterprises (2522).

6. Grants (26)

6.62 Grants are noncompulsory current or capital transfers from one government unit to another government unit or an international organization. Grants are classified first by the type of unit receiving the grant and then by whether the grant is current or capital.

6.63 Three types of recipients of grants are recognized in the GFS system: grants to foreign governments (261), grants to international organizations (262), and grants to other general government units (263). The category of grants to other general government units is required only when statistics are compiled for a subsector of the general government sector. Otherwise these transactions are eliminated in consolidation.

6.64 Current grants are those made for purposes of current expense and are not linked to or conditional on the acquisition of an asset by the recipient. Capital grants involve the acquisition of assets by the recipient and may consist of a transfer of cash that the recipient is expected or required to use to acquire an asset or assets (other than inventories), the transfer of an asset (other than inventories and cash), the cancellation of a liability by mutual agreement between the creditor and debtor, or the assumption of another unit's debt. ¹² If doubt exists regarding the character of a grant, it should be classified as current. ¹³

6.65 Grants in kind should be valued at current market prices. If market prices are not available, then the

value should be the explicit costs incurred in providing the resources or the amounts that would be received if the resources were sold.

6.66 Grants are recorded when all requirements and conditions for receiving them are satisfied and the donor unit has an unconditional obligation. Determining this time can be complex because there is a wide variety of eligibility conditions that have varying legal powers. In some cases, a potential grant recipient has a legal claim when it has satisfied certain conditions, such as the prior incurrence of expenses for a specific purpose or the passage of legislation. In many cases, the grant recipient never has a claim on the donor and the grant should be attributed to the time at which the payment is made.

7. Social benefits [GFS] (27)

6.67 Social benefits are defined in the annex to Chapter 2 as transfers in cash or in kind to protect the entire population or specific segments of it against certain social risks. A social risk is an event or circumstance that may adversely affect the welfare of the households concerned either by imposing additional demands on their resources or by reducing their incomes. Examples of social benefits are the provision of medical services, unemployment compensation, and social security pensions. They are classified according to the type of scheme governing their payment, which are social security, social assistance, and employer social insurance schemes.

6.68 Not all social benefits as defined in the annex to Chapter 2 are treated as expense. The payment of pensions and other retirement benefits through employer social insurance schemes are treated as reductions in liabilities. ¹⁴ Social benefits produced by a general government unit and transferred to households are expense transactions but are not classified as social benefits. Instead, the expenses of producing them are part of compensation of employees, use of goods and services, and consumption of fixed capital. ¹⁵ All social benefits are current transfers; none are capital transfers.

¹¹See footnote 10 for an exception.

¹²Appendix 2 provides details on debt cancellation, debt assumption, and other government debt operations.

¹³The identification of capital grants is necessary to calculate gross and net saving.

¹⁴In the *1993 SNA*, payments of retirement benefits by autonomous and nonautonomous pension funds are treated as transfer payments as well as reductions in liabilities. An adjustment entry is made to remove the double counting of the payment. Payments by unfunded retirement schemes are only transfer payments.

¹⁵In the *1993 SNA*, when a general government unit produces goods and services that are distributed as social benefits, the costs of producing them, such as compensation of employees, are classified in the same way as in this manual. In addition, the value of the goods and services produced is included as social benefits.

6.69 Social security benefits (271) are social benefits payable in cash or in kind to households by social security schemes. Typical social security benefits in cash include sickness and invalidity benefits, maternity allowances, children's or family allowances, unemployment benefits, retirement and survivors' pensions, and death benefits.

6.70 Social security benefits in kind consist of goods and services purchased from a market producer on behalf of households and reimbursements of benefits purchased by households in accordance with the rules of the scheme. These benefits are likely to consist of medical or dental treatments, surgery, hospital accommodation, spectacles or contact lenses, pharmaceutical products, home care, and similar goods or services.

6.71 Social assistance benefits (272) are transfers payable to households to meet the same needs as social insurance benefits but which are not made under a social insurance scheme. Social assistance benefits may be payable when no social insurance scheme exists to cover the circumstances in question, certain households do not participate in existing social insurance schemes, or social insurance benefits are deemed inadequate to meet particular needs. Social assistance benefits do not include transfers made in response to events or circumstances that are not normally covered by social insurance schemes, such as natural disasters. Such transfers are recorded under miscellaneous other expense (282). Social assistance benefits in kind consist of transfers to households similar in nature to social security benefits in kind and provided under the same circumstances as social assistance benefits.

6.72 Employer social benefits (273) are social benefits payable in cash or in kind by government units to their employees or employees of other government units participating in the scheme (or to survivors and dependents of the employees who are eligible for such payments). The kinds of benefits provided are similar to those listed for social security schemes, such as the continued payment of wages during periods of absence from work as a result of ill health, accidents, maternity, etc.; family, education, or other allowances; severance allowances in the event of redundancy, incapacity, or accidental death; general medical expenses not related to the employees' work; and charges for convalescent and retirement homes. Outlays on pensions and other retirement benefits are reductions in liabilities, not social benefits expense.

8. Other expense (28)

a. Property expense other than interest (281)

6.73 Property expense is the expense payable by a general government unit to the owner of a financial asset or a tangible nonproduced asset when the general government unit makes use of such an asset. One type of property expense is interest, which is classified in category 24. Property expense other than interest may take the form of dividends, withdrawals from income of quasi-corporations, property expense attributed to insurance policyholders, or rent. ¹⁶ Dividends and withdrawals from income of quasi-corporations apply only to public corporations.

6.74 *Dividends* (2811). Because public corporations receive equity funds from general government units and possibly other units, they may pay dividends to those units. Such payments are not required; the board of directors or other managers of the corporation must declare a dividend payable on their own volition. Distributions of profits by public corporations may take place irregularly and may not be explicitly labeled as dividends. Nevertheless, except for distributions by fiscal, export, or import monopolies, dividends include all distributions of profits by public corporations to their shareholders or owners.¹⁷ Dividends are recorded either on the date they are declared payable or, if no prior declaration occurs, on the date the payment is made. Large and exceptional one-off payments based on accumulated reserves, privatization receipts and other sales of assets, or holding gains are withdrawals of equity rather than dividends. See paragraphs 5.85 to 5.87 of Chapter 5.

6.75 Withdrawals from income of quasi-corporations (2812). By definition, quasi-corporations cannot

¹⁶In the *1993 SNA*, reinvested earnings on direct foreign investment is a type of property expense that conceivably could apply to a public corporation. Briefly, a direct foreign investment enterprise is a public corporation in which at least one foreign investor owns sufficient shares to have an effective voice in its management. An increase in retained earnings of a direct foreign investment enterprise is treated as if it were remitted as a form of property expense to the foreign direct investors in proportion to their ownership of the equity of the enterprise and then reinvested in additional equity. The imputed remittance of these retained earnings is treated as property expense in the 1993 SNA but not in the GFS system. Such an increase in the value of the equity held by a direct foreign investor is accounted for as a holding gain in the same way as it is for other equities (see Chapter 10). This different treatment causes net lending/borrowing in the two systems to differ. Reinvested earnings on direct foreign investment are described in paragraphs 7.119 to 7.122 of the 1993 SNA.

¹⁷Distributions of profits by fiscal, export, and import monopolies are treated as taxes, classified as *miscellaneous other expense* (282).

distribute income in the form of dividends, but the owner may choose to withdraw some or all of the income. Conceptually, the withdrawal of such income is equivalent to the distribution of corporate income through dividends and is treated in the same way. The amount of income that the owner of a quasi-corporation chooses to withdraw will depend largely on the size of its net income. All such withdrawals are recorded on the date the payment actually occurs. As with dividends, withdrawals from income of quasi-corporations do not include withdrawals of funds realized by the sale or other disposal of assets. See paragraphs 5.88 and 5.89 of Chapter 5.

6.76 Property expense attributed to insurance policyholders [GFS] (2813). Public corporations can be insurance enterprises, in which case they will hold technical reserves in the form of reserves against outstanding risks in respect of life insurance policies, including reserves for with-profit policies that add to the value on maturity of with-profit endowments or similar policies; prepayments of premiums; and reserves against outstanding claims. The reserves are considered to be assets of the policyholders or beneficiaries and liabilities of the insurance enterprises. In general, any income received from the investment of insurance technical reserves is also considered to belong to the policyholders or beneficiaries and therefore a property expense is recorded to reflect the increase in liabilities.

6.77 General government units are less likely to operate an insurance scheme, but if they do and if they maintain separate reserves, the property expense attributed to insurance policyholders would be recorded in the same manner as for a public corporation. If the general government unit does not maintain separate reserves, then no property expense is recorded. A change in the amount of the liability would be recorded as a revaluation.

6.78 Retirement schemes for government employees and their dependents and other beneficiaries are treated differently. ¹⁸ There are three types of employer retirement schemes: autonomous pension funds, nonautonomous pension funds, and unfunded retirement schemes. Autonomous and nonautonomous pension funds hold reserves dedicated to the payment of pensions and other retirement benefits to the employees of general government units and their dependents

or other beneficiaries. Both types of funds have liabilities equal to the present value of the promised benefits. An unfunded retirement scheme does not hold reserves dedicated to the payment of benefits, but the general government unit operating the scheme does have a liability equal to the present value of the promised benefits, just as with autonomous and nonautonomous pension funds. The property expense attributed to insurance policyholders for all three types of schemes is a component of the change in the scheme's liability.

6.79 There are two basic types of retirement schemes: defined benefit and defined contribution.¹⁹ With a defined-benefit scheme, the future retirement benefits are defined by some formula normally related to participants' length of service and salary. The nominal values of the retirement benefits to be paid in the future are determined actuarially based on estimates of variables such as expected retirement ages, mortality rates, expected inflation, and expected salary increases. The nominal values can then be converted to present values using an appropriate discount rate. Over time, the total liability of the pension scheme will change because of the receipt of additional contributions, the payment of benefits, changes in the actuarial assumptions, and the passage of time. The property expense attributed to insurance policyholders is equal to the increase in the liability resulting from the passage of time, which occurs because the future benefits are discounted over fewer accounting periods.

6.80 With defined-contribution schemes, the level of contributions to the fund, rather than the level of benefits, is guaranteed by the employer. All defined-contribution schemes are funded, and the liability of a defined-contribution scheme is equal to the current market value of the fund's assets. Therefore, the property expense attributed to insurance policyholders is just the property income received from the investment of the fund's assets. Any holding gains received on the fund's assets are recorded as equal-valued holding losses for the unit's liability to the beneficiaries.

6.81 *Rent* (2814). Rent is the expense incurred in connection with certain leases of land, subsoil assets, and other naturally occurring assets. Other leases of these types of assets, notably leases of the

¹⁸Because no liabilities are recorded for pensions paid by social security schemes, no property expense is attributed to insurance policyholders.

¹⁹Defined-contribution schemes are also known as money-purchase

electromagnetic spectrum, may be considered to be intangible nonproduced assets. The terms and conditions governing the classification of leases of naturally occurring assets were still under discussion at the time of publication of this manual. The remainder of this section concerns only those leases classified as rent.

- **6.82** Rent accrues continuously to the asset's owner throughout the period of the contract. The rent recorded for a particular accounting period is, therefore, equal to the value of the accumulated rent that becomes payable over the accounting period and may differ from the amount of rent that becomes due for payment or is actually paid during the period.
- 6.83 Payments for the extraction of minerals or fossil fuels are often described as royalties but are actually rents that accrue to owners of assets in return for putting the assets at the disposal of general government units for specified periods of time. The rents may take the form of periodic payments of fixed amounts, irrespective of the rate of extraction, or, more usually, will be derived according to the quantity, volume, or value of the asset extracted. Payments in exchange for the right to undertake test drilling or otherwise investigate the existence and location of subsoil assets are also treated as rents even though no extraction may take place. The actual outlays on drilling and other exploration are treated as the acquisition of a nonfinancial asset, as described in Chapter 8.
- **6.84** Other types of rent include payments for the right to cut timber on noncultivated land, to exploit bodies of unmanaged water for recreational or commercial purposes, including fishing, to use water for irrigation, and to graze animals on land owned by other units.
- **6.85** Rent should not be confused with the rental of produced assets, which is treated as *use of goods and services* (22). The difference in treatment arises because lessors of produced assets are engaged in a production process whereby they provide services to the lessees, such as maintaining inventories of fixed assets available for lease at short notice and repairing and maintaining the leased assets. In particular, the rentals paid by general government units as tenants are treated as payments for the provision of building or housing services. Units that own land or subsoil assets and merely place these assets at the disposal of general government units are not considered to be engaged in productive activity.

6.86 A single transaction may comprise both rent and use of goods and services. Such an event can occur, for instance, when a general government unit, in a single contract, leases land and buildings situated on the land, and the contract does not separately identify the rent of the land from rental of the buildings. If there is no objective basis on which to apportion the payment between rent on land and rental on the buildings, the whole amount is recorded as a rental if the value of the building is greater than the value of the land and vice versa.

b. Miscellaneous other expense (282)

- **6.87** Miscellaneous other expense includes a number of transfers serving quite different purposes and any other expense transaction not elsewhere classified. The most important types of transfers in this category follow:
- Current transfers to nonprofit institutions serving households. These transfers usually consist of cash in the form of membership dues, subscriptions, and voluntary donations, whether made on a regular or occasional basis. Such transfers are intended to cover the costs of the production of nonprofit institutions serving households or to provide the funds out of which current transfers may be made to households in the form of social assistance benefits. This category also covers transfers in kind in the form of food, clothing, blankets, and medicines to charities for distribution to households.
- Current and capital taxes, compulsory fees, and fines imposed by one level of government on another level. These transfers are subject to elimination by consolidation.
- Net tax credits. When the amount of a tax credit exceeds the amount of tax otherwise receivable from a taxpayer and the excess is paid to the taxpayer, the net payment is treated as expense rather than negative tax.
- Fines and penalties imposed by courts of law or quasi-judicial bodies. These transfers can be payable to any sector.
- Payments of compensation for injuries or damages caused by natural disasters.
- Payments of compensation for injury to persons or damage to property caused by general government units, excluding payments of non-life insurance claims. These payments can be either compulsory

payments awarded by courts of law or ex gratia payments agreed out of court.

- Scholarships and other educational benefits.
- Capital transfers to market enterprises and nonprofit institutions serving households in cash or in kind to finance all or part of the costs of acquiring nonfinancial assets, to cover large operating deficits accumulated over two or more years, to cancel a debt by mutual agreement with the debtor, or to assume a debt.
- Non-life insurance premiums payable to insurance corporations to obtain cover against various events or accidents. Such payments are always treated as current transfers.²⁰
- Non-life insurance claims payable by insurance schemes operated by a general government unit in settlement of claims that become due during the current accounting period. Claims become due when the eventuality occurs that gives rise to a valid claim. Such payments are always treated as current transfers, even when large sums are involved.
- Purchases of goods and services from market producers that are distributed directly to households for final consumption other than social benefits.

6.88 Other expense is subdivided into *miscellaneous other current expense* (2821) and *miscellaneous other capital expense* (2822). It may be of analytic interest to classify this group of transactions according to their recipients, such as residents and nonresidents. Among residents, it may also be of interest to classify them according to whether they are households, nonprofit institutions serving households, public nonfinancial corporations, public financial corporations, or private corporations.

C. The functional classification of expense

6.89 The Classification of Functions of Government (COFOG) is a detailed classification of the functions, or socioeconomic objectives, that general government units aim to achieve through various kinds of

outlays. It is one of a family of four classifications referred to as classifications of expenditure according to purpose.²¹

6.90 COFOG provides a classification pertaining to outlays by governments on functions that experience has shown to be of general interest and amenable to a wide variety of analytic applications. Statistics on health, education, social protection, and environmental protection, for example, can be used to study the effectiveness of government programs in those areas.

6.91 The classification codes of COFOG are somewhat different from the structure of other GFS classification codes. The functions are classified using a three-level scheme. There are 10 first-level, or twodigit, categories, referred to as divisions. Examples are health (Division 07) and social protection (Division 10). Within each division, there are several groups, or three-digit categories, such as hospital services (073) and sickness and disability (101). Within each group, there are one or more classes, or four-digit categories, such as nursing and convalescent home services (0734) and disability (1012). All three classification levels and detailed descriptions of the contents of each class are reproduced in the annex to this chapter. Table 6.2 lists the divisions and groups. In this manual, the prefix "7" has been added to align the COFOG codes with other GFS classification codes.

6.92 All outlays for a particular function are collected in one category of COFOG regardless of how the outlays are implemented. That is, cash transfer payments designed to be used for a particular function, the purchase of goods and services from a market producer that are transferred to households for the same function, the production of goods and services by a general government unit, or the acquisition of an asset for that same function are all in the same category.

6.93 COFOG permits trends in government outlays on particular functions or purposes to be examined over time. Conventional government accounts are not usually suitable for this purpose because they reflect the organizational structures of governments. Not only might time series be distorted by organizational changes, but at a specific time some organizations may be responsible for more than one function,

²⁰ In the *1993 SNA*, payments of non-life insurance premiums are partitioned into a purchase of a service and a transfer payment. In the GFS system, the entire premium is considered a transfer payment.

²¹COFOG was produced by the Organisation for Economic Co-operation and Development and was published together with the other three classifications in United Nations, *Classifications of Expenditure According to Purpose* (New York, 2000). Material in this section is adapted from that publication.

Table 6.2: Classification of Expense by Function of Government

7	Total outlays	706	Housing and community amenities			
70 I	General public services	7061	Housing development			
7011	Executive and legislative organs, financial and fiscal	7062	Community development			
	affairs, external affairs	7063	Water supply			
7012	Foreign economic aid	7064	Street lighting			
7013	General services	7065	0 0			
7014	Basic research	7066	Housing and community amenities n.e.c.			
7015	R&D ¹ General public services	707	Health			
7016	General public services n.e.c. ²	707 I	Medical products, appliances, and equipment			
7017	Public debt transactions	7072	Outpatient services			
7018	Transfers of a general character between different	7073	Hospital services			
	levels of government	7074	Public health services			
702	Defense	7075	R&D Health			
702 I	Military defense	7076	Health n.e.c.			
7022	Civil defense	708	Recreation, culture, and religion			
7023	Foreign military aid	7081	Recreational and sporting services			
7024	R&D Defense	7082	Cultural services			
7025	Defense n.e.c.	7083	Broadcasting and publishing services			
703	Public order and safety	7084	Religious and other community services			
703 I	Police services	7085	R&D Recreation, culture, and religion			
7032	Fire protection services	7086	Recreation, culture, and religion n.e.c.			
7033	Law courts	709	Education			
7034	Prisons	7091	Pre-primary and primary education			
7035	R&D Public order and safety	7092	Secondary education			
7036	Public order and safety n.e.c.	7093	Postsecondary nontertiary education			
704	Economic affairs	7094	Tertiary education			
704 I	General economic, commercial, and labor affairs	7095	Education not definable by level			
7042	Agriculture, forestry, fishing, and hunting	7096	Subsidiary services to education			
7043	Fuel and energy	7097	R&D Education			
7044	Mining, manufacturing, and construction	7098	Education n.e.c.			
7045	Transport	710	Social protection			
7046	Communication	7101	Sickness and disability			
7047	Other industries	7102	Old age			
7048	R&D Economic affairs	7103	Survivors			
7049	Economic affairs n.e.c.	7104	Family and children			
705	Environmental protection	7105	Unemployment			
705 I	Waste management	7106	Housing			
7052	Waste water management	7107	Social exclusion n.e.c.			
7053	Pollution abatement	7108	R&D Social protection			
7054	Protection of biodiversity and landscape	7109	Social protection n.e.c.			
7055	R&D Environmental protection		·			
7056	Environmental protection n.e.c.					

¹R&D = Research and development. ²n.e.c. = not elsewhere classified.

and responsibility for one function might be divided among several organizations. For example, if a government establishes a new department that brings together some of the functions previously administered by several departments or at several levels of government, it will not usually be possible to use conventional government accounts to compare outlays on these purposes over time.

6.94 COFOG is also used for making international comparisons of the extent to which governments are involved in economic and social functions. Just

as COFOG avoids the problems of organizational changes in a single government, so too does it avoid the problems of organizational differences among countries. In one country, for example, all functions connected with water supply may be undertaken by a single government agency, while in another country they may be distributed among departments dealing with the environment, housing, and industrial development.

6.95 Government services can benefit the community either individually or collectively. COFOG is

used to distinguish between the individual and collective services provided by general government. The COFOG functions are defined so that they represent individual or collective consumption, but not both. In the annex, each class is marked "CS" or "IS" to designate it as collective services or individual services, respectively. Purchases of goods and services that are transferred to individual households or persons are treated as social transfers in kind in the 1993 SNA so that the actual final consumption of government and households, in addition to their final consumption expenditure, can be computed. Thus statistics compiled by function will be useful for compiling national accounts according to the 1993 SNA.

6.96 The items classified should be, in principle, individual transactions. Each purchase of goods and services, wage payment, transfer, or other outlay should be assigned a COFOG code according to the function that the transaction serves. For most outlays, however, it will generally not be possible to use transactions as the classification items. Instead, COFOG codes may have to be assigned to all transactions of agencies, offices, program units, bureaus, and similar units within government departments or ministries.

6.97 When government bodies rather than transactions are used for classification, it may happen that the smallest bodies that can be identified in the government accounts may perform more than one COFOG function. If possible, the outlays of multifunction bodies should be allocated among COFOG functions using a relevant physical indicator, such as hours worked by employees. It may be possible only to assign all outlays by multifunction units to whichever purpose appears to account for the largest part of total outlays.

6.98 A single classification cannot serve all analytic purposes. The selection of functions in COFOG is not unique. The scope of each function could be broader or narrower, and completely different functions could have been included. For example, outlays for medical schools are classified in COFOG as education rather than health. Also, research and development could be a function of its own, but in COFOG research and development outlays are classified according to the function the goal of the research and development most closely serves. Thus, COFOG statistics must be used with care to be sure that the desired coverage is obtained for a specific analytic purpose.

6.99 Government ministries generally are responsible for the formulation, administration, coordination, and monitoring of overall policies, plans, programs, and budgets; for the preparation and enforcement of legislation; and for the production and dissemination of general information, technical documentation, and statistics. Consequently, the outlays of these ministries have to be shared across the classes for which they are responsible. For example, the outlays of a ministry of transport should be divided between *road transport* (70451), *water transport* (70452), *railway transport* (70453), *air transport* (70454), and *pipeline and other transport* (70455).

6.100 Administrative outlays on general services, such as personnel services, supply and purchasing services, accounting and auditing services, and computer and data processing services, undertaken by ministries or units within ministries should be classified at the most detailed level possible. If administrative outlays overlap two or more classes, an attempt should be made to apportion outlays between the classes concerned. If this approach is not feasible, the total should be allocated to that class that accounts for the largest part of the total outlay.

6.101 Particular difficulties may arise with regard to subsidies. The main objective behind such government support may be, for example, to assure capacity to build naval vessels considered vital to national defense, to maintain living standards of important groups such as farmers or miners, or to provide employment for workers in underutilized hospitals. These political objectives are not to be confused with functions as the term is used in COFOG. Hence a government subsidy to shipyards is classified under manufacturing (70442); and grants to hospitals are classified under hospital services (7073) regardless of the ultimate purposes. Subsidies and grants designed chiefly to increase employment opportunities in general are an exception to this rule. As such programs do not focus on any single industry, they are classified under general labor affairs (70412).

6.102 It is likely that consumption of fixed capital will be difficult to allocate by function, especially if only aggregated figures for total government capital stock and consumption of fixed capital are compiled. In these circumstances, approximations will have to be used. One possibility may be to distribute consumption of fixed capital according to

book value depreciation, if it is available for detailed organizational units within government. Another approach would be to distribute consumption of fixed capital among functions in proportion to gross fixed capital formation over a number of earlier years.

6.103 A final caution regarding the use of COFOG statistics relates to outlays for nonfinancial assets. Because expense transactions classified by COFOG include consumption of fixed capital, which represents part of the resource cost of using previously acquired fixed assets, there is an overlap between the COFOG statistics for the current period and COFOG statistics for the periods in

which the assets were acquired. Thus, COFOG statistics should be cross-classified at least with total expense and acquisitions of nonfinancial assets. A cross-classification of COFOG with all categories of the economic classification of expense would be even more beneficial (see Table 6.3).

D. Cross-classification of expense

6.104 The economic and functional classifications of expense can be cross-classified as illustrated in Table 6.3. The table includes a column for acquisitions of nonfinancial assets in addition to columns for each type of expense.

Table 6.3: Cross-Classification of Functional and Economic Classifications of Expense

	Compensation of employees [GFS]	Use of goods and services	Consumption of fixed capital [GFS]	Interest [GFS]	Subsidies	Grants	Social benefits [GFS]	Other expense	Acquisition of nonfinancial assets
General public services									
Defense									
Public order and safety									
Economic affairs									
Environmental protection									
Housing and community amenities									
Health									
Recreation, culture, and religion									
Education									
Social protection									

Annex to Chapter 6: Classification of the Functions of Government

The Classification of the Functions of Government (COFOG) was developed by the Organization for Economic Co-operation and Development and published by the United Nations Statistical Division. It can be applied to government expense and the net acquisition of nonfinancial assets. COFOG has three levels of detail: Divisions, Groups, and Classes. The Divisions could be seen as the broad objectives of government, while the Groups and Classes detail the means by which these broad objectives are achieved. For further information on COFOG, see Classifications of Expenditure According to Purpose (United Nations, Department of Economic and Social Affairs, Statistics Division, Statistical Papers, Series M, No. 84, New York, 2000). The initials "CS" or "IS" follow the title of each Class in parentheses to indicate whether the services produced by general government units and included in this Class are collective or individual services. This distinction is used for the computation of final consumption expenditure and actual final consumption in the national accounts, as described in Appendix 3. The classification numbers have been modified slightly to conform with the coding system of this manual. The numeral "7" is prefixed to all codes and the punctuation separating Divisions, Groups, and Classes are deleted.

701 GENERAL PUBLIC SERVICES

7011 EXECUTIVE AND LEGISLATIVE ORGANS, FINANCIAL AND FISCAL AFFAIRS, EXTERNAL AFFAIRS

70111 Executive and legislative organs (CS)

- Administration, operation or support of executive and legislative organs.

Includes: office of the chief executive at all levels of government - office of the monarch, governor-general, president, prime minister, governor, mayor, etc.; legislative bodies at all levels of government -parliaments, chambers of deputies, senates, assemblies, town councils, etc.; advisory, administrative and political staffs attached to chief executive offices and legislatures; libraries and other reference services serving mainly executive and legislative organs; physical amenities provided to the chief executive, the legislature and their aides; permanent or ad hoc commissions and committees created by or acting on behalf of the chief executive or legislature.

Excludes: ministerial offices, offices of heads of departments of local governments, interdepartmental committees, etc. concerned with a specific function (classified according to function).

70112 Financial and fiscal affairs (CS)

- Administration of financial and fiscal affairs and services; management of public funds and public debt; operation of taxation schemes;
- operation of the treasury or ministry of finance, the budget office, the inland revenue agency, the customs authorities, the accounting and auditing services;
- production and dissemination of general information, technical documentation and statistics on financial and fiscal affairs and services.

Includes: financial and fiscal affairs and services at all levels of government.

Excludes: underwriting or flotation charges and interest payments on government loans (70170); supervision of the banking industry (70411).

70113 External affairs (CS)

- Administration of external affairs and services;
- operation of the ministry of external affairs and diplomatic and consular missions stationed abroad
 or at offices of international organizations; operation or support of information and cultural services for distribution beyond national boundaries; operation or support of libraries, reading rooms
 and reference services located abroad;
- regular subscriptions and special contributions to meet general operating expenses of international organizations.

Excludes: economic aid to developing countries and countries in transition (70121); economic aid missions accredited to foreign governments (70121); contributions to aid programs administered by international or regional organizations (70122); military units stationed abroad (70210); military aid to foreign countries (70230); general foreign economic and commercial affairs (70411); tourism affairs and services (70473).

7012 FOREIGN ECONOMIC AID

70121 Economic aid to developing countries and countries in transition (CS)

- Administration of economic cooperation with developing countries and countries in transition;
- operation of economic aid missions accredited to foreign governments; operation or support of technical assistance programs, training programs and fellowship and scholarship schemes;
- economic aid in the form of grants (in cash or in kind) or loans (regardless of interest charged).

Excludes: contributions to economic development funds administered by international or regional organizations (70122); military aid to foreign countries (70230).

70122 Economic aid routed through international organizations (CS)

- Administration of economic aid routed through international organizations;
- contributions in cash or in kind to economic development funds administered by international, regional or other multinational organizations.

Excludes: aid to international peacekeeping operations (70230).

7013 GENERAL SERVICES

This group covers services that are not connected with a specific function and which are usually undertaken by central offices at the various levels of government. It also covers those services connected with a particular function that are undertaken by such central offices. For example, the compilation of industry, environment, health or education statistics by a central statistical agency is included here.

70131 General personnel services (CS)

Administration and operation of general personnel services, including development and implementation of general personnel policies and procedures covering selection, promotion, rating methods, the description, evaluation and classification of jobs, the administration of civil service regulations and similar matters.

Excludes: personnel administration and services connected with a specific function (classified according to function).

70132 Overall planning and statistical services (CS)

Administration and operation of overall economic and social planning services and of overall statistical services, including formulation, coordination and monitoring of overall economic and social plans and programs and of overall statistical plans and programs.

Excludes: economic and social planning services and statistical services connected with a specific function (classified according to function).

70133 Other general services (CS)

 Administration and operation of other general services such as centralized supply and purchasing services, maintenance and storage of government records and archives, operation of government owned or occupied buildings, central motor vehicle pools, government operated printing offices, centralized computer and data processing services, etc.

Excludes: other general services connected with a specific function (classified according to function).

7014 BASIC RESEARCH

Basic research is experimental or theoretical work undertaken primarily to acquire new knowledge of the underlying foundations of phenomena and observable facts, without any particular application or use in view.

70140 Basic research (CS)

- Administration and operation of government agencies engaged in basic research;
- grants, loans or subsidies to support basic research undertaken by non-government bodies such as research institutes and universities.

Excludes: applied research and experimental development (classified by function).

7015 R&D GENERAL PUBLIC SERVICES

Applied research is original investigation undertaken in order to acquire new knowledge, but directed primarily towards a specific practical aim or objective.

Experimental development is systematic work, drawing on existing knowledge gained from research and practical experience, that is directed to producing new materials, products and devices; to installing new processes, systems and services; or to improving substantially those already produced or installed.

70150 R&D General public services (CS)

- Administration and operation of government agencies engaged in applied research and experimental development related to general public services;
- grants, loans or subsidies to support applied research and experimental development related to general public services undertaken by non-government bodies such as research institutes and universities.

Excludes: basic research (70140).

7016 GENERAL PUBLIC SERVICES N.E.C.

70160 General public services n.e.c. (CS)

Administration, operation or support of general public services such as registration of voters, holding of elections and referendums, administration of non-self-governing and trust territories, etc.

Includes: general public services that cannot be assigned to (7011), (7012), (7013), (7014) or (7015).

Excludes: public debt transactions (7017); transfers of a general character between different levels of government (7018).

7017 PUBLIC DEBT TRANSACTIONS

70170 Public debt transactions (CS)

- Interest payments and outlays for underwriting and floating government loans.

Excludes: administrative costs of public debt management (70112).

7018 TRANSFERS OF A GENERAL CHARACTER BETWEEN DIFFERENT LEVELS OF GOVERNMENT

70180 Transfers of a general character between different levels of government (CS)

 Transfers between different levels of government that are of a general character and not allocated to a particular function.

702 DEFENSE

7021 MILITARY DEFENSE

70210 Military defense (CS)

- Administration of military defense affairs and services;
- operation of land, sea, air and space defense forces; operation of engineering, transport, communication, intelligence, personnel and other non-combat defense forces; operation or support of reserve and auxiliary forces of the defense establishment.

Includes: offices of military attachés stationed abroad; field hospitals.

Excludes: military aid missions (70230); base hospitals (7073); military schools and colleges where curricula resemble those of civilian institutions even though attendance may be limited to military personnel and their families (7091), (7092), (7093) or (7094); pension schemes for military personnel (7102).

7022 CIVIL DEFENSE

70220 Civil defense (CS)

- Administration of civil defense affairs and services; formulation of contingency plans; organization of exercises involving civilian institutions and populations;
- operation or support of civil defense forces.

Excludes: civil protection services (70320); purchase and storage of food, equipment and other supplies for emergency use in the case of peacetime disasters (71090).

7023 FOREIGN MILITARY AID

70230 Foreign military aid (CS)

- Administration of military aid and operation of military aid missions accredited to foreign governments or attached to international military organizations or alliances;
- military aid in the form of grants (in cash or in kind), loans (regardless of interest charged) or loans
 of equipment; contributions to international peacekeeping forces including the assignment of manpower.

7024 R&D DEFENSE

Definitions of basic research, applied research and experimental development are given under (7014) and (7015).

70240 R&D Defense (CS)

- Administration and operation of government agencies engaged in applied research and experimental development related to defense;
- grants, loans or subsidies to support applied research and experimental development related to defense undertaken by non-government bodies such as research institutes and universities.

Excludes: basic research (70140).

7025 DEFENSE N.E.C.

70250 Defense n.e.c. (CS)

Administration, operation or support of activities such as formulation, administration, coordination and monitoring of overall policies, plans, programs and budgets relating to defense; preparation and enforcement of legislation relating to defense; production and dissemination of general information, technical documentation and statistics on defense; etc.

Includes: defense affairs and services that cannot be assigned to (7021), (7022), (7023) or (7024).

Excludes: administration of war veterans' affairs (7102).

703 PUBLIC ORDER AND SAFETY

7031 POLICE SERVICES

70310 Police services (CS)

- Administration of police affairs and services, including alien registration, issuing work and travel
 documents to immigrants, maintenance of arrest records and statistics related to police work, road
 traffic regulation and control, prevention of smuggling and control of offshore and ocean fishing;
- operation of regular and auxiliary police forces, of port, border and coast guards, and of other special police forces maintained by public authorities; operation of police laboratories; operation or support of police training programs.

Includes: traffic wardens.

Excludes: police colleges offering general education in addition to police training (7091), (7092), (7093) or (7094).

7032 FIRE PROTECTION SERVICES

70320 Fire protection services (CS)

- Administration of fire prevention and fire fighting affairs and services;
- operation of regular and auxiliary fire brigades and of other fire prevention and fire fighting services maintained by public authorities; operation or support of fire prevention and fire fighting training programs.

Includes: civil protection services such as mountain rescue, beach surveillance, evacuation of flooded areas, etc.

Excludes: civil defense (70220); forces especially trained and equipped for fighting or preventing forest fires (70422).

7033 LAW COURTS

70330 Law courts (CS)

- Administration, operation or support of civil and criminal law courts and the judicial system, including enforcement of fines and legal settlements imposed by the courts and operation of parole and probation systems;
- legal representation and advice on behalf of government or on behalf of others provided by government in cash or in services.

Includes: administrative tribunals, ombudsmen and the like.

Excludes: prison administration (70340).

7034 PRISONS

70340 Prisons (CS)

Administration, operation or support of prisons and other places for the detention or rehabilitation
of criminals such as prison farms, workhouses, reformatories, borstals, asylums for the criminally
insane, etc.

7035 R&D PUBLIC ORDER AND SAFETY

Definitions of basic research, applied research and experimental development are given under (7014) and (7015).

70350 R&D Public order and safety (CS)

- Administration and operation of government agencies engaged in applied research and experimental development related to public order and safety;
- grants, loans or subsidies to support applied research and experimental development related to public order and safety undertaken by non-government bodies such as research institutes and universities.

Excludes: basic research (70140).

7036 PUBLIC ORDER AND SAFETY N.E.C.

70360 Public order and safety n.e.c. (CS)

Administration, operation or support of activities such as formulation, administration, coordination and monitoring of overall policies, plans, programs and budgets relating to public order and

safety; preparation and enforcement of legislation and standards for the provision of public order and safety; production and dissemination of general information, technical documentation and statistics on public order and safety.

Includes: public order and safety affairs and services that cannot be assigned to (7031), (7032), (7033), (7034) or (7035).

704 ECONOMIC AFFAIRS

7041 GENERAL ECONOMIC, COMMERCIAL, AND LABOR AFFAIRS

70411 General economic and commercial affairs (CS)

- Administration of general economic and commercial affairs and services, including general foreign commercial affairs; formulation and implementation of general economic and commercial policies; liaison among different branches of government and between government and business;
- regulation or support of general economic and commercial activities such as export and import trade as a whole, commodity and equity markets, overall income controls, general trade promotion activities, general regulation of monopolies and other restraints on trade and market entry, etc.; supervision of the banking industry;
- operation or support of institutions dealing with patents, trademarks, copyrights, company registration, weather forecasting, standards, hydrologic surveys, geodesic surveys, etc.;
- grants, loans or subsidies to promote general economic and commercial policies and programs.

Includes: consumer education and protection.

Excludes: economic and commercial affairs of a particular industry (classified to (7042) through (7047) as appropriate).

70412 General labor affairs (CS)

- Administration of general labor affairs and services; formulation and implementation of general labor policies; supervision and regulation of labor conditions (hours of work, wages, safety, etc.); liaison among different branches of government and between government and overall industrial, business and labor organizations;
- operation or support of general programs or schemes to facilitate labor mobility, to reduce sex, race, age and other discrimination, to reduce the rate of unemployment in distressed or underdeveloped regions, to promote the employment of disadvantaged or other groups characterized by high unemployment rates, etc.; operation of labor exchanges; operation or support of arbitration and mediation services:
- production and dissemination of general information, technical documentation and statistics on general labor affairs and services;
- grants, loans or subsidies to promote general labor policies and programs.

Excludes: labor affairs of a particular industry (classified to (7042) through (7047) as appropriate); provision of social protection in the form of cash benefits and benefits in kind to persons who are unemployed (71050).

7042 AGRICULTURE, FORESTRY, FISHING AND HUNTING

70421 Agriculture (CS)

 Administration of agricultural affairs and services; conservation, reclamation or expansion of arable land; agrarian reform and land settlement; supervision and regulation of the agricultural industry;

- construction or operation of flood control, irrigation and drainage systems, including grants, loans or subsidies for such works:
- operation or support of programs or schemes to stabilize or improve farm prices and farm incomes;
 operation or support of extension services or veterinary services to farmers, pest control services,
 crop inspection services and crop grading services;
- production and dissemination of general information, technical documentation and statistics on agricultural affairs and services;
- compensation, grants, loans or subsidies to farmers in connection with agricultural activities, including payments for restricting or encouraging output of a particular crop or for allowing land to remain uncultivated.

Excludes: multi-purpose development projects (70474).

70422 Forestry (CS)

- Administration of forestry affairs and services; conservation, extension and rationalized exploitation of forest reserves; supervision and regulation of forest operations and issuance of tree-felling licenses;
- operation or support of reforestation work, pest and disease control, forest fire-fighting and fire prevention services and extension services to forest operators;
- production and dissemination of general information, technical documentation and statistics on forestry affairs and services;
- grants, loans or subsidies to support commercial forest activities.

Includes: forest crops in addition to timber.

70423 Fishing and hunting (CS)

This class covers both commercial fishing and hunting, and fishing and hunting for sport. The fishing and hunting affairs and services listed below refer to activities that take place outside natural parks and reserves.

- Administration of fishing and hunting affairs and services; protection, propagation and rationalized exploitation of fish and wildlife stocks; supervision and regulation of freshwater fishing, coastal fishing, ocean fishing, fish farming, wildlife hunting and issuance of fishing and hunting licenses;
- operation or support of fish hatcheries, extension services, stocking or culling activities, etc.;
- production and dissemination of general information, technical documentation and statistics on fishing and hunting affairs and services;
- grants, loans or subsidies to support commercial fishing and hunting activities, including the construction or operation of fish hatcheries.

Excludes: control of offshore and ocean fishing (70310); administration, operation or support of natural parks and reserves (70540).

7043 FUEL AND ENERGY

70431 Coal and other solid mineral fuels (CS)

This class covers coal of all grades, lignite and peat irrespective of the method used in their extraction or beneficiation and the conversion of these fuels to other forms such as coke or gas.

- Administration of solid mineral fuel affairs and services; conservation, discovery, development and rationalized exploitation of solid mineral fuel resources; supervision and regulation of the extraction, processing, distribution and use of solid mineral fuels;
- production and dissemination of general information, technical documentation and statistics on solid mineral fuel affairs and services;
- grants, loans or subsidies to support the solid mineral fuel industry and the coke, briquette or manufactured gas industries.

Excludes: solid mineral fuel transportation affairs (classified to the appropriate class of group 7045).

70432 Petroleum and natural gas (CS)

This class covers natural gas, liquefied petroleum gases and refinery gases, oil from wells or other sources such as shale or tar sands and the distribution of town gas regardless of its composition.

- Administration of petroleum and natural gas affairs and services; conservation, discovery, development and rationalized exploitation of petroleum and natural gas resources; supervision and regulation of the extraction, processing, distribution and use of petroleum and natural gas;
- production and dissemination of general information, technical documentation and statistics on petroleum and natural gas affairs and services;
- grants, loans or subsidies to support the petroleum extraction industry and the industry refining crude petroleum and related liquid and gaseous products.

Excludes: petroleum or gas transportation affairs (classified to the appropriate class of group 7045).

70433 Nuclear fuel (CS)

- Administration of nuclear fuel affairs and services; conservation, discovery, development and rationalized exploitation of nuclear material resources; supervision and regulation of the extraction and processing of nuclear fuel materials and of the manufacture, distribution and use of nuclear fuel elements:
- production and dissemination of general information, technical documentation and statistics on nuclear fuel affairs and services;
- grants, loans or subsidies to support the nuclear materials mining industry and the industries processing such materials.

Excludes: nuclear fuel transportation affairs (classified to the appropriate class of group 7045); disposal of radioactive wastes (70510).

70434 Other fuels (CS)

- Administration of affairs and services involving fuels such as alcohol, wood and wood wastes, bagasse and other non-commercial fuels;
- production and dissemination of general information, technical documentation and statistics on availability, production and utilization of such fuels;
- grants, loans or subsidies to promote the use of such fuels for the production of energy.

Excludes: forest management (70422); wind and solar heat (70435) or (70436); geothermal resources (70436).

70435 Electricity (CS)

This class covers both traditional sources of electricity such as thermal or hydro supplies and newer sources such as wind or solar heat.

- Administration of electricity affairs and services; conservation, development and rationalized exploitation of electricity supplies; supervision and regulation of the generation, transmission and distribution of electricity;
- construction or operation of non-enterprise-type electricity supply systems;
- production and dissemination of general information, technical documentation and statistics on electricity affairs and services;
- grants, loans or subsidies to support the electricity supply industry, including such outlays for the construction of dams and other works designed chiefly to provide electricity.

Excludes: non-electric energy produced by wind or solar heat (70436).

70436 Non-electric energy (CS)

- Administration of non-electric energy affairs and services which chiefly concern the production, distribution and utilization of heat in the form of steam, hot water or hot air;
- construction or operation of non-enterprise-type systems supplying non-electric energy;
- production and dissemination of general information, technical documentation and statistics on availability, production and utilization of non-electric energy;
- grants, loans or subsidies to promote the use of non-electric energy.

Includes: geothermal resources; non-electric energy produced by wind or solar heat.

7044 MINING, MANUFACTURING, AND CONSTRUCTION

70441 Mining of mineral resources other than mineral fuels (CS)

This class covers metal-bearing minerals, sand, clay, stone, chemical and fertilizer minerals, salt, gemstones, asbestos, gypsum, etc.

- Administration of mining and mineral resource affairs and services; conservation, discovery, development and rationalized exploitation of mineral resources; supervision and regulation of prospecting, mining, marketing and other aspects of mineral production;
- production and dissemination of general information, technical documentation and statistics on mining and mineral resource affairs and services;
- grants, loans or subsidies to support commercial mining activities.

Includes: issuance of licenses and leases, regulation of production rates, inspection of mines for conformity to safety regulations, etc.

Excludes: coal and other solid fuels (70431), petroleum and natural gas (70432) and nuclear fuel materials (70433).

70442 Manufacturing (CS)

- Administration of manufacturing affairs and services; development, expansion or improvement of manufacturing; supervision and regulation of the establishment and operation of manufacturing plants; liaison with manufacturers' associations and other organizations interested in manufacturing affairs and services;
- production and dissemination of general information, technical documentation and statistics on manufacturing activities and manufactured products;
- grants, loans or subsidies to support manufacturing enterprises.

Includes: inspection of manufacturing premises for conformity with safety regulations, protection of consumers against dangerous products, etc.

Excludes: affairs and services concerning the coal processing industry (70431), the petroleum refinery industry (70432) or the nuclear fuel industry (70433).

70443 Construction (CS)

- Administration of construction affairs and services; supervision of the construction industry; development and regulation of construction standards;
- production and dissemination of general information, technical documentation and statistics on construction affairs and services.

Includes: issuance of certificates permitting occupancy, inspection of construction sites for conformity with safety regulations, etc.

Excludes: grants, loans and subsidies for the construction of housing, industrial buildings, streets, public utilities, cultural facilities, etc. (classified according to function); development and regulation of housing standards (70610).

7045 TRANSPORT

70451 Road transport (CS)

- Administration of affairs and services concerning operation, use, construction and maintenance of road transport systems and facilities (roads, bridges, tunnels, parking facilities, bus terminals, etc.);
- supervision and regulation of road users (vehicle and driver licensing, vehicle safety inspection, size and load specifications for passenger and freight road transport, regulation of hours of work of bus, coach and lorry drivers, etc.), of road transport system operations (granting of franchises, approval of freight tariffs and passenger fares and of hours and frequency of service, etc.) and of road construction and maintenance;
- construction or operation of non-enterprise-type road transport systems and facilities;
- production and dissemination of general information, technical documentation and statistics on road transport system operations and on road construction activities;
- grants, loans or subsidies to support the operation, construction, maintenance or upgrading of road transport systems and facilities.

Includes: highways, urban roads, streets, bicycle paths and footpaths.

Excludes: road traffic control (70310); grants, loans and subsidies to road vehicle manufacturers (70442); street cleaning (70510); construction of noise embankments, hedges and other anti-noise facilities including the resurfacing of sections of urban highways with noise reducing surfaces (70530); street lighting (70640).

70452 Water transport (CS)

- Administration of affairs and services concerning operation, use, construction and maintenance of
 inland, coastal and ocean water transport systems and facilities (harbors, docks, navigation aids
 and equipment, canals, bridges, tunnels, channels, breakwaters, piers, wharves, terminals, etc.);
- supervision and regulation of water transport users (registration, licensing and inspection of vessels
 and crews, regulations concerning passenger safety and freight security, etc.), of water transport system operations (granting of franchises, approval of freight tariffs and passenger fares and of hours
 and frequency of service, etc.) and of water transport facility construction and maintenance;

- construction or operation of non-enterprise-type water transport systems and facilities (such as ferries);
- production and dissemination of general information, technical documentation and statistics on water transport system operations and on water transport facility construction activities;
- grants, loans or subsidies to support the operation, construction, maintenance or upgrading of water transport systems and facilities.

Includes: radio and satellite navigation aids; emergency rescue and towing services.

Excludes: grants, loans and subsidies to shipbuilders (70442).

70453 Railway transport (CS)

- Administration of affairs and services concerning operation, use, construction or maintenance of railway transport systems and facilities (railway roadbeds, terminals, tunnels, bridges, embankments, cuttings, etc.);
- supervision and regulation of railway users (rolling stock condition, roadbed stability, passenger safety, security of freight, etc.), of railway transport system operations (granting of franchises, approval of freight tariffs and passenger fares and of hours and frequency of service, etc.) and of railway construction and maintenance;
- construction or operation of non-enterprise-type railway transport systems and facilities;
- production and dissemination of general information, technical documentation and statistics on railway transport system operations and on railway construction activities;
- grants, loans or subsidies to support the operation, construction, maintenance or upgrading of railway transport systems and facilities.

Includes: long-line and interurban railway transport systems, urban rapid transit railway transport systems and street railway transport systems; acquisition and maintenance of rolling stock.

Excludes: grants, loans and subsidies to rolling stock manufacturers (70442); construction of noise embankments, hedges and other anti-noise facilities including the resurfacing of sections of railways with noise reducing surfaces (70530).

70454 Air transport (CS)

- Administration of affairs and services concerning operation, use, construction and maintenance of air transport systems and facilities (airports, runways, terminals, hangars, navigation aids and equipment, air control amenities, etc.);
- supervision and regulation of air transport users (registration, licensing and inspection of aircraft, pilots, crews, ground crews, regulations concerning passenger safety, investigation of air transport accidents, etc.), of air transport system operations (allocation of routes, approval of freight tariffs and passenger fares and of frequency and levels of service, etc.) and of air transport facility construction and maintenance;
- construction or operation of non-enterprise-type public air transport services and facilities;
- production and dissemination of general information, technical documentation and statistics on air transport system operations and on air transport facility construction;
- grants, loans or subsidies to support the operation, construction, maintenance or upgrading of air transport systems and facilities.

Includes: radio and satellite navigation aids; emergency rescue services; scheduled and non-scheduled freight and passenger services; regulation and control of flying by private individuals.

Excludes: grants, loans and subsidies to aircraft manufacturers (70442).

70455 Pipeline and other transport (CS)

- Administration of affairs and services concerning operation, use, construction and maintenance of pipeline and other transport systems (funiculars, cable cars, chairlifts, etc.);
- supervision and regulation of users of pipeline and other transport systems (registration, licensing, inspection of equipment, operator skills and training; safety standards, etc.); of pipeline and other transport systems operations (granting of franchises, setting tariffs, frequency and levels of service, etc.) and of pipeline and other transport systems construction and maintenance;
- construction or operation of non-enterprise-type pipeline and other transport systems;
- production and dissemination of general information, technical documentation and statistics on the operation and construction of pipeline and other transport systems;
- grants, loans or subsidies to support the operation, construction, maintenance or upgrading of pipeline and other transport systems.

7046 COMMUNICATION

70460 Communication (CS)

- Administration of affairs and services concerning construction, extension, improvement, operation and maintenance of communication systems (postal, telephone, telegraph, wireless and satellite communication systems);
- regulation of communication system operations (granting of franchises; assignment of frequencies, specification of markets to be served and tariffs to be charged, etc.);
- production and dissemination of general information, technical documentation and statistics on communication affairs and services;
- grants, loans or subsidies to support the construction, operation, maintenance or upgrading of communication systems.

Excludes: radio and satellite navigation aids for water transport (70452) and air transport (70454); radio and television broadcasting systems (70830).

7047 OTHER INDUSTRIES

70471 Distributive trades, storage, and warehousing (CS)

- Administration of affairs and services concerning the distributive trade and the storage and ware-housing industry;
- supervision and regulation of wholesale and retail trade (licensing, sales practices, labeling of packaged food and other goods intended for household consumption, inspection of scales and other weighing machines, etc.) and of the storage and warehousing industry (including licensing and control of government-bonded warehouses, etc.);
- administration of price control and rationing schemes operating through retailers or wholesalers regardless of the type of goods involved or intended consumer; administration and provision of food and other such subsidies to the general public;
- production and dissemination of information to the trade and to the public on prices, on the availability of goods and on other aspects of the distributive trade and the storage and warehousing industry; compilation and publication of statistics on the distributive trade and the storage and warehousing industry;
- grants, loans or subsidies to support the distributive trade and to the storage and warehousing industry.

Excludes: administration of price and other controls applied to the producer (classified according to function); food and other such subsidies applicable to particular population groups or individuals (710).

70472 Hotels and restaurants (CS)

- Administration of affairs and services concerning construction, extension, improvement, operation and maintenance of hotels and restaurants;
- supervision and regulation of hotel and restaurant operations (regulations governing prices, cleanliness and sales practices, hotel and restaurant licensing, etc.);
- production and dissemination of general information, technical documentation and statistics on hotel and restaurant affairs and services;
- grants, loans or subsidies to support the construction, operation, maintenance or upgrading of hotels and restaurants.

70473 Tourism (CS)

- Administration of tourism affairs and services; promotion and development of tourism; liaison
 with the transport, hotel and restaurant industries and other industries benefiting from the presence
 of tourists;
- operation of tourist offices at home and abroad, etc.; organization of advertising campaigns, including the production and dissemination of promotional literature and the like;
- compilation and publication of statistics on tourism.

70474 Multipurpose development projects (CS)

Multipurpose development projects typically consist of integrated facilities for generation of power, flood control, irrigation, navigation and recreation.

- Administration of affairs and services concerning construction, extension, improvement, operation and maintenance of multi-purpose projects;
- production and dissemination of general information, technical documentation and statistics on multi-purpose development project affairs and services;
- grants, loans or subsidies to support the construction, operation, maintenance or upgrading of multi-purpose development projects;

Excludes: projects with one main function and other functions that are secondary (classified according to main function).

7048 R&D ECONOMIC AFFAIRS

Definitions of basic research, applied research and experimental development are given under (7014) and (7015).

70481 R&D General economic, commercial, and labor affairs (CS)

- Administration and operation of government agencies engaged in applied research and experimental development related to general economic, commercial and labor affairs;
- grants, loans or subsidies to support applied research and experimental development related to general economic, commercial and labor affairs undertaken by non-government bodies such as research institutes and universities.

Excludes: basic research (70140).

70482 R&D Agriculture, forestry, fishing and hunting (CS)

- Administration and operation of government agencies engaged in applied research and experimental development related to agriculture, forestry, fishing and hunting;
- grants, loans or subsidies to support applied research and experimental development related to agriculture, forestry, fishing and hunting undertaken by non-government bodies such as research institutes and universities.

Excludes: basic research (70140).

70483 R&D Fuel and energy (CS)

- Administration and operation of government agencies engaged in applied research and experimental development related to fuel and energy;
- grants, loans or subsidies to support applied research and experimental development related to fuel and energy undertaken by non-government bodies such as research institutes and universities.

Excludes: basic research (70140).

70484 R&D Mining, manufacturing, and construction (CS)

- Administration and operation of government agencies engaged in applied research and experimental development related to mining, manufacturing and construction;
- grants, loans or subsidies to support applied research and experimental development related to mining, manufacturing and construction undertaken by non-government bodies such as research institutes and universities.

Excludes: basic research (70140).

70485 R&D Transport (CS)

- Administration and operation of government agencies engaged in applied research and experimental development related to transport;
- grants, loans or subsidies to support applied research and experimental development related to transport undertaken by non-government bodies such as research institutes and universities.

Excludes: basic research (70140).

70486 R&D Communication (CS)

- Administration and operation of government agencies engaged in applied research and experimental development related to communication;
- grants, loans or subsidies to support applied research and experimental development related to communication undertaken by non-government bodies such as research institutes and universities.

Excludes: basic research (70140).

70487 R&D Other industries (CS)

- Administration and operation of government agencies engaged in applied research and experimental development related to other sectors;
- grants, loans or subsidies to support applied research and experimental development related to other sectors undertaken by non-government bodies such as research institutes and universities.

Includes: distributive trades, storage and warehousing; hotels and restaurants; tourism and multi-purpose development projects.

Excludes: basic research (70140).

7049 ECONOMIC AFFAIRS N.E.C.

70490 Economic affairs n.e.c. (CS)

- Administration, operation or support activities relating to general and sectoral economic affairs that cannot be assigned to (7041), (7042), (7043), (7044), (7045), (7046), (7047) or (7048).

705 ENVIRONMENTAL PROTECTION

The breakdown of environmental protection is based upon the Classification of Environmental Protection Activities (CEPA) as elaborated in the European System for the Collection of Economic Information on the Environment (SERIEE) of the Statistical Office of the European Communities (Eurostat).

7051 WASTE MANAGEMENT

This group covers collection, treatment and disposal of waste.

Waste collection includes sweeping of streets, squares, paths, markets, public gardens, parks, etc.; collection of all types of waste, whether selective by type of product or undifferentiated covering all waste, and their transport to place of treatment or discharge.

Waste treatment includes any method or process designed to change the physical, chemical or biological character or composition of any waste so as to neutralize it, to render it non-hazardous, to make it safer for transport, to make it amenable for recovery or storage or to reduce it in volume.

Waste disposal includes final placement of waste for which no further use is foreseen by landfill, containment, underground disposal, dumping at sea or any other relevant disposal method.

70510 Waste management (CS)

- Administration, supervision, inspection, operation or support of waste collection, treatment and disposal systems;
- grants, loans or subsidies to support the operation, construction, maintenance or upgrading of such systems.

Includes: collection, treatment and disposal of nuclear waste.

7052 WASTE WATER MANAGEMENT

This group covers sewage system operation and waste water treatment.

Sewage system operation includes management and construction of the system of collectors, pipelines, conduits and pumps to evacuate any waste water (rainwater, domestic and other available waste water) from the points of generation to either a sewage treatment plant or to a point where waste water is discharged to surface water.

Waste water treatment includes any mechanical, biological or advanced process to render waste water fit to meet applicable environment standards or other quality norms.

70520 Waste water management (CS)

- Administration, supervision, inspection, operation or support of sewage systems and waste water treatment;
- grants, loans or subsidies to support the operation, construction, maintenance or upgrading of such systems.

7053 POLLUTION ABATEMENT

This group covers activities relating to ambient air and climate protection, soil and groundwater protection, noise and vibration abatement and protection against radiation.

These activities include construction, maintenance and operation of monitoring systems and stations (other than weather stations); construction of noise embankments, hedges and other anti-noise facilities including the resurfacing of sections of urban highways or railways with noise reducing surfaces; measures to clean pollution in water bodies; measures to control or prevent the emissions of greenhouse gases and pollutants that adversely affect the quality of the air; construction, maintenance and operation of installations for the decontamination of polluted soils and for the storage of pollutant products; transportation of pollutant products.

70530 Pollution abatement (CS)

- Administration, supervision, inspection, operation or support of activities relating to pollution abatement and control;
- grants, loans or subsidies to support activities relating to pollution abatement and control.

7054 PROTECTION OF BIODIVERSITY AND LANDSCAPE

This group covers activities relating to the protection of fauna and flora species (including the reintroduction of extinct species and the recovery of species menaced by extinction), the protection of habitats (including the management of natural parks and reserves) and the protection of landscapes for their aesthetic values (including the reshaping of damaged landscapes for the purpose of strengthening their aesthetic value and the rehabilitation of abandoned mines and quarry sites).

70540 Protection of biodiversity and landscape (CS)

- Administration, supervision, inspection, operation or support of activities relating to the protection of biodiversity and landscape;
- grants, loans or subsidies to support activities relating to the protection of biodiversity and landscape.

7055 R&D ENVIRONMENTAL PROTECTION

Definitions of basic research, applied research and experimental development are given under (7014) and (7015).

70550 R&D Environmental protection (CS)

- Administration and operation of government agencies engaged in applied research and experimental development related to environmental protection;
- grants, loans or subsidies to support applied research and experimental development related to environmental protection undertaken by non-government bodies such as research institutes and universities.

Excludes: basic research (70140).

7056 ENVIRONMENTAL PROTECTION N.E.C.

70560 Environmental protection n.e.c. (CS)

Administration, management, regulation, supervision, operation and support of activities such
as formulation, administration, coordination and monitoring of overall policies, plans, programs
and budgets for the promotion of environmental protection; preparation and enforcement of legislation and standards for the provision of environmental protection services; production and

dissemination of general information, technical documentation and statistics on environmental protection.

Includes: environmental protection affairs and services that cannot be assigned to (7051), (7052), (7053), (7054) or (7055).

706 HOUSING AND COMMUNITY AMENITIES

7061 HOUSING DEVELOPMENT

70610 Housing development (CS)

- Administration of housing development affairs and services; promotion, monitoring and evaluation of housing development activities whether or not the activities are under the auspices of public authorities; development and regulation of housing standards;
- slum clearance related to provision of housing; acquisition of land needed for construction of dwellings; construction or purchase and remodeling of dwelling units for the general public or for people with special needs;
- production and dissemination of public information, technical documentation and statistics on housing development affairs and services;
- grants, loans or subsidies to support the expansion, improvement or maintenance of the housing stock.

Excludes: development and regulation of construction standards (70443); cash benefits and benefits in kind to help households meet the cost of housing (71060).

7062 COMMUNITY DEVELOPMENT

70620 Community development (CS)

- Administration of community development affairs and services; administration of zoning laws and land-use and building regulations;
- planning of new communities or of rehabilitated communities; planning the improvement and development of facilities such as housing, industry, public utilities, health, education, culture, recreation, etc. for communities; preparation of schemes for financing planned developments;
- production and dissemination of general information, technical documentation and statistics on community development affairs and services.

Excludes: plan implementation, that is, the actual construction of housing, industrial buildings, streets, public utilities, cultural facilities, etc. (classified according to function); agrarian reform and land resettlement (70421); administration of construction standards (70443) and housing standards (70610).

7063 WATER SUPPLY

70630 Water supply (CS)

- Administration of water supply affairs; assessment of future needs and determination of availability in terms of such assessment; supervision and regulation of all facets of potable water supply including water purity, price and quantity controls;
- construction or operation of non-enterprise-type of water supply systems;

- production and dissemination of general information, technical documentation and statistics on water supply affairs and services;
- grants, loans or subsidies to support the operation, construction, maintenance or upgrading of water supply systems.

Excludes: irrigation systems (70421); multi-purpose projects (70474); collection and treatment of waste water (70520).

7064 STREET LIGHTING

70640 Street lighting (CS)

- Administration of street lighting affairs; development and regulation of street lighting standards;
- installation, operation, maintenance, upgrading, etc. of street lighting.

Excludes: lighting affairs and services associated with the construction and operation of highways (70451).

7065 R&D HOUSING AND COMMUNITY AMENITIES

Definitions of basic research, applied research and experimental development are given under (7014) and (7015).

70650 R&D Housing and community amenities (CS)

- Administration and operation of government agencies engaged in applied research and experimental development related to housing and community amenities;
- grants, loans or subsidies to support applied research and experimental development related to housing and community amenities undertaken by non-government bodies such as research institutes and universities.

Excludes: basic research (70140); applied research and experimental development into construction methods or materials (70484).

7066 HOUSING AND COMMUNITY AMENITIES N.E.C.

70660 Housing and community amenities n.e.c. (CS)

Administration, operation or support of activities such as formulation, administration, coordination and monitoring of overall policies, plans, programs and budgets relating to housing and community amenities; preparation and enforcement of legislation and standards relating to housing and community amenities; production and dissemination of general information, technical documentation and statistics relating to housing and community amenities.

Includes: administration, operation or support activities relating to housing and community amenities that cannot be assigned to (7061), (7062), (7063), (7064) or (7065).

707 HEALTH

Government outlays on health include expenditures on services provided to **individual** persons and services provided on a **collective** basis. Expenditures on individual services are allocated to groups (7071) through (7074); expenditures on collective services are assigned to groups (7075) and (7076).

Collective health services are concerned with matters such as formulation and administration of government policy; setting and enforcement of standards for medical and paramedical personnel and for

hospitals, clinics, surgeries, etc.; regulation and licensing of providers of health services; and applied research and experimental development into medical and health-related matters. However, overhead expenses connected with administration or functioning of a group of hospitals, clinics, surgeries, etc. are considered to be individual expenditures and are classified to groups (7071) through (7074) as appropriate.

7071 MEDICAL PRODUCTS, APPLIANCES, AND EQUIPMENT

This group covers medicaments, prostheses, medical appliances and equipment and other health-related products obtained by individuals or households, either with or without a prescription, usually from dispensing chemists, pharmacists or medical equipment suppliers. They are intended for consumption or use outside a health facility or institution. Such products supplied directly to outpatients by medical, dental and paramedical practitioners or to in-patients by hospitals and the like are included in outpatient services (7072) or hospital services (7073).

70711 Pharmaceutical products (IS)

- Provision of pharmaceutical products such as medicinal preparations, medicinal drugs, patent medicines, serums and vaccines, vitamins and minerals, cod liver oil and halibut liver oil, oral contraceptives;
- administration, operation or support of the provision of pharmaceutical products.

70712 Other medical products (IS)

- Provision of medical products such as clinical thermometers, adhesive and non-adhesive bandages, hypodermic syringes, first-aid kits, hot-water bottles and ice bags, medical hosiery items such as elasticated stockings and knee-pads, pregnancy tests, condoms and other mechanical contraceptive devices;
- administration, operation or support of the provision of prescribed other medical products.

70713 Therapeutic appliances and equipment (IS)

- Provision of therapeutic appliances and equipment such as corrective eyeglasses and contact lenses, hearing aids, glass eyes, artificial limbs and other prosthetic devices, orthopedic braces and supports, orthopedic footwear, surgical belts, trusses and supports, neck braces, medical massage equipment and health lamps, powered and unpowered wheelchairs and invalid carriages, "special" beds, crutches, electronic and other devices for monitoring blood pressure, etc.;
- administration, operation or support of the provision of prescribed therapeutic appliances and equipment.

Includes: dentures but not fitting costs; repair of therapeutic appliances and equipment.

Excludes: hire of therapeutic equipment (70724).

7072 OUTPATIENT SERVICES

This group covers medical, dental and paramedical services delivered to outpatients by medical, dental and paramedical practitioners and auxiliaries. The services may be delivered at home, in individual or group consulting facilities, dispensaries or the outpatient clinics of hospitals and the like.

Outpatient services include the medicaments, prostheses, medical appliances and equipment and other health-related products supplied directly to outpatients by medical, dental and paramedical practitioners and auxiliaries.

Medical, dental and paramedical services provided to in-patients by hospitals and the like are included in hospital services (7073).

70721 General medical services (IS)

This class covers the services provided by general medical clinics and general medical practitioners.

General medical clinics are defined as institutions which chiefly provide outpatient services which are not limited to a particular medical specialty and which are chiefly delivered by qualified medical doctors. General medical practitioners do not specialize in a particular medical specialty.

- Provision of general medical services;
- administration, inspection, operation or support of general medical services delivered by general medical clinics and general medical practitioners.

Excludes: services of medical analysis laboratories and x-ray centers (70724).

70722 Specialized medical services (IS)

This class covers the services of specialized medical clinics and specialist medical practitioners.

Specialized medical clinics and specialist medical practitioners differ from general medical clinics and general medical practitioners in that their services are limited to treatment of a particular condition, disease, medical procedure or class of patient.

- Provision of specialized medical services;
- administration, inspection, operation or support of specialized medical services delivered by specialized medical clinics and specialist medical practitioners.

Includes: services of orthodontic specialists.

Excludes: dental clinics and dentists (70723); services of medical analysis laboratories and x-ray centers (70724).

70723 Dental services (IS)

This class covers the services of general or specialist dental clinics and dentists, oral hygienists or other dental operating auxiliaries.

Dental clinics provide outpatient services. They are not necessarily supervised or staffed by dentists; they may be supervised or staffed by oral hygienists or by dental auxiliaries.

- Provision of dental services to outpatients;
- administration, inspection, operation and support of dental services delivered by general or specialist dental clinics and by dentists, oral hygienists or other dental auxiliaries.

Includes: fitting costs of dentures.

Excludes: dentures (70713); services of orthodontic specialists (70722); services of medical analysis laboratories and x-ray centers (70724).

70724 Paramedical services (IS)

- Provision of paramedical health services to outpatients;
- administration, inspection, operation or support of health services delivered by clinics supervised by nurses, midwives, physiotherapists, occupational therapists, speech therapists or other paramedical personnel and of health services delivered by nurses, midwives and paramedical personnel in non-consulting rooms, in patients' homes or other non-medical institutions.

Includes: acupuncturists, chiropodists, chiropractors, optometrists, practitioners of traditional medicine, etc.; medical analysis laboratories and x-ray centers; hire of therapeutic equipment; medically prescribed corrective-gymnastic therapy; outpatient thermal bath or sea-water treatments; ambulance services other than ambulance services operated by hospitals.

Excludes: public health service laboratories (70740); laboratories engaged in determining the causes of disease (70750).

7073 HOSPITAL SERVICES

Hospitalization is defined as occurring when a patient is accommodated in a hospital for the duration of the treatment. Hospital day-care and home-based hospital treatment are included, as are hospices for terminally ill persons.

This group covers the services of general and specialist hospitals, the services of medical centers, maternity centers, nursing homes and convalescent homes which chiefly provide in-patient services, the services of military base hospitals, the services of institutions serving old people in which medical monitoring is an essential component and the services of rehabilitation centers providing in-patient health care and rehabilitative therapy where the objective is to treat the patient rather than to provide long-term support.

Hospitals are defined as institutions which offer in-patient care under direct supervision of qualified medical doctors. Medical centers, maternity centers, nursing homes and convalescent homes also provide in-patient care but their services are supervised and frequently delivered by staff of lower qualification than medical doctors.

The group does not cover facilities such as military field hospitals (7021), surgeries, clinics and dispensaries devoted exclusively to outpatient care (7072), institutions for disabled persons and rehabilitation centers providing primarily long-term support (71012), retirement homes for elderly persons (71020). Neither does it cover payments to patients for loss of income due to hospitalization (71011).

Hospital services include medicaments, prostheses, medical appliances and equipment and other health-related products supplied to hospital patients. It also includes non-medical expenditure of hospitals on administration, non-medical staff, food and drink, accommodation (including staff accommodation), etc.

70731 General hospital services (IS)

- Provision of general hospital services;
- administration, inspection, operation or support of hospitals that do not limit their services to a particular medical specialty.

Excludes: medical centers not under the direct supervision of a qualified medical doctor (70733).

70732 Specialized hospital services (IS)

Specialized hospitals differ from general hospitals in that their services are limited to treatment of a particular condition, disease, or class of patient, for example, diseases of the chest and tuberculosis, leprosy, cancer, otorhinolaryngology, psychiatry, obstetrics, pediatrics, and so forth.

- Provision of specialized hospital services;
- administration, inspection, operation or support of hospitals that limit their services to a particular medical specialty.

Excludes: maternity centers not under the direct supervision of a qualified medical doctor (70733).

70733 Medical and maternity center services (IS)

- Provision of medical and maternity center services;
- administration, inspection, operation or support of medical and maternity center services.

70734 Nursing and convalescent home services (IS)

Nursing and convalescent homes provide in-patient services to persons recovering from surgery or a debilitating disease or condition that requires chiefly monitoring and administering of medicaments, physiotherapy and training to compensate for loss of function or rest.

- Provision of nursing and convalescent home services;
- administration, inspection, operation or support of nursing and convalescent home services.

Includes: institutions serving old people in which medical monitoring is an essential component; rehabilitation centers providing in-patient health care and rehabilitative therapy where the objective is to treat the patient rather than to provide long-term support.

7074 PUBLIC HEALTH SERVICES

70740 Public health services (IS)

- Provision of public health services;
- administration, inspection, operation or support of public health services such as blood-bank operation (collecting, processing, storing, shipping), disease detection (cancer, tuberculosis, venereal disease), prevention (immunization, inoculation), monitoring (infant nutrition, child health), epidemiological data collection, family planning services and so forth;
- preparation and dissemination of information on public health matters.

Includes: public health services delivered by special teams to groups of clients, most of whom are in good health, at workplaces, schools or other non-medical settings; public health services not connected with a hospital, clinic or practitioner; public health services not delivered by medically qualified doctors; public health service laboratories.

Excludes: medical analysis laboratories (70724); laboratories engaged in determining the causes of disease (70750).

7075 R&D HEALTH

Definitions of basic research, applied research and experimental development are given under (7014) and (7015).

70750 R&D Health (CS)

- Administration and operation of government agencies engaged in applied research and experimental development related to health;
- grants, loans and subsidies to support applied research and experimental development related to health undertaken by non-government bodies such as research institutes and universities.

Includes: laboratories engaged in determining the causes of disease.

Excludes: basic research (70140).

7076 HEALTH N.E.C.

70760 Health n.e.c. (CS)

Administration, operation or support of activities such as formulation, administration, coordination and monitoring of overall health policies, plans, programs and budgets; preparation and enforcement of legislation and standards for the provision of health services, including the licensing of medical establishments and medical and paramedical personnel; production and dissemination of general information, technical documentation and statistics on health.

Includes: health affairs and services that cannot be assigned to (7071), (7072), (7073), (7074) or (7075).

708 RECREATION, CULTURE, AND RELIGION

Government outlays on recreation, culture, and religion include expenditures on services provided to **individual** persons and households and expenditures on services provided on a **collective** basis. Individual expenditures are allocated to groups (7081) and (7082); expenditures on collective services are assigned to groups (7083) to (7086).

Collective services are provided to the community as a whole. They include activities such as formulation and administration of government policy; formulation and enforcement of legislation and standards for providing recreational and cultural services; and applied research and experimental development into recreational, cultural and religious affairs and services.

7081 RECREATIONAL AND SPORTING SERVICES

70810 Recreational and sporting services (IS)

- Provision of sporting and recreational services; administration of sporting and recreational affairs;
 supervision and regulation of sporting facilities;
- operation or support of facilities for active sporting pursuits or events (playing fields, tennis courts, squash courts, running tracks, golf courses, boxing rings, skating rinks, gymnasia, etc.); operation or support of facilities for passive sporting pursuits or events (chiefly specially equipped venues for playing cards, board games, etc.); operation or support of facilities for recreational pursuits (parks, beaches, camping grounds and associated lodging places furnished on a non-commercial basis, swimming pools, public baths for washing, etc.);
- grants, loans or subsidies to support teams or individual competitors or players.

Includes: facilities for spectator accommodation; national, regional or local team representation in sporting events.

Excludes: zoological or botanical gardens, aquaria, arboreta and similar institutions (70820); sporting and recreational facilities associated with educational institutions (classified to the appropriate class of Division 709).

7082 CULTURAL SERVICES

70820 Cultural services (IS)

- Provision of cultural services; administration of cultural affairs; supervision and regulation of cultural facilities;
- operation or support of facilities for cultural pursuits (libraries, museums, art galleries, theatres, exhibition halls, monuments, historic houses and sites, zoological and botanical gardens, aquaria, arboreta, etc.); production, operation or support of cultural events (concerts, stage and film productions, art shows, etc.);
- grants, loans or subsidies to support individual artists, writers, designers, composers and others working in the arts or to organizations engaged in promoting cultural activities.

Includes: national, regional or local celebrations provided they are not intended chiefly to attract tourists.

Excludes: cultural events intended for presentation beyond national boundaries (70113); national, regional or local celebrations intended chiefly to attract tourists (70473); production of cultural material intended for distribution by broadcasting (70830).

7083 BROADCASTING AND PUBLISHING SERVICES

70830 Broadcasting and publishing services (CS)

- Administration of broadcasting and publishing affairs; supervision and regulation of broadcasting and publishing services;
- operation or support of broadcasting and publishing services;
- grants, loans or subsidies to support: the construction or acquisition of facilities for television or radio broadcasting; the construction or acquisition of plant, equipment or materials for newspaper, magazine or book publishing; the production of material for, and its presentation by, broadcasting; the gathering of news or other information; the distribution of published works.

Excludes: government printing offices and plants (70133); provision of education by radio or television broadcasting (709).

7084 RELIGIOUS AND OTHER COMMUNITY SERVICES

70840 Religious and other community services (CS)

- Administration of religious and other community affairs;
- provision of facilities for religious and other community services, including support for their operation, maintenance and repair;
- payment of clergy or other officers of religious institutions; support for the holding of religious services; grants, loans or subsidies to support fraternal, civic, youth and social organizations or labor unions and political parties.

7085 R&D RECREATION, CULTURE, AND RELIGION

Definitions of basic research, applied research and experimental development are given under (7014) and (7015).

70850 R&D Recreation, culture, and religion (CS)

- Administration and operation of government agencies engaged in applied research and experimental development related to recreation, culture and religion;
- grants, loans and subsidies to support applied research and experimental development related to recreation, culture and religion undertaken by non-government bodies such as research institutes and universities.

Excludes: basic research (70140).

7086 RECREATION, CULTURE, AND RELIGION N.E.C.

70860 Recreation, culture, and religion n.e.c. (CS)

Administration, operation or support of activities such as formulation, administration, coordination and monitoring of overall policies, plans, programs and budgets for the promotion of sport, recreation, culture and religion; preparation and enforcement of legislation and standards for the provision of recreational and cultural services; production and dissemination of general information, technical documentation and statistics on recreation, cultural and religion.

Includes: affairs and services relating to recreation, culture and religion that cannot be assigned to (7081), (7082), (7083), (7084) or (7085).

709 EDUCATION

Government outlays on education include expenditures on services provided to **individual** pupils and students and expenditures on services provided on a **collective** basis. Expenditures on individual services are allocated to groups (7091) through (7096); expenditures on collective services are assigned to groups (7097) and (7098).

Collective educational services are concerned with matters such as formulation and administration of government policy; setting and enforcement of standards; regulation, licensing and supervision of educational establishments; and applied research and experimental development into education affairs and services. However, overhead expenses connected with administration or functioning of a group of schools, colleges, etc. are considered to be individual expenditures and are classified to groups (7091) through (7096) as appropriate.

The breakdown of education is based upon the level categories of the 1997 International Standard Classification of Education (ISCED-97) of the United Nations Educational, Scientific and Cultural Organization (UNESCO).

This division includes military schools and colleges where curricula resemble those of civilian institutions, police colleges offering general education in addition to police training and the provision of education by radio or television broadcasting. Expenditures so incurred are classified to groups (7091) to (7095) as appropriate.

7091 PRE-PRIMARY AND PRIMARY EDUCATION

70911 Pre-primary education (IS)

- Provision of pre-primary education at ISCED-97 level 0;
- administration, inspection, operation or support of schools and other institutions providing preprimary education at ISCED-97 level 0.

Excludes: subsidiary services to education (70960).

70912 Primary education (IS)

- Provision of primary education at ISCED-97 level 1;
- administration, inspection, operation or support of schools and other institutions providing primary education at ISCED-97 level 1.

Includes: literacy programs for students too old for primary school.

Excludes: subsidiary services to education (70960).

7092 SECONDARY EDUCATION

70921 Lower-secondary education (IS)

- Provision of lower-secondary education at ISCED-97 level 2;
- administration, inspection, operation or support of schools and other institutions providing lowersecondary education at ISCED-97 level 2;
- scholarships, grants, loans and allowances to support pupils pursuing lower-secondary education at ISCED-97 level 2.

Includes: out-of-school lower-secondary education for adults and young people.

Excludes: subsidiary services to education (70960).

70922 Upper-secondary education (IS)

- Provision of upper-secondary education at ISCED-97 level 3;
- administration, inspection, operation or support of schools and other institutions providing uppersecondary education at ISCED-97 level 3;
- scholarships, grants, loans and allowances to support pupils pursuing upper-secondary education at ISCED-97 level 3.

Includes: out-of-school upper-secondary education for adults and young people.

Excludes: subsidiary services to education (70960).

7093 POST-SECONDARY NON-TERTIARY EDUCATION

70930 Post-secondary non-tertiary education (IS)

- Provision of post-secondary non-tertiary education at ISCED-97 level 4;
- administration, inspection, operation or support of institutions providing post-secondary non-tertiary education at ISCED-97 level 4;
- scholarships, grants, loans and allowances to support students pursuing post-secondary non-tertiary education at ISCED-97 level 4.

Includes: out-of-school post-secondary non-tertiary education for adults and young people.

Excludes: subsidiary services to education (70960).

7094 TERTIARY EDUCATION

70941 First stage of tertiary education (IS)

- Provision of tertiary education at ISCED-97 level 5;
- administration, inspection, operation or support of universities and other institutions providing tertiary education at ISCED-97 level 5;
- scholarships, grants, loans and allowances to support students pursuing tertiary education at ISCED-97 level 5.

Excludes: subsidiary services to education (70960).

70942 Second stage of tertiary education (IS)

- Provision of tertiary education at ISCED-97 level 6;
- administration, inspection, operation or support of universities and other institutions providing tertiary education at ISCED-97 level 6;
- scholarships, grants, loans and allowances to support students pursuing tertiary education at ISCED-97 level 6.

Excludes: subsidiary services to education (70960).

7095 EDUCATION NOT DEFINABLE BY LEVEL

70950 Education not definable by level (IS)

 Provision of education not definable by level (that is, educational programs, generally for adults, which do not require any special prior instruction, in particular vocational training and cultural development);

- administration, inspection, operation or support of institutions providing education not definable by level;
- scholarships, grants, loans and allowances to support students pursuing education programs not definable by level.

7096 SUBSIDIARY SERVICES TO EDUCATION

70960 Subsidiary services to education (IS)

- Provision of subsidiary services to education;
- administration, inspection, operation or support of transportation, food, lodging, medical and dental care and related subsidiary services chiefly for students regardless of level.

Excludes: school health monitoring and prevention services (70740); scholarships, grants, loans and allowances in cash to defray the costs of subsidiary services (7091), (7092), (7093), (7094) or (7095).

7097 R&D EDUCATION

Definitions of basic research, applied research and experimental development are given under (7014) and (7015).

70970 R&D Education (CS)

- Administration and operation of government agencies engaged in applied research and experimental development related to education;
- grants, loans and subsidies to support applied research and experimental development related to education undertaken by non-government bodies such as research institutes and universities.

Excludes: basic research (70140).

7098 EDUCATION N.E.C.

70980 Education n.e.c. (CS)

Administration, operation or support of activities such as formulation, administration, coordination and monitoring of overall educational policies, plans, programs and budgets; preparation and enforcement of legislation and standards for the provision of education, including licensing of educational establishments; production and dissemination of general information, technical documentation and statistics on education.

Includes: education affairs and services that cannot be assigned to (7091), (7092), (7093), (7094), (7095), (7096) or (7097).

710 SOCIAL PROTECTION

Government outlays on social protection include expenditures on services and transfers provided to **individual** persons and households and expenditures on services provided on a **collective** basis. Expenditures on individual services and transfers are allocated to groups (7101) through (7107); expenditures on collective services are assigned to groups (7108) and (7109).

Collective social protection services are concerned with matters such as formulation and administration of government policy; formulation and enforcement of legislation and standards for providing social protection; and applied research and experimental development into social protection affairs and services.

The social protection functions and their definitions are based on the 1996 European System of integrated Social Protection Statistics (ESSPROS) of the Statistical Office of the European Communities (Eurostat).

In ESSPROS, social protection includes health care, but this division does not include health care. Health care is covered by Division 707. Hence, medical goods and services provided to persons who receive the cash benefits and benefits in kind specified in groups (7101) through (7107) are classified under (7071), (7072) or (7073) as appropriate.

7101 SICKNESS AND DISABILITY

71011 Sickness (IS)

- Provision of social protection in the form of cash benefits or benefits in kind that replace in whole
 or in part loss of earnings during a temporary inability to work due to sickness or injury;
- administration, operation or support of such social protection schemes;
- cash benefits, such as flat-rate or earnings-related sick leave payments, miscellaneous payments provided to help persons temporarily unable to work due to sickness or injury;
- benefits in kind, such as assistance with daily tasks provided to persons temporarily unable to work due to sickness or injury (home help, transport facilities, etc.).

71012 Disability (IS)

- Provision of social protection in the form of cash benefits or benefits in kind to persons who are fully or partially unable to engage in economic activity or lead a normal life due to a physical or mental impairment that is either permanent or likely to persist beyond a minimum prescribed period;
- administration, operation or support of such social protection schemes;
- cash benefits, such as disability pensions paid to persons below the standard retirement age who encounter a disability which impairs their ability to work, early retirement benefits paid to older workers who retire before reaching the standard retirement age due to reduced capacity to work, care allowances, allowances paid to disabled persons undertaking work adapted to their condition or undergoing vocational training, other periodic or lump-sum payments paid to disabled persons for social protection reasons;
- benefits in kind, such as lodging and possibly board provided to disabled persons in appropriate establishments, assistance provided to disabled persons to help them with daily tasks (home help, transport facilities etc.), allowances paid to the person who looks after the disabled person, vocational and other training provided to further the occupational and social rehabilitation of disabled persons, miscellaneous services and goods provided to disabled persons to enable them to participate in leisure and cultural activities or to travel or to participate in community life.

Excludes: cash benefits and benefits in kind paid to disabled persons on reaching the standard retirement age (71020).

7102 OLD AGE

71020 Old age (IS)

- Provision of social protection in the form of cash benefits and benefits in kind against the risks linked to old age (loss of income, inadequate income, lack of independence in carrying out daily tasks, reduced participation in social and community life, etc.);
- administration, operation or support of such social protection schemes;

- cash benefits, such as old-age pensions paid to persons on reaching the standard retirement age, anticipated old-age pensions paid to older workers who retire before the standard retirement age, partial retirement pensions paid either before or after the standard retirement age to older workers who continue working but reduce their working hours, care allowances, other periodic or lump-sum payments paid upon retirement or on account of old age;
- benefits in kind, such as lodging and sometimes board provided to elderly persons either in specialized institutions or staying with families in appropriate establishments, assistance provided to elderly persons to help them with daily tasks (home help, transport facilities etc.), allowances paid to the person who looks after an elderly person, miscellaneous services and goods provided to elderly persons to enable them to participate in leisure and cultural activities or to travel or to participate in community life.

Includes: pension schemes for military personnel and for government employees.

Excludes: early retirement benefits paid to older workers who retire before reaching standard retirement age due to disability (71012) or unemployment (71050).

7103 SURVIVORS

71030 Survivors (IS)

- Provision of social protection in the form of cash benefits and benefits in kind to persons who are survivors of a deceased person (such as the person's spouse, ex-spouse, children, grandchildren, parents or other relatives);
- administration, operation or support of such social protection schemes;
- cash benefits, such as survivors' pensions, death grants, other periodic or lump-sum payments to survivors;
- benefits in kind, such as payments towards funeral expenses, miscellaneous services and goods provided to survivors to enable them to participate in community life.

7104 FAMILY AND CHILDREN

71040 Family and children (IS)

- Provision of social protection in the form of cash benefits and benefits in kind to households with dependent children;
- administration, operation or support of such social protection schemes;
- cash benefits, such as maternity allowances, birth grants, parental leave benefits, family or child allowances, other periodic or lump-sum payments to support households and help them meet the costs of specific needs (for example, those of the lone parent families or families with handicapped children);
- benefits in kind, such as shelter and board provided to pre-school children during the day or part of the day, financial assistance towards payment of a nurse to look after children during the day, shelter and board provided to children and families on a permanent basis (orphanages, foster families, etc.), goods and services provided at home to children or to those who care for them, miscellaneous services and goods provided to families, young people or children (holiday and leisure centers).

Excludes: family planning services (70740).

7105 UNEMPLOYMENT

71050 Unemployment (IS)

- Provision of social protection in the form of cash benefits and benefits in kind to persons who are capable of work, available for work but are unable to find suitable employment;
- administration, operation or support of such social protection schemes;
- cash benefits, such as full and partial unemployment benefits, early retirement benefits paid to older workers who retire before reaching the standard retirement age due to unemployment or job reduction caused by economic measures, allowances to targeted groups in the labor force who take part in training schemes intended to develop their potential for employment, redundancy compensation, other periodic or lump-sum payments to the unemployed, particularly the long-term unemployed;
- benefits in kind, such as mobility and resettlement payments, vocational training provided to persons without a job or retraining provided to persons at risk of losing their job, accommodation, food or clothes provided to unemployed persons and their families.

Excludes: general programs or schemes directed towards increasing labor mobility, reducing the rate of unemployment or promoting the employment of disadvantaged or other groups characterized by high unemployment (70412); cash benefits and benefits in kind paid to unemployed persons on reaching the standard retirement age (71020).

7106 HOUSING

71060 Housing (IS)

- Provision of social protection in the form of benefits in kind to help households meet the cost of housing (recipients of these benefits are means-tested);
- administration, operation or support of such social protection schemes;
- benefits in kind, such as payments made on a temporary or long-term basis to help tenants with rent costs, payments to alleviate the current housing costs of owner-occupiers (that is to help with paying mortgages or interest), provision of low-cost or social housing.

7107 SOCIAL EXCLUSION N.E.C.

71070 Social exclusion n.e.c. (IS)

- Provision of social protection in the form of cash benefits and benefits in kind to persons who are socially excluded or at risk of social exclusion (such as persons who are destitute, low-income earners, immigrants, indigenous people, refugees, alcohol and substance abusers, victims of criminal violence, etc.):
- administration and operation of such social protection schemes;
- cash benefits, such as income support and other cash payments to the destitute and vulnerable persons to help alleviate poverty or assist in difficult situations;
- benefits in kind, such as short-term and long-term shelter and board provided to destitute and vulnerable persons, rehabilitation of alcohol and substance abusers, services and goods to help vulnerable persons such as counseling, day shelter, help with carrying out daily tasks, food, clothing, fuel, etc.

7108 R&D SOCIAL PROTECTION

Definitions of basic research, applied research and experimental development are given under (7014) and (7015).

71080 R&D Social protection (CS)

- Administration and operation of government agencies engaged in applied research and experimental development related to social protection;
- grants, loans and subsidies to support applied research and experimental development related to social protection undertaken by non-government bodies such as research institutes and universities.

Excludes: basic research (70140).

7109 SOCIAL PROTECTION N.E.C.

71090 Social protection n.e.c. (CS)

Administration, operation or support of activities such as formulation, administration, coordination and monitoring of overall social protection policies, plans, programs and budgets; preparation and enforcement of legislation and standards for the provision of social protection; production and dissemination of general information, technical documentation and statistics on social protection.

Includes: provision of social protection in the form of cash benefits and benefits in kind to victims of fires, floods, earthquakes and other peacetime disasters; purchase and storage of food, equipment and other supplies for emergency use in the case of peacetime disasters; other social protection affairs and services that cannot be assigned to (7101), (7102), (7103), (7104), (7105), (7106), (7107) or (7108).

7. The Balance Sheet

This chapter defines assets, liabilities, and net worth and describes their classification and the various balance sheet memorandum items.

A. Introduction

- **7.1** This chapter and the following three chapters are concerned with the stocks and flows of assets and liabilities. A balance sheet, or compilation of stocks, is a statement of the values of the assets owned at a specific time and the financial claims, or liabilities, held by other units against the owner of those assets. The total value of the assets owned less the total value of liabilities is defined as net worth and is an indicator of wealth. Net worth can also be viewed as a stock resulting from the transactions and other economic flows of all previous periods. A balance sheet is typically compiled at the end of each accounting period, which is also the beginning of the next accounting period. A highly abbreviated version of a balance sheet is shown in Table 7.1.
- 7.2 This chapter first defines assets and liabilities in general and the two major types of assets, financial and nonfinancial assets. The following section describes the principles used to value assets and liabilities. The chapter then describes the classification of assets and liabilities and the types of assets and liabilities included in each category of the classification. The final sections describe net worth, recommended memorandum items, and a supplemental cross-classification of financial assets or liabilities with the sectors of the other party to the financial instrument underlying the financial asset or liability.

B. Definitions of assets and liabilities

7.3 This section first defines an economic asset and the asset boundary used in the GFS system. It then describes the two major types of assets as financial and nonfinancial and defines a liability as the counterpart of a financial asset.

1. The asset boundary

- **7.4** All assets recorded in the GFS system are *economic assets*, which are entities
- Over which ownership rights are enforced by institutional units, individually or collectively, and
- From which economic benefits may be derived by their owners by holding them or using them over a period of time.
- **7.5** The value of an asset at any given time is its current market value, which is defined as the amount that would have to be paid to acquire the asset on the valuation date, taking into account its age, condition, and other relevant factors. This amount depends on the economic benefits that the owner of the asset can derive by holding or using it. The remaining benefits expected to be received from some assets diminish with the passage of time, which will reduce the value of the asset, and the value of the remaining benefits may increase or decrease because of changes in prices.
- **7.6** Every economic asset provides benefits by functioning as a store of value. In addition:
- Some benefits are derived by using assets, such as buildings or machinery, in the production of goods and services; and
- Some benefits consist of property incomes, such as interest, dividends, and rents received by the owners of financial assets, land, and certain other assets.

¹A balance sheet can be compiled for an individual unit or any collection of units, such as the public sector, the general government sector, or a subsector of the general government sector. It is often convenient to describe a balance sheet in reference to a single institutional unit, but any such statement applies equally to the balance sheet of a sector or subsector.

Table	7 I	· The	Rala	nca	Shoot
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Assets	Opening Balance Sheet	Closing Balance Sheet	Liabilities and Net Worth	Opening Balance Sheet	Closing Balance Sheet
Nonfinancial assets Financial assets			Liabilities Net worth		
Total assets			Total liabilities and net worth		
Memorandum items					

- **7.7** When ownership rights are established and enforced, the entity is an economic asset regardless of who receives the benefits. For example, a government may own land in a national park with the intention that its benefits accrue directly to the community at large.
- **7.8** To be an economic asset, an entity must also be able to supply economic benefits given the technology, scientific knowledge, economic infrastructure, available resources, and relative prices existing at a given time or expected in the foreseeable future. Thus, a known deposit of minerals is an economic asset only if it is already commercially exploitable or is expected to become commercially exploitable in the foreseeable future.
- **7.9** Some entities would be economic assets except that ownership rights over them have not been established or are not enforced. For example, it may not be feasible to establish ownership rights over the atmosphere and certain other naturally occurring assets. In other cases, ownership rights may be established, but it may not be feasible to enforce them, such as government-owned land that is so remote or inaccessible that the government cannot exercise effective control over it or the government does not choose to enforce its ownership rights. In such cases, it can be a matter of judgment as to whether the degree of control exercised by the government is sufficient for the land to be classified as an economic asset.
- **7.10** Governments use assets to produce goods and services much like corporations. For example, office buildings, together with the services of government employees, office equipment, and other goods and services, are used to produce collective or individual services such as general administrative services. In addition, however, governments often own assets whose services are consumed directly by the general public and assets that need to be preserved because of their historic or cultural importance. Thus, when

the asset boundary is applied to the general government sector, it often incorporates a wider range of assets than is normally owned by a private organization. That is, government units frequently own

- General-purpose assets, which are assets that other units would be likely to possess and use in similar ways, such as schools, road-building equipment, fire engines, office buildings, furniture, and computers.
- Infrastructure assets, which are immovable nonfinancial assets that generally do not have alternative uses and whose benefits accrue to the community at large. Examples are streets, highways, lighting systems, bridges, communication networks, canals, and dikes.
- Heritage assets, which are assets that a government intends to preserve indefinitely because they have unique historic, cultural, educational, artistic, or architectural significance.
- **7.11** In some cases, governments can create economic assets by exercising their sovereign powers or other powers delegated to them. For example, a government may have the authority to assert ownership rights over naturally occurring assets that otherwise would not be subject to ownership, such as the electromagnetic spectrum and natural resources in international waters subject to designation as an exclusive economic zone. These assets are economic assets only if the government uses its authority to establish and enforce ownership rights.

2. An overview of assets and liabilities

7.12 *Financial assets* consist of financial claims, monetary gold, and Special Drawing Rights (SDRs) allocated by the IMF. Financial claims are assets that entitle one unit, the owner of the asset (i.e., the creditor), to receive one or more payments from a second

unit, the debtor, according to the terms and conditions specified in a contract between the two units. A financial claim is an asset because it provides benefits to the creditor by acting as a store of value. The creditor may receive additional benefits in the form of interest or other property income payments and/or holding gains. Typical types of financial claims are cash, deposits, loans, bonds, financial derivatives, and accounts receivable.

7.13 Most contracts, also referred to as instruments or financial instruments, that underlie a financial claim are created when one unit provides funds to a second unit and the second unit agrees to repay the funds in the future.² In many cases, financial claims are explicitly identified by formal documents expressing the debtor-creditor relationship. In some cases, however, a financial claim is created by an implicit provision of funds by the creditor to the debtor. For example, a government unit may acquire a claim on another unit when the other unit does not make payments as obligations arise, such as transferring sales taxes immediately after a sale. In other cases, the GFS system creates claims to bring out the underlying economic reality of a transaction, such as the creation of a notional loan when an asset is acquired under a financial lease. Regardless of how a financial claim is created, it is extinguished when the debtor pays the sum agreed in the contract.³

7.14 When a financial claim is created, a *liability* of equal value is simultaneously incurred by the debtor as the counterpart of the financial asset. That is, the payment or payments that the creditor has a contractual right to receive are also the payment or payments that the debtor is contractually obligated to provide. Thus, liabilities are obligations to provide economic benefits to the units holding the corresponding financial claims.

7.15 Shares and other equities issued by corporations and similar legal forms of organization are treated as financial claims even though their holders do not have a fixed or predetermined monetary claim on the corporation. Shares and other equities do, however, entitle their owners to benefits in the form of any dividends and other ownership distributions, and they often are held with the expectation of receiving holding gains. In the event the issuing unit

is liquidated, shares and other equities become claims on the residual value of the unit after the claims of all creditors have been met.

7.16 Because of their treatment as financial claims, shares and other equities must also be treated as liabilities of the issuing units. If a public corporation has formally issued shares or another form of equity, then the shares are a liability of that unit and an asset of the government or other unit that owns them. If a public corporation has not issued any type of equity, then the implicit existence of shares is imputed. General government units are not owned by other units. Hence, the existence of shares or other equities is never imputed for them.

7.17 Contingent assets or liabilities are not treated as financial assets and liabilities. Also, sums set aside in business accounting as provisions to provide for a unit's future liabilities, either certain or contingent, or for a unit's future expenditures are not recognized in the GFS system. Only actual current liabilities to another party or parties are included.

7.18 Monetary gold and SDRs are not financial claims, which means that they are not the liability of any other unit. They do, however, provide economic benefits by serving as a store of value and they are used as a means of payment to settle financial claims and finance other types of transactions. As a result, they are, by convention, treated as financial assets.

7.19 *Nonfinancial assets* are all economic assets other than financial assets. By implication, nonfinancial assets do not represent claims on other units. As with financial assets, nonfinancial assets are stores of value. In addition, most nonfinancial assets provide benefits either through their use in the production of goods and services or in the form of property income.

7.20 Nonfinancial assets may come into existence as outputs from a production process, be naturally occurring, or be constructs of society. As described later in this chapter, produced assets are classified as fixed assets, inventories, or valuables:

- Fixed assets are produced assets that are used repeatedly or continuously in processes of production for more than one year.
- Inventories are goods and services held by producers for sale, use in production, or other use at a later date.

²The contracts underlying certain types of financial derivatives do not involve one unit providing funds to a second unit.

³A liability can be extinguished in other ways, such as cancellation by the creditor.

 Valuables are produced goods of considerable value that are acquired and held primarily as stores of value over time and are not used primarily for purposes of production or consumption.

7.21 Naturally occurring assets and constructs of society are both referred to as nonproduced assets. Naturally occurring assets include land, subsoil mineral deposits, fish in open but territorial waters, and the electromagnetic spectrum when ownership rights are enforced. Constructs of society that are assets include patents and leases.⁴

C. Valuation of assets and liabilities

7.22 As stated in paragraph 7.5, all assets and liabilities should be valued at their current market value, which is defined as the amount that would have to be paid to acquire the asset on the valuation date. This value includes all transport and installation charges and all costs of ownership transfer for nonfinancial assets but not for financial assets. Costs of ownership transfer include fees paid to surveyors, engineers, architects, lawyers, and estate agents and taxes payable on the transfer. The costs of ownership transfer are excluded from the current market value of financial assets in part because counterpart financial assets and liabilities refer to the same financial instrument and should have the same value.

7.23 The ideal source of price observations on which to base a valuation is a market in which the identical assets are traded in considerable volume and their market prices are listed at regular intervals. Such prices are often available for financial claims, transportation equipment, crops, livestock, and inventories.

7.24 If there are no observable prices because the assets in question are not currently traded on a market or traded only infrequently, then a price or value has to be estimated. The following paragraphs provide general descriptions of possible methods of estimating current market prices. Additional guidance on the valuation of specific types of assets and liabilities is included in the relevant parts of the section that describes the classification of assets and liabilities. Because the valuation of liabilities is the

same as the valuation of the corresponding financial assets, in most cases the remainder of this chapter will refer only to financial assets, but such references should be read as including liabilities equally.

7.25 If assets of the same kind are still being produced and sold on the market, an existing asset may be valued at the current market price of a newly produced asset adjusted for consumption of fixed capital in the case of fixed assets, and any other differences between the existing asset and a newly produced asset. The allowance for consumption of fixed capital should be calculated on the basis of the prices prevailing at the time the balance sheet is drawn up rather than the actual amounts previously recorded as an expense.

7.26 Information from markets may also be used to price assets that are not being traded currently but are similar to assets that are traded. For example:

- It may be possible to use information on securities that are traded on a stock exchange to value similar securities by analogy, making an allowance for the inferior marketability of the nontraded securities.
- Appraisals of tangible assets for insurance or other purposes generally are based on observed prices for items that are close substitutes. These appraisals may be usable for balance sheet valuations.
- If an existing fixed asset is no longer being produced but has been replaced by an asset whose characteristics are significantly different in some specific aspects but otherwise are broadly similar (for example, new models of vehicles or aircraft), then it may be reasonable to assume that the price of the existing asset would have moved in the same way as the price of the asset currently being sold.
- **7.27** It may be possible to value assets at their initial acquisition costs plus an appropriate revaluation for subsequent price changes and minus an allowance for consumption of fixed capital, amortization, or depletion.
- Most fixed assets are recorded in the balance sheet at their "written-down replacement cost." This value is the original acquisition value of the asset adjusted by an allowance for price changes and then written down for the accumulated consumption of fixed capital.
- Nonproduced intangible assets, such as patented entities, are typically valued at their initial acquisition costs (appropriately revalued) less an allowance

⁴In the 1993 SNA, naturally occurring assets are referred to as tangible nonproduced assets. With the inclusion of the electromagnetic spectrum in this category, naturally occurring assets is a more accurate title. Constructs of society are referred to as intangible nonproduced assets in the 1993 SNA and elsewhere in this manual.

for amortization. For this method, a pattern of decline must be chosen, which may be based on tax laws and accounting conventions.

- It may be possible to value subsoil assets at their initial acquisition costs (appropriately revalued) less an allowance for depletion.
- **7.28** The perpetual inventory method is commonly used to estimate the written-down replacement cost of a category of assets, especially tangible fixed assets. With this method, the value of the stock is based on estimates of acquisitions and disposals that have been accumulated (after deduction of the accumulated consumption of fixed capital, amortization, or depletion) and revalued over a long enough period to cover the acquisition of all assets in the category.
- **7.29** In other cases, market prices may be approximated by the present value of the future economic benefits expected from a given asset. This method may be feasible for a number of financial assets, naturally occurring assets, and intangible assets. For example, timber and subsoil assets are assets whose benefits are normally received well in the future and/or spread over several years. Current prices can be used to estimate the gross return from the disposition of these assets and the costs of bringing them to market. These returns and costs can then be discounted to estimate the present value of the expected benefits.
- **7.30** The value of assets and liabilities denominated in foreign currencies should be converted into the national currency at the market exchange rate prevailing on the date to which the balance sheet relates. The rate used should be the midpoint between the buying and selling spot rates for currency transactions. When a multiple exchange rate system is in operation, the valuation should be based on the rate applicable to the type of asset in question.

D. Classification of assets and liabilities

I. Nonfinancial assets (61)⁵

7.31 Nonfinancial assets were defined in paragraph 7.19 as all economic assets other than financial assets. At the first level of classification, there are four categories of nonfinancial assets. The first three categories

Table 7.2: Classification of Nonfinancial Assets

61	Nonfinancial assets
611	Fixed assets
6111	Buildings and structures
61111	Dwellings
61112	Nonresidential buildings
61113	Other structures
6112	Machinery and equipment
61121	Transport equipment
61122	Other machinery and equipment
6113	Other fixed assets
61131	Cultivated assets
61132	Intangible fixed assets
612	Inventories
6121	Strategic stocks
6122	Other inventories
61221	Materials and supplies
61222	Work in progress
61223	Finished goods
61224	Goods for resale [GFS]
613	Valuables
614	Nonproduced assets
6141	Land
6142	Subsoil assets
6143	Other naturally occurring assets
6144	Intangible nonproduced assets

are produced assets—fixed assets (611), inventories (612), and valuables (613)—and the fourth consists of all nonproduced assets (614). The complete classification of nonfinancial assets is shown in Table 7.2.

a. Fixed assets (611)

- **7.32** Fixed assets are produced assets that are used repeatedly or continuously in production processes for more than one year. The distinguishing feature of a fixed asset is not that it is durable in some physical sense, but that it may be used repeatedly or continuously in production over a long period of time. Some goods, such as coal used as fuel, may be highly durable physically but cannot be fixed assets because they can be used only once. Fixed assets are further classified as *buildings and structures* (6111), *machinery and equipment* (6112), and *other fixed assets* (6113).
- **7.33** In general, fixed assets are most effectively valued when the current written-down replacement cost is used as a proxy for the current market value. In the remainder of this section, it is noted when a particular type of fixed asset is likely to be more accurately valued by another method.
- **7.34** The production of some fixed assets, primarily buildings and structures, may span two or more

⁵The numbers in parentheses after each classification category are the GFS classification codes. Appendix 4 provides all classification codes used in the GFS system.

accounting periods. Uncompleted structures that are being acquired through progress payments required under a contract of sale are classified as fixed assets on the purchaser's balance sheet rather than as a financial asset for any progress payments made. Similarly, fixed assets being constructed on own account are treated as fixed assets rather than work-in-progress inventories.

7.35 Fixed assets acquired under a financial lease, most likely machinery and equipment, are treated as if purchased and owned by the user or lessee rather than the legal owner, the lessor. The acquisition is treated as being financed by a financial claim, classified as a loan. For example, if a bank purchases a railway car and then leases it to the national railroad, then the railway car is recorded as an asset of the railroad and a loan is recorded as a liability of the railroad and an asset of the bank.

7.36 Weapons (for example, missiles, rockets, and bombs) are not treated as fixed assets because they are single-use goods rather than goods used repeatedly or continuously in production. By extension, vehicles, other equipment, and structures whose function is to release such weapons (for example, warships, submarines, military aircraft, tanks, and missile carriers and silos) also are not treated as fixed assets. On the other hand, structures and equipment possessed by the military that are used in much the same way as similar items are used by civilian producers, such as military airfields, docks, colleges, hospitals, and office machinery, are treated as fixed assets. All light weapons and armored vehicles used by nonmilitary organizations engaged in internal security or policing activities are classified as fixed assets notwithstanding the fact that such items are not assets when owned by the armed forces.

(i) Buildings and structures (6111)

7.37 Buildings and structures consist of *dwellings* (61111), *nonresidential buildings* (61112), and *other structures* (61113). The value of buildings and structures includes the costs of site clearance and preparation and the value of all fixtures, facilities, and equipment that are integral parts of the structures.

7.38 Some structures are major improvements to land, such as dikes, ditches, and sea walls constructed for flood control, drainage, or land reclamation. These assets are constructed to obtain more or better land and are not used directly to produce other goods and services. Their value is included with the value of the land.

7.39 Buildings and structures that are also historic monuments are included within the appropriate category of buildings and structures. Historic monuments are structures or sites of special archaeological, historic, or cultural significance. They are usually accessible to the general public, and visitors are often charged for admission to the monuments or their vicinity. General government units typically use historic monuments to produce cultural or entertainment-type services. They can be valued directly, however, only when their significance has been recognized by someone other than the owner, typically by a sale or a formal appraisal. Historic monuments should be valued at the most recent sale price, updated, if need be, by a general price index. If no sale price is available, then an alternative valuation, such as an insurance appraisal, should be used.

Dwellings (61111)

7.40 Dwellings are buildings that are used entirely or primarily as residences, including garages and other associated structures. Houseboats, barges, mobile homes, and caravans that are used as principal residences are also included. Dwellings acquired for military personnel are included because they are used in the same way as dwellings acquired by civilians. Because dwellings are traded in the normal course of events, prices observed in the real estate market may supplement or replace the valuation at written-down replacement cost.

Nonresidential buildings (61112)

7.41 Nonresidential buildings are all buildings other than dwellings. Examples of types of buildings included in this category are office buildings, schools, hospitals, buildings for public entertainment, warehouse and industrial buildings, commercial buildings, hotels, and restaurants. Buildings and structures acquired for military purposes are included to the extent that they are similar to civilian buildings acquired for purposes of production and can be used in the same way.

Other structures (61113)

7.42 This category consists of all structures other than buildings. Included are the following:

 Highways, streets, roads, bridges, elevated highways, tunnels, railways, subways, and airfield runways.

- Sewers, waterways, harbors, dams, and other waterworks.
- Shafts, tunnels, and other structures associated with mining subsoil assets.
- Communication lines, power lines, and pipelines.
- · Outdoor sport and recreation facilities.
- **7.43** Structures acquired for military purposes are included to the extent that they resemble civilian structures and can be used in the same way.
- (ii) Machinery and equipment (6112)
- **7.44** Machinery and equipment is divided into *transport equipment* (61121) and *other machinery and equipment* (61122). Machinery and equipment forming an integral part of a building or other structure is included in the value of the building or structure rather than in machinery and equipment. Tools that are inexpensive and purchased at a relatively steady rate, such as hand tools, are not considered fixed assets unless they form a large share of the stock of machinery and equipment.

Transport equipment (61121)

7.45 Transport equipment consists of equipment for moving people and objects, including motor vehicles, trailers and semitrailers, ships, railway locomotives and rolling stock, aircraft, motorcycles, and bicycles. Markets for existing automobiles, aircraft, and some other types of transportation equipment may be sufficiently representative to yield price observations that are superior to valuations at written-down replacement cost.

Other machinery and equipment (61122)

7.46 This category consists of all machinery and equipment other than transport equipment. Types of assets that would be included are general- and special-purpose machinery; office, accounting, and computing equipment; electrical machinery; radio, television, and communication equipment; medical appliances; precision and optical instruments; furniture; watches, and clocks; musical instruments; and sports goods. It also includes paintings, sculptures, other works of art or antiques, and other collections of considerable value that are owned and displayed by government museums and similar organizations for the purpose of producing nonmarket services, mostly collective ser-

vices. Items of this nature not intended for use in production would be classified as valuables.

(iii) Other fixed assets (6113)

7.47 Other fixed assets consist of *cultivated assets* (61131) and *intangible fixed assets* (61132).

Cultivated assets (61131)

7.48 Cultivated assets consist of animals and plants that are used repeatedly or continuously for more than one year to produce other goods or services. The types of animals included in this category include breeding stocks (including fish and poultry), dairy cattle, draft animals, sheep or other animals used for wool production, and animals used for transportation, racing, or entertainment. The types of plants in this category include trees, vines, and shrubs cultivated for fruits, nuts, sap, resin, bark, and leaf products. Animals and plants for one-time use, such as cattle raised for slaughter and trees grown for timber, are classified as inventories rather than fixed assets.

7.49 Only animals and plants cultivated under the direct control, responsibility, and management of general government units are cultivated assets or inventories. All other animals and plants either are classified as nonproduced assets or are not economic assets.

7.50 Animals in this category usually can be valued on the basis of the current market prices for similar animals of a given age. Such information is less likely to be available for plants; more likely they will have to be valued at the written-down replacement cost.

Intangible fixed assets (61132)

- **7.51** Intangible fixed assets consist of mineral exploration; computer software; entertainment, literary, and artistic originals; and miscellaneous other intangible fixed assets. To qualify as a fixed asset, the item must be intended for use in production for more than one year and its use must be restricted to the units that have established ownership rights over it or to units licensed by the owner. Outlays on research and development, staff training, market research, and similar activities are not treated as intangible fixed assets even though some of them may bring future benefits. These outlays are treated as expense.
- **7.52** Mineral exploration is undertaken to discover new deposits of petroleum, natural gas, and other

subsoil assets that may be exploited commercially. The information obtained from exploration influences the production activities of those who obtain it over a number of years.

- **7.53** The value of the resulting asset is measured by the value of the resources allocated to exploration because it is not possible to value the information obtained. In addition to the costs of actual test drilling and boring, mineral exploration includes any prelicense, license, acquisition, and appraisal costs, the costs of aerial and other surveys, and transportation and other costs incurred to make the exploration possible. Exploration undertaken in the past whose value has not yet been fully written off should be revalued at the prices and costs of the current period.
- **7.54** Computer software includes computer programs, program descriptions, and supporting materials for both systems and applications software that are expected to be used for more than one year. The software may be purchased from other units or developed on own account. Large expenditures on the purchase, development, or extension of computer databases that are expected to be used in production for more than one year are also included.
- **7.55** The value of computer software should be based on the amount paid for the software if acquired from another unit or on the costs of production when produced on own account. Software acquired in previous years and not yet fully written off should be revalued at current prices or costs.
- **7.56** Entertainment, literary, and artistic originals are original films, sound recordings, manuscripts, tapes, and models in which drama performances, radio and television programming, musical performances, sporting events, and literary and artistic output are recorded or embodied. They should be valued at their current market price when they are actually traded. Otherwise, they should be valued either on the basis of their acquisition price or costs of production, appropriately revalued at the prices of the current period and written down; or on the basis of the net present value of the expected future receipts.
- **7.57** Other intangible fixed assets consist of new information and specialized knowledge not elsewhere classified, the use of which is restricted to the units that have established ownership rights over the information or to other units licensed by the owners. The assets should be valued at their current written-

down cost of production or the present value of expected future receipts.

b. Inventories (612)

7.58 Inventories are goods and services held by producers for sale, use in production, or other use at a later date. Inventories are classified as *strategic stocks* (6121) and *other inventories* (6122). Inventories should be valued at their current market prices on the balance sheet date rather than their acquisition prices. In principle, current market prices should be available for most types of inventories, but in practice the values of inventories frequently are estimated by adjusting book or acquisition values of inventories with the aid of price indexes.

(i) Strategic stocks (6121)

7.59 Strategic stocks include goods held for strategic and emergency purposes, goods held by market regulatory organizations, and commodities of special importance to the nation, such as grain and petroleum. This category is not in the *1993 SNA*, which treats strategic stocks as goods for resale (61224). Such stocks may be quite large for some governments and represent important components of government policies.

(ii) Other inventories (6122)

7.60 Other inventories consist of materials and supplies (61221), work in progress (61222), finished goods (61223), and goods for resale (61224).

Materials and supplies (61221)

7.61 Materials and supplies consist of all goods held with the intention of using them as inputs to a production process. General government units may hold a variety of goods as materials and supplies, including office supplies, fuels, and foodstuffs. Every general government unit may be expected to hold some materials and supplies, if only office supplies. Materials and supplies often can be valued on the basis of the current market prices for the same goods.

Work in progress (61222)

7.62 Work in progress consists of goods and services that have been partially processed, fabricated, or assembled by the producer but that are not usually sold, shipped, or turned over to others without further processing and whose production will be continued in

a subsequent period by the same producer.⁶ General government units that primarily produce nonmarket services are likely to have little or no work in progress as the production of most such services is completed in a short time span or continuously.

7.63 Work-in-progress inventories are valued on the basis of the current price of the production costs incurred as of the balance sheet date. The value of standing timber and other cultivated crops may be estimated by discounting the future proceeds of selling the final product at current prices and the expenses of bringing the product to maturity.

Finished goods (61223)

7.64 Finished goods consist of goods that are the output of a production process, are still held by their producer, and are not expected to be processed further by the producer before being supplied to other units. General government units will have finished goods only if they produce goods for sale or transfer to other units. Inventories of finished goods are valued at their current sales value.

Goods for resale [GFS]7 (61224)

7.65 Goods for resale are goods acquired for the purpose of reselling or transferring to other units without being further processed.⁸ Goods for resale may be transported, stored, graded, sorted, washed, or packaged by their owners to present them for resale in ways that are attractive to their customers, but they are not otherwise transformed. Any general government unit that sells goods for economically significant prices, such as a museum gift shop, is likely to possess an inventory of goods for resale. This category also includes goods purchased by general government units for provision free of charge or at prices that are not economically significant to other units. Inventories of goods intended for resale are valued at their current replacement prices.

c. Valuables (613)

7.66 Valuables are produced goods of considerable value acquired and held primarily as stores of value and not used primarily for purposes of production or consumption. They are expected to appreciate, or at least not to decline, in real value, and they do not deteriorate over time under normal conditions.

7.67 Valuables consist of

- Precious stones and metals such as diamonds, nonmonetary gold, platinum, and silver that are not intended to be used as intermediate inputs into processes of production.
- Paintings, sculptures, and other objects recognized as works of art or antiques.
- Jewelry of significant value fashioned out of precious stones and metals, collections, and miscellaneous other valuables.

Most items fitting the description of a valuable that are owned by general government units will be classified as other machinery and equipment (61122) because they are used primarily in museums to produce services for the public rather than held as stores of value.

7.68 To the extent that there are well-organized markets for valuables, they can be valued at current market prices, including any agents' fees or commissions. Otherwise the amounts for which they are insured against fire, theft, and other risks may be appropriate.

d. Nonproduced assets (614)

7.69 Nonproduced assets consist of tangible, naturally occurring assets over which ownership rights are enforced, and *intangible nonproduced assets* (6144) that are constructs of society. Naturally occurring assets include *land* (6141), *subsoil assets* (6142), *other naturally occurring assets* (6143). If ownership rights have not or cannot be enforced over naturally occurring entities, then they are not economic assets.

(i) Land (6141)

7.70 Land is the ground itself, including the soil covering, associated surface water, and major improvements that cannot be physically separated from the land, but excluding the following:

⁶As noted in paragraphs 7.34 and 7.48, uncompleted fixed assets, including immature animals and plants that will be used repeatedly or continuously for more than one year to produce other goods and services, that are being produced on own account are treated as fixed assets rather than work in progress. Immature animals and plants being raised for one-time use, such as livestock raised for slaughter and trees grown for timber, are work in progress.

⁷[GFS] indicates that this item has the same name but different coverage in the *1993 SNA*.

⁸Strategic stocks are included in this category in the 1993 SNA but are separately classified in the GFS system.

- Buildings and other structures constructed on the land or through it, such as roads, office buildings, and tunnels.
- Cultivated vineyards, orchards, and other plantations of trees, animals, and crops.
- · Subsoil assets.
- Noncultivated biological resources.
- Water resources below the ground.

The associated surface water includes any reservoirs, lakes, rivers, and other inland waters over which ownership rights can be exercised and which can, therefore, be the subject of transactions between units.

7.71 The value of major improvements that cannot be physically separated from the land is included in the value of the land. Such improvements either increase the quantity, quality, or productivity of land or prevent its deterioration. Examples of major improvements are land reclaimed from the sea by the construction of dikes, sea walls, or dams; forests cleared to enable land to be used in production for the first time; drained marshes; and breakwaters, sea walls, or other barriers constructed to prevent floods. The value of major improvements is normally determined by their written-down replacement costs.

7.72 The value of land can vary enormously depending on its location and the uses for which it is suitable or sanctioned. As a result, these factors must be taken into account when the current market price for the land is determined. In a number of instances, it may be difficult or impractical to separate the value of land from the value of structures erected on the land. One valuation method is to calculate general ratios of the value of land to the value of structures from appraisals. A second method is to deduct the current written-down replacement cost of a structure from the combined market value of the land and structure.

(ii) Subsoil assets (6142)

7.73 Subsoil assets are proven reserves of oil, natural gas, coal (including anthracite, bituminous, and brown coal), metallic mineral reserves (including ferrous, nonferrous, and precious metal ores), and nonmetallic mineral reserves (including stone quarries, clay and sand pits, chemical and fertilizer mineral deposits, and deposits of salt, quartz, gypsum, natural gem stones, asphalt, bitumen, and peat).

Mine shafts, wells, and other subsoil extraction facilities are fixed assets (611) rather than subsoil assets.

7.74 The deposits may be located on or below the earth's surface, including deposits under the sea, but they must be economically exploitable. The value of the reserves is usually estimated as the present value of the expected net returns resulting from their commercial exploitation, but if the ownership of subsoil assets changes frequently on markets, then it may be possible to obtain appropriate prices.

(iii) Other naturally occurring assets (6143)

7.75 Other naturally occurring assets include noncultivated biological resources, water resources, and the electromagnetic spectrum. Noncultivated biological resources are animals and plants that are subject to ownership rights that are enforced but whose natural growth and/or regeneration is not under the direct control, responsibility, and management of any unit. Examples are virgin forests and fisheries that are commercially exploitable. Only those resources that have economic value that is not included in the value of the associated land are included. As observed prices are not likely to be available, such assets are usually valued at the net present value of expected future returns.

7.76 Water resources are aquifers and other ground-water resources that are sufficiently scarce to warrant enforcement of ownership and/or use rights, that are exploitable for economic purposes or are likely to be exploitable soon, and that have economic value that is not included in the value of the associated land. As observed prices are not likely to be available, such assets are usually valued at the net present value of expected future returns.

7.77 The electromagnetic spectrum consists of the range of radio frequencies used in the transmission of sound, data, and television. The value of the spectrum is usually determined as the net present value of expected future returns. If a long-term contract to use the spectrum has been let, it can be used as a basis for estimating the total value of the asset.⁹

(iv) Intangible nonproduced assets (6144)

7.78 Intangible nonproduced assets are constructs of society evidenced by legal or accounting actions. Some entitle their owners to engage in certain specific

⁹The treatment and valuation of the electromagnetic spectrum when a long-term contract for its use has been let was a topic still under discussion at the time of publication of this manual.

62	Financial assets	63	Liabilities
62 I	Domestic	631	Domestic
6212	Currency and deposits	6312	Currency and deposits
6213	Securities other than shares	6313	Securities other than shares
6214	Loans	6314	Loans
6215	Shares and other equity	6315	Shares and other equity (public corporations only)
6216	Insurance technical reserves	6316	Insurance technical reserves [GFS]
6217	Financial derivatives	6317	Financial derivatives
6218	Other accounts receivable	6318	Other accounts payable
622	Foreign	632	Foreign
6222	Currency and deposits	6322	Currency and deposits
6223	Securities other than shares	6323	Securities other than shares
6224	Loans	6324	Loans
6225	Shares and other equity	6325	Shares and other equity (public corporations only)
6226	Insurance technical reserves	6326	Insurance technical reserves [GFS]
6227	Financial derivatives	6327	Financial derivatives
6228	Other accounts receivable	6328	Other accounts payable
623	Monetary gold and SDRs		

activities or to produce certain specific goods or services and to exclude other units from doing so except with the permission of the owner. The owners of the assets may be able to earn monopoly profits by restricting the use of the assets to themselves. Intangible non-produced assets include patented entities, leases and other contracts, and purchased goodwill. Whenever possible, intangible assets should be valued at current prices when they are actually traded on markets. Otherwise, it may be necessary to use estimates of the net present value of expected future returns.

7.79 Patents provide protection, by law or by judicial decision, for inventions. Examples of inventions that can be protected include constitutions of matter, processes, mechanisms, electrical and electronic circuits and devices, pharmaceutical formulations, and new varieties of living things produced by artifice.

7.80 Leases and other contracts that might be classified as economic assets include leases of land, buildings, and other structures; concessions or exclusive rights to exploit mineral deposits or the electromagnetic spectrum; contracts with athletes and authors; and options to buy tangible assets not yet produced. The criteria for determining which leases or other contracts are economic assets was a topic still under discussion at the time of publication of this manual.

7.81 Purchased goodwill is the difference between the value paid for an enterprise as a going concern and the sum of its assets less the sum of its liabilities. The value of goodwill, therefore, includes anything of long-term benefit to the business that has not been

separately identified as an asset, as well as the value of the fact that the group of assets is used jointly and is not simply a collection of separable assets. Purchased goodwill should be valued at its acquisition cost less accumulated amortization, appropriately revalued.

2. Financial assets (62) and liabilities (63)

7.82 Financial assets and liabilities were defined in paragraphs 7.12 and 7.14. The classifications of financial assets and liabilities are based primarily on the liquidity and legal characteristics of the instruments that describe the underlying creditor-debtor relationships. The liquidity of a financial instrument embraces characteristics such as negotiability, transferability, marketability, and convertibility.

7.83 In addition to classifying financial assets and liabilities by the characteristics of the financial instrument, they are also classified according to the residence of the other party to the instrument (the debtors for financial assets and the creditors for liabilities). Residency is defined in paragraph 2.71 of Chapter 2. The classifications of financial assets and liabilities are shown in Table 7.3.

7.84 Because a given financial instrument is common to a financial asset and a liability, the same descriptions of instruments can be used for both. For simplicity, the descriptions will refer only to financial assets unless there is a specific need to refer to liabilities.

 $[\]overline{^{10}}\text{There}$ is no underlying creditor-debtor relationship for monetary gold and SDRs.

7.85 In principle, all financial claims should be valued at their current market price. That value, however, may differ from a claim's nominal value. ¹¹ Because the debtor can extinguish the claim on the date of the balance sheet by buying back the security at its current market price, it is that price that is relevant for the balance sheet. The current market price excludes any service charges, fees, commissions, and similar payments for services that would be necessary to acquire the asset or incur the liability.

7.86 Some financial assets and liabilities, most typically deposits, securities other than shares, loans, and accounts payable/receivable, require the debtor to pay interest. The interest accrues continuously and increases the total amount that the debtor will be required to pay. This manual recommends that accrued but unpaid interest be added to the principal of the underlying instrument. That is, as interest accrues on a government bond, the principal of the bond would increase. It is recognized, however, that interest accruing on deposits and loans may have to follow national practices and be classified under accounts payable.

7.87 The definition of the overall balance in Box 4.1 of Chapter 4 includes a provision for treating financial assets acquired by government units in support of their fiscal policies differently than financial assets acquired for liquidity management. The distinction between these two types of financial assets would be required to compute the overall balance but is not included in the classification of financial assets because it rests on the judgment of the analyst and the particular purpose for employing the overall balance.

7.88 Some fiscal policies that may lead to the ownership of financial claims include fostering new industries, assisting ailing government corporations, or helping particular businesses that are suffering economic adversity. For example, a government unit may provide loans at subsidized rates to a particular economic sector, acquire shares in a corporation active in an area that the government wishes to promote, or sell shares in a public corporation for less than their market value.

7.89 Liquidity management, on the other hand, refers to actions taken to ensure the availability of financial assets to fulfill requirements for short-term funds and to ensure that such funds earn the best

available rate of return. Prudent financial management requires that government units acquire and dispose of financial assets in the process of financing government operations. The motive underlying these transactions is the effective management of finances.

7.90 Some factors that should be considered when identifying policy-related financial assets are as follows:

- Nonnegotiable financial assets usually are policy related.¹²
- A government statement about the acquisition of a financial asset may indicate the purpose.
- Noncommercial terms favoring the borrower generally indicate a policy-motivated purpose, such as concessional interest rates on loans or arrangements for repayment that do not meet normal commercial standards.
- Financial assets acquired for a policy purpose typically involve shares and other equity, securities other than shares, or loans, especially when the issuer of the instrument is a public corporation. In addition, negotiable financial claims issued by a lower level of government and held by a higher level of government are often acquired for a policy purpose.
- Assets acquired as a result of government units acting as guarantors are likely to be policy related.
- Assets acquired through nationalization are policy related.
- Holdings of monetary gold, SDRs, currency, and insurance technical reserves are always liquidity related. Deposits may be acquired for policy or liquidity purposes.

7.91 In addition to identifying financial assets issued by public corporations in order to compute the overall balance, a classification of financial assets and liabilities according to whether the other party to the instrument is a public corporation would be necessary to compile consolidated statistics for the public sector. This distinction is also not a part of the GFS classification system, but it should be part of the underlying accounting records.

¹¹ Nominal value is defined in footnote 8 of Chapter 3.

¹²A negotiable financial instrument is one whose legal ownership is capable of being transferred from one unit to another unit by delivery or endorsement.

a. Monetary gold and SDRs (623)

7.92 Monetary gold consists of gold coins, ingots, and bars with a purity of at least 995/1000 that are

- Owned by units that undertake monetary authority functions and
- A component of the nation's official reserve assets
 The monetary authority will normally be the central bank, but it is possible for a unit of the general government sector to undertake some functions of the monetary authority.¹³
- **7.93** Monetary gold is a financial asset for which there is no corresponding liability on the part of another unit. It is valued at the current price established in organized markets or in bilateral arrangements between monetary authorities.
- **7.94** Any gold held by a government unit that does not satisfy the definition of monetary gold is treated as a nonfinancial asset, either a type of *inventory* (612) or a *valuable* (613). Deposits, loans, and securities denominated in gold are treated as deposits, loans, and securities and not as monetary gold. A gold swap is treated as a loan.
- 7.95 SDRs are international reserve assets created by the IMF and allocated to its members to supplement existing reserve assets. SDRs are held only by the monetary authorities of IMF member countries and a limited number of authorized international financial institutions. An SDR is a financial asset for which there is no corresponding liability, and the members to whom they have been allocated do not have an unconditional liability to repay their SDR allocations. A general government unit will hold SDRs only when it acts as the monetary authority.
- **7.96** An SDR represents an unconditional right to obtain foreign exchange or other reserve assets from other IMF members. They can be sold, loaned, or used to settle financial obligations. The value of the SDR is determined by the IMF as a weighted average of selected major currencies. Both the currencies and the weights are revised from time to time.

b. Currency and deposits (6212, 6222, 6312, 6322)

7.97 Currency consists of the notes and coins in circulation that are commonly used to make payments. They are issued either by the central bank or government units and are a liability of the units that issue them. Domestic currency has a fixed nominal value. Any currency that is an asset and a liability of the same unit or sector should be eliminated in accordance with the principle of consolidation described in Chapter 3. Unissued currency held by a government unit is not treated as an asset. Gold and commemorative coins that are not in circulation as legal tender are classified as nonfinancial assets rather than currency.

7.98 The value of foreign-denominated currency is converted to the domestic currency at the exchange rate valid on the date to which the balance sheet relates. Depending on the amount of foreign currency owned, it may be useful to subclassify the total amount of currency held according to whether it is denominated in the domestic currency or a foreign currency.

7.99 Deposits also are financial assets that have fixed nominal values and are used to make payments. They are stores of value and, depending on the type of deposit, may be a direct medium of exchange and may earn interest or entitle the deposit holder to specific services. The value of a domestic deposit is its nominal value, which is the amount that the debtor is contractually obliged to repay to the creditor when the deposit is liquidated.

7.100 Most government units can be expected to hold a variety of deposits as assets, including deposits in foreign currencies. It is also possible for a government unit to incur liabilities in the form of deposits. For example, a court or tax authority may hold a security deposit pending resolution of a dispute. It may be useful to subclassify deposits according to whether they are denominated in the domestic currency or a foreign currency.

7.101 Deposits can be transferable or nontransferable. Transferable deposits comprise all deposits that are (a) exchangeable, without penalty or restriction, on demand at par and (b) directly usable for making third-party payments by check, draft, giro order, direct debit/credit, or other direct payment facility. Included are shares of money market mutual funds that offer unrestricted check-writing privileges.

¹³Gold held by other units that is subject to the effective control of the central bank or the general government sector acting as the monetary authority is also treated as monetary gold.

7.102 Some types of deposit accounts embody limited features of transferability. For example, some deposits have restrictions on the number of third-party payments that can be made per period and/or the minimum size of individual third-party payments. Judgment must be applied in deciding whether deposits with less-than-full transferability features should be classified as transferable or nontransferable deposits.¹⁴

7.103 Nontransferable deposits include all other financial claims represented by evidence of deposit, including the following:

- Sight deposits that permit immediate cash withdrawals but not direct third-party transfers.
- Savings and fixed-term deposits, including nonnegotiable certificates of deposit. Negotiable certificates of deposit are classified as securities other than shares.
- Financial corporations' liabilities in the form of shares or similar evidence of deposit that are, legally or in practice, redeemable immediately or at relatively short notice.
- Shares of money market mutual funds whose restrictions on transferability, such as the number of checks that may be written per period or the minimum amount per check, prevent them from being classified as transferable deposits.
- Repurchase agreements that are included in the national measures of broad money.¹⁵
- Deposits that are required of importers in advance of importation.
- Transferable deposits that have been posted to depositors' accounts but cannot be drawn upon until the deposited items, such as checks or drafts, have been collected by the depository corporations that accepted them.
- Compulsory savings deposits arising from an official requirement that a share of a worker's earnings be placed in a deposit account that can be accessed only after a specified period or from which withdrawals may be made only for specified purposes.

- Foreign currency deposits that are blocked because of the rationing of foreign exchange as a matter of national policy.
- Deposits in financial corporations that are closed pending liquidation or reorganization.
- Claims on the IMF that are components of international reserves and are not evidenced by loans.

c. Securities other than shares (6213, 6223, 6313, 6323)

7.104 Securities other than shares are negotiable financial instruments serving as evidence that units have obligations to settle by means of providing cash, a financial instrument, or some other item of economic value. The security normally specifies a schedule for interest payments and principal repayments. Examples of securities other than shares are

- · Bills.
- Bonds and debentures, including bonds that are convertible into shares.
- Commercial paper.
- · Negotiable certificates of deposit.
- Tradable depository receipts.
- Notes issued through revolving underwriting facilities and note-issuance facilities.
- Securitized mortgage loans and credit card receivables.
- Loans that have become marketable de facto.
- Preferred stocks or shares that pay a fixed income but do not provide for participation in the distribution of the residual value of a corporation on dissolution.
- · Bankers' acceptances.

7.105 Bills, negotiable certificates of deposit, banker's acceptances, and commercial paper are short-term securities that give the holder the unconditional right to receive a stated fixed sum on a specified date. They are issued and traded at discounts relative to the stated fixed sum by amounts that depend on the rate of interest and the time to maturity. If market values of these securities are not available, then they should be valued

¹⁴The decisions made for the GFS system should be coordinated with the decisions made for the national accounts and for monetary and financial statistics.

¹⁵Other repurchase agreements are classified as loans.

at the issue price plus accrued interest, where the amount of interest is determined by the interest rate implicit in the original issue price.

7.106 Bonds and debentures are long-term securities that give owners the unconditional right to fixed money incomes or contractually determined variable money incomes, normally referred to as interest. Most bonds and debentures also give owners the unconditional right to a fixed sum or sums as repayment of principal on a specified date or dates. Perpetual bonds, however, have no maturity date.

7.107 Zero-coupon bonds are long-term securities that do not involve periodic payments during the life of the bond. Similar to short-term securities, the bonds are sold at a discount and a single payment that includes accrued interest is made at maturity. Deep-discount bonds are long-term securities that require periodic payments during the life of the instrument, but the amount is substantially below the market rate of interest.

7.108 If market values of long-term securities are not available, they should be valued at the issue price plus accrued but unpaid interest. It is important that deep-discount and zero-coupon bonds should not be valued at their face value.

7.109 Some corporate bonds are convertible into shares of the same corporation at the option of the bondholder. If the conversion option is traded separately, then it is treated as a separate asset, classified as a financial derivative (6217).

d. Loans (6214, 6224, 6314, 6324)

7.110 A loan is a financial instrument that is created when a creditor lends funds directly to a debtor and receives a nonnegotiable document as evidence of the asset. ¹⁶ This category includes mortgage loans, installment loans, hire-purchase credit, loans to finance trade credit and advances, repurchase agreements, financial assets and liabilities implicitly created by financial leases, and claims on or liabilities to the IMF in the form of loans. Ordinary trade credit and similar accounts receivable/payable are not loans.

7.111 Normally it will be necessary to value loans at nominal prices because they are not traded regularly on markets. Loans that have become marketable in

secondary markets should be reclassified under securities other than shares and should be valued on the basis of market prices or fair values in the same manner as other types of securities other than shares.

7.112 When goods are acquired under a financial lease, a change of ownership from the lessor to the lessee is deemed to take place, even though legally the leased good remains the property of the lessor, because all the risks and rewards of ownership have been, de facto, transferred to the lessee. This change in ownership is deemed to have been financed by a loan, which is an asset of the lessor and a liability of the lessee.

7.113 A securities repurchase agreement (repo) is an arrangement involving the sale for cash of securities at a specified price with a commitment to repurchase the same or similar securities at a fixed price either on a specified future date (often one or a few days hence) or with an open maturity.¹⁷ The economic nature of the transaction is that of a collateralized loan (or a deposit¹⁸) because the risks and rewards of ownership remain with the original owner. Thus, the funds advanced by the apparent purchaser to the apparent seller are treated as a loan and the underlying securities remain on the balance sheet of the borrower, despite the legal change in ownership.¹⁹

7.114 Securities lending is an arrangement whereby a security holder transfers securities to a borrower subject to the stipulation that the same or similar securities be returned on a specified date or on demand. As with a securities repurchase agreement, the risks and rewards of ownership remain with the original owner. If the borrower provides cash as collateral, then the arrangement is treated in the same way as a repo. If the borrower provides noncash collateral, then no transaction is recorded. In either case, the securities involved remain on the balance sheet of their original owners.

7.115 A gold swap is a repo in which monetary gold is exchanged for other reserve assets, usually foreign exchange deposits. Gold loans occur in the same form as securities lending and should be treated in the same way.

 $^{^{16}}$ A loan is distinguished from a deposit (6212) on the basis of the representation in the documents that evidence them.

¹⁷An open maturity exists when both parties agree daily to renew or terminate the agreement.

¹⁸Repurchase agreements that are included in the national definition of broad money should be classified as nontransferable deposits. All other securities repurchase agreements should be classified under loans.

¹⁹See pp. 29–33 of the *Monetary and Financial Statistics Manual* for additional details and an alternative treatment of repos. In all cases, the treatment used in the GFS system should be consistent with the treatment used in the national accounts and in monetary and financial statistics.

7.116 When securities that have been obtained in repos or securities lending are sold to third parties, a short sale results. In this case, a negative asset equal to the current market value of the security that was sold should be included on the balance sheet of the seller.

e. Shares and other equity (6215, 6225, 6315, 6325)

7.117 Shares and other equity comprise all instruments and records acknowledging, after the claims of all creditors have been met, claims on the residual value of a corporation. Most equity securities do not provide the right to a predetermined income or to a fixed sum on dissolution of the corporation. Ownership of equity is usually evidenced by shares, stocks, participations, or similar documents. Shares and other equity cannot be a liability of general government units, but they can be held by these units as assets.

7.118 In addition to common shares of corporations, the following types of securities are classified as shares or other equity:

- The value of a government unit's ownership interest in a quasi-corporation.
- Partnerships and limited partnership interests.
- Preferred stocks or shares that provide for participation in the distribution of the residual value on dissolution of an incorporated enterprise.
- Mutual fund shares.

7.119 If possible, shares and other equities should be valued at their current prices on stock exchanges or other organized financial markets, including the shares of public corporations that are actively traded. The equity held by government units in public corporations with untraded shares and all quasi-corporations is equal to the total value of the corporation's or quasi-corporation's assets less the total value of its other liabilities.²¹ The value of shares in private corporations that are not traded regularly are estimated using the prices of quoted shares that are comparable in earnings, dividend history, and prospects. The prices may be adjusted downward to allow for the inferior marketability or liquidity of unquoted shares.

f. Insurance technical reserves [GFS] (6216, 6226, 6316, 6326)

7.120 Insurance technical reserves consist of the net equity of households in pension funds and life insurance reserves, prepaid premiums, and reserves against outstanding claims. General government units may incur liabilities for insurance technical reserves as operators of non-life insurance schemes and nonautonomous or unfunded pension schemes, and they may hold assets as non-life insurance policyholders. It is unlikely that a general government unit would incur liabilities or hold assets with respect to life insurance. Public financial corporations, including autonomous pension funds, can engage in all types of insurance schemes, including life insurance.

7.121 The individuals covered by a retirement scheme have claims against the unit operating the scheme that are liquidated by the payment of benefits when the individuals satisfy specified criteria, usually by attaining a certain age and/or number of years of service. The nature of those claims, and the corresponding liabilities of the units operating the pension funds, depends on the type of benefits promised.

7.122 The two main types of pension schemes are defined-benefit schemes and defined-contribution schemes.²² In a defined-benefit scheme, the level of pension benefits promised by the employer to participating employees is guaranteed and usually is determined by a formula based on participants' length of service and salary. The liability of a defined-benefit pension scheme is the present value of the promised benefits. In a defined-contribution scheme, the level of contributions to the fund by the employer is guaranteed, but the benefits that will be paid depend on the assets of the fund. The liability of a defined-contribution pension fund is the current market value of the fund's assets.

7.123 A pension fund for government employees can be managed on behalf of the government by a public or private insurance corporation or it can be organized and managed by the government as an autonomous or nonautonomous pension fund. By its nature, an unfunded scheme must be organized and managed by the employer, which may be a general government unit or a public corporation.

²⁰Some preferred shares provide for a predetermined property income in the form of dividends and for participation in the distribution of the residual value of the corporation when it is liquidated. ²¹If the government unit does not own all of the equity of the public corporation, then only its proportional share would be an asset.

 $[\]overline{^{22}} \text{Defined}\text{-contribution}$ schemes are also referred to as money-purchase schemes.

7.124 A pension scheme operated by an insurance corporation or as an autonomous pension fund can have a net worth, positive or negative, if the assets of the fund exceed or fall short of the fund's liability for the retirement benefits. As with other public corporations, this net worth is owned by the employer or employers that established the fund. A nonautonomous pension fund is not a separate unit and the assets of the fund belong to the employer. The employees, however, have a claim against the employer, and the employer has a liability equal to the present value of the promised benefits.

7.125 If a public financial corporation is a life insurance enterprise, then it must retain reserves against its outstanding life insurance and annuity policies. Households have claims against the enterprise equal to the present value of the expected payments of policy benefits. Hence, the life insurance enterprise has a liability equal to the same amount.

7.126 With respect to social security schemes, no liability is recognized in the GFS system for government promises to pay retirement pensions and other benefits in the future, regardless of the level of assets in a social security fund or other segregated accounts. Liabilities for the payment of benefits that were due to be paid but have not yet been paid are classified as other accounts payable.

7.127 Prepayments of non-life insurance premiums result from the fact that most insurance premiums are paid at the start of the period covered by the insurance. Therefore, at any given time part of the insurance premiums already paid have not yet been earned by the insurance enterprise because they cover risks in the future. The value of the prepaid premiums is determined on the basis of the ratio of the risks involved in the time remaining on the contract to the risks involved for the entire contract period.²³

7.128 Prepaid insurance premiums are assets of the policyholders and liabilities of the insurance enterprises. General government units may purchase insurance, usually non-life insurance, to manage its risks. General government units may also operate insurance schemes, such as flood insurance or deposit insurance. Thus, it is possible for a government unit to have both an asset and a liability for prepaid premiums.

7.129 Reserves against outstanding claims are reserves that operators of non-life insurance schemes hold in order to cover the amounts they expect to pay for claims that are not yet settled or claims that may be disputed. Claims accepted by insurance operators are accrued when the eventuality or accident that gives rise to the claim occurs. These reserves are assets of the beneficiaries who will eventually receive them as compensation for their claims and liabilities of insurance operators. The value of reserves against outstanding claims is the present value of the amounts expected to be paid out in settlement of claims, including disputed claims.

g. Financial derivatives (6217, 6227, 6317, 6327)

7.130 Financial derivatives are financial instruments that are linked to a specific financial instrument, indicator, or commodity, and through which specific financial risks can be traded in financial markets in their own right. The value of a financial derivative derives from the price of the underlying item: the reference price. The term "underlying item" may refer to indices as well as commodities and other financial variables, and the term "reference price" may relate to a commodity, a financial asset, an interest rate, an exchange rate, another derivative, a spread between two prices, an index, or a basket of prices. An observable market price or an index for the underlying item is essential for calculating the value of any financial derivative. If a financial derivative cannot be valued because a prevailing market price or index for the underlying item is not available, it cannot be regarded as a financial asset. Unlike many other financial claims, no principal amount is advanced that has to be repaid and no investment income accrues.

7.131 There are two broad classes of financial derivatives: forward-type contracts, including swaps, and option contracts. Under a forward contract, the two counterparties agree to exchange a specified quantity of an underlying item, which may be real or financial, at an agreed price on a specified date. At the inception of the contract, risk exposures of equal market value are exchanged and the contract has zero value. Some time must elapse for the market value of each party's risk to differ so that an asset is created for one party and a liability for the other. The debtorcreditor relationship may change both in magnitude and direction during the life of the forward contract.

7.132 Common forward-type contracts include interest rate swaps, forward rate agreements, foreign

²³ In the *1993 SNA*, insurance premiums are divided into two parts: a payment for services produced by the insurance enterprise and a transfer. In this manual, the entire payment is treated as a transfer.

exchange swaps, forward foreign exchange contracts, and cross-currency interest rate swaps:

- An interest rate swap is an exchange of cash flows related to interest payments or receipts on a notional amount of principal on one currency over a period of time. The principal, however, is never exchanged.
- Forward rate agreements are arrangements in which two parties agree on an interest rate to be paid at a specified settlement date on a notional amount of principal that is never exchanged. The buyer of the forward rate agreement receives payment from the seller if the prevailing rate exceeds the agreed rate and the seller receives payment from the buyer if the prevailing rate is lower than the agreed rate.
- A foreign exchange swap is a spot sale/purchase of currencies and a simultaneous forward purchase/sale of the same currencies.
- Forward foreign exchange contracts involve two counterparties who agree to transact in foreign currencies at an agreed exchange rate in a specified amount at some agreed future date.
- Cross-currency interest rate swaps, sometimes known as currency swaps, involve an exchange of cash flows related to interest payments and an exchange of principal amounts at an agreed exchange rate at the end of the contract. There might also be an exchange of principal at the beginning of the contract.
- **7.133** Options are contracts that give the purchaser of the option the right, but not the obligation, to buy (a "call" option) or to sell (a "put" option) a particular financial instrument or commodity at a predetermined price within a given time span or on a given date. Options are sold or "written" on many types of underlying bases such as equities, interest rates, foreign currencies, commodities, and specified indexes. The buyer of the option pays a premium to the seller for the latter's commitment to sell or purchase the specified amount of the underlying instrument or commodity on demand of the buyer.
- **7.134** Warrants are a form of options. They are tradable instruments giving the holder the right to buy, under specified terms for a specified period of time, from the issuer of the warrant (usually a corporation) a certain number of shares or bonds. There are also currency warrants based on the amount of one currency required to buy another and cross-currency warrants tied to third currencies.

7.135 Margins are payments of cash or collateral that cover actual or potential obligations under financial derivative contracts. Repayable margins consist of cash or other collateral deposited to protect a counterparty against default risk, but which remain under the ownership of the unit that made the deposit. Repayable margins paid in cash are deposits rather than financial derivatives. Repayable margins made in securities or other noncash assets retain their character as securities or other assets. Nonrepayable margins reduce a liability created under a financial derivative contract.

7.136 Market prices are available for many financial derivatives because they are traded on active markets. If market values are unavailable, then other fair value methods, such as options models or discounted present values, may be used. If the current market value of an option is not available, then it may be valued at the amount of the premium paid or payable.

h. Other accounts receivable/payable (6218, 6228, 6318, 6328)

7.137 Other accounts receivable/payable consist of trade credits and advances and miscellaneous other items due to be received or paid. All such assets and liabilities should be valued at the amount the debtor is contractually obliged to pay the creditor to extinguish the obligation.

7.138 Trade credits and advances include (1) trade credit extended directly to purchasers of goods and services and (2) advances for work that is in progress or to be undertaken, such as progress payments made during construction, or for prepayments of goods and services. Such credit arises both from normal delays in receiving payment and from deliberate extensions of vendor credit to finance sales. Trade credit does not include loans, securities other than shares, or other liabilities that are issued to finance trade. If a government unit issues a promissory note or other security to consolidate the payment due on several trade credits, then the note or security is classified as a security other than shares. The value of an advance for work in progress refers only to work that is classified as inventories.²⁴

7.139 Miscellaneous other accounts receivable/ payable includes accrued but unpaid taxes, dividends, purchases and sales of securities, rent, wages and

²⁴As described in paragraph 7.34, the value of work carried out on uncompleted structures being acquired through progress payments required under a contract of sale is classified as fixed assets on the purchaser's balance sheet.

salaries, social contributions, social benefits, and similar items. In principle, accrued but unpaid interest should be added to the principal of the underlying asset rather than included in this category. It is recognized, however, that interest accruing on deposits and loans may have to follow national practices and be classified under accounts payable. Taxes receivable and/or wages payable should be separately indicated if the amounts are substantial.

E. Net worth

7.140 Net worth is the difference between the total value of all assets and the total value of all liabilities. As noted in paragraph 7.15, shares and other equities are treated as liabilities of public corporations in the GFS system. If they are traded in the market or can otherwise be valued independently, the net worth of a public corporation is determined by including the value of its shares and other equities in the total value of its liabilities. Thus, even though a corporation is wholly owned by a government unit, it may have a net worth, which could be positive or negative. For other public corporations and for all quasi-corporations, the value of the corporation's or quasi-corporation's liability for shares and other equity is assumed to be equal to the total value of its assets less the total value of its other liabilities. As a result, the net worth of these units is zero. Net financial worth, equal to the total value of all financial assets less the total value of all liabilities, is an important component of total net worth.

F. Memorandum Items

7.141 It may be desirable to record memorandum items to provide supplemental information about items related to, but not included on, the balance sheet.

I. Debt

7.142 Debt consists of all liabilities that require payment or payments of interest and/or principal by the debtor to the creditor at a date or dates in the future. Thus, all liabilities in the GFS system are debt except for shares and other equity and financial derivatives.

7.143 In some cases, the current market value of a debt may differ significantly from its nominal value, which is defined in footnote 8 of Chapter 3. For some analytic purposes, nominal values of debt may be preferable to current market values, and, in general, it is useful to be able to compare nominal values with

current market values. It is recommended, therefore, that estimates of total debt and the most important categories of debt be presented in both values.

2. Arrears

7.144 A debt is in arrears when it has not been liquidated by its due-for-payment date. Information on debt in arrears can be useful for various types of policy analysis and solvency assessments. The total amount of debt in arrears should be indicated as a memorandum item and the classification of liabilities should be expanded to show how much of each category is in arrears whenever the amounts are significant. For example, a government unit's liability for securities other than shares owed to domestic units (item 6313 in Table 7.3) should be divided into the amount not in arrears and the amount in arrears.

3. Obligations for social security benefits

7.145 No liability is recognized in the GFS system for government promises to pay social security benefits in the future, such as retirement pensions and health care. All contributions to social security schemes are treated as transfers (revenue) and all payments of benefits are also treated as transfers (expense). The present value of social security benefits that have already been earned according to the existing laws and regulations but are payable in the future should be calculated in a manner similar to the liabilities of an employer retirement scheme and be shown as a memorandum item.

4. Contingent contracts

7.146 Contingent contracts are contracts that create a conditional financial claim on a unit. In this context, conditional means that the claim only becomes effective if a stipulated condition or conditions arise. By conferring rights or obligations that may affect future decisions, contingent arrangements produce an economic impact on the parties involved. Collectively, such contingencies may be important for financial policy and analysis. Accordingly, important contingent contracts should be recorded as a memorandum item.

7.147 Contingent contracts can represent either potential assets or liabilities. A common type of contingent liability of a general government unit is a guarantee of payment by a third party, such as when the general government unit guarantees the repayment of a loan by another borrower. Such arrangements are contingent because the guarantor is required to repay the loan only if the borrower defaults. Other examples of contingent

liabilities include letters of credit, lines of credit, indemnities against unforeseen tax liabilities arising in government contracts with other units, and damages and other legal claims against the government in pending court cases. An example of a contingent asset is a pending legal case in which the government has claimed damages against another party.

7.148 Not all contingent assets or liabilities are easily quantifiable in terms of the net value of economic benefits expected to be received or paid. For example, the original nominal value of all loans guaranteed should be known, but the present value of the future payments by the government as guarantor depends on the likelihood and timing of default of each loan. Although precise recommendations cannot be specified for contingencies, a description of the nature of the various contingencies should be provided together with some indication of their possible value.

7.149 In a number of financial arrangements, such as many financial derivatives, the contract is conditional on the part of one or both parties, but the arrangement itself has value because it is tradable. Any such contracts should be recognized as financial assets and liabilities.

5. International reserves and foreign currency liquidity

7.150 A country's international reserves refer to those external assets that are readily available to and controlled by the monetary authorities for direct financing of payments imbalances, for indirectly regulating the magnitudes of such imbalances through intervention in exchange markets to affect the currency exchange rate, and/or for other purposes. Reserve assets consist of currency, deposits, and securities denominated in foreign currencies, monetary gold, SDRs, and the nation's reserve position in the IMF. In many countries, reserve assets will be held by the central bank, but it is possible for a government unit to hold reserve assets, especially when it acts as the monetary authority. If so, the amount and type of reserve assets held by the units covered by the balance sheet should be indicated as a memorandum item.

7.151 The usability of international reserves is affected by both actual and potential demands on them resulting from short-term foreign currency liabilities and off-balance-sheet activities of the mone-

tary authorities. For the purpose of assessing liquidity, foreign currency assets other than international reserves may be taken into consideration. In addition, relevant assets and liabilities of all public-sector entities responsible for, or involved in, responding to currency crises should be taken into account. In practice, this coverage includes the central government except for social security funds.²⁵

6. Uncapitalized military weapons and weapondelivery systems

7.152 As described in paragraph 7.36, destructive weapons and vehicles, other equipment, and structures whose function is to release such weapons are not treated as fixed assets. Nevertheless, these items generally are held and, in some cases, used repeatedly or continuously for several years. For some analytic purposes, therefore, it may be useful to know the current market value of these items as if they had been treated as fixed assets and to report that value as a memorandum item.

G. Supplemental cross-classification of financial claims by sector of the other party to the instrument

7.153 The classifications of financial assets and liabilities in Table 7.3 focus on the type of instrument underlying the claim. For a full understanding of financial assets and liabilities of the general government sector or the public sector, it is often important to identify more detailed financial relationships. For example, it is often important to know not just what types of liabilities the general government sector has used to obtain financing but also which sectors have provided the financing. Within the general government sector, it is often necessary to analyze debtor-creditor relationships between subsectors.

7.154 Two parties are associated with all financial claims. As a result, it is possible to cross-classify the financial instruments of financial claims with the second party. This supplemental classification is presented in Table 7.4, which should be compiled separately for financial assets and liabilities. The definitions of sectors are given in Chapter 2.

²⁵Guidelines for assessing a nation's foreign currency liquidity position are described in International Monetary Fund, *International Reserves and Foreign Currency Liquidity: Guidelines for a Data Template* (Washington 2001).

Table 7.4: Cross-Classification of Financial Claims and Sectors

	Currency and deposits	Securities other than shares	Loans	Shares and other equity	Insurance technical reserves	Financial derivatives	Other accounts receivable/ payable
Domestic							
Other general government units							
Central bank							
Other depository corporations							
Financial corporations not elsewhere classified							
Nonfinancial corporations							
Households and nonprofit institutions serving households							
Foreign							
International organizations							
General government							
Financial corporations other than international organizations							
Other nonresidents							

8. Transactions in Nonfinancial Assets

This chapter describes transactions in nonfinancial assets and their classification.

A. Introduction

- **8.1** Chapter 7 describes the balance sheet and the assets and liabilities recorded on it. As an integrated system, the GFS system also includes the flows necessary to explain all changes between the balance sheet at the end of one period and the balance sheet at the end of the next period. As described in paragraph 3.4 of Chapter 3, there are two types of flows—transactions and other economic flows—both of which can affect stocks of assets and liabilities. This chapter describes the transactions that affect holdings of nonfinancial assets. Chapter 9 describes the transactions that affect holdings of financial assets and liabilities, and Chapter 10 describes other economic flows, all of which affect assets and liabilities.
- **8.2** For each category of nonfinancial assets, there is an accounting identity linking successive balance sheets. It states that

The value of a category of nonfinancial assets on the balance sheet at the beginning of an accounting period.

plus

The total value of that category of assets acquired in transactions during the accounting period.

minus

The total value of that category of assets disposed of in transactions during the accounting period (including consumption of fixed capital).

plus

The net value of other economic flows that affect that category of assets.

equals

The value of the category of assets on the balance sheet at the end of the accounting period.

This identity requires that transactions, other economic flows, and stocks be recorded consistently with regard to time of recording and valuation. The accounting rules governing these factors are described in Chapter 3.

- **8.3** Transactions can change stocks of nonfinancial assets in different ways and all must be accounted for. The more important types of transactions follow:
- Existing assets of all types can be acquired from other units by purchase, barter, payment in kind, or transfer. The same transaction is a disposal of an asset from the viewpoint of the other unit.
- Newly produced fixed assets, inventories, and valuables can be sold or otherwise disposed of by their producers in the same manner as existing assets, or the producers can retain them for their own use.
- Renovations, reconstructions, or enlargements that significantly increase the productive capacity or extend the service life of an existing fixed asset are treated as acquisitions of fixed assets even though physically they function as part of the existing asset. Major improvements to land are treated as acquisitions of land.
- Consumption of fixed capital is an internal transaction that records the decrease in the value of fixed assets and certain other nonfinancial assets because they have been used repeatedly or continuously in production.
- Inventories can be acquired or disposed of through internal transactions as well as transactions with other units. For example, withdrawals from the inventory of materials and supplies for use in the production of general government services and transfers of completed production from the work-in-progress inventory to the finished-goods inventory are internal transactions. Recurrent losses and spoilage of goods held in inventories are also treated as internal transactions.

- **8.4** All transactions that increase a unit's holdings of assets are labeled *acquisitions*. With the exception of consumption of fixed capital, all transactions that decrease a unit's holdings of assets are labeled *disposals*. Thus, the results of transactions in a particular category of assets can be presented either as total acquisitions and total disposals or as net acquisitions.¹
- **8.5** The remainder of this chapter describes first the valuation, time of recording, consumption of fixed capital, and netting of transactions that affect nonfinancial assets and then provides details on transactions that affect specific categories of nonfinancial assets.

B. Valuation

- **8.6** Acquisitions of nonfinancial assets other than inventories are valued at their exchange price plus all transport and installation charges and all costs incurred in the transfer of ownership, such as fees paid to lawyers and taxes payable on the transfer. Interest and other financing charges incurred in connection with a transaction are not a cost of ownership transfer. Assets produced on own account are valued at their cost of production.² Sales and other disposals of existing nonfinancial assets are valued at their exchange value less any costs of ownership transfer incurred by the disposing unit.
- **8.7** Additions to and withdrawals from inventories are valued at the prices applicable at the time of the addition or withdrawal, which in the case of withdrawals may be quite different from their value when acquired. No costs for installation or ownership transfer are added or subtracted for transactions in inventories.
- **8.8** The value of a transaction expressed in a foreign currency is converted to the domestic currency using the midpoint of the buying and selling exchange rates at the time of the transaction.
- **8.9** General government units may acquire or dispose of nonfinancial assets on a nonmarket basis as an ele-

¹The net acquisition of inventories is referred to as "changes in inven-

tories." Transactions in fixed assets, valuables, and nonproduced assets would be summarized as acquisitions, disposals, and consumption of fixed capital. Net acquisitions of assets can, of course, be negative.

In the 1993 SNA, assets produced on own account should be valued at their basic price, which is the amount that would be received by the producer from a purchaser minus any tax payable plus any subsidy receivable. If this price is not known, then the assets should be valued by their total costs of production plus a markup for the operating surplus. In the GFS system, it is assumed that market prices of fixed assets constructed by general government units will not be known and that the operating surplus of a general government unit is zero.

ment of their fiscal policy, either by purchasing an asset for more than its market value or by selling an asset for less than its market value. By their nature, such transactions involve a transfer component. If the asset's market value can be determined, then the transaction should be valued at that amount and a second transaction should be recorded as an expense to account for the transfer.³ Usually, however, there is not an active market for the assets and it is difficult to estimate a market value. In this case, the value of the acquisition or disposal should be the amount of funds exchanged.

C. Time of recording

- **8.10** As described in paragraph 3.41 of Chapter 3, under the accrual basis, transactions are recorded at the time economic value is created, transformed, exchanged, transferred, or extinguished. For transactions in non-financial assets, this time is when the ownership of the nonfinancial assets is obtained or relinquished.
- **8.11** The acquisition or disposal of an existing non-financial asset by purchase or sale is recorded according to the terms of the contract. For movable assets, this moment is usually the time when the asset is shipped from the seller to the purchaser or when the purchaser receives it. For an immovable asset, the moment is usually the time of the formal settlement of the contract. Acquisitions and disposals by barter, payment in kind, or transfer in kind are recorded when there is a change in control of the asset.
- **8.12** The time of recording of the acquisition of a new nonfinancial asset depends on how the asset is acquired.
- If the asset is acquired from the producing unit as a
 finished good, then the timing is determined in the
 same manner as for the purchase of an existing
 asset. Typically this time is not the time at which
 the asset was produced or the time at which it is put
 to use in production.
- When another unit produces a structure under a contract of sale agreed in advance and the production extends over more than one accounting period, then ownership of the structure is deemed to be transferred as work proceeds. If the contract does not specify the time of the ownership transfer, then the time of the stage or progress payments may be used.

³The expense often will be a capital transfer to a market enterprise and classified as miscellaneous other expense. It could be a capital grant if the other unit is a general government unit.

- When production is carried out on own account, there is no formal transfer of ownership. The producing unit effectively takes possession progressively as production proceeds so that the asset is acquired as each transaction involved in its production is recorded. For example, if a government unit constructs a building using its own workforce, then each use of goods and services and work performed by employees is treated as an acquisition of a fixed asset.
- **8.13** Consumption of fixed capital, in principle, should be recorded continuously throughout each accounting period. In practice, it can be computed only after the end of the accounting period because it depends on the average price of the asset over the entire period.
- **8.14** Fixed assets acquired or disposed of by means of a financial lease are deemed to be acquired or disposed of when the lease is signed or control of the asset otherwise changes hands.

D. Consumption of fixed capital

- **8.15** Consumption of fixed capital is an internal transaction that reflects the fact that a general government unit used up a portion of each of its fixed assets through its productive activities during the accounting period and the value of those assets declined correspondingly. As a result, consumption of fixed capital, which is recorded as an expense, is also recorded as a transaction in nonfinancial assets. For convenience, paragraphs 6.33 to 6.38 of Chapter 6 describing this calculation are repeated in the following paragraphs.
- **8.16** Consumption of fixed capital is the decline during the course of an accounting period in the value of fixed assets owned and used by a general government unit as a result of physical deterioration, normal obsolescence, or normal accidental damage.⁴ It is valued in the average prices of the period. Consumption of fixed capital may deviate considerably from depreciation as recorded in government financial records, which is normally calculated using the original costs of fixed assets.

- 8.17 Consumption of fixed capital is a forward-looking measure because its value is based on future events rather than past events. The value of a fixed asset is the present discounted value of the stream of rentals that the owner of a fixed asset could expect if it were rented out over the remainder of its service life. The rentals, in turn, depend upon the benefits that units expect to derive from using the asset. Thus, consumption of fixed capital is the decrease in the present value of the remaining sequence of rentals, with the rentals valued at the average prices of the period. The extent of the decrease will be influenced not only by the decrease in the benefits derived from the asset, or its efficiency, during the current period, but also by the shortening of its service life and the rate at which its efficiency is expected to decline over its remaining service life. Furthermore, changes in the price of the asset must be excluded from consumption of fixed capital. Price changes are recorded as holding gains, as described in Chapter 10.
- **8.18** Consumption of fixed capital is estimated with respect to all tangible and intangible fixed assets, including infrastructure assets, major improvements to land, and the costs of ownership transfer incurred on the acquisition of valuables and nonproduced assets. Although some fixed assets, such as roads or railway tracks, may appear to have infinite service lives if properly maintained, their value may nevertheless decline because of a decrease in the demand for their services as a result of technical progress and the appearance of substitutes. Many fixed assets are scrapped or demolished only because they have become obsolete. Consequently, consumption of fixed capital must include an allowance for anticipated obsolescence.
- **8.19** If a general government unit engages in own-account capital formation, then this category of expense does not include the consumption of fixed capital related to the fixed assets used in that production process. As described in the previous sections on compensation of employees and use of goods and services, the costs incurred in own-account capital formation, including consumption of fixed capital, are classified as acquisitions of fixed assets.
- **8.20** Consumption of fixed capital also excludes the loss of value when fixed assets are destroyed by acts of war, natural disasters, and other exceptional events. Similarly, it excludes losses due to unexpected technological developments that may significantly shorten the service life of an existing fixed asset and the depletion or degradation of nonpro-

⁴The concept of consumption of fixed capital is identical to the concept used in the *1993 SNA*. The coverage of consumption of fixed capital expense may differ from the amount recorded in the production account of the *1993 SNA* because of the GFS treatment of own-account capital formation. When nonfinancial assets are produced on own account, some consumption of fixed capital is recorded in the GFS system as acquisitions of fixed assets rather than expense (see paragraph 8.19). Consumption of fixed capital is described in the *1993 SNA* in paragraphs 6.179 through 6.203.

duced assets such as land and subsoil assets. These events are treated as other economic flows, as described in Chapter 10.

8.21 To compute consumption of fixed capital, the fixed assets purchased in the past and still in use have to be revalued at the average prices of the current period and assumptions have to be made regarding the remaining service lives of each asset and the rate at which their efficiency is expected to diminish. Linear or geometric patterns of decline, or some combination of them, are the patterns most commonly assumed.⁵ In limited cases, it may be possible to estimate consumption of fixed capital from observations of used asset prices in markets.

E. Netting of flows

8.22 It is recommended that transactions in nonfinancial assets other than inventories be presented as acquisitions, disposals, and consumption of fixed capital, as indicated in Table 8.1. The net acquisition of a category of assets then could easily be computed as acquisitions less disposals. The total change in the holding of the category of assets is the net acquisitions of that category less consumption of fixed capital.

8.23 In general, changes in inventories should be netted because the separate data for acquisitions and disposals are not economically meaningful. In addition, as a matter of practice, it is often impossible to estimate individual transactions in inventories. Consumption of fixed capital does not apply to inventories.

F. Classification of transactions in nonfinancial assets

8.24 The classification of transactions in nonfinancial assets is shown in Table 8.1. The table summarizes transactions in nonfinancial assets as acquisitions, disposals, and consumption of fixed capital. The three amounts can be combined into the total change in a category of nonfinancial assets resulting from transactions.

8.25 The classification of nonfinancial assets is identical to the classification of the same assets employed in Chapter 7 (Table 7.2). Chapter 7 also provides full definitions of the assets included in each category, and those definitions are not repeated here. The immediately preceding sections of this chapter provide guidance applicable to transactions affecting all or most categories of nonfinancial assets. The remainder of this section provides guidance only on those transactions for which the general guidance may not be sufficient.

8.26 In addition to the classification of transactions in nonfinancial assets described in this chapter, the Classification of Functions of Government (COFOG) can also be applied to the acquisitions less disposals of these assets. COFOG is described in the annex to Chapter 6 and that description is not repeated here.

I. Fixed assets (311)⁶

8.27 As explained in paragraph 7.34 of Chapter 7, the production of some types of fixed assets, especially structures, transport equipment, and cultivated assets, extends over more than one accounting period. When production on own account or production of a structure taking place under a contract of sale agreed in advance is incomplete at the end of an accounting period, then the amount that has been completed is considered an acquisition of a fixed asset. When there is a contract with another producer, stage or progress payments are usually required and the amounts paid may approximate the value of the production accomplished at each stage. If the payments are made in advance or in arrears of completion of the relevant work, then short-term credits have implicitly been extended by the purchaser to the construction enterprise, or vice versa, and the stage payments should be adjusted by the amount of these credits.

8.28 When the production of fixed assets is carried out on own account, the value of all of the production taking place during the accounting period should be recorded as the acquisition of a fixed asset. Each transaction that otherwise would be recorded as compensation of employees, use of goods and services, and consumption of fixed capital should be recorded as acquisitions of the relevant

⁵Organisation for Economic Co-operation and Development, Measuring Capital—OECD Manual: Measurement of Capital Stocks, Consumption of Fixed Capital and Capital Services (Paris, 2001) contains an extensive discussion of the methods for estimating consumption of fixed capital.

⁶The numbers in parentheses after each classification category are the GFS classification codes. Appendix 4 provides all classification codes used in the GFS system.

Table 8.1: Classification of Transactions in Nonfinancial Assets

		Acquisitions	Disposals	Consumption of fixed capital 1
31	Nonfinancial assets			
311	Fixed assets			
3111	Buildings and structures			
31111	Dwellings			
31112	Nonresidential buildings			
31113	Other structures			
3112	Machinery and equipment			
31121	Transport equipment			
31122	Other machinery and equipment			
3113	Other fixed assets			
31131	Cultivated assets			
31132	Intangible fixed assets			
312	Inventories ²			
3121	Strategic stocks			
3122	Other inventories			
31221	Materials and supplies			
31222	Work in progress			
31223	Finished goods			
31224	Goods for resale [GFS]			
313	Valuables			
314	Nonproduced assets			
3141	Land			
3142	Subsoil assets			
3143	Other naturally occurring assets			
3144	Intangible nonproduced assets			
	Memorandum items			
3MI	Own-account capital formation			
3MII	Compensation of employees			
3M12	Use of goods and services			
3M13	Consumption of fixed capital			
3M14	Other taxes on production minus			
	other subsidies on production			

¹Consumption of fixed capital is not recorded for inventories. It is recorded with respect to valuables and nonproduced assets only to the extent of costs of ownership transfer and major improvements to nonproduced assets.

category of fixed assets when they relate to own-account capital formation.⁷

8.29 Major improvements to existing assets that increase their productive capacity, extend their service lives, or both are treated as acquisitions of fixed assets, while the use of goods and services for the maintenance and repair of fixed assets constitute an expense. By definition, however, major improvements do not lead to the creation of new assets that can be separately identified and valued. Instead, the value of such an improvement is added to the existing value of the underlying asset.

8.30 The distinction between maintenance and repair and a major improvement is not clear-cut. Major improvements to assets are distinguished by the following features: (a) the decision to renovate, reconstruct, or enlarge an asset is a deliberate investment decision that may be undertaken at any time and is not dictated by the condition of the asset and (b) the renovations or enlargements increase the performance or capacity of existing assets or significantly extend their previously expected service lives. Maintenance and repairs are distinguished by two features: (a) they are activities that owners or users of assets are obliged to undertake periodically in order to be able to utilize such assets over their expected service lives and (b) they do not change the asset or its performance, but simply maintain it

²Only the net change in inventories resulting from transactions is recorded, not gross acquisitions and disposals.

⁷This treatment also applies to the production of valuables and major improvements to land when carried out on own account.

in good working order or restore it to its previous condition in the event of a breakdown.

8.31 As explained in Chapters 6 and 7, purchases by the military of weapons and equipment used to deliver those weapons are treated as use of goods and services expense rather than acquisitions of fixed assets. Weapons or armored vehicles acquired by the police and internal security services are treated as acquisitions of fixed assets, even though expenditures on the same kind of equipment by the military would be treated as use of goods and services expense.

a. Buildings and structures (3111)

- **8.32** In addition to the transactions reflecting the acquisition of newly constructed buildings and structures, acquisitions of buildings and structures include site clearance and preparation expenses and the cost of all fixtures, facilities, and equipment that are integral parts of buildings and structures.
- **8.33** Certain structures, such as buildings, roads, and bridges, may be produced for communal use by groups of households. After they are finished, the ownership of such structures may then be transferred to a general government unit that will assume responsibility for their maintenance. When the transfer occurs, an acquisition of a structure is recorded together with the receipt of a capital transfer in kind.

b. Machinery and equipment (3112)

8.34 The determination of which goods should be classified as machinery and equipment is normally straightforward. Some goods, however, such as hand tools, may be used repeatedly, or continuously, in production over many years but may nevertheless be small, inexpensive, and used to perform relatively simple operations. If expenditures on such goods take place at a fairly steady rate and if their value is small compared with expenditures on more complex machinery and equipment, it may be appropriate to treat the acquisition of the tools as use of goods and services expense rather than acquisitions of nonfinancial assets.

c. Other fixed assets (3113)

8.35 Acquisitions of cultivated assets (31131) include acquisitions from other units of plants and animals that are cultivated for the products they yield

year after year and the value of similar plants and animals produced on own account. Disposals consist of animals and plants sold or otherwise disposed of, including animals sold for slaughter or slaughtered by their owners and plants cut down before the end of their service lives. Disposals do not include exceptional losses of animals and plants due to major outbreaks of disease, contamination, drought, famine, or other natural disasters. Consumption of fixed capital includes incidental losses of animals and plants from natural causes as well as the decline in an animal's or plant's value as it gets older.

- **8.36** The information obtained from mineral exploration influences the production activities of those who obtain it over a number of years. The expenditures incurred on exploration are therefore treated as expenditures on the acquisition of an intangible fixed asset (31132). Mineral exploration expenditures include the costs of actual test drillings and borings and all other costs incurred to make it possible to carry out the tests, such as aerial or other surveys and transportation costs. The value of the resulting asset is not measured by the value of new deposits discovered by the exploration but by the value of the resources allocated to exploration during the accounting period. Consumption of fixed capital may be calculated for such assets by using average service lives similar to those used by mining or oil corporations in their own accounts.
- **8.37** Acquisitions of computer software includes programs, program descriptions, and supporting materials for both systems and applications software that are expected to be used for more than one year. It also includes the purchase or development of large databases that the unit expects to use for more than one year. Software developed in-house is valued at its cost of production.
- **8.38** The production of new entertainment, literary, and artistic originals is often undertaken on own account. In such cases, it may be difficult to establish their value, which depends on the present value of the future benefits the owner expects to derive from their use. In the absence of other information it may be necessary to value the acquisition of the original by its cost of production.
- **8.39** Expenditures for research and development, staff training, market research, and similar activities are

⁸Plants and animals grown for a single use, such as animals grown for slaughter and trees grown for timber, are treated as inventories rather than fixed assets.

treated as use of goods and services expense rather than acquisitions of intangible fixed assets even though some of them may bring benefits for more than one year.

2. Changes in inventories (312)

- **8.40** In general, acquisitions and disposals of inventories are recorded according to the same principles used for recording transactions in other nonfinancial assets. Acquisitions of (or additions to) inventories are recorded when products are purchased, produced, or otherwise acquired, and disposals of (or withdrawals from) inventories are recorded when products are sold, used up in production, transferred to a different category of inventories, or otherwise relinquished. Both additions and withdrawals are valued at the current market prices prevailing at the time of the transaction.
- **8.41** As opposed to nonfinancial assets, however, no costs of ownership transfer are included in the values of acquisitions or disposals of inventories, and no consumption of fixed capital is attributed to inventories, which is indicated by a shaded area in Table 8.1. Also different from other nonfinancial assets, only the net value of additions less withdrawals is estimated rather than separate values for additions and withdrawals.
- **8.42** Many acquisitions and disposals of inventories are purchases from or distributions to other units, but other acquisitions and disposals reflect internal transactions.
- When materials and supplies (31221) are transferred to a production process, a transaction is recorded for the withdrawal from inventories, which is balanced by an addition either to work-in-progress inventories (31222) or to use of goods and services (22), depending on the nature of the production process.
- If work-in-progress inventories (31222) exist, then transactions are, in principle, recorded continuously as production takes place to reflect the value of materials and supplies, other goods and services, labor, and other inputs consumed. When production is completed, a transaction is recorded to decrease work-in-progress inventories and either increase *finished-goods inventories* (31223) or sales of goods and services (142).
- When goods acquired for resale (31224) are sold or otherwise disposed of, their cost is recorded as use of goods and services expense. Thus, a transaction must be recorded to reduce inventories of goods for resale and increase use of goods and services (22).

- Losses of inventories resulting from physical deterioration, normal accidental damage, or pilfering should be treated as disposals in the same way as inventories disposed of on purpose. In practice, determining the time of recording may be difficult because the time at which the inventories were stolen or spoiled may be unknown.
- **8.43** All acquisitions and disposals of inventories should be valued at current market prices. Because of the continuous or frequent withdrawals from materials and supplies inventories and the additions to and withdrawals from work-in-progress inventories, it is unlikely that information will be available to record these internal transactions accurately, and estimates may be necessary.
- **8.44** Withdrawals of work-in-progress inventories should be valued at their cost of production, where all inputs are valued at their current market prices at the time of withdrawal rather then the prices paid for them. Goods for resale added to inventories are valued at their purchase prices, including any transportation charges paid to other units. Goods for resale withdrawn from inventories are valued similarly at the purchase prices at which they can be replaced when they are withdrawn, which may differ from the prices that were paid to acquire them and the prices for which they were sold.

3. Valuables (313)

8.45 As with all nonfinancial assets other than inventories, acquisitions of valuables are valued at the prices paid plus any associated costs of ownership transfer incurred by the general government units acquiring the assets. Disposals are valued at the sales price less any associated costs of ownership transfer incurred by the general government units disposing of the assets. Costs of ownership transfer may be significant for the services of appraisers, auctioneers, and dealers. Government units fulfilling some functions of the monetary authority may have transactions in both monetary and nonmonetary gold, and care needs to be taken to classify them correctly and to record the other economic flows needed to transfer gold from one category to the other.

4. Nonproduced assets (314)

8.46 Nonproduced assets either are naturally occurring or come into existence through legal or accounting actions. As a result, they normally enter the GFS

system through other economic flows rather than transactions. Once in the system, however, transactions reflecting a change in their ownership should be recorded in the same manner as transactions in existing fixed assets. One exception regarding the appearance of nonproduced assets occurs when a government unit acquires land that is physically located in a foreign country. The transaction converts the land into part of the economic territory of the country of the acquiring government and therefore it enters the system by means of a transaction (acquisition of a nonproduced asset) rather than an other economic flow.

8.47 Productive activities may be undertaken to improve the quantity, quality, or productivity of land or prevent its deterioration. These activities may lead to the creation of substantial new structures, but they are not used directly to produce other goods and services in the way that most structures are used. Instead, the result is more or better land, and it is the land that is used for production. Major improvements to land are treated in the same way as major improvements to fixed assets. That is, a transaction is first recorded to increase the balance sheet value of the land by the cost of the improvement, and then consumption of fixed capital is recorded over the service life of the improvement. Examples of major improvements to land are reclaiming land from the sea by the construction of dikes, sea walls, or dams; clearing forests to enable land to be used in production for the first time; draining marshes; irrigating arid land by constructing irrigation channels; and preventing floods or erosion by the sea or rivers by constructing breakwaters, sea walls, or flood barriers.

8.48 Acquisitions of tunnels and other structures associated with the mining of mineral deposits are classified as acquisitions of structures and not as improvements to land. These assets are used separately from the land through which they are drilled or bored. Site clearance and preparation of land for purposes of construction also are not classified as improvements to land but as acquisitions of buildings or other structures.

8.49 Buildings, other structures, and cultivated assets are often purchased or sold together with the land on which they are situated. If possible, separate valuations of the land and the fixed asset should be obtained. If it is not possible to obtain separate valuations, then the transaction should be classified as a transaction in the type of asset believed to have the greater value, which often will be the fixed asset. In most cases, subsoil assets may be owned separately from the land and separate valuations should be estimated if possible. On the other hand, the law may stipulate that the ownership of the subsoil assets is inseparably linked to that of the land.

8.50 A government unit, as owner of a subsoil asset, may grant a concession or lease to another unit entitling the latter to extract the asset over a specified period of time in return for a series of payments, usually described as royalties. This arrangement is similar to a landowner conceding to a tenant the right to exploit the land in return for the payment of rents, except that subsoil assets are exhaustible. Nevertheless, the payments normally are treated as property income transactions rather than disposals of an asset.

8.51 When a long-term contract is let by the owner of a naturally occurring nonproduced asset that gives a second unit the exclusive right to use or exploit the asset, then the contract itself could be treated as an intangible nonproduced asset. Auctions by government units of the rights to use portions of the electromagnetic spectrum are particularly likely to result in the contracts being treated as economic assets. At the time of publication of this manual, the criteria for treating a contract or lease as an asset had not been decided.

8.52 Depletion is the decline in the value of a subsoil asset, noncultivated biological resource, or a water resource because a portion of the asset has been extracted. It is recorded as an other economic flow, as described in paragraph 10.41 of Chapter 10, and is not a transaction in nonfinancial assets. Similarly, the amortization of a patent, purchased goodwill, or other intangible nonproduced asset over its service or legal life is an other economic flow rather than a transaction.

9. Transactions in Financial Assets and Liabilities

This chapter describes transactions in financial assets and liabilities and their classification.

A. Introduction

- **9.1** Chapter 7 describes the balance sheet and the assets and liabilities recorded on it. As an integrated system, the GFS system also includes the flows necessary to explain all changes between the balance sheet at the end of one period and the balance sheet at the end of the next period. As described in Chapter 3, there are two types of flows—transactions and other economic flows—both of which can affect stocks of assets and liabilities. This chapter describes the transactions that affect holdings of financial assets and liabilities, and Chapter 10 describes other economic flows, all of which affect holdings of assets and liabilities.
- **9.2** The accounting identity given in paragraph 8.2 of Chapter 8 for nonfinancial assets also holds for financial assets and liabilities. It states that

The value of a category of financial assets (liabilities) on the balance sheet at the beginning of an accounting period.

plus

The total value of that category of assets (liabilities) acquired (incurred) in transactions during the accounting period.

minus

The total value of that category of assets (liabilities) disposed of (extinguished) in transactions during the accounting period.

plus

The net value of other economic flows that affect that category of assets (liabilities).

equals

The value of the category of assets (liabilities) on the balance sheet at the end of the accounting period.

This identity requires that transactions, other economic flows, and stocks be recorded consistently with regard to time of recording and valuation. The accounting rules governing these factors are described in Chapter 3.

- **9.3** Transactions can change stocks of financial assets or liabilities in different ways and all must be accounted for. The more important types of transactions follow:
- Existing assets of all types can be acquired from other units by purchase, barter, payment in kind, or transfer. The same transaction is a disposal of an asset from the viewpoint of the other unit.
- New financial claims are often created by transactions in which a creditor advances funds to a
 debtor. The creditor then owns a financial asset and
 the debtor incurs a liability.
- Financial claims are normally terminated by transactions. In some cases, the debtor pays the creditor
 the funds stipulated by the financial instrument,
 thereby canceling the claim. In other cases, the
 debtor buys its own instrument in the market.
- Accrued interest is deemed to be reinvested in an additional quantity of the underlying financial instrument by means of a transaction.
- The settlement of a financial derivative may involve two transactions: the termination of the financial claim and the sale of an underlying item from which the derivative obtained its value.
- **9.4** All transactions that increase a unit's holdings of assets are labeled *acquisitions*. All transactions that decrease a unit's holdings of assets are labeled *disposals*. Transactions that increase liabilities are referred to as the *incurrence* of a liability. Transactions that decrease liabilities are variously titled repayments, reductions, redemptions, liquidations, or extinguishments. Thus, the results of transactions in a particular

¹For ease of expression, assets will often be used as a reference to both assets and liabilities.

category of financial assets can be presented either as total acquisitions and total disposals or as net acquisitions. Similarly, changes in liabilities can be presented as total incurrences and total reductions or as net incurrences. Transactions that change a category of financial assets are never combined with transactions that change the same category of liabilities. That is, the net acquisition of loans would never refer to the increase in loans held as financial assets less the increase of loans as liabilities.

9.5 The remainder of this chapter describes first the valuation, time of recording, and netting of transactions that affect financial assets and liabilities and then details on transactions that affect specific categories of financial assets and liabilities.

B. Valuation

- **9.6** The value of an acquisition or disposal of an existing financial asset or liability is its exchange value. The value of a newly created financial claim is generally the amount advanced by a creditor to a debtor.
- **9.7** All service charges, fees, commissions, and similar payments for services provided in carrying out transactions and any taxes payable on transactions are excluded from transactions in financial assets and liabilities. They are expense transactions. In particular, when new securities are marketed by underwriters or other intermediaries as agents for the unit issuing the securities, the securities should be valued at the price paid by the purchasers. The difference between that price and the amount received by the issuing general government unit is a payment for the services of the underwriters.
- **9.8** When a security is issued at a discount or premium relative to its contractual redemption value, the transaction should be valued at the amount actually paid for the asset and not the redemption value. Any interest that is prepaid jointly with the acquisition of a security should be treated as accrued interest that had been reinvested in an additional quantity of the security. In this case, the value of the acquisition is the sum of the amount paid for the security directly plus the amount prepaid for accrued interest. It is recognized, however, that interest accruing on deposits and loans may have to follow national practices and be classified under accounts receivable.
- **9.9** Not all financial assets have prices as the term is normally understood. Financial assets denominated in

purely monetary terms, such as cash and deposits, do not have physical units with which prices can be associated. In such cases, the relevant quantity unit is effectively a unit of the currency itself so that the price per unit is always unity. In the case of nontransferable financial assets, such as some loans, the monetary value is the amount of principal outstanding. Thus, the term "price" has to be used in a broad sense to cover the unitary prices of assets such as cash, deposits, and loans as well as conventional market prices.

- **9.10** In some cases, the value of a financial asset is determined by the value of the counterpart to the transaction. For example, the initial value of a loan resulting from a financial lease is the value of the nonfinancial asset leased. The value of an account payable resulting from the purchase of goods or services is the value of the goods acquired or services received.
- **9.11** The value of a transaction expressed in a foreign currency is converted to the domestic currency using the midpoint of the buying and selling exchange rates at the time of the transaction. If a transaction expressed in a foreign currency involves the creation of a financial asset or liability, such as accounts payable/receivable, and is followed by a second transaction in the same foreign currency that extinguishes the financial asset or liability, then both transactions are valued at the exchange rates effective when each takes place.
- **9.12** Government units may acquire or dispose of financial assets on a nonmarket basis as an element of their fiscal policy rather than as a part of their liquidity management. For example, they may lend money at a below-market interest rate or purchase shares of a corporation at an inflated price. Although such transactions involve a transfer component, they are often structured so that the market price is not clear. If the market value can be determined, then the transaction should be valued at that amount and a second transaction should be recorded as an expense to account for the transfer. Otherwise, the value of the transaction should be the amount of funds exchanged.

C. Time of recording

9.13 Transactions in financial assets and liabilities are recorded when ownership of the asset changes, when the asset is created or liquidated, or when the addition or reduction in the amount of the financial instrument is made. This time is usually clear when the transaction involves an exchange of existing financial assets or the

simultaneous creation or extinction of a financial asset and a liability. In most cases, it will be when the contract is signed or when money or some other financial asset is paid by the creditor to the debtor or repaid by the debtor to the creditor.

- **9.14** In some cases, the parties to a transaction may perceive ownership to change on different dates because they acquire the documents evidencing the transaction at different times. This variation usually is caused by the process of check clearing or the length of time checks are in the mail. The amounts involved in such "float" may be substantial in the case of transferable deposits and other accounts receivable or payable. If there is disagreement on a transaction between two general government units or a government unit and a public corporation, the date on which the creditor records the transaction is the date of record because a financial claim exists up to the point that the payment is cleared and the creditor has control of the funds.
- **9.15** When a transaction in a financial asset or liability involves a nonfinancial component, the time of recording is determined by the nonfinancial component. For example, when a sale of goods or services gives rise to a trade credit, the transaction should be recorded when ownership of the goods is transferred or when the service is provided. When a financial lease is created, the loan implicit in the transaction is recorded when control of the fixed asset changes.
- **9.16** Some transactions, such as the accrual of interest expense and its borrowing as an additional quantity of the financial instrument, take place continuously. In this case, the transaction in the associated financial asset or liability also takes place continuously.

D. Netting and consolidation of flows

9.17 Transactions in financial assets and liabilities are presented in Table 9.1 as the net acquisition of each category of financial asset and the net incurrence of each category of liability. That is, only the net change in the holding of a type of asset is presented, not gross acquisitions and gross disposals as with most nonfinancial assets. (Separate amounts for gross acquisitions and gross disposals may, of course, be presented if the underlying accounting records permit and the information is meaningful.) When the same type of financial instrument is held both as a financial asset and a liability, transactions in financial assets are presented separately from transactions in

liabilities rather than netting transactions in liabilities against transactions in financial assets.

9.18 Transactions in financial assets are eliminated when the two parties to the transaction are units that are being consolidated. For example, if a local government unit purchases a security issued by the central government, both the acquisition of the financial asset and the incurrence of the liability would disappear in a presentation of statistics for the entire general government sector but not in a presentation of either the central or the local government subsector separately.

E. Arrears

9.19 Some types of financial assets and liabilities, most notably securities other than shares, loans, financial derivatives, and other accounts receivable/payable, mature at a scheduled date or series of dates when the debtor is obligated to make specified payments to the creditor. If the payments are not made as scheduled, then the payments are said to be in arrears. Depending on the conditions of the financial instrument may change. In all cases, the debtor has effectively obtained additional financing by not making the scheduled payments. To provide information on this type of implicit financing, when a scheduled payment is not made, it should be treated as if it had been made and then replaced by a new, usually short-term liability and each category of the classification of financial instruments should be subclassified to show the transactions leading to new arrears. As noted in Chapter 7, the total amount in arrears should be recorded as a memorandum item to the balance sheet.

F. Classification of transactions in financial assets and liabilities by type of financial instrument and residence

9.20 Table 9.1 presents a classification of transactions in financial assets and liabilities based on the type of financial instrument involved in the transaction and the residence of the unit that incurred the liability being held by a general government unit as a financial asset or holds as a financial asset the liability incurred by the general government unit. The units classified by residence are not necessarily the units that were a party to the transaction being

Table 9.1: Net Acquisition of Financial Assets and Net Incurrence of Liabilities Classified by Financial Instrument and Residence

32	Financial assets	33	Liabilities
321	Domestic	331	Domestic
3212	Currency and deposits	3312	Currency and deposits
3213	Securities other than shares	3313	Securities other than shares
3214	Loans	3314	Loans
3215	Shares and other equity	3315	Shares and other equity (public corporations only)
3216	Insurance technical reserves	3316	Insurance technical reserves [GFS]
3217	Financial derivatives	3317	Financial derivatives
3218	Other accounts receivable	3318	Other accounts payable
322	Foreign	332	Foreign
3222	Currency and deposits	3322	Currency and deposits
3223	Securities other than shares	3323	Securities other than shares
3224	Loans	3324	Loans
3225	Shares and other equity	3325	Shares and other equity (public corporations only)
3226	Insurance technical reserves	3326	Insurance technical reserves [GFS]
3227	Financial derivatives	3327	Financial derivatives
3228	Other accounts receivable	3328	Other accounts payable
323	Monetary gold and SDRs		. <i>.</i>

recorded. For example, a general government unit might purchase a financial asset in a secondary market from a nonresident, but the asset was originally issued by a resident. Under such circumstances, this instrument would be shown as a domestic instrument even though it was purchased from a nonresident.

9.21 The classifications are consistent with the classifications of the same financial assets and liabilities employed in Chapter 7 (Table 7.3). Chapter 7 also provides full definitions of the financial assets or liabilities included in each category, and those definitions are not repeated here. The immediately preceding sections of this chapter provide guidance applicable to transactions affecting all or most categories. The remainder of this section provides guidance only on those transactions for which the general guidance may not be sufficient.

9.22 Liabilities in several categories are considered debt, as defined in Chapter 7 (see paragraphs 7.142 and 7.143). In addition to normal interest and principal transactions regarding debt liabilities, government units may undertake a range of complex debt-related transactions, such as assuming debt of other units, making payments on behalf of other units, rescheduling debt, debt forgiveness, debt defeasance, and financial leasing. The special features of these types of transactions are described in Appendix 2.

9.23 The classifications described in this chapter do not include functional categories such as direct investment, portfolio investment, or international reserves. In Chapter 7, however, a memorandum item provides for the stocks of reserve assets and reserve-related liabilities of the general government sector. 3

I. Monetary gold and SDRs (323)⁴

9.24 Transactions in monetary gold are the exclusive responsibility of the monetary authority, which will normally be the central bank, a public corporation. It is possible, however, for a unit of the general government sector to undertake some functions of the monetary authority, in which case it may have transactions in monetary gold or SDRs. Transactions in monetary gold and SDRs cannot be classified by the residence of the issuing unit because they are not the liabilities of any unit. When transactions in financial assets are classified by residency, transactions in monetary gold and SDRs are placed in a separate category.

9.25 Transactions in monetary gold can only take place between two monetary authorities or between a

²For information on these categories, see paragraph 176ff of International Monetary Fund, *Balance of Payments Manual*, 5th ed. (Washington, 1993).

³If analytically important, other classifications could be introduced. For example, transactions in financial assets and liabilities could be classified by their remaining maturities.

⁴The numbers in parentheses after each classification category are the GFS classification codes. Appendix 4 provides all classification codes used in the GFS system.

monetary authority and an international financial institution. If the monetary authority adds to its holdings of monetary gold by acquiring either newly mined gold or existing gold offered on the private market, then the gold so acquired is said to have been monetized. No transaction in financial assets is recorded. Instead, the acquisition is recorded first as a transaction in nonfinancial assets, and then an other economic flow is recorded to reclassify the gold as monetary gold. Demonetization of gold is recorded symmetrically (see Chapter 10).

9.26 SDRs are held only by the monetary authorities of IMF member countries and a limited number of authorized international financial institutions. Transactions in SDRs take place when an official holder exercises its right to obtain foreign exchange or other reserve assets from other IMF members and when SDRs are sold, loaned, or used to settle financial obligations.

2. Currency and deposits (3212, 3222, 3312, 3322)

9.27 Because the market price of domestic currency and deposits is fixed in nominal terms, the net acquisition of domestic currency and deposits is equal to the stock held at the end of the accounting period less the stock held at the beginning of the period, adjusted for any currency that was lost, stolen, or destroyed. Calculation of the net acquisition of foreign currencies and deposits must take changes in exchange rates into consideration.

9.28 Currency is treated as a liability of the unit that issued the currency. Consequently, when a unit puts new currency into circulation, a transaction is recorded that increases its liability for currency. Usually the counterpart to the increase in liabilities is an increase in the unit's financial assets, most likely deposits.⁵ Transactions in gold and commemorative coins that do not circulate as legal tender are treated as transactions in nonfinancial assets rather than currency. The cost of producing new currency is an expense transaction unrelated to transactions in currency.

3. Securities other than shares (3213, 3223, 3313, 3323)

9.29 Most transactions in bonds and other types of securities other than shares are covered by the general guidelines previously established. Discounted

⁵In the 1986 GFS Manual, seigniorage profits from issuing currency were treated as revenue.

bonds may require special attention because the difference between the discounted issue price of such a bond and its price at maturity is treated as interest accruing over the life of the bond. For the holder of the bond, a transaction must be constructed in each accounting period that records the receipt of interest revenue and its reinvestment to purchase an additional quantity of the bond. The issuer of the bond records the accrual of interest expense and an increase in its liability for bonds. For securities other than shares issued at a premium, the difference between the issue price and the price at maturity is treated as negative interest.

9.30 Index-linked securities are instruments for which either the interest or the principal is linked to a price index, the price of a commodity, or an exchange rate index. When the value of the principal is indexed, then, as with discounted bonds, each increase in principal is a transaction reflecting the payment of interest by the issuer of the security and a purchase of an additional quantity of the security by the holder.⁶

4. Loans (3214, 3224, 3314, 3324)

9.31 The terms of a loan contract frequently require periodic payments that will pay all interest expense accrued since the previous periodic payment and repay a portion of the original amount borrowed. Between payments, interest accrues and is added to the principal continuously. In practice, the periodic payments are usually partitioned into two transactions, one equal to the amount of interest incurred since the previous payment and the second a repayment of the original principal.

9.32 When goods are acquired under a financial lease, a change of ownership from the lessor to the lessee is deemed to take place, even though legally the leased good remains the property of the lessor. This de facto change in ownership is financed by the implicit creation of a loan.

9.33 If a loan that is a liability of a public corporation is assumed by the government unit that owns or controls it, there may be no documentary evidence to indicate whether the debt assumption was intended as a purchase of equity or a capital transfer. In the absence of evidence to the contrary, a loan assumption is treated as an acquisition of equity. If it is

⁶It is possible for loans and other financial instruments to be index linked and the same transactions would be recorded.

treated as a capital transfer, then the government unit holding the shares and other equity will record a holding gain of the same amount. Appendix 2 discusses government debt operations in more detail.

9.34 As described in Chapter 7, repurchase agreements and gold swaps are treated as loans with no change of ownership for the underlying assets that legally were sold. Similarly, consummation of the repurchase agreement or swap according to the initial terms of the agreement is treated as a liquidation of a loan.

5. Shares and other equity (3215, 3225, 3315, 3325)

- **9.35** The treatment of transactions in publicly traded shares is straightforward. Problems may be created, however, by the operations of quasi-corporations and public corporations.
- **9.36** Additions to the funds and other resources of a quasi-corporation, including in-kind transfers of non-financial assets, are treated as purchases of shares and other equities by the owner of the quasi-corporation. Similarly, receipt by the owner of proceeds from sales of any of the quasi-corporation's assets, transfers in kind from the quasi-corporation, and withdrawals by the owner of accumulated retained earnings of the quasi-corporation are treated as sales of shares and other equity by the owner. Regular transfers to quasi-corporations to cover persistent operating deficits are subsidies, and regular withdrawals from the income of quasi-corporations are property income.
- **9.37** Government units may acquire equity in a public corporation or quasi-corporation as a result of legislation or an administrative change creating the corporation or quasi-corporation. In some cases, this event will amount to a reclassification of existing assets and liabilities, which is recorded as an other economic flow that results in an addition of shares and other equity. An advance of funds to create the new enterprise would be a transaction reflecting the purchase of equity.
- **9.38** Privatization generally is the disposal to private owners by a government unit of the controlling equity of a public corporation or quasi-corporation. Such a disposal is treated as a transaction in shares and other equity. If a public corporation or quasi-corporation sells some of its assets and transfers part or all of the proceeds to its parent government unit, then the transaction would also be a sale of shares

and other equity by the government unit. Brokers' commissions and other privatization costs are expense transactions just as all other costs of ownership transfer related to the acquisition or disposal of a financial asset.

9.39 Government units also can be privatized. If the assets disposed of as a single transaction constitute a complete institutional unit, the transaction should be classified as a sale of equity. The government is assumed to have converted the unit to a quasi-corporation immediately prior to disposal by means of a reclassification of assets, which is an other economic flow. If the assets disposed of do not constitute a complete institutional unit, then the transactions should be classified as a disposal of the individual nonfinancial and/or financial assets.

Insurance technical reserves (3216, 3226, 3316, 3326) [GFS]⁷

- **9.40** General government units may incur liabilities for insurance technical reserves as operators of nonlife insurance schemes and both nonautonomous pension funds and unfunded retirement schemes, and they may acquire insurance technical reserves as financial assets in their capacity as holders of non-life insurance policies. Public corporations can engage in all types of insurance activities.⁸
- **9.41** If a general government unit operates a retirement scheme, then it will have transactions in liabilities for insurance technical reserves. Social contributions receivable from employees, employers, or other institutional units on behalf of individuals or households with claims on the general government unit for future retirement benefits will increase the unit's liability for insurance technical reserves. The existing liability, which is equal to the present value of future payments, will increase over time because the future payments are discounted over fewer periods. This increase in the liability is recorded as a transaction in insurance technical reserves. Payments to retired persons or their dependents and survivors in the form of periodic payments or lump sums reduce the liability.

 $^{^{7}}$ [GFS] indicates that this item has the same name but different coverage in the 1993~SNA.

⁸It is assumed that general government units do not operate life insurance schemes and do not purchase life insurance policies. The treatment of insurance technical reserves created by life insurance activities of public corporations is similar to autonomous pension funds, but they are not addressed separately here. Annex IV of the 1993 SNA describes the treatment of all types of insurance schemes.

- **9.42** In general, non-life insurance premiums are paid in advance of the period covered by the policy. All such payments are transactions that increase the insurance unit's liability and the policyholder's asset for insurance technical reserves. As the period covered by the premium progresses, the insurance unit continuously earns the premium, which requires a transaction to decrease its liability and the policyholder's asset for insurance technical reserves.
- **9.43** When valid claims are accepted by non-life insurance enterprises, they are attributed to the time at which the eventuality or accident that gave rise to the claim occurred. At that time, a transaction is recorded that increases reserves against outstanding claims as a liability of the insurance unit and an asset of the beneficiaries. If payment of the claim will be delayed for a substantial time or will consist of periodic payments over several accounting periods, then the value of the transaction should be the present value of the expected payments.

7. Financial derivatives (3217, 3227, 3317, 3327)

- 9.44 There are two broad classes of financial derivatives: forward-type contracts and option contracts. At the inception of a forward-type contract, it has zero value and no transaction is recorded. Forward-type contracts are typically settled by the payment of cash or the provision of some other financial instrument rather than by actual delivery of the underlying item. Any such settlement payment is recorded as a transaction in financial derivatives. If the contract is settled by delivery of the underlying item, then a transaction in the underlying item is recorded at its market price at the time of settlement, and any difference between the contract price and the market price is a transaction in financial derivatives. Forward-type contracts can also be traded before settlement, in which case a transaction in financial derivatives is recorded.
- **9.45** The buyer of an option pays a premium to the seller for the latter's commitment to sell or purchase the specified amount of the underlying item on demand of the buyer. The payment of the premium is a transaction in financial derivatives in which the buyer acquires an asset and the seller incurs a liability.
- **9.46** Depending on the type of contract, premiums on options may be paid when the contract begins, when the option is exercised, or when the option expires. The value of the transaction at the inception of the option is the full price of the premium. If the

- premium is paid after the purchase of the option, then the acquisition of the option is deemed to be financed by a loan.
- 9.47 Many option contracts are settled by a cash payment rather than by delivery of the underlying assets or commodities to which the contract relates. Any such cash payment is recorded as a transaction in financial derivatives. If an option is exercised and the underlying item is delivered, then the acquisition or sale of the underlying asset is recorded at its market price at the time of settlement, and any difference between this amount and the contract price is recorded as a transaction in financial derivatives. If an option expires without being exercised, then no transaction is recorded to mark the expiration. Instead, an other economic flow is recorded to remove the asset and liability from the balance sheets of the parties involved.
- **9.48** Repayable margins paid in cash are transactions in deposits rather than transactions in financial derivatives. Repayable margins paid in collateral are not transactions. The payment of a nonrepayable margin is normally recorded as a reduction in financial derivative assets and liabilities for the two parties involved in the contract.
- **9.49** Any commission paid to brokers or other intermediaries for arranging a financial derivatives contract is treated as a payment for a service. In many cases, however, financial derivatives transactions involve implicit service charges, and it is usually not possible to estimate the service element. In such cases, the entire value of the transaction should be treated as a transaction in financial derivatives.

8. Other accounts receivable/payable (3218, 3228, 3318, 3328)

- **9.50** Transactions in trade credits and advances occur when credit is extended directly to purchasers of goods and services. Other transactions occur when advances are paid for work in progress, such as progress payments made during construction, or for prepayments of goods and services.
- **9.51** Miscellaneous other accounts receivable/payable occur in respect of accrued but unpaid taxes, dividends, purchases and sales of securities, rent, wages and salaries, social contributions, and similar transactions. Accrued but unpaid interest should be treated as an additional quantity of the

underlying asset, but it is recognized that interest accruing on deposits and loans may have to follow national practices and be classified as accounts receivable/payable.

G. Classification of transactions in financial assets and liabilities by sector and residence

9.52 For a full understanding of financial flows and the role they play in government finance, it is often important to know not just what types of liabilities a general government unit uses to finance its activities, but also which sectors are providing the financing. In addition, it is often necessary to analyze financial flows between subsectors of the general government sector. Table 9.2 presents a classification of transac-

tions in financial assets and liabilities based on the sector of the unit that incurred the liability being held by a general government unit as a financial asset or that holds as a financial asset the liability incurred by the general government unit.

9.53 The composition of the sectors listed in Table 9.2 is described in Chapter 2. In the *1993 SNA*, the term "sector" refers to a group of resident units. All nonresident units are referred to collectively as the rest of the world and treated as a pseudo-sector. In the GFS system, it is important to know not only the total amount of financing received from nonresident units, but also the types of nonresident units supplying the financing. In the GFS system, therefore, the classification of "sectors" is applied to nonresident units in the same manner as resident units. In particular, all international organizations are treated as a sector in Table 9.2.

Table 9.2: Net Acquisition of Financial Assets and Net Incurrence of Liabilities Classified by Sector of the Counterparty to the Financial Instrument and Residence

82	Financial assets	83	Liabilities
82 I	Domestic	83 I	Domestic
8211	General government	8311	General government
8212	Central bank	8312	Central bank
8213	Other depository corporations	8313	Other depository corporations
8214	Financial corporations not elsewhere classified	8314	Financial corporations not elsewhere classified
8215	Nonfinancial corporations	8315	Nonfinancial corporations
8216	Households and nonprofit institutions serving	8316	Households and nonprofit institutions serving
	households		households
822	Foreign	832	Foreign
822 I	General government	8321	General government
8227	International organizations	8327	International organizations
8228	Financial corporations other than international organizations	8328	Financial corporations other than international organizations
8229	Other nonresidents	8329	Other nonresidents
823	Monetary gold and SDRs		

10. Other Economic Flows

This chapter describes the flows other than transactions that are recorded in the GFS system. The two major categories of these other economic flows are holding gains and other changes in the volume of assets.

A. Introduction

10.1 This chapter describes the flows other than transactions, known as other economic flows, that change the values of assets, liabilities, and net worth. Most other economic flows change both the value of an asset or a liability and the value of net worth by the same or opposite amount. A few other economic flows do not affect net worth because they change the value of two assets or two liabilities by the same amount but with opposite signs, or they change one asset and one liability by the same amount.

10.2 There are two major categories of other economic flows: holding gains and losses and other changes in the volume of assets.

• A holding gain or loss is a change in the monetary value of an asset or liability resulting from changes in the level and structure of prices, assuming that the asset or liability has not changed qualitatively or quantitatively. Holding gains and losses can apply to all assets and liabilities and, in the case of assets and liabilities expressed in a foreign currency, include gains and losses resulting from changes in exchange rates.¹ For ease of expression, the term "holding gain" will be used as a shorthand reference for holding gain or loss.

 An other change in the volume of assets is any change in the value of an asset or liability that does not result from a transaction or a holding gain. Other changes in the volume of assets result from events that change the quantity or quality of an existing asset, events that add a new asset to the balance sheet or delete an existing asset from the balance sheet, and events that require a reclassification of existing assets.

10.3 Other economic flows are classified by the type of asset or liability affected. The classification of assets and liabilities given in Chapter 7 is used for this purpose. In addition, other economic flows can be classified by the type of event that caused the flow in as much detail as needed for the analysis being undertaken. In Table 10.1, other economic flows are classified only as being either holding gains or other changes in the volume of assets, but types of holding gains or specific types of other changes in the volume of assets could be introduced as an expansion of the table.

B. Holding Gains

I. Holding gains in general

10.4 Holding gains result from price changes and can accrue on all economic assets held for any length of time during an accounting period. It does not matter whether an asset is held the entire period, acquired during the period and held until the end of the period, held at the beginning of the period and disposed of during the period, or acquired and disposed of within the same period. In each case, a holding gain is possible and must be recorded for the entire difference between the opening and closing balance sheet to be explained correctly.

10.5 Holding gains are sometimes described as capital gains. The term holding gain is preferred because it

¹A holding gain or loss always affects net worth. The words "gain" and "loss" are used in reference to the direction of the change in net worth. A flow that increases the value of an asset or decreases the value of a liability will increase net worth and is referred to as a holding gain. A flow that decreases the value of an asset or increases the value of a liability will decrease net worth and is a holding loss. References to financial assets can be assumed to refer also to liabilities.

emphasizes the facts that gains accrue purely as a result of holding assets and liabilities over time and the term applies equally to all types of assets and liabilities.²

10.6 Holding gains may be realized or unrealized. A holding gain is said to be realized when the asset in question is sold, redeemed, used, or otherwise disposed of. It is unrealized if the asset is still owned. In addition, a realized holding gain is usually understood as the gain received over the entire period that the asset is owned, but a holding gain is determined with reference to a specific accounting period.

10.7 Holding gains do not include a change in the value of an asset resulting from a change in the quantity or quality of the asset. In particular:

- The decline in the value of the fixed assets due to physical deterioration, normal rates of obsolescence, and normal accidental damage is recorded as consumption of fixed capital and not as a holding loss.
- Bills and bonds issued at a discount may increase in value progressively prior to redemption because of the accrual of interest. The increase in the market value of a bill or bond due to the accrual of interest is recorded as a transaction in the asset and is not a holding gain.

10.8 The precise calculation of holding gains requires records to be maintained of all individual transactions and other changes in the volume of assets plus the price of each asset at the time of the opening and closing balance sheets, each transaction, and each other change in the volume of an asset. In practice, it is unlikely that all of the requisite data will be available, and alternative estimation techniques using less information must be employed.

10.9 A commonly used alternative method is based on the identity that the ending balance sheet value for a category of assets must equal the beginning balance sheet value plus the net value of transactions, other changes in the volume of assets, and holding gains that affect that category of assets. If the information available on balance sheets, transactions, and other changes in the volume of assets is complete and accurate, then the net value of holding gains can be calculated as the residual value necessary to complete the identity. This formulation should not be

Table 10.1: Classification of Other Economic Flows

	Holding	Other changes in the volume
	gains	of assets
Nonfinancial assets	41	51
Fixed assets	411	511
Buildings and structures	4111	5111
Dwellings	41111	51111
Nonresidential buildings	41112 41113	51112 51113
Other structures Machinery and equipment	41113	51113
Transport equipment	41121	5112
Other machinery and equipment	41122	51122
Other fixed assets	4113	5113
Cultivated assets	41131	51131
Intangible fixed assets	41132	51132
Inventories	412	512
Strategic stocks	4121	5121
Other inventories	4122	5122
Materials and supplies	41221 41222	51221
Work in progress Finished goods	41222	51222 51223
Goods for resale [GFS]	41223	51223
Valuables	413	51224
Nonproduced assets	414	514
Land	4141	5141
Subsoil assets	4142	5142
Other naturally occurring assets	4143	5143
Intangible nonproduced assets	4144	5144
Financial assets	42	52
Domestic	421	521
Currency and deposits	4212	5212 5213
Securities other than shares Loans	4213 4214	5213 5214
Shares and other equity	4215	5215
Insurance technical reserves	4216	5216
Financial derivatives	4217	5217
Other accounts receivable	4218	5218
Foreign	422	522
Currency and deposits	4222	5222
Securities other than shares	4223	5223
Loans	4224	5224
Shares and other equity Insurance technical reserves	4225 4226	5225 5226
Financial derivatives	4226	5227
Other accounts receivable	4228	5228
Monetary gold and SDRs	423	523
Liabilities	43	53
Domestic	431	531
Currency and deposits	4312	5312
Securities other than shares	4313	5313
Loans	4314	5314
Shares and other equity	45.15	
(public corporations only)	4315	5315
Insurance technical reserves [GFS]	4316	5316
Financial derivatives	4317 4318	5317 5318
Other accounts payable Foreign	4318	5318
Currency and deposits	4322	5322
Securities other than shares	4323	5323
Loans	4324	5324
Shares and other equity		
(public corporations only)	4325	5325
Insurance technical reserves [GFS]	4326	5326
Financial derivatives	4327	5327
Other accounts payable	4328	5328
Change in net worth resulting		_
from other economic flows	4	5

²"Revaluation" is also used in the *1993 SNA* with the same meaning as "holding gain." "Holding gain" is used exclusively in this manual.

interpreted, however, as implying that the value of holding gains is a residual item.

10.10 For some analytic purposes, it may be desirable to divide the total value of holding gains accruing on a category of assets into neutral and real holding gains. A neutral holding gain is the value of a holding gain that would accrue if the price of the asset changed in the same proportion as the general price level. It is the value needed to preserve the real value of the asset. A real holding gain is defined as the value accruing to an asset as a result of a change in its price relative to the prices of goods and services in general. An increase in the relative price of an asset leads to a positive real holding gain and a decrease in the relative price of an asset leads to a negative real gain.³

10.11 In concept, holding gains and losses occur continuously because prices change continuously. As a practical matter, holding gains for the entire accounting period are normally estimated at the end of the period.

2. Holding gains for particular types of assets

a. Financial assets with fixed monetary values

10.12 Not all assets have market prices in the ordinary sense of the term "price." The monetary values of some assets denominated in the domestic currency (including currency, deposits, most loans, advances, and trade credits) remain constant over time because the price of such assets is always unity. As a result, holding gains on these assets are always zero. Assets denominated in a foreign currency can change in value because of a change in the exchange rate.

b. Bonds and bills

10.13 When bonds and bills, especially deep-discount and zero-coupon bonds, are issued at a discount, then, in the absence of other changes, the price will gradually rise over the life of the bond until it reaches the maturity value. This increase in price is not a holding gain. Instead, the debtor is treated as having paid interest that the creditor has reinvested in an additional quantity of the bond or bill. The same treatment applies to bonds issued at a premium.

10.14 The values of bonds and bills also change, however, when the market rates of interest change.

With the exception of index-linked securities, changes in the values of bonds and bills that are attributable to changes in market rates of interest are holding gains. An increase in interest rates causes a decrease in the value of the bond or bill, which is a holding gain for the debtor and a holding loss for the creditor, and conversely for a decrease in interest rates.

10.15 An index-linked security is one in which the interest and/or principal payments are indexed to changes in prices.⁴ All changes in the volume of the security arising from indexation are treated as interest that is reinvested in an additional quantity of the security, much like securities issued at a discount.

c. Shares and other equity (4215, 4225)5

10.16 General government units may own all or part of the equity of a public corporation or the equity of a quasi-corporation. As with any other asset, a change in the monetary value of these financial assets resulting from price changes is a holding gain.

10.17 As mentioned in paragraphs 5.85 to 5.89 of Chapter 5, dividends and withdrawals of income from quasi-corporations are distributions of profits by corporations and quasi-corporations. Such distributions also decrease the net worth of the corporations and quasi-corporations and, therefore, the value of shares and other equity held by the owners. These changes in the value of shares and other equity are treated as holding gains.

10.18 As noted in footnote 9 of Chapter 5, reinvested earnings on direct foreign investment is treated as a type of property income in the *1993 SNA* but not in the GFS system. As a result, the increase in the value of the equity of a direct foreign investment enterprise resulting from an increase in retained earnings is accounted for in the GFS system as a holding gain in the same way as it is for other equity holdings. In the *1993 SNA*, it is accounted for as a transaction reflecting the acquisition of additional shares and other equity.

10.19 If the shares of a public corporation are publicly traded, then the holding gain of the government unit that owns the shares is determined by reference to the market price per share. Quasi-corporations,

³Information on the calculation and interpretation of neutral and real holding gains is in Chapter XII of the *1993 SNA*.

⁴This treatment of index-linked securities also applies to deposits and loans.

⁵The numbers in parentheses after each classification category are the GFS classification codes. Appendix 4 provides all classification codes used in the GFS system.

however, do not issue shares, so there cannot be a market price. In addition, the shares of public corporations may not be traded, most likely because the controlling general government unit owns all of the shares. In these cases, the total value of the shares or implicit equity of the corporation or quasi-corporation is equal to the total value of its assets less the total value of its liabilities other than shares and other equity. As a result, the holding gain is equal to the change in the total value of this measure of the equity, taking into account additions to and withdrawals from equity that may have occurred.

d. Insurance technical reserves [GFS]⁶ (4216, 4226)

10.20 Liabilities for insurance technical reserves include liabilities for the future payment of pensions and other retirement benefits of defined-benefit retirement schemes. The value of these liabilities can change for several reasons, one of which is the passage of time. The liability is computed as the present value of the future benefits and it will increase each period because there is one fewer period over which it is discounted. In the GFS system, this increase is treated as a property expense. In the 1993 SNA, the increase is treated as a property expense only to the extent of any property income received from the investment of the assets of an autonomous or nonautonomous pension fund. The remaining increase is treated as a holding gain.

10.21 In the GFS system, a holding gain is recorded with respect to the liability for a defined-benefit retirement scheme when there is a change in the value of the liability because of a change in the interest rate used to discount the future benefits. The liability should be reviewed periodically and revalued as necessary for changes in market interest rates. A holding gain is recorded with respect to the liability for a defined-contribution retirement scheme whenever a holding gain is recorded with respect to the assets of the fund.

e. Financial assets denominated in foreign currencies

10.22 The value of a financial asset denominated in a foreign currency is its current value in the foreign currency converted into the domestic currency at the current exchange rate. Holding gains may occur, therefore, not only because the price of the asset in the foreign currency changes but also because the exchange rate changes.

f. Fixed assets (411)

10.23 Estimating the holding gains on fixed assets is complicated by the fact that the value of a fixed asset changes as a result of consumption of fixed capital as well as price changes. Consumption of fixed capital, however, is valued in terms of the average prices prevailing during an accounting period. Thus, estimating the change in the price of a given fixed asset of a given age and condition is critical for estimating both consumption of fixed capital and holding gains.

10.24 When new assets of the same type are no longer being produced, the valuation of existing assets may pose difficult conceptual and practical problems. If broadly similar kinds of assets are still being produced, it may be reasonable to assume that the prices of the existing assets would have moved in the same way as those of new assets if they were still being produced. Such an assumption becomes questionable, however, when the characteristics of new assets are much improved by technical progress.

g. Inventories (412)

10.25 The estimation of holding gains on inventories may be difficult because of a lack of data on transactions or other changes in the volume of assets:

- Many transactions in inventories are internal transactions, and the prices prevailing at the time they occur may not be adequately recorded.
- Withdrawals from inventories include an allowance for recurrent losses that are part of the normal operations of a production process.
- Other changes in the volume of assets are likely to consist of goods destroyed by natural disasters, major fires, and other exceptional events. Estimating the prices and quantities involved in these events may be difficult.

10.26 If the records needed for a direct estimation of changes in inventories are not available, it will be necessary to estimate holding gains using assumptions about the timing of additions to and withdrawals from inventories and the prices prevailing at those times. High rates of inflation complicate the difficulty of estimating the value of changes in inventories, but also increase the importance of making accurate estimates.

⁶[GFS] indicates that this item has the same name but different coverage in the 1993 SNA.

h. Nonfinancial assets disposed of during the accounting period

10.27 When a nonfinancial asset is disposed of in a transaction, the amount of the transaction is the exchange value of the asset less any costs of ownership transfer incurred by the disposing unit. For example, when a general government unit sells a building, it may incur a commission if it engages a sales agent to help find a buyer. The value of the disposal would then be the exchange value of the building less the commission paid. The balance sheet value of the asset immediately before the disposal, however, was the exchange value of the asset plus any costs of ownership transfer that would have had to be incurred to acquire the asset at that time and in its existing condition. The difference between the balance sheet value and the disposal value is the sum of the two types of costs of ownership transfer. To bridge this difference, a holding loss of the same value must be recorded.

C. Other changes in the volume of assets

10.28 Other changes in the volume of assets cover a wide variety of events. For the purpose of description, these events are divided into three groups. The first group consists of events that involve the recognition or derecognition of existing entities as economic assets. The second group consists of all other changes in the quantity or quality of existing assets. The final group consists of changes in the classification of assets.

10.29 Many other volume changes occur at specific times and should be recorded when the event occurs. Some other volume changes occur continuously or at frequent intervals, such as the depletion of subsoil assets, environmental damage to assets, or the expiration of a patent. These changes should be recorded in the same manner as holding gains.

I. Recognition and derecognition of economic assets

10.30 For an entity to be an economic asset, ownership rights over it must be enforced and it must be capable of providing economic benefits. If an entity, which is known to exist but is not classified as an economic asset, becomes an economic asset because of a change in relative prices, technology, or some other event, then an other volume change is recorded to

recognize the asset's value and add it to the balance sheet. Conversely, an economic asset may need to be removed from the balance sheet because it is no longer capable of supplying economic benefits or because the owner is no longer willing or capable of exercising ownership rights over the asset.

10.31 Several events may require a naturally occurring nonproduced asset to be recognized. For example:

- A deposit of subsoil minerals may become economically exploitable as a result of technological progress or relative price changes.
- General economic development in nearby areas may transform land from a wild or waste state to a state in which ownership rights can be enforced and the land can be put to economic use.
- Improved access or changes in relative prices may make large-scale harvesting of timber, commercial fishing, or a significant diversion of groundwater feasible, which would move the forest, fishstock, or aquifer inside the asset boundary.
- 10.32 It may be difficult to determine the exact time that a natural asset should be added to the balance sheet, the value that should be attributed to it at that time, or both. Often the first substantial commercial exploitation or the signing of a contract to permit commercial exploitation is used to establish the time of recording.
- **10.33** Produced entities also may exist that are not recorded on the balance sheet. For example:
- The acquisition of a durable good may have been recorded as an expense because of its small cost, but its value has since increased to the point that it should be classified as a fixed asset or valuable. This type of other volume change most likely occurs with antiques, art objects, jewelry, and similar items.
- A structure or site may acquire economic value because special archaeological, historic, or cultural significance is attributed to it and it is designated as a historic monument. It may not already be on the balance sheet because its acquisition predated the accounts or its original value had been written off through consumption of fixed capital.
- **10.34** Conversely, a nonfinancial asset that no longer has economic value because of a change in technology, relative prices, or other event must be removed from

the balance sheet. For example, the commercial exploitation of mineral reserves, land, forests, fish-stocks, aquifers, and other naturally occurring assets may become infeasible, or production facilities with long construction periods may cease to have an economic rationale before being completed or put into service. If so, then a negative other volume change would be recorded to remove the asset from the balance sheet.

10.35 Most intangible nonproduced assets are created by legal or accounting actions. These actions often recognize an existing entity as an economic asset.

- When a government grants patent protection to an invention, the value of the invention is captured as an economic asset.
- When a production unit is sold at a price that exceeds its net worth, where net worth includes the value of shares and other equity in the case of a public corporation, then the excess of the purchase price over the net worth is the economic asset known as purchased goodwill. It can represent many types of assets that are not separately recognized as economic assets, such as trademarks, superior management skills, or unpatented inventions. The purchased goodwill would be recognized through an other volume change so that the revised net worth exactly equals the purchase price. The goodwill would then be sold immediately along with the production unit's other assets and liabilities.
- A contract that is a binding agreement to provide some economic benefit may change in value because of changes in prices or other events.

10.36 With regard to financial assets, a creditor may determine that a financial claim can no longer be collected because of the debtor's bankruptcy or other factors. If so, the creditor should remove the claim from its balance sheet by means of an other volume change.⁷

2. Other changes in the quantity or quality of assets

10.37 Changes in the quantities or qualities of assets other than from transactions or from the recognition or derecognition of assets may result from several types of events. Some of these events change the quantity of existing economic assets. Other events

add or delete assets that have been discovered, created, cancelled, destroyed, or seized by one unit from another unit. Finally, some events change the quality of existing economic assets.

a. Changes in the quantity of existing economic assets

10.38 A catastrophic loss is the partial or complete destruction of an asset resulting from a large-scale, discrete, and recognizable event, such as a major earthquake, a volcanic eruption, a hurricane, or a major toxic spill. An other volume change is recorded to reduce or eliminate the value of any asset damaged or destroyed.

10.39 Although produced assets are the most likely candidates to be damaged or destroyed by a catastrophic loss, nonproduced assets and financial assets are also subject to damage or destruction. For example, major decreases in the value of land and other natural assets caused by abnormal flooding or wind damage and the accidental destruction of currency or bearer securities as a result of natural catastrophes or abnormal political events would be included.

10.40 Many tangible nonproduced assets, such as forests and fishstocks, will increase in volume on their own accord. Although these resources are economic assets, growth of this kind is not under the direct control, responsibility, and management of a unit. Accordingly, the increase in the value of the asset is treated as an other volume change rather than a result of productive activity.

10.41 Depletion is an other volume change that recognizes the reduction in the volume of subsoil assets, natural forests, fishstocks in the open seas, water resources, and other noncultivated biological resources as a result of the physical removal, harvesting, forest clearance, or other use of the assets.

10.42 Intangible nonproduced assets normally have a finite service life. For example, patent protection of an invention usually ceases after a fixed number of years, or the value of the invention may decline because of newer inventions. Similarly, a contract usually expires after a fixed period. The amortization of intangible nonproduced assets measures these decreases in value and is recorded as an other volume change.

10.43 In defined-benefit retirement schemes, the level of benefits promised to participating employees is determined by a formula that is usually based on participants' length of service and salary. A change in

⁷As described in Appendix 2, a reduction in a financial claim by mutual agreement between the creditor and debtor is a transaction in financial assets rather than an other economic flow.

the liability of a retirement scheme resulting from a change in the benefit structure is treated as an other volume change because it is assumed to be a unilateral change by the employer rather than a capital transfer negotiated by mutual agreement.

10.44 Consumption of fixed capital includes an allowance for a normal, expected amount of damage, and changes in inventories includes an allowance for a normal rate of shrinkage. Damage to these assets that differs from the amount covered by these allowances and that is not a catastrophic loss is considered unforeseen damage and treated as an other volume change. For example, substantial inventory losses from fire, robbery, and insect and vermin infestation of grain stores are included here. The adjustment for unforeseen damage could be an increase in assets if the actual damage falls short of the amount covered by the allowances.

b. Creation, discovery, cancellation, or seizure of economic assets

- **10.45** A government unit can create an economic asset by exerting ownership rights over a naturally occurring asset, such as the electromagnetic spectrum or fishstocks in exclusive economic zones. When it does so, the asset enters the balance sheet as an other volume change.
- **10.46** Normally the amount of land is fixed. In some cases, however, land can be created by reclaiming it from the sea with the use of dikes or other sea barriers. Such a creation would be recognized as an other volume change.
- 10.47 New allocations of SDRs and cancellations of existing SDRs are treated as changes in financial assets resulting from other volume changes. In most cases, SDRs are allocated to central banks, but they could be recorded on the balance sheet of a government unit when it undertakes some of the functions of the monetary authority.
- **10.48** Although the total volume of subsoil resources does not increase, only discovered resources can be recorded as assets. Thus, the discovery of a new deposit, whether as a result of systematic scientific explorations or by chance, that is commercially exploitable is recorded as an other volume change.
- **10.49** Government units may take possession of the assets of other institutional units without full compensation for reasons other than the failure to pay

taxes, fines, or similar levies. Such seizures of assets, legal or illegal, are not capital transfers because they do not take place by mutual agreement of the units involved. The excess of the value of the assets seized over the value of any compensation paid is recorded as an other volume change. Foreclosures and repossessions of assets by creditors are transactions because the contractual agreement between debtor and creditor provides this avenue of recourse.

c. Changes in the quality of existing economic assets

10.50 In general, differences in quality are treated as differences in volume because different qualities reflect different use values. Such changes may occur because of a change in the permitted use of the asset, environmental damage, unforeseen obsolescence, or a fixed asset lasting longer than expected. The difference between a quality change and a price change is a matter of degree, and it may not always be clear whether an other volume change or a holding gain is most appropriate.

10.51 A change in the permitted or designated use of an asset may represent a different quality of asset. For example, a change of land use, such as from cultivated land to land underlying buildings, may increase or decrease its value, especially if such a change results from a change in a zoning classification or other administrative procedure. An other volume change of this nature would be recorded together with a reclassification, as described in the following section. An increase in the value of an existing structure or site that has been designated as a historic monument because of its special archaeological, historic, or cultural significance would also be treated as a quality change.

10.52 The quality of nonproduced assets such as land, water resources, and wildlife can be degraded by economic activity. Typical damages caused are erosion to land from deforestation or improper agricultural practices and the harmful effects on fish-stocks and water resources from acid rain or excess nutrients from agricultural runoff. Another type of quality damage is the unforeseen environmental degradation of fixed assets from the effects of acidity in air and rain on building surfaces or vehicle bodies.

10.53 Improved technology embodied in new models of fixed assets or new production processes may cause obsolescence at a rate exceeding the amount allowed for in consumption of fixed capital. Decreases in the value of fixed assets from this source are recorded as

other volume changes. Conversely, a fixed asset may last longer than expected. When the increased service life is determined, an other volume change is used to record the higher quality of the asset.

3. Changes in classification

10.54 The composition of the general government sector's assets may change because there has been a reclassification of an entire institutional unit or of a group of assets and liabilities. A reclassification rearranges assets and liabilities without changing the net worth of the unit or sector involved.

a. Changes in sector classification and structure

10.55 An entire unit may be reclassified from the general government sector to another sector or to the general government sector from another sector without a change of ownership or control, normally because the unit either begins or ceases to sell its output for economically significant prices. When a unit is reclassified out of the general government sector, all of the unit's assets and liabilities are removed from the general government sector and the net value of those assets and liabilities is replaced by a financial asset, shares and other equity, to reflect the continued ownership or control of the unit by a general government unit. The reverse will be true when a unit is reclassified into the general government sector.

10.56 A change in the structure of units is also recorded as a classification change. For example, two general government units may be merged into a single unit, or a single unit may be split into two units. When two units are merged, all financial claims and liabilities that existed between them are eliminated.

Symmetrically, when a unit is split into two or more units, new financial claims and liabilities may appear between the new units.

b. Changes in classification of assets

10.57 Depending on the degree of detail of the classifications of assets, there may be reclassifications of existing assets and liabilities from one category to another, usually when there is a change in the purpose for which an asset is used. The change in classification is recorded as an other volume change with the same value for both entries. If the change in the use also means a change in its value, then a second other volume change is recorded as a change in quality rather than a holding gain.

10.58 Nonmonetary gold is treated as a commodity, and holdings of it are classified as an inventory or a valuable. Monetization of nonmonetary gold occurs when a unit of the monetary authority reclassifies nonmonetary gold to be monetary gold. Conversely, it might demonetize gold by reclassifying monetary gold to be nonmonetary gold. Such a change in the status of gold is treated as a reclassification.

10.59 The use of a structure may be changed from a dwelling to a government office building or vice versa. If these types of structures are classified separately, then an other volume change is recorded. The positive change in one asset category is balanced by a negative change in the other asset category.

10.60 The use of land may change, such as from cultivation to building lots or recreational use. If these types of land uses are classified separately, then an other volume change is recorded.

Appendix I: Changes from the 1986 A Manual on Government Finance Statistics

This appendix summarizes the principal methodological changes from the 1986 GFS Manual.

A. Introduction

1. The revised GFS system described in this manual represents a substantial modernization and expansion of the system described in the 1986 GFS Manual. Major changes have been made in the coverage of units and economic events to be recorded in the system, the timing at which economic events are to be recorded, definitions, classifications, and balancing items. The revised GFS system is also more harmonized with other macroeconomic statistical systems than was the 1986 GFS system. There are numerous detailed changes within each major topic, but an exhaustive listing of all such changes is beyond the scope of this appendix.

B. Coverage of units

2. The focus of the coverage of units in the revised GFS system is the general government sector as defined in the 1993 SNA. Its definition is based on the concept of an institutional unit, which is described in Chapter 2. The general government sector consists of all resident government units and all resident nonprofit institutions that are controlled and mainly financed by government. The coverage of the 1986 GFS system is defined on a functional basis rather than a unit basis. It includes all units carrying out a function of government, but in principle, only those transactions that are directly related to the functions of government are included. By implication, the transactions that do not represent the fulfillment of a fiscal policy are excluded. In particular, all transactions related to the functions of the monetary authority and other depository financial institutions are excluded.

3. Supranational authorities are international organizations that have been endowed with the authority to raise taxes or other compulsory transfers within the territories of the countries that are members of the authority. Despite the fact that supranational authorities fulfill some of the functions of government within each member country, they are always considered nonresident institutional units. As a result they are not included in the revised GFS system for any country. In the 1986 GFS Manual, transactions resulting from governmental functions carried out within a country by supranational organizations are included in the statistics for that country. It is possible, however, to compile statistics for supranational authorities using the revised GFS framework as if they constituted a separate country and to classify relevant categories of transactions by country.

C. Time of recording economic events

- **4.** The time at which transactions and other economic flows are recorded is determined by the principles of accrual accounting in the revised *GFS Manual*. That is, flows are recorded when economic value is created, transformed, exchanged, transferred, or extinguished. In the *1986 GFS Manual*, transactions are recorded when cash is received or paid. In general, flows are recorded at an earlier time under the accrual basis than under the cash basis.
- **5.** Recording flows on the accrual basis will automatically capture past-due obligations, such as arrears of debt principal, interest payments, or payments for goods and services. In the *1986 GFS Manual*, use of the cash basis means that arrears and changes in the level of arrears are not recorded.
- **6.** The accrual basis of recording permits the difference between the redemption value of a bond or similar security and its issue price to be recorded as

interest as it is earned or incurred rather than when the security matures. In the 1986 GFS Manual, the entire difference between the issue and redemption prices is recorded as interest when the security is redeemed.

D. Coverage of events

- 7. The coverage of events in the revised GFS system is broader than in the 1986 GFS Manual because the revised system includes all economic events that affect assets, liabilities, revenue, or expense rather than just those represented by a cash transaction. For example, barter and grants of goods and services are included. The 1986 GFS Manual incorporates in-kind transactions only selectively and as memorandum items.
- **8.** The revised *GFS Manual* includes other economic flows, which are all flows other than transactions that affect a unit's stocks of assets, liabilities, and net worth. Other economic flows must be included to reconcile fully the balance sheet at the beginning of an accounting period with the balance sheet at the end of the period. Examples of other economic flows are price changes and the destruction of assets. By definition, other economic flows are noncash events, which means that they are not part of the 1986 *GFS Manual*.

E. Valuation

9. Assets and liabilities are valued at current market prices in the revised *GFS Manual*, including debt securities that may have a different nominal value. Loans generally are not traded and therefore do not have market values. They are recorded at their nominal values. In the *1986 GFS Manual*, debt securities are always valued at the amount the government is obligated to pay when the debt matures, which may differ from both the nominal value and the current market value. The revised *GFS Manual* includes a provision for recording the nominal value of debt securities as a memorandum item.

F. Gross and net recording of flows

10. The presentation of flows on a gross or net basis is, for the most part, the same in the revised *GFS Manual* and the *1986 GFS Manual*. The major excep-

tion pertains to the sales and expenses of market establishments. Generally speaking, a market establishment is a part of a general government unit that is situated in a single location and whose primary activity is to produce and sell goods and services at economically significant prices. In concept, it is possible to compile complete accounting records with respect to an establishment's productive activity, including sales and the costs of production. In the revised GFS Manual, the sales and costs of production of market establishments are presented on a gross basis as revenue and expense, respectively. In the 1986 GFS Manual, the net value of sales less the costs of production is recorded as revenue if positive and as expenditure if negative.

G. Integration of flows and stocks

11. The revised GFS system is a fully integrated system in which the stock data at the end of an accounting period can be derived from the stock data at the beginning of the accounting period and the flows occurring during the period. As a result of this integration, all events that affect the financial performance, financial position, or liquidity situation of the general government sector are included. In the 1986 GFS Manual, the stock data included are limited to debt liabilities. The changes in the stocks of debt liabilities normally cannot be reconciled with the flows recorded. Supplementary tables are included that indicate the additional data that would be needed to complete the reconciliation.

H. Definitions and classifications

- 12. Revenue in the revised GFS system is an increase in net worth resulting from a transaction. Thus, revenue includes grants but excludes proceeds from disposals of nonfinancial assets. In the 1986 GFS Manual, revenue is defined as the set of all nonrepayable receipts other than grants. Thus, revenue includes proceeds from disposals of nonfinancial assets.
- 13. Similarly, expense in the revised GFS system is a decrease in net worth resulting from a transaction. Purchases of nonfinancial assets do not affect net worth and are not considered expense transactions. The term "expense" replaces "expenditure" from the 1986 GFS Manual because it is more closely associated with the accrual basis of recording and indicates

that transactions in nonfinancial assets are excluded. Expenditure is defined in the 1986 GFS Manual as the set of all nonrepayable payments and includes purchases of nonfinancial assets.

- **14.** The classifications of revenue are substantially different in the two manuals. Revenue in the *1986 GFS Manual* is classified as tax, nontax, or capital revenue. Grants form a separate, nonrevenue category of receipts. In the revised *GFS Manual*, revenue is subdivided into taxes, social insurance contributions, grants, and other revenue. In more detail:
- Taxes exclude social security contributions in the revised GFS Manual, but include them in the 1986 GFS Manual.
- Social insurance contributions in the revised GFS
 Manual include social security contributions, which
 are classified as taxes in the 1986 GFS Manual, and
 contributions to social insurance schemes operated
 for the benefit of government employees, which are
 classified as nontax revenue in the 1986 GFS
 Manual.
- Other revenue in the revised GFS Manual includes most of the category of nontax revenue in the 1986 GFS Manual plus capital transfers, which are classified as capital revenue in the 1986 GFS Manual.
- Capital revenue in the 1986 GFS Manual consists
 of sales of nonfinancial assets and receipts of capital transfers. Sales of assets are not revenue in the
 revised GFS Manual and capital transfers are classified as other revenue.
- **15.** Expense/expenditure is classified in two ways—by function and by economic type of transaction—in both the revised *GFS Manual* and the *1986 GFS Manual*. The classification by function in both manuals is the Classification of Functions of Government (COFOG) published by the United Nations, but that classification has itself been revised. The revised *GFS Manual* incorporates the revised COFOG.
- **16.** The classification of expense by economic type in the revised *GFS Manual* is broadly similar to the corresponding classification in the *1986 GFS Manual*. The primary exception is that acquisitions

¹The revised COFOG was developed by the Organisation for Economic Co-operation and Development and published by the United Nations.

of nonfinancial assets are not considered an expense in the revised *GFS Manual*. Other changes include the following:

- Consumption of fixed capital is an expense in the revised *GFS Manual*. As a noncash expense, it was excluded from the *1986 GFS Manual*.
- Transfer payments are classified by type of payment in the revised *GFS Manual*. In the *1986 GFS Manual*, they are classified by the sector receiving the payment. The major types of transfer payments are subsidies, grants, and social benefits.
- 17. A new classification is dedicated to changes in nonfinancial assets resulting from transactions because they are not classified as revenue or expense in the revised *GFS Manual*. The classification follows the parallel classification in the *1993 SNA*, which is based on the type of asset involved in the transaction. This classification includes consumption of fixed capital because it represents a decline in the value of fixed assets.
- **18.** Lending minus repayments is a category of transactions in the 1986 GFS Manual representing the net acquisition of financial assets for policy purposes and is classified together with expenditures for the calculation of the overall deficit/surplus. In the revised GFS Manual, these transactions are classified together with other transactions in financial assets.

I. Balancing items

- 19. Several new balancing items are introduced in the revised *GFS Manual*, a consequence of the view that fiscal analysis must include a variety of considerations and that no single measure is sufficient for all purposes. In the *1986 GFS Manual*, the analytic framework is focused on a single balancing item, the overall deficit/surplus, although provision was made for other balancing items.
- **20.** The analytic framework of the revised *GFS Manual* features several balancing items. The Statement of Government Operations includes the following:
- The net operating balance, which is defined as revenue less expense and represents the change in net worth resulting from transactions.

- Net lending/borrowing, which is defined as the net acquisition of financial assets less the net incurrence of liabilities, or alternatively as the net operating balance less the net acquisition of nonfinancial assets.
- 21. The Statement of Sources and Uses of Cash includes the cash surplus/deficit to indicate the balance of cash flows from government operations and the net acquisition of nonfinancial assets. It is similar to the overall deficit/surplus of the 1986 GFS Manual except that net cash outflows from lending and repayment transactions are not subtracted.
- **22.** Another balancing item in the revised *GFS* Manual is the overall balance, defined as net lending/borrowing adjusted through the rearrangement of transactions in assets and liabilities that are deemed to be for public policy purposes. Notably, all proceeds under privatization (including fixed asset sales) would be included as financial items; and subsidies given in the form of loans would be recognized as an expense. It is the equivalent of the overall deficit/surplus in the *1986 GFS Manual*, but determined using the accrual basis or recording.
- **23.** Other balancing items in the revised *GFS Manual* include net worth, net financial worth, the change in net worth, and the change in net financial worth—all related to the balance sheet—the change in net worth from other economic flows, the primary balance, and saving. There are no similar balancing items in the *1986 GFS Manual*.

J. Harmonization with other statistical systems

- **24.** The revised GFS system is harmonized with other international macroeconomic statistical systems. That is, the basic concepts, definitions, and conventions are the same to the extent possible given the goal of the GFS system of supporting fiscal analysis. The other statistical manuals with which the GFS system has been harmonized are the *1993 SNA*, the fifth edition of the IMF's *Balance of Payments Manual*, and the IMF's *Monetary and Financial Statistics Manual*. The *1986 GFS Manual* follows the 1968 version of the SNA² where possible, but the degree of harmonization is much less, primarily because of the use of the cash basis of recording in the *1986 GFS Manual*.
- 25. The major differences between the revised GFS system and the macroeconomic statistical systems with which it is harmonized are the classifications used and the resulting balancing items. For example, the classifications of taxes in the revised GFS system and in the 1993 SNA are quite different, but the definition of a tax is the same in both systems. The treatments of retirement schemes and reinvested earnings on direct foreign investment in the GFS system differ from the treatment in the 1993 SNA, and, as a result, net lending/borrowing differs in the two systems. In addition, differences in coverage mean that some items, such as compensation of employees, are defined identically but are less inclusive in the GFS system than in the 1993 SNA. Appendix 3 provides additional information on harmonization of the GFS system with the 1993 SNA.

²United Nations, *A System of National Accounts*, Studies in Methods, Series F, No. 2, Rev. 3 (New York, 1968).

Appendix 2: Government Debt Operations

This appendix describes various debt and debtrelated transactions and other economic flows in which a general government unit may be involved.

A. Introduction

1. In addition to normal interest expense and principal repayment transactions regarding their own debt, general government units may undertake a range of often complex debt and debt-related transactions, including assuming debt guaranteed for other units, rescheduling debt, and canceling debt. This appendix summarizes the transactions and other economic flows that arise from government debt and debt-related operations.

B. Interest, principal, and arrears

2. The most common debt transactions of general government units are interest expense and the repayment of principal. Interest is an expense incurred by a debtor for the use of another unit's funds. An interest-bearing financial instrument can be classified as deposits, securities other than shares, loans, or accounts receivable/payable. Interest accrues continuously and is treated as if the debtor pays it continuously to the creditor and the debtor continuously borrows an additional quantity of the same financial instrument, thereby increasing the debtor's total liability. When the debtor makes a payment, the liability is reduced. Traditionally, the share of a periodic payment equal to the amount of interest that has accrued and is due for payment is referred to as an interest payment. The remainder is referred to as a principal payment.

3. If the debtor does not make a payment on or before its scheduled date, including any grace period, a payment arrear is created. Depending on the contractual conditions, the existence of arrears may change the terms of the entire liability or only the portion in arrears. For example, failure to make a scheduled payment may convert the entire principal of a long-term loan into a loan callable on demand. If the terms and conditions have changed with respect to any part of the liability, that part should be treated as a separate instrument, possibly in a different category of liabilities. Thus, it is recorded as if a payment were made on the scheduled date equal to the amount being reclassified, and then the creditor lent the same amount to the debtor under the new terms. In this way, the amount of financing obtained by not making scheduled payments becomes clear. When arrears exist, either each relevant category of liabilities should be subclassified to indicate the amounts in arrears, or the amounts in arrears should all be classified as accounts payable.

C. Debt assumption

4. General government units often guarantee debts incurred by other units. Frequently the creditor is willing to lend funds to the debtor only if a general government unit guarantees the debt. Debt assumption takes place when the creditor invokes the contract conditions permitting the guarantee to be called, and the general government unit assumes responsibility for the debt as the primary obligor, or debtor. Thus, debt assumption involves three units—the general government unit, the creditor, and the original debtor. The government incurs a new liability to the creditor and the liability of the original debtor is extinguished. The new debt may carry the same terms as the original debt, or new terms may come into force because the guarantee was invoked.

¹Interest accruing on deposits and loans may have to follow national practices and be classified under accounts payable/receivable rather than additional amounts of deposits and loans.

- 5. When a general government unit assumes a debt, it may or may not acquire a claim against the original debtor. If it does acquire a claim, the claim may or may not be effective in the sense that there is a realistic probability that it will be paid. When the general government unit acquires an effective claim, it records an increase in liabilities to the creditor and the acquisition of a financial asset with the original debtor as the counterparty. There is no change in net worth, assuming the new claim is equal in value to the liability incurred.
- **6.** If the general government unit does not acquire an effective claim on the original debtor, then the classification of the transaction depends on the relationship between the general government unit and the original debtor. If the original debtor is a public corporation owned or controlled by the assuming general government unit and the corporation continues to be a going concern, then the assumption amounts to an increase in the equity owned by the general government unit. In this case, the general government unit records an increase in liabilities to the creditor and an increase in shares and other equity. There is no change in the net worth of either unit. If the original debtor is bankrupt, no longer a going concern, or is not a unit owned or controlled by the assuming general government unit, then the general government unit has made a transfer payment. It records an increase in liabilities and an expense, which is classified as a capital grant if the original debtor is a foreign government or another general government unit and as other miscellaneous expense/capital transfers if the original debtor is any other unit. Net worth has decreased by the amount of the transaction.

D. Debt payments on behalf of other units

7. General government units may make one or more debt-service payments on behalf of other units, usually under guarantees or similar arrangements, without actually assuming the debt. These payments may involve interest or principal that is due to be paid by the other unit. Such payments cannot be classified as interest expense or repayment of principal because the general government unit does not have an actual liability. The treatment of these payments depends on whether the general government unit acquires an effective financial claim on the debtor and, if not, the nature of the unit.

8. If the general government unit obtains an effective financial claim against the original debtor, then it records an increase in financial assets and a decrease in cash. If the general government unit does not obtain an effective financial claim, then it records an expense. When a single payment of a small part of the debtor's liability or a series of such payments is involved, the expense is classified as a current grant when the debtor is another general government unit or a foreign government, as a subsidy when the debtor is a corporation, and as miscellaneous other expense when the debtor is any other type of unit. If the general government unit pays the entire liability of the debtor in a single payment, then the transaction is treated as debt assumption.

E. Debt forgiveness

- **9.** Debt forgiveness is the cancellation of a debt by mutual agreement between a creditor and debtor. It is always recorded as the creditor providing a capital grant or transfer to the debtor. General government units may be involved in debt forgiveness as a creditor or a debtor.
- 10. Debt forgiveness results in a decrease in financial assets and usually a decrease in net worth for the creditor equal to the value of the debt forgiven and a decrease in liabilities and an increase in net worth for the debtor. If the second party to the transaction is a foreign government or a unit at another general government unit, then the transaction is a capital grant for both the creditor and the debtor. If the second party to the transaction is any other type of unit, then the transaction is classified as miscellaneous other expense/capital transfers when the general government unit is the creditor and as other revenue/capital voluntary transfers other than grants when it is the debtor.

F. Debt restructuring and rescheduling

11. General government units may agree in a bilateral arrangement to alter the terms for servicing an existing debt, either as a creditor or a debtor, usually on more favorable terms for the debtor and possibly with partial debt forgiveness. These terms may include extending repayment schedules, adding or extending grace periods for interest and principal payments, or rescheduling debt-service payments that are due and/or in arrears. All such changes in the

contractual relationship between debtors and creditors are accounted for by transactions that reduce liabilities by the amount of debt that has been reorganized and increase liabilities by the market value of the new debt.² Any debt forgiven is accounted for as a capital transfer as described in paragraphs 9 and 10. Other adjustments, such as to take into account changes in foreign exchange rates, are accounted for as a holding gain or loss.

G. Debt write-offs and write-downs

- 12. General government units that are creditors may write off financial assets without an agreement with the debtor in cases such as bankruptcy of the debtor. For example, a public corporation that has borrowed from the general government unit may be insolvent and its assets liquidated. As a result, the general government unit's claim has no value and is eliminated from the balance sheet by recording an other economic flow. A unilateral write-down of a partial value of a debt is treated similarly, but the reduced amount of the debt remains on the balance sheet. A unilateral write-off by a debtor, or debt repudiation, is not recognized.
- 13. In general, loans are valued in the balance sheet of both creditors and debtors at nominal value. Loans that have become marketable in secondary markets should be reclassified as securities other than shares and valued at market prices. In addition, general government units may find that other loans are worth less than their nominal value on the evidence of similar debt that has been traded in the market (for example, under loan-for-equity swaps). In such circumstances, a memorandum item should be recorded noting the apparently lower value of the loans.

H. Debt-for-equity swaps

- **14.** A general government unit acting as a creditor might exchange a debt instrument for shares and other equity issued by the same unit that issued the debt instrument. The recording of this event depends on the value of the shares and other equity received by the general government unit and whether there has been an agreement to forgive debt.
- **15.** In all cases, the general government unit will record transactions reflecting an exchange of finan-

²Nominal value if a loan is involved.

cial assets as debt has been exchanged for equity. The value of the shares and other equity received may be the same or differ from the value of the debt given up. If there was a bilateral agreement to forgive part of the debt, then a capital transfer would be recorded for the amount forgiven. The remaining difference between the value of the shares and other equity and the value of the debt should be recorded as a holding gain or loss. If there is no bilateral agreement to forgive debt then any difference is a holding gain or loss.

16. Determining the value of the shares may be difficult if the shares are not actively traded on a market, as is likely to be the case if the unit that issued the shares is a controlled public corporation. If the shares are not traded, then most likely they will have to be valued based on the total value of the corporation's assets less the total value of its liabilities, where the shares and other equity are not included as liabilities.

I. Financial and operating leases

- 17. A general government unit may be involved in leasing fixed assets, most likely as the lessee, but possibly as the lessor. If so, the lease must be classified as an operating or financial lease. If it is an operating lease, the lease payments are treated as use of goods and services expense if the general government unit is the lessee and as sales of goods and services if it is the lessor. If it is a financial lease, then the lessor is treated as having sold the asset to the lessee and financed the sale with a loan. This treatment of leases of fixed assets is the same as the treatment in the 1993 SNA.
- 18. Operating leasing is a productive activity that involves renting fixed assets for terms less than the expected service lives of the assets. It is a form of production in which the lessor provides a service to the lessee in exchange for the lease payments. Operating leasing can be identified by the following characteristics: (a) the lessor normally maintains a stock of equipment in good working order which can be hired on demand or at short notice, (b) the equipment may be rented out for varying periods of time, and (c) the lessor is frequently responsible for the maintenance and repair of the equipment as part of the service provided to the lessee.
- **19.** In contrast, financial leasing is an arrangement for financing acquisitions of fixed assets. It is a contract between a lessor and a lessee whereby the lessor owns a fixed asset and puts it at the disposal of the

lessee, and the lessee contracts to pay rentals that permit the lessor to recover all or almost all of its costs, including interest. As a result, the risks and rewards of ownership pass from the lessor to the lessee. In order to capture the economic reality of such arrangements, a change of ownership from the lessor to the lessee is deemed to take place, even though legally the leased good remains the property of the lessor, at least until the termination of the lease when the legal ownership is usually transferred to the lessee.

20. The rental payments made each period by the lessee include an interest payment and a principal payment. If the market value of the asset is known at the inception of the lease, then it is the value of the transaction, and the rate of interest on the loan is determined implicitly by the total amount paid as rentals over the life of the lease in relation to the price of the asset. If the market value of the asset cannot be determined reliably, then its value is estimated as the present value of the lease payments discounted at an appropriate market rate of interest.

J. Defeasance

21. Another debt-related operation is defeasance, in which a debtor unit removes liabilities from its balance sheet by pairing them with financial assets, the income and value of which are sufficient to ensure that all debt-service payments are met. Defeasance may be carried out by placing the assets and liabilities in a separate account within the institutional unit concerned or by transferring them to another unit. In either case, the GFS system does not recognize defeasance as affecting the outstanding debt of the debtor. Thus, no transactions with respect to defeasance are recorded in the GFS system as long as there has been no change in the legal obligations of the debtor. When the assets and liabilities are transferred to a separate account within the unit, both assets and liabilities should be reported on a gross basis. If a separate unit is created to hold the assets and liabilities, that new unit should be treated as an ancillary unit and consolidated with the defeasing unit.

Appendix 3: Government Finance Statistics and the System of National Accounts

This appendix describes the relationship between the GFS system and the System of National Accounts.

A. Introduction

- 1. With few exceptions, the stocks and flows of the GFS system are defined and valued in the same way and are recorded with the same timing as they are in the SNA.¹ The presentation of the GFS system in Chapter 4, however, differs from the presentation of the general government sector in the 1993 SNA. In addition, the GFS treatment of some activities differs from the SNA treatment of the same activities, both systems have balancing items that are not in the other system, and the classifications differ.
- 2. This appendix summarizes the important similarities of and differences between the two statistical systems. It also indicates how the data compiled for the GFS system can be used as an input to the compilation of the accounts for the general government sector in the SNA. It does not list, however, all differences between the two systems and should not be considered a comprehensive guide.

B. Coverage and accounting rules

3. As described in Chapter 2, the general government sector in the GFS system is identical to the general government sector in the SNA.² Compilers of both systems should ensure that the actual coverage used in their statistics is identical.

5. The principal difference between the two systems regarding accounting rules concerns consolidation, which is the elimination of all within-sector asset-liability positions and all transactions between two units of the same sector.³ In general, consolidation is not used in the SNA. Thus, government bonds held by one government unit that are issued by another government unit are shown as both financial assets and liabilities in the balance sheet of the general government sector. In contrast, full consolidation is used in the GFS system.⁴ The purpose is to show the activities of the general government sector, or any other grouping of units, as if only a single unit existed. Consolidation is an adjustment process that takes place after the statistics have been compiled for each unit. Because SNA statistics are not consolidated, the GFS compiler should preserve the unconsolidated statistics for use by the national accounts compiler.

C. Comparison of the structures of the GFS and SNA systems

6. Both the GFS and SNA systems can be described as the systematic recording and presentation of stocks and flows, with the flows comprising transactions and other economic flows. The actual flows recorded, however, differ in a number of instances, primarily

^{4.} Most of the accounting rules employed in the two systems are identical. In particular, the rules for time of recording and the valuation of stocks and flows and the rules governing the gross or net recording of stocks and flows are identical.

¹In this appendix, most references to the *1993 SNA* concern the general content of the volume rather than the citation of a specific portion of the text. The expression "in the SNA" is used to refer to the *1993 SNA* as a body of thought.

²The public sector is not one of the five primary sectors in the SNA, but it is defined in Chapter XIX, and that definition is identical to the definition in Chapter 2 of this manual.

³Consolidation can be applied to the statistics of any group of units, including subsectors of the general government sector, the entire public sector, or any other grouping suggested in Chapter 2 as having analytic interest.

⁴It is acknowledged in paragraph 3.121 of the *1993 SNA* that consolidation is relevant for the general government sector.

because the treatments of government productive activities are quite different in the two systems.

- 7. The GFS analytic framework consists of four statements. The Statement of Government Operations is a presentation of all transactions recorded in the GFS system. Other economic flows are presented in the Statement of Other Economic Flows, and the stocks are presented in the Balance Sheet. Finally, the Statement of Sources and Uses of Cash provides information on cash flows.
- **8.** In the SNA, transactions are presented in a sequence of seven accounts (see Table A3.1), other economic flows are presented in two accounts, and stocks are presented in the Balance Sheet. There is no SNA equivalent to the GFS Statement of Sources and Uses of Cash.
- **9.** In the SNA, the sequence of transaction accounts is divided into current and accumulation accounts. The current accounts record the production of goods and services and the generation, distribution, redistribution, and use of income. The accumulation accounts record the acquisition and disposal of assets and liabilities. Despite the large number of accounts in the SNA, there is a close correspondence between the structures of the two systems.⁵
- 10. The GFS Statement of Government Operations is divided into three sections. The transactions presented in the first section are similar to the transactions in the current accounts of the SNA with one exception: capital transfers are shown in the Capital Account of the SNA, one of the accumulation accounts. All of the GFS transactions presented in the second and third sections of the Statement of Government Operations are shown in the Capital and Financial Accounts, respectively, of the SNA.
- 11. There are more balancing items in the SNA than in the GFS system because there are more transaction accounts than sections of the Statement of Government Operations. In addition, the different treatment of selected activities and the placement of capital transfers means that the GFS balancing item for the first section of the Statement of Government Operations, the net operating balance, differs from saving, the final balancing item in the sequence of current accounts in the SNA.⁶

Table A3.1 Sequence of SNA Transaction Accounts

Current accounts	l.	Production Account
	II.1.1.	Generation of Income Account
	11.1.2.	Allocation of Primary Income Account
	II.2.	Secondary Distribution of Income
		Account
	11.4.1.	Use of Disposable Income Account
Accumulation accounts	III.1.	Capital Account
	III.2.	Financial Account

¹There is an alternative sequence of accounts in which the Secondary Distribution of Income Account (II.2) is augmented with the Redistribution of Income In-kind Account (II.3) and the Use of Disposable Income account (II.4.1) is replaced by the Use of Adjusted Disposable Income Account (II.4.2). See Chapters VIII and IX of the 1993 SNA for additional details on these accounts.

Net lending/borrowing is the balancing item for the second and third sections of the Statement of Government Operations and for the Capital and Financial Accounts of the SNA.⁷

12. The GFS Statement of Other Economic Flows covers all other economic flows, classified by type of asset or liability affected and whether the flow is a holding gain⁸ or an other change in the volume of assets. In the SNA, the same distinction between holding gains and other changes in the volume of assets is made, but these two types of flows are recorded in separate accounts rather than in a single statement: the Other Changes in Volume of Assets Account and the Revaluation Account. The coverage of the GFS Balance Sheet is identical to the coverage of the Balance Sheet in the SNA.

D. Use of GFS data to compile the SNA

13. Despite the structural similarities, the different treatments of certain activities in the two systems and the particular needs of fiscal analysis mean that the actual transactions and other flows recorded in the various statements and accounts may differ. This section reviews these differences, which are also noted in the main text.

⁵Explicit provision is made in the SNA for flexibility in the presentation of stocks and flows. The accounts described here comprise the basic presentation described in Chapters VI through XIII of the *1993 SNA*.

⁶The net operating balance is comparable to "changes in net worth due to saving and net capital transfers," an aggregate determined in the Capital Account of the SNA.

⁷Because of the different treatments of some activities, net lending/borrowing and saving in the GFS system differ from net lending/borrowing and saving in the SNA.

⁸As stated in Chapter 10, holding gain is used as a short reference to holding gain or loss.

⁹"Revaluations" and "holding gains" are used interchangeably in the 1993 SNA.

14. In addition, it is likely that in many countries the statistics compiled for the GFS system will be used by the compilers of the national accounts as the starting point for compiling statistics for the general government sector of the SNA. Table A3.2 identifies the SNA account in which a transaction from the GFS system would be recorded, the SNA classification code, and whether the transaction is considered a resource, use, change in an asset, change in a liability, or change in net worth. 10 When a transaction is recorded in a current account of the SNA, it is classified as a "use" (a reduction in the economic value of the unit) or a "resource" (an addition to the economic value of a unit). When a transaction is recorded in an accumulation account of the SNA, it is classified as a change in an asset, a change in a liability, or a change in net worth depending on its effect on the balance sheet. This section also provides guidance on estimating selected elements of the SNA.

I. Accounting for production

- **15.** The productive activities of government are recorded quite differently in the two statistical systems. As a result, deriving the production-related entries of the SNA from statistics of the GFS system is complex. In order to facilitate an understanding of the links between the two systems, the SNA accounts are referred to by their names and the SNA and GFS classification codes are indicated the first time a particular category of flows is referenced.¹¹
- **16.** Output is the value of goods and services produced during an accounting period. It is not recorded as such in the GFS system because most of the output of general government units is distributed on a nonmarket basis. In the SNA, transactions related to the production of goods and services are recorded in the Production and the Generation of Income Accounts.

a. The Production Account

17. The Production Account includes (1) the output (SNA classification code P.1) of all goods and services produced by a general government unit as a

resource, with the total divided into market output (P.11), output for own final use (P.12) (referred to as own-account capital formation in this manual), and other nonmarket output (P.13); (2) intermediate consumption of goods and services (P.2) as a use; and (3) consumption of fixed capital (K.1) as a use. The balancing item is value added (B.1), which can be presented gross or net of consumption of fixed capital.

- **18.** The total output of the general government sector is determined as the sum of the output of nonmarket establishments and the output of market establishments. The output of the two types of establishments is derived quite differently, as described in the following paragraphs.
- 19. The output of nonmarket establishments cannot be determined from sales statistics because most of it is distributed without charge or sold for prices that are not economically significant. Instead, the output of nonmarket establishments is defined to be equal to the sum of the production costs: compensation of employees, intermediate consumption, consumption of fixed capital, other taxes on production paid, and other subsidies on production received (as a negative value). In order to make this calculation, the total values of each of these expense categories need to be divided into expenses incurred by market and nonmarket establishments.
- **20.** The output of market establishments is equal to the sales of those establishments (GFS revenue category 1421) plus changes in inventories of work in progress and finished goods of those establishments. Thus, GFS data on the total change of those types of inventories need to be divided into separate data for market and nonmarket establishments for SNA purposes.
- 21. Once the total output of the general government sector has been estimated, it must be allocated among the three components: market output, output for own final use, and other nonmarket output. Output for own final use is the value of nonfinancial assets constructed for own use by general government units and is available directly from the GFS system as memorandum item 3M1 in Table 8.1.¹² Market output and other nonmarket output, however, are not available directly and do not necessarily

¹⁰Table A3.2 is designed to be read from left to right. The left column is a list of transaction categories in the GFS system. The right column identifies the SNA category in which a given GFS transaction would be recorded. The SNA category may, however, include transactions that are not recorded in the GFS system or transactions from more than one GFS category.

¹¹SNA classification codes for transactions and other flows have the form of a letter (D, F, K, or P) followed by a number. SNA codes for balancing items use the letter B. The GFS coding system is presented in Appendix 4.

¹² In the SNA, provision is made to value this output at market prices if the assets constructed on own account are also offered for sale on the market. In the GFS system, it is assumed that assets constructed on own account by the general government sector are not offered for sale on the market so that valuation based on the cost of production is acceptable.

correspond to the output of market and nonmarket establishments because nonmarket establishments can produce market output.

- 22. Market output is the sum of the entire output of market establishments, actual sales of nonmarket establishments, and other output that is imputed to have been sold. Imputed sales are in-kind transactions that are valued at market prices. They comprise goods and services produced by general government units and provided (a) to employees as part of their compensation, (b) as social benefits in accordance with employer social insurance schemes, (c) to other governments and international organizations, and (d) to nonprofit institutions serving households and to individuals or households in compensation for damage or in settlement of an insurance claim. These transactions are described in more detail in paragraph 33. Once market output and output for own final use are determined, the value of other nonmarket output can be calculated residually as the total output of the general government sector less output for own final use and market output.
- 23. Intermediate consumption is needed for the SNA production account but is not a GFS expense category. It is the total value of all goods and services consumed by general government units in their productive activities. Intermediate consumption is equal to:

Use of goods and services (GFS expense category 22).

plus

Goods and services used in own-account capital formation (memorandum item 3M12).

plus

The consumption of financial intermediation services indirectly measured (FISIM) and insurance services.

minus

Goods purchased for resale.

plus

The change of inventories of work in progress, finished goods, and goods purchased for resale.

24. For SNA purposes, the values for FISIM and insurance services are derived by partitioning actual interest and non-life insurance premium transactions. A financial intermediary sets its interest rates for depositors and borrowers at levels that will provide a margin large enough to defray the costs of providing its services to its depositors and borrowers without explicit fees. Interest payable to or receivable from a

financial intermediary is, therefore, partitioned in the SNA into a payment for FISIM services and an adjusted amount of interest. Similarly, the payment of non-life insurance premiums is partitioned into purchases of services from the insurance enterprise and the payment of net non-life premiums (D.71). In the GFS system, these partitions are not made because they can be estimated only with the aid of data for the entire economy. Instead, the entire values of the actual transactions are recorded as interest and non-life insurance premiums.¹³

- **25.** Establishments engaged in own-account capital formation by definition do not purchase goods for resale and do not have changes in inventories of work in progress or finished goods. All other establishments could have these items.
- **26.** Consumption of fixed capital in the SNA equals the expense category of the same name in the GFS system (23) plus the amount recorded as a component of own-account capital formation (memorandum item 3M13).

b. The Generation of Income Account

- 27. The Generation of Income Account starts with value added and then includes (1) compensation of employees (D.1) as a use, (2) other taxes on production (D.29) paid as a use, and (3) other subsidies on production (D.39) received as a negative use. Its balancing item is the operating surplus (B.2), which also can be presented gross or net of consumption of fixed capital.
- **28.** Compensation of employees in the SNA equals the expense category of the same name in the GFS system (21) plus the amount recorded as a component of own-account capital formation (memorandum item 3M11).
- 29. The taxes and subsidies that are included in the valuation of the output of nonmarket establishments consists of other taxes on production paid by general government units to other government units and other subsidies on production received by general government units from other government units. These amounts are likely to be rare and/or small in magnitude. Taxes paid are classified in the GFS system as miscellaneous other expense (282) and subsidies are classified as grants received from other

¹³See Annexes III and IV of the *1993 SNA* for additional details on the estimation of these services.

levels of national government (133). Both would be eliminated in consolidation when statistics for the general government sector are compiled.

2. Final consumption

- **30.** Final consumption is a key component of gross domestic product. It is implemented in the SNA in two ways: final consumption expenditure (P.3) and actual final consumption (P.4). The difference between them is social transfers in kind (D.63), which represents the final consumption of goods and services purchased by general government units but actually consumed by households.
- **31.** Final consumption expenditure of the general government sector is not an element of the GFS system. It can be calculated as

Total output, as described in paragraphs 18 to 20. *plus*

Purchases of goods and services that are transferred to households without further transformation.

minus

Actual and imputed sales of goods and services, including sales of used goods and scrap.

minus

Changes in inventories of work in progress and finished goods.

minus

Output of own-account capital formation.

- **32.** Purchases of goods and services that are transferred to final consumers without further transformation are classified as social security benefits in kind (2712), social assistance benefits in kind (2722), or other current expense (2821) depending on the nature of the program governing their distribution. See paragraph 36 for additional details.
- **33.** Actual sales of goods and services is the sum of sales by market establishments (1421), administrative fees (1422), and incidental sales by nonmarket establishments (1423). Imputed sales include the following:
- Goods and services produced by the general government sector and provided as social benefits in kind in accordance with employer social insurance schemes are treated as if there had been a transfer to the beneficiaries in cash followed by a sale of the output to the beneficiaries. Thus, the output is shown in the SNA as final consumption expenditure of the households while the transfer is shown

- as a social benefit (recorded in the Secondary Distribution of Income Account/social benefits other than social transfers in kind/private funded social insurance benefits (D.622) or unfunded employee social insurance benefits (D.623)).
- Goods and services produced by the general government sector and provided as grants in kind to other governments and international organizations are treated as if there had been a transfer in cash followed by a sale of the output to the recipients of the goods and services. The output is shown as exports (P.6) in the case of grants to foreign governments and international organizations and either government final consumption expenditure or gross fixed capital formation (P.51) in the case of grants to other domestic general government units. The transfer is shown in the Secondary Distribution of Income Account/other current transfers/current transfers within general government (D.73) or current international cooperation (D.74) or in the Capital Account/capital transfers/investment grants (D.92) or other capital transfers (D.99).
- Goods and services produced by the general government sector and provided to employees as wages in kind are treated as compensation of employees paid in cash followed by a sale to the employees (1424). The compensation is recorded in the Generation of Income Account/compensation of employees/wages and salaries (D.11), and the output is recorded as household final consumption expenditure.
- Goods and services produced by the general government sector and provided as transfers in kind to non-profit institutions serving households or to individuals or households as compensation for damage to property or personal injury or as the settlement of an insurance claim are treated as a transfer in cash and a sale of market output. The transfer is recorded in the Secondary Distribution of Income Account/other current transfers/non-life insurance claims (D.72) or miscellaneous current transfers (D.75), and the output is recorded as final consumption expenditure of the households sector or the non-profit institutions serving households sector.
- **34.** When an existing good is sold, the amount received from its sale is recorded as negative final consumption expenditure if the acquisition of the good had been classified as final consumption expenditure. For example, acquisitions of weapons and weapon-delivery systems by the military are classified as final consumption expenditure. Therefore,

sales of used military weapons and weapon-delivery systems are negative final consumption expenditure. Sales of used goods and scrap are part of miscellaneous and unidentified revenue (145).

- **35.** Changes in inventories of work in progress and finished goods are categories 31222 and 31223 in Table 8.1. Own-account capital formation is part of output but not part of final consumption expenditure. In the GFS system, the value can be obtained from memorandum item 3M1.
- **36.** As mentioned in paragraph 32, the difference between final consumption expenditure and actual final consumption is social transfers in kind. The GFS expense categories of social security benefits in kind (2712) and social assistance benefits in kind (2722) consist entirely of reimbursements of households for purchases of social security benefits in kind or direct purchases by general government units of social security or social assistance benefits from market producers. In addition, category 2821 may include purchases of individual nonmarket goods and services (D.632), such as purchases of education, recreation, and cultural services from market producers. Also included in social transfers in kind is the value of goods and services produced by general government units and transferred to households as social security benefits, social assistance benefits, or individual nonmarket goods and services. Information on these goods and services may be obtainable from the cross-classification of the Classification of Functions of Government (COFOG) and economic type of expense in Table 6.3. The annex to Chapter 6 lists the services that are considered individual.

3. Social insurance

- 37. Social contributions paid by employers as part of compensation of employees in the GFS system (212) is identical to the same category in the SNA (D.12). The amount recorded for social contributions received by units operating social insurance schemes, however, can be quite different in the two systems. In the SNA, all social contributions received by employees as compensation are deemed to be paid to the operator of the scheme as social contributions (D.61). In the GFS system, social contributions paid to employer social insurance schemes providing pensions and other retirement benefits are classified as incurrences of liabilities by the operator of the scheme (3316) rather than as revenue from social contributions (12).
- **38.** In addition to social contributions paid as compensation of employees, operators of funded employer

social insurance schemes are deemed in the SNA to pay property income attributed to insurance policyholders (D.44) to the beneficiaries of the schemes equal to the property income and net operating surplus earned from the investment of the reserves of the scheme. This property income is then deemed to be paid by the beneficiaries to the operator of the scheme as a supplemental social contribution. These imputed social contributions are not recorded in the GFS system. The value of this item must be derived from the records of the applicable social insurance schemes.

- **39.** In the SNA, all social benefits paid, including pensions and other retirement benefits, are recorded either in the Secondary Distribution of Income Account/social benefits other than social transfers in kind (D.62) or in the Redistribution of Income Account/social transfers in kind. In the GFS system, the expense category of social benefits (27) is narrower. It includes (a) all social security and social assistance benefits except benefits in the form of goods and services produced by general government units and (b) employer social benefits except retirement benefits and all benefits in the form of goods and services produced by general government units. Retirement benefits are classified as reductions in liabilities of insurance technical reserves. The costs of social benefits produced by general government units are recorded as costs of production in the various GFS expense categories, such as compensation of employees and use of goods and services. The estimation of social security and social assistance benefits produced by general government units has already been mentioned in paragraph 36. Employer social benefits would have to be estimated similarly.
- 40. In the SNA, an entry in the Use of Disposable Income and Use of Adjustment Disposable Income Accounts is labeled the adjustment for the change in the net equity of households in pension funds" (D.8). It is equal to the total value of the actual social contributions payable to funded employer retirement schemes plus the total value of social contribution supplements minus the value of the associated service charges minus the total value of the pensions paid out as social insurance benefits by funded employer retirement schemes. The different treatment of retirement schemes eliminates the need for this item in the GFS system.

4. Other transactions and other economic flows

41. The GFS system includes a detailed classification of taxes based on common practices in tax administration. In the SNA, taxes are classified according to their role in economic activities as (1) taxes on

production and imports (D.2), (2) current taxes on income, wealth, etc. (D.5), or (3) capital taxes (D.91). The result is that some tax categories in the GFS system, such as motor vehicle taxes, need to be allocated between two of the SNA tax categories according to whether they are payable by producers or final consumers. These taxes are indicated in Table A3.2. The information necessary to allocate these taxes, however, may not be available to the GFS compilers.

- **42.** There are several types of property income:
- Dividends (D.421 in the SNA and 1412 or 2811 in the GFS system), withdrawals from income of quasi-corporations (D.422, 1413, and 2812), and rent (D.45, 1415, and 2814) are identical in both systems.
- The amounts recorded as interest revenue (1411) and expense (24) in the GFS system must be adjusted for recording in the SNA (D.41) when they include sums paid to or received from financial intermediaries. This adjustment, which was described in paragraph 24, can be made only by compilers of the national accounts.
- Property income attributed to insurance policy holders with respect to funded employer social insurance schemes was described in paragraph 38 as a transaction in the SNA equal in value to the property income and/or net operating surplus earned by the fund from the investment of its reserves. In the GFS system this item (2813) is equal to the increase in the liability of a definedbenefit retirement scheme resulting from the passage of time. The SNA values can be derived from the detailed records of the retirement schemes.
- Reinvested earnings on direct foreign investment (D.43) is not recorded in the GFS system; it must be estimated from other sources. It is described in footnote 9 of Chapter 5.
- 43. Other current transfers (D.7) in the SNA is a disparate collection of entries that are found in various places in the GFS system. Net non-life insurance premiums must be adjusted for the imputation of the sale or purchase of insurance services, as described in paragraph 24. In the GFS system, gross non-life insurance premiums are recorded as miscellaneous and unidentified revenue (145) or miscellaneous other expense (282). Non-life insurance claims are identical in both systems. As with premiums, they are recorded in the GFS system as miscellaneous and unidentified revenue

- (145) or miscellaneous other expense (282). Current transfers within general government and current international cooperation are recorded in the GFS system as current grants received (1311, 1321, or 1331) or paid (2611, 2621, or 2631) except for goods and services produced by general government units (paragraph 33). Miscellaneous current transfers might be recorded as fines, penalties, and forfeits (143), current voluntary transfers other than grants (1441), miscellaneous and unidentified revenue (145), miscellaneous other expense (282), or goods and services produced by general government units (paragraph 33).
- **44.** Most of the entries in the Capital Account of the SNA can be derived directly from the corresponding entries in the GFS system. In particular, acquisitions less disposals of tangible fixed assets (P.511) is the sum of acquisitions less disposals of buildings and structures (3111), machinery and equipment (3112), and cultivated assets (31131). Acquisitions less disposals of intangible fixed assets (P.512) is the same as category 31132 in the GFS system. Additions to the value of nonproduced nonfinancial assets (P.513) is part of the GFS entry for the acquisition of nonproduced assets (314) and consists of the value of major improvements to nonproduced nonfinancial assets (P.5131) and costs of ownership transfer on nonproduced nonfinancial assets (P.5132).
- **45.** Consumption of fixed capital in the SNA is identical to the total value of consumption of fixed capital recorded in Table 8.1. Changes in inventories in the SNA (P.52) is the same as changes in inventories in the GFS system, but the amounts for types of inventories differ because the GFS system includes a category for strategic stocks that does not appear in the SNA. Strategic stocks are classified as goods for resale in the SNA.
- **46.** Acquisitions less disposals of valuables (P.53), land and other tangible nonproduced assets (K.21), and intangible nonproduced assets (K.22) are the same as the corresponding items in the GFS system with the exception of the amounts recorded as additions to the value of nonproduced nonfinancial assets in the SNA described in paragraph 44.
- **47.** Capital transfers in the SNA are recorded in various places in the GFS system. Capital transfers receivable can be recorded as estate, inheritance, and gift taxes (1133), other nonrecurrent taxes on property (1135), capital grants (1312, 1322, and 1332), or capital voluntary transfers other than grants (1442). Capital

transfers payable can be recorded as capital grants (2612, 2622, and 2632) or other expense/miscellaneous other expense/other capital transfers (2822).

- **48.** With the exception of transactions in insurance technical reserves and shares and other equity, the transactions recorded in the Financial Account of the SNA should be identical to the transactions recorded in Table 9.1. The transactions recorded under insurance technical reserves differ in the two systems because of the different treatment of employer social insurance schemes that provide pensions and other retirement benefits. The receipt of social contributions and payment of social benefits by unfunded retirement schemes are treated as transactions in insurance technical reserves in the GFS system but as transfer payments in the SNA. The amounts recorded as increases in insurance technical reserves for property expense attributed to insurance policyholders also differ in the two systems, as explained in para-
- graph 42. Transactions in shares and other equity differ because the SNA includes reinvested earnings on direct foreign investment as an imputed purchase of shares and other equity but this imputation is not made in the GFS system. Instead, the increase in the value of shares and other equity is treated as a holding gain.
- **49.** For the most part, other flows are the same in both systems. A few differences arise from differing treatments of certain activities. As described in the previous paragraph, reinvested earnings on direct foreign investment is an imputed transaction in the SNA but a holding gain in the GFS system. In the SNA, the difference between the change in the liability of a funded employer retirement scheme from the passage of time (paragraph 42) and the amount that can be attributed to property income attributed to insurance policyholders is treated as a holding gain. This holding gain does not appear in the GFS system.

Table A3.2: Correspondence of GFS and SNA Transaction Categories

dary Distribution of Income Account/current taxes on income, wealth, etc./taxes on income (D.51) (resource) tion of Primary Income Account/taxes on production and imports/other taxes on production (D.29) (resource) by enterprises are recorded in the Allocation of Primary Income Account/taxes on production and imports/other taxes on production ource) by final consumers, including owner-occupiers of dwellings, are recorded in the Secondary Distribution of Income Account/current taxes, wealth, etc./other current taxes (D.59) (resource) by enterprises are recorded in the Allocation of Primary Income Account/taxes on production and imports/other taxes on production ource) by final consumers are recorded in the Secondary Distribution of Income Account/current taxes on income, wealth, etc./other current (Primary Income) (resource) If Account/capital transfers/capital taxes (D.91) (increase in net worth) tion of Primary Income Account/taxes on production and imports/taxes on products, excluding VAT, import, and es (D.214) (resource) If Account/capital transfers/capital taxes (D.91) (increase in net worth) by enterprises are recorded in the Allocation of Primary Income Account/taxes on production and imports/other taxes on production
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by final consumers are recorded in the Secondary Distribution of Income Account/current taxes on income, wealth, etc./other current ?) (resource)
tion of Primary Income Account/taxes on production and imports/taxes on products/value-added-type taxes (D.211) (resource)
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by enterprises are recorded in the Allocation of Primary Income Account/taxes on production and imports/other taxes on production
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Table A3.2: Correspondence of GFS and SNA Transaction Categories (continued)

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Fines, penalties, and forfeits The Secondary Distribution of Income Account/other current transfers/miscellaneous current transfers (D.75) (resource) Voluntary transfers other than grants Current transfers are recorded in the Secondary Distribution of Income Account/other current transfers/miscellaneous current tr	(resource)	Sales at prices that are not economically significant are recorded in the Production Account/output/other nonmarket output (P.13) (resou	
Voluntary transfers other than grants Current transfers are recorded in the Secondary Distribution of Income Account/other current transfers/miscellaneous current transfers (resource) Capital transfers are recorded in the Capital Account/capital transfers/investment grants (D.92) or other capital transfers (D.99) (increase Miscellaneous and unidentified revenue Sales of scrap and used goods not classified as assets are recorded in the Production Account/intermediate consumption (P.2) (negative description)		Imputed sales of goods and services are recorded in the Production Account/output/market output (P.11) (resource)	
(resource) Capital transfers are recorded in the Capital Account/capital transfers/investment grants (D.92) or other capital transfers (D.99) (increase Miscellaneous and unidentified revenue Sales of scrap and used goods not classified as assets are recorded in the Production Account/intermediate consumption (P.2) (negative description).		The Secondary Distribution of Income Account/other current transfers/miscellaneous current transfers (D.75) (resource)	Fines, penalties, and forfeits
Miscellaneous and unidentified revenue Sales of scrap and used goods not classified as assets are recorded in the Production Account/intermediate consumption (P.2) (negative consumption)	nt transfers (D.75)	Current transfers are recorded in the Secondary Distribution of Income Account/other current transfers/miscellaneous current transfers/cource)	Voluntary transfers other than grants
	rease in net worth)	Capital transfers are recorded in the Capital Account/capital transfers/investment grants (D.92) or other capital transfers (D.99) (increase in	
	negative use)	Sales of scrap and used goods not classified as assets are recorded in the Production Account/intermediate consumption (P.2) (negative	Miscellaneous and unidentified revenue
(resource)	t transfers (D.75)	All other transactions are recorded in the Secondary Distribution of Income Account/other current transfers/miscellaneous current trans (resource)	

Table A3.2: Correspondence of GFS and SNA Transaction Categories (continued)

GFS Transaction Category	SNA Account and Transaction Category in Which the GFS Transaction Is Recorded
Expense Transactions	
Compensation of employees	The Generation of Income Account/compensation of employees (D.1) (use). The SNA category also includes compensation of employees related to the construction of nonfinancial assets on own account, which is recorded in the GFS system as the net acquisition of fixed assets or valuables.
Use of goods and services	Most transactions are recorded in the Production Account/intermediate consumption (P.2) (use). The SNA category also includes transactions related to own-account capital formation, which are recorded in the GFS system as the net acquisition of fixed assets or valuables. See paragraph 23 of the text for a more complete derivation of intermediate consumption.
Consumption of fixed capital	The Production Account/consumption of fixed capital (K.1) (use). The SNA category also includes consumption of fixed capital related to the construction of nonfinancial assets on own account, which is recorded in the GFS system as the net acquisition of fixed assets or valuables.
Interest	The Allocation of Primary Income Account/property income/interest (D.41) (use). See paragraph 24 of the text for a possible adjustment related to financial intermediation services indirectly measured.
Subsidies	The Allocation of Primary Income Account/subsidies (D.3) (negative resource)
Grants	Current transfers are recorded in the Secondary Distribution of Income Account/other current transfers/current transfers within general government (D.73) or current international cooperation (D.74) (use)
	Capital transfers are recorded in the Capital Account/capital transfers/investment grants (D.92) or other capital transfers (D.99) (decrease in net worth)
Social benefits	Social benefits in cash and all funded employer and unfunded employee social insurance benefits are recorded in the Secondary Distribution of Income Account/social benefits other than social transfers in kind (D.62) (use).
	All other social benefits in kind are recorded in the Use of Disposable Income Account/final consumption expenditure/individual consumption expenditure (P.31) (use)
Other expense	Property expense other than interest is recorded in The Allocation of Primary Income Account/property income (D.4) (use)
	Current taxes paid to other government units are recorded in Generation of Income Account/taxes on production and imports /other taxes on production (D.29) (use)
	Other current transactions are recorded in the Secondary Distribution of Income Account/other current transfers/miscellaneous current transfers (D.75) (use)
	Capital transfers are recorded in the Capital Account/capital transfers/capital taxes (D.91), investment grants (D.92), or other capital transfers (D.99) (decrease in net worth)

Table A3.2: Correspondence of GFS and SNA Transaction Categories (concluded)

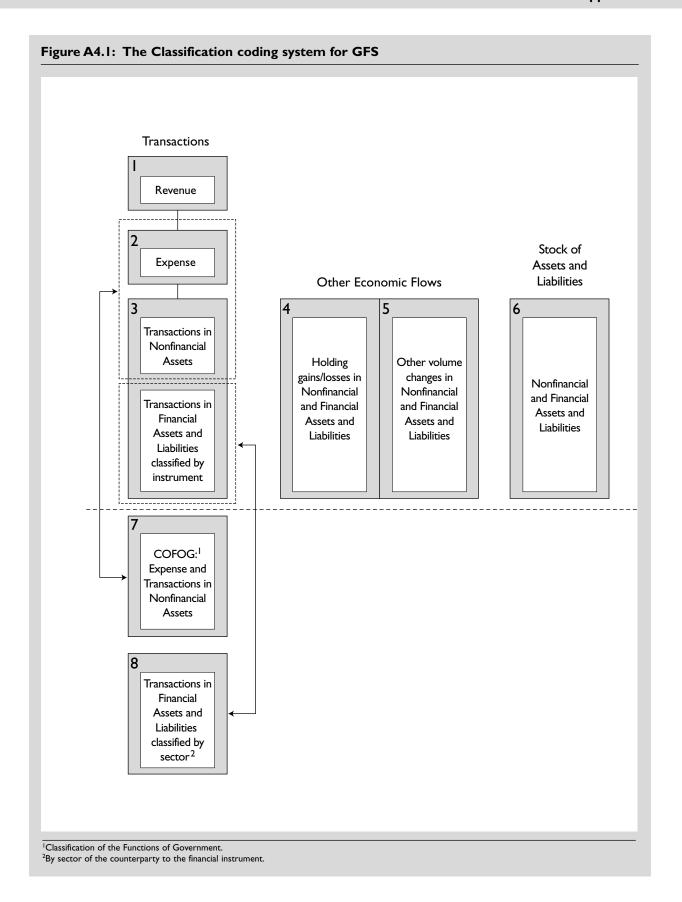
GFS Transaction Category	SNA Account and Transaction Category in Which the GFS Transaction Is Recorded
Transactions in Nonfinancial Assets	
Net acquisition of fixed assets	Transactions other than consumption of fixed capital are recorded in the Capital Account/gross fixed capital formation (P51) (change in assets). In the SNA, transactions related to the construction of fixed assets on own account will also be recorded under compensation of employees, intermediate consumption, consumption of fixed capital, and taxes less subsidies on production.
Consumption of fixed capital	The Capital Account/consumption of fixed capital (K.1) (decrease in assets)
Changes in inventories	The Capital Account/changes in inventories (P.52) (change in assets)
Net acquisition of valuables	The Capital Account/acquisitions less disposals of valuables (P.53) (change in assets)
Net acquisition of nonproduced assets	The Capital Account/acquisitions less disposals of nonproduced nonfinancial assets (K.2) (change in assets)
Transactions in Financial Assets and Liabilities	3
Monetary gold and SDRs	The Financial Account/monetary gold and SDRs (F.I) (change in assets)
Currency and deposits	The Financial Account/currency and deposits (F.2) (change in assets and/or change in liabilities)
Securities other than shares	The Financial Account/securities other than shares (F.3) (change in assets and/or change in liabilities)
Loans	The Financial Account/loans (F.4) (change in assets and/or change in liabilities)
Shares and other equity	The Financial Account/shares and other equity (F.5) (change in assets and/or change in liabilities)
Insurance technical reserves	The Financial Account/insurance technical reserves (F.7) (change in assets and/or change in liabilities)
Financial derivatives	The Financial Account/financial derivatives (F.6) (change in assets and/or change in liabilities)
Other accounts receivable/payable	The Financial Account/other accounts receivable/payable (F.8) (change in assets and/or change in liabilities)

Appendix 4: Classifications

This appendix provides all of the classification codes used in the GFS system.

- 1. Classification codes are used in the GFS system to identify types of transactions, other economic flows, and stocks of assets and liabilities. This appendix presents in one place all of the codes that were presented in Chapters 5 through 10. The overall organization of the codes is displayed in Figure A4.1.
- 2. Codes beginning with 1 refer to revenue; codes beginning with 2 refer to expense; and codes beginning with 3 refer to transactions in nonfinancial assets, financial assets, and liabilities. For financial assets and liabilities, the code 3 signifies that they have been classified by financial instrument.
- **3.** The first digit of the classification code for an other economic flow is always 4 or 5. Codes beginning with 4 refer to holding gains and codes beginning with 5 refer to other changes in the volume of assets and liabilities. The first digit of the classification code for a stock of a type of asset or liability is always 6.
- **4.** Transactions in assets and liabilities, other economic flows, and stocks of assets and liabilities all

- refer to types of assets and liabilities. Hence, the second and subsequent digits of each code are identical for each type of asset or liability. That is, 311 refers to transactions in fixed assets, 411 to holding gains in fixed assets, 511 to other changes in the volume of fixed assets, and 611 to the stock of fixed assets.
- 5. Expense transactions and transactions in nonfinancial assets can also be classified using the Classification of Functions of Government (COFOG) as described in Chapter 6. All COFOG classification codes begin with 7. Transactions in financial assets and liabilities can be classified according to the sector of the other party to the financial instrument as well as according to the type of financial instrument. When classified by sector, the classification codes for these transactions begin with 8.
- **6.** In practical applications, it may be possible and desirable to use more detailed classifications. Such an expansion can be accomplished by adding another digit to any given classification code. For example, the classification code for the stock of transport equipment is 61121. If types of transport equipment were to be classified separately, the codes 611211, 611212, and so forth would be used.



A. Classification of Revenue

I	Revenue	12	Social contributions [GFS]
П	Taxes	121	Social security contributions
Ш	Taxes on income, profits, and capital gains	1211	Employee contributions
1111	Payable by individuals	1212	Employer contributions
1112	Payable by corporations and other enterprises	1213	Self-employed or nonemployed contributions
1113	Unallocable	1214	Unallocable contributions
112	Taxes on payroll and workforce	122	Other social contributions
113	Taxes on property	1221	Employee contributions
1131	Recurrent taxes on immovable property	1222	Employer contributions
1132	Recurrent taxes on net wealth	1223	Imputed contributions
1133	Estate, inheritance, and gift taxes	13	Grants
1134	Taxes on financial and capital transactions	131	From foreign governments
1135	Other nonrecurrent taxes on property	1311	Current
1136	Other recurrent taxes on property	1312	Capital
114	Taxes on goods and services	132	From international organizations
1141	General taxes on goods and services	1321	Current
11411	Value-added taxes	1322	Capital
11412	Sales taxes	133	From other general government units
11413	Turnover and other general taxes on goods	1331	Current
	and services	1332	Capital
1142	Excises	14	Other revenue
1143	Profits of fiscal monopolies	141	Property income [GFS]
1144	Taxes on specific services	1411	Interest [GFS]
1145	Taxes on use of goods and on permission to use	1412	Dividends
	goods or perform activities	1413	Withdrawals from income of quasi-corporations
11451	Motor vehicles taxes	1414	Property income attributed to insurance policyholders
11452	Other taxes on use of goods and on	1415	Rent
	permission to use goods or perform activities	142	Sales of goods and services
1146	Other taxes on goods and services	1421	Sales by market establishments
115	Taxes on international trade and transactions	1422	Administrative fees
1151	Customs and other import duties	1423	Incidental sales by nonmarket establishments
1152	Taxes on exports	1424	Imputed sales of goods and services
1153	Profits of export or import monopolies	143	Fines, penalties, and forfeits
1154	Exchange profits	144	Voluntary transfers other than grants
1155	Exchange taxes	1441	Current
1156	Other taxes on international trade and transactions	1442	Capital
116	Other taxes	145	Miscellaneous and unidentified revenue
1161	Payable solely by business		
1162	Payable by other than business or unidentifiable		

[GFS] indicates that this item has the same name but different coverage in the $1993\,$ SNA.

B. Economic Classification of Expense

2	Expense	27	Social benefits [GFS]
21	Compensation of employees [GFS]	271	Social security benefits
211	Wages and salaries [GFS]	2711	Social security benefits in cash
2111	Wages and salaries in cash [GFS]	2712	Social security benefits in kind
2112	Wages and salaries in kind [GFS]	272	Social assistance benefits
212	Social contributions [GFS]	2721	Social assistance benefits in cash
2121	Actual social contributions [GFS]	2722	Social assistance benefits in kind [GFS]
2122	Imputed social contributions [GFS]	273	Employer social benefits
22	Use of goods and services	2731	Employer social benefits in cash
23	Consumption of fixed capital [GFS]	2732	Employer social benefits in kind
24	Interest [GFS]	28	Other expense
241	To nonresidents	281	Property expense other than interest
242	To residents other than general government	2811	Dividends (public corporations only)
243	To other general government units	2812	Withdrawals from income of quasi-corporations
25	Subsidies		(public corporations only)
251	To public corporations	2813	Property expense attributed to insurance
2511	To nonfinancial public corporations		policyholders [GFS]
2512	To financial public corporations	2814	Rent
252	To private enterprises	282	Miscellaneous other expense
2521	To nonfinancial private enterprises	2821	Current
2522	To financial private enterprises	2822	Capital
26	Grants		
261	To foreign governments		
2611	Current		
2612	Capital		
262	To international organizations		
2621	Current		
2622	Capital		
263	To other general government units		
2631	Current		
2632	Capital		

[GFS] indicates that this item has the same name but different coverage in the $1993\,\,\mathrm{SNA}.$

C. Classifications of Flows and Stocks in Assets and Liabilities

	Classification of	Classification of	Classification of	Classification of
	transactions	holding	other changes	the stocks
	in assets	gains in assets	in the volume of	of assets
	and liabilities	and liabilities	assets and liabilities	and liabilities
Net worth and its changes	3	4	5	6
Nonfinancial assets	31	41	51	61
Fixed assets	311	411	511	611
Buildings and structures	3111	4111	5111	6111
Dwellings	31111	41111	51111	61111
Nonresidential buildings	31112	41112	51112	61112
Other structures	31113	41113	51113	61113
Machinery and equipment	3112	4112	5112	6112
Transport equipment	31121	41121	51121	61121
Other machinery and equipment	31122	41122	51122	61122
Other fixed assets	3113	4113	5113	6113
Cultivated assets	31131	41131	51131	61131
Intangible fixed assets	31132	41132	51132	61132
Inventories	312	412	512	612
Strategic stocks	3121	4121	5121	6121
Other inventories	3122	4122	5122	6122
Materials and supplies	31221	41221	51221	61221
Work in progress	31222	41222	51222	61222
Finished goods	31223	41223	51223	61223
Goods for resale [GFS]	31224	41224	51224	61224
Valuables	313	413	513	613
Nonproduced assets	314	414	514	614
Land	3141	4141	5141	6141
Subsoil assets	3142	4142	5142	6142
Other naturally occurring assets	3143	4143	5143	6143
Intangible nonproduced assets	3144	4144	5144	6144
Financial assets	32	42	52	62
Domestic	321	421	521	621
Currency and deposits	3212	4212	5212	6212
Securities other than shares	3213	4213	5213	6213
Loans	3214	4214	5214	6214
Shares and other equity	3215	4215	5215	6215
Insurance technical reserves	3216	4216	5216	6216
Financial derivatives	3217	4217	5217	6217
Other accounts receivable	3218	4218	5218	6218
Foreign	322	422	522	622
Currency and deposits	3222	4222	5222	6222
Securities other than shares	3223	4223	5223	6223
Loans	3224	4224	5224	6224
Shares and other equity	3225	4225	5225	6225
Insurance technical reserves	3226	4226	5226	6226
Financial derivatives	3227	4227	5227	6227
Other accounts receivable	3228	4228	5228	6228
Monetary gold and SDRs	323	423	523	623

C. Classifications of Flows and Stocks in Assets and Liabilities (concluded)

	Classification of transactions in assets	Classification of holding gains in assets	Classification of other changes in the volume of	Classification of the stocks of assets
	and liabilities	and liabilities	assets and liabilities	and liabilities
Liabilities	33	43	53	63
Domestic	331	431	531	63 I
Currency and deposits	3312	4312	5312	6312
Securities other than shares	3313	4313	5313	6313
Loans	3314	4314	5314	6314
Shares and other equity (public				
corporations only)	3315	4315	5315	6315
Insurance technical reserves [GFS]	3316	4316	5316	6316
Financial derivatives	3317	4317	5317	6317
Other accounts payable	3318	4318	5318	6318
Foreign	332	432	532	632
Currency and deposits	3322	4322	5322	6322
Securities other than shares	3323	4323	5323	6323
Loans	3324	4324	5324	6324
Shares and other equity (public			552.	
corporations only)	3325	4325	5325	6325
Insurance technical reserves [GFS]	3326	4326	5326	6326
Financial derivatives	3327	4327	5327	6327
Other accounts payable	3328	4328	5328	6328
Memorandum items				
Own-account capital formation	3M1			
Compensation of employees	3M11			
Use of goods and services	3M12			
Consumption of fixed capital	3MI3			
Other taxes on production minus	51115			
other subsidies on production	3M14			
Net financial worth				6M1
Debt (at market value)				6M2
Debt (at market value) Debt (at nominal value)				6M3
Arrears				6M4
Obligations for social security benefits				6M5
Contingent liabilities				6M6
International reserves and foreign				OI 10
S S				6M7
currency liquidity				61*17
Uncapitalized military weapons and				/M0
weapon-delivery systems				6M8

[GFS] indicates that this item has the same name but different coverage in the $1993\,$ SNA.

D. Classification of Outlays by Functions of Government

7	Total outlays	70433	Nuclear fuels
701	General public services	70434	Other fuels
7011	Executive and legislative organs, financial and	70435	Electricity
	fiscal affairs, external affairs	70436	Nonelectric energy
70111	Executive and legislative organs	7044	Mining, manufacturing, and construction
70112	Financial and fiscal affairs	70441	Mining of mineral resources other than mineral
70113	External affairs		fuels
7012	Foreign economic aid	70442	Manufacturing
70121	Economic aid to developing countries and	70443	Construction
	countries in transition	7045	Transport
70122	Economic aid routed through international	7045 I	Road transport
	agencies	70452	Water transport
7013	General services	70453	Railway transport
70131	General personnel services	70454	Air transport
70132	Overall planning and statistical services	70455	Pipeline and other transport
70133	Other general services	7046	Communication
7014	Basic research	7047	Other industries
7015	R&D ¹ General public services	70471	Distributive trades, storage, and warehousing
7016	General public services n.e.c. ²	70472	Hotels and restaurants
7017	Public debt transactions	70473	Tourism
7018	Transfers of a general character between	70474	Multipurpose development projects
	different levels of government	7048	R&D Economic affairs
702	Defense	70 4 81	R&D General economic, commercial, and
7021	Military defense		labor affairs
7022	Civil defense	70482	R&D Agriculture, forestry, fishing, and hunting
7023	Foreign military aid	70483	R&D Fuel and energy
7024	R&D Defense	70484	R&D Mining, manufacturing, and construction
7025	Defense n.e.c.	70485	R&D Transport
703	Public order and safety	70486	R&D Communication
7031	Police services	70487	R&D Other industries
7032	Fire protection services	7049	Economic affairs n.e.c.
7033	Law courts	705	Environmental protection
7034	Prisons	7051	Waste management
7035	R&D Public order and safety	7052	Waste water management
7036	Public order and safety n.e.c.	7053	Pollution abatement
704	Economic affairs	7054	Protection of biodiversity and landscape
7041	General economic, commercial, and labor affairs	7055	R&D Environmental protection
70411	General economic and commercial affairs	7056	Environmental protection n.e.c.
70412	General labor affairs	706	Housing and community amenities
7042	Agriculture, forestry, fishing, and hunting	7061	Housing development
70421	Agriculture	7062	Community development
70422	Forestry	7063	Water supply
70423	Fishing and hunting	7064	Street lighting
7043	Fuel and energy	7065	R&D Housing and community amenities
7043 I	Coal and other solid mineral fuels	7066	Housing and community amenities n.e.c.
70432	Petroleum and natural gas		

D. Classification of Outlays by Functions of Government (concluded)

707	Health	709	Education
7071	Medical products, appliances, and equipment	7091	Pre-primary and primary education
70711	Pharmaceutical products	70911	Pre-primary education
70712	Other medical products	70912	Primary education
70713	Therapeutic appliances and equipment	7092	Secondary education
7072	Outpatient services	70921	Lower-secondary education
70721	General medical services	70922	Upper-secondary education
70722	Specialized medical services	7093	Postsecondary nontertiary education
70723	Dental services	7094	Tertiary education
70724	Paramedical services	70941	First stage of tertiary education
7073	Hospital services	70942	Second stage of tertiary education
70731	General hospital services	7095	Education not definable by level
70732	Specialized hospital services	7096	Subsidiary services to education
70733	Medical and maternity center services	7097	R&D Education
70734	Nursing and convalescent home services	7098	Education n.e.c.
7074	Public health services	710	Social protection
7075	R&D Health	7101	Sickness and disability
7076	Health n.e.c.	71011	Sickness
708	Recreation, culture, and religion	71012	Disability
7081	Recreational and sporting services	7102	Old age
7082	Cultural services	7103	Survivors
7083	Broadcasting and publishing services	7104	Family and children
7084	Religious and other community services	7105	Unemployment
7085	R&D Recreation, cultural, and religion	7106	Housing
7086	Recreation, culture, and religion n.e.c.	7107	Social exclusion n.e.c.
	C	7108	R&D Social protection
		7109	Social protection n.e.c.

 1 R&D = research and development 2 n.e.c. = not elsewhere classified

E. Classification of Transactions in Financial Assets and Liabilities by Sector

8	Net financial worth change due to transactions (=82-83)
82	Financial assets (=32)
82 I	Domestic (=321)
8211	General government
8212	Central bank
8213	Other depository corporations
8214	Financial corporations not elsewhere classified
8215	Nonfinancial corporations
8216	Households and nonprofit institutions serving households
822	Foreign (=322)
8221	General government
8227	International organizations
8228	Financial corporations other than international organizations
8229	Other nonresidents
823	Monetary gold and SDRs (=323)
83	Liabilities (=33)
83 I	Domestic (=331)
8311	General government
8312	Central bank
8313	Other depository corporations
8314	Financial corporations not elsewhere classified
8315	Nonfinancial corporations
8316	Households and nonprofit institutions serving households
832	Foreign (=332)
8321	General government
8327	International organizations
8328	Financial corporations other than international organizations
8329	Other nonresidents

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Volume changes. See Other volume changes

Value-added taxes, 3.58, 5.48

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Report No. 46861-IQ

EMERGENCY PROJECT PAPER

FOR A

PROPOSED GRANT

IN THE AMOUNT OF

US \$18.0 MILLION

FROM THE WORLD BANK IRAQ TRUST FUND

TO THE

REPUBLIC OF IRAQ

FOR THE

PUBLIC FINANCE MANAGEMENT PROJECT

June 27, 2009

Social and Economic Development Sector Unit Middle East and North Africa Region

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CURRENCY EQUIVALENTS

(Exchange Rate Effective, June 1, 2009)

Currency Unit = Iraqi Dinar 1 US\$ 1167.50 IQD

FISCAL YEAR

January 1 – December 31

ABBREVIATIONS AND ACRONYMS

BD Bidding Documents
BSA Board of Supreme Audit
CAS Country Assistance Strategy

CFAA Country Financial Accountability Assessment

CTT Component Technical Team

DA Designated Account

DFID UK Department for International Development

ESSAF Environmental and Social Screening and Assessment Framework

FM Fiduciary Monitoring Agent

FO Financial Officer

GDP Gross Domestic Product GFS Government Finance Statistics

GOI Government of Iraq

IBRD International Bank for Reconstruction and Development

IDA International Development Association

IFR Interim Financial ReportsIMF International Monetary FundISN Interim Strategy Note

KRG Kurdistan Regional Government
M&E Monitoring and Evaluation
MIM Master Implementation Manual

MNA World Bank Middle East and North Africa Region

MoE Ministry of Education MoF Ministry of Finance MoH Ministry of Health

MoPDC Ministry of Planning and Development Cooperation

MTFF Medium-Term Fiscal Framework NPM National Procurement Manual

OGPCP Office of Government Public Contract Policy

PCD Public Contracting Department
PFM Public Finance Management
PFS Project Financial Statements
PIM Project Implementation Manual
PMT Project Management Team
PO Procurement Officer

PRA Procurement Regulatory Authority

RFP Request for Proposals
SOEs Statement of Expenditure
WA Withdrawal Applications

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REPUBLIC OF IRAQ PUBLIC FINANCE MANAGEMENT PROJECT (PFMP) MIDDLE EAST AND NORTH AFRICA REGION

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IRAQ PUBLIC FINANCE MANAGEMENT PROJECT MIDDLE EAST AND NORTH AFRICA REGION EMERGENCY PROJECT PAPER DATA SHEET

Date: June 27, 2009	Team Leader: Monali Chowdhurie-Aziz			
Country Director: Hedi Larbi				
Sector Manager/Director:	Sectors: Sub-national government			
Farrukh Iqbal / Ritva S. Reinikka	administration (50%); Central			
Project ID: P110862	government administration (50%)			
	Themes: Public expenditure, financial			
	management and procurement			
	(P); Administrative and civil service			
	reform (S);Decentralization (S)			
	Environmental Category: C			
Recipient: Ministry of Finance				
Responsible Agency: Ministry of Finance				
Implementing Agency: Ministry of Finance				
Type of operation:				
New operation [X] Additional financing [] Existing financing (restructuring) []				
Financing type: Loan [] Credit []	IDA Grant [] Other [X]			
Total amount: US\$18.0 million	Expected implementation period: June 1, 2009			
	through February 28, 2013			
Expected effectiveness date: July 31, 2009	Expected/revised closing date:			
	June 30, 2013			
D 1 4 11 41				

Development objective:

The Project Development Objective is to support the Government of Iraq's efforts to develop more effective, accountable and transparent public financial management. Support will be provided for strengthening budget management, improving public financial reporting and control, strengthening public procurement, and establishing the tools, systems and institutions required to build capacity for effective public financial management.

Specifically, the Project supports the first stage of the Government of Iraq's multi-year Public Financial Management Action Plan (see Annex 9c). The primary target group is resource managers and their superiors in the Ministry of Finance (MoF) and Ministry of Planning and Development Cooperation (MoPDC), as well as in the line ministries.

Short description:

The Project has four components: 1) Strengthening Budget Formulation and Implementation; 2) Strengthening Public Sector Procurement; 3) Strengthening Budget Execution and Implementation; and 4) Capacity Development and Project Management. To achieve component goals, the Project finances international and local technical assistance, limited procurement of goods, and significant capacity building measures for relevant public sector staff.

Project Implementation. A dedicated Project Management Team (hereafter PMT) within the Ministry of Finance will be responsible for project implementation covering fiduciary and other matters. Fiduciary responsibilities cover procurement management, financial management,

monitoring and evaluation (M&E), and reporting to the World Bank and other relevant agencies. In addition, a dedicated Component Technical Team (CTT) responsible for ensuring fulfillment of technical requirements will support each component. The CTTs will include the relevant technical staff from the concerned ministry or level of government and will report directly to the Director of the PMT. Agencies selected for direct assistance under the Project may establish smaller Project Implementation Teams to handle day-to-day Project-related tasks. All implementation teams are expected to be staffed by existing GoI civil servants, with limited external consultant input on an 'as needed' basis.

In addition to the recipient-executed grant, the Bank will execute a smaller complementary grant (US \$2 million) to provide technical assistance. Such assistance would cover just in time advisory services by World Bank staff and international consultants when necessary, initiation of a particular subcomponent, and dissemination or follow-up for other subcomponents (such as assessments, formal training inside and outside Iraq and on the job training) including supporting the efforts of the Board of Supreme Audit (BSA) to reinforce their operational capacities.

Financing plan (US\$m.)							
Source		Local		Foreign		Total	
Borrower		0.0		0.0		0.0	
Total IBRD/IDA							
Trust funds		4.0		14.0		18.0	
Others							
Total		4.0		14.0		18.0	
Estimated disbursements (Bank FY/US\$m.)							
	2009	2010	2011	2012	20	13	
Total IBRD/IDA							
Trust funds	1.0	4.0	6.0	5.0	2.0		
Does the emergency operation require any exceptions from Bank policies?						Yes [] No [X]	
Have these been approved by Bank management?					Yes [] No []		
Are any critical risks rated "substantial" or "high"?					Yes [X] No []		
What safeguard policies are triggered, if any?					N/A		
Significant nonstandard conditions, if any: N/A							

A. INTRODUCTION

- 1. Sound public financial management (PFM) is critical to ensuring efficiency and accountability in the management of public resources. Iraq is resource rich and has enjoyed a substantial increase in oil revenues in recent years. However, for the people of Iraq to benefit from its resource wealth, public finance reforms are a priority. Weaknesses in the PFM system not only have high costs in terms of allocative and operational efficiency but also create high levels of fiduciary risk.
- 2. The GoI has made progress in recent years but much remains to be done. Iraq has made progress in reforming public expenditure policy and management since 2003. Key measures include the adoption of a budget classification system that is compliant with Government Finance Statistics (GFS) standards and of a plan to integrate capital and current budgeting processes. However, many challenges remain. Selected examples include:
 - **Budget Preparation**: Budget negotiations between line ministries and central ministries are time-consuming as line ministries are not provided with ceilings within which to prepare budgets. The technical capacity of staff to evaluate and approve capital projects has eroded due to high attrition in recent years.
 - **Budget implementation**: Annual implementation plans for projects presented by line ministries are often revised during the lifetime of the project. Sites for projects are poorly prepared and disputes regarding ownership of the sites lead to further delays. Some line ministries interrupt project execution after projects have been approved and there is no system by which central ministries (finance and planning) can either support the implementation of these projects or find an alternative solution to delays in initiating project implementation by affected line ministries.
 - Contracting issues: Few contractors have the capacity to implement large capital projects, often lacking even the capacity to prepare contracts that meet the detailed specification required for the projects. Work orders are frequently changed leading to delays. There is no system to resolve differences between the contractors and spending agencies speedily. Delays lead to increasing project costs that need to go through an approval process leading to further delays.
 - **Payments System**: The payments system is insufficiently flexible. Currently, Iraq uses a cash-based payments system limited to the fiscal year; this precludes the ability to make commitments when necessary and make cash payments according to these commitments. The system also allocates the total cost over the period of execution and requires that these amounts be fully spent within assigned years.
 - **Reporting**: The new chart of accounts is not uniformly used at all levels of government, leading to a weak control environment. Independent audits of all Government budget accounts for any recent financial year have either not been undertaken or have not been made available.

B. EMERGENCY CHALLENGE

I. Country Context

3. **Iraq maintained macroeconomic stability and good economic performance in 2008.** Real GDP growth in 2008 is estimated at 10.4 percent, while end-2008 inflation reached 6.8 percent, compared to 4.7 percent in 2007 and 64.8 in 2006. The overall fiscal situation in 2008 was positive due to high oil revenues. Oil revenues totaled nearly \$62 billion in 2008, almost double the budgeted amount. Although capital spending outturns for the first 3 quarters of 2008 increased twofold from their 2007 levels, capital spending remained below the budgeted amount. The balance in the Development Fund for Iraq (DFI) increased by 85 percent by end September 2008 from end-2007.

- 4. The fiscal situation will be much more constrained in 2009 due to lower oil prices. A significant overall fiscal deficit in the order of 30 percent of GDP is expected in 2009 because of the recent fall in world oil prices. This deficit is expected to be partly financed through a considerable draw down of assets held abroad. Measures are being considered to restrain spending so that the fiscal outturn is not any worse. These include steps to reduce the outlay on food subsidies by restricting the eligibility of better-off families for coverage by the Public Distribution System (PDS). Also, with lower world oil prices, indirect subsidies on fuel products are expected to decline in 2009. While direct budgetary fuel subsidies were eliminated in 2007 (except for a small subsidy on kerosene which will should be removed in 2009), indirect subsidies remained considerable at 6 percent of GDP. It should be noted, however, that the final impact of developments in oil markets on Iraq's fiscal situation remains somewhat uncertain, since oil prices have recently started to rise again.
- 5. The final review of the second IMF Stand-by Agreement (SBA) was completed in December 2008. This triggered the third and final stage of Iraq's Paris Club debt reduction agreement, for a total debt reduction of 80 percent in NPV terms. The IMF precautionary arrangement concluded on March 18, 2009. Iraq has now completed over 3 years of programs. Iraq has received extensive assistance from the IMF under three consecutive programs (Emergency Post-Conflict Assistance (EPCA) and two SBAs).
- 6. **Iraq is entering a year of political transition and fiscal fragility.** Economic performance from 2009 onwards hinges on the security situation and the political reconciliation process. Continued recovery of non-oil activity and increase of production and export volumes is expected. However, public finances and balance of payments will continue to be affected by volatile oil prices. Iraq's economy is projected to grow by about 8 percent and annual inflation is expected to be contained at 10 percent. Economic prospects for 2009 also hinge on sustained political stability and security. Provincial elections took place on January 31 2009. These elections were perceived for many as a pivotal step to promoting national reconciliation

II. Rationale for Proposed Bank Emergency Project

- 7. The main rationale for the Project is that it will improve PFM in Iraq thereby leading to better use of national resources for the public's welfare. The areas where improvement is needed have been identified in the previous section. In addition, the Project will serve to improve donor coordination. Donor efforts in the PFM area to date are shown in Table 1. However, these efforts have not been adequately coordinated, resulting in duplication of effort.
- 8. The process of Project preparation has already contributed to improved coordination since key donor partners have been involved at all stages. The placement of a senior public sector specialist in the Bank's Baghdad office has also been helpful: meetings are regularly convened to ensure that donor efforts in the PFM area complement one another. Moreover, the Ministry of Finance has developed and passed a PFM Action Plan with support provided by the Bank with inputs from the IMF and DFID during project preparation. This now serves as the blue print for all donor support including the proposed project.
- 9. The GoI has demonstrated its commitment by putting PFM issues at the heart of the socio-economic pillar of the International Compact for Iraq. The Government recognizes the importance of PFM reform, as indicated in the National Development Strategy and the International Compact for Iraq.
- 10. Finally, GoI is eager to bring to Iraq the Bank's extensive worldwide (and regional) experience in providing guidance on good practices in PFM reform, as demonstrated by their strong commitment throughout project preparation.

Table 1. Donor Support to PFM Issues

Components/ Donors	Component 1 – Strengthening Budget Formulation	Component 2 – Strengthening Public Procurement	Component 3 – Strengthening Budget Execution	Component 4 – Capacity Building
USA (Treasury, USAID, State)	Medium term planning and MTFF Budget Manual Budget Classification		Commitment Control Cash Release Systems, Reducing outstanding balances (CBI) Accounting Framework Monthly and annual reporting IFMIS MoF Website	Curriculum design
UN			Subnational budget execution assistance KRG, Anbar, Basra	
DFID	MTFF Budget Strategy – Budget Circular Priorities		Accounting framework and reporting	
Others		Procurement assistance and capacity building with beneficiary ministries	Budget execution assistance with beneficiary ministries and local government	Training for MoF and subnational level officials in various areas including through Finance Institute

C. BANK RESPONSE: THE PROJECT

I. Brief Description of Bank's Strategy for Emergency Support

- 11. The Project will be implemented in accordance with the Third Interim Strategy Note for Iraq (ISN-3), which was presented to the World Bank Board of Directors on March 19, 2009. Under ISN-3, the Bank's assistance to Iraq focuses on (i) continuing to support ongoing reconstruction and socioeconomic recovery; (ii) improving governance and management of public resources, including human, natural and financial; and (iii) supporting policies and institutions that promote broad-based, private-sector-led growth, with the goal of revitalizing the private sector and facilitating job creation. The preparation of this Project straddles both ISN-2 and ISN-3.
- 12. The Project is a direct response to a request from the GoI to implement key reforms identified through previous analytical work (see Annex 9b) and reflected in the Public Finance Management Action Plan (see Annex 9c). This Action Plan was prepared with support from the Bank with inputs as well from the IMF and DFID. Importantly, the PFM Action Plan is part of the conditions for the IMF's current Stand-by Arrangement. From the Bank's internal perspective, the Project will help ensure that future Bank investments will be implemented in an improving PFM context.
- 13. The Project is covered by the International Reconstruction Fund Facility for Iraq (IRFFI). IRFFI aims to help donors channel resources and coordinate support for capacity building, reconstruction, and development in Iraq in line with Iraq's priority program through two trust funds: the World Bank Iraq Trust Fund (ITF), and the UN Development Group Trust Fund. The ITF finances nineteen grants (of which 16 are active) totaling US\$488.9 million, thereby committing most of the donor deposits (US\$494 million) (see Annexes 9a and 9b for details on specific activities).

II. Project Development Objective

- 14. The total estimated cost of the Project is US\$18 million, to be funded by: i) US\$16 million from the ITF, to be recipient-executed; and ii) US\$2 million from the ITF, to be Bank-executed, to allow initiation of some subcomponents as well as facilitate opportunities to disseminate results of the reform activities.
- 15. The Project Development Objective is to support the Government of Iraq's efforts to develop more effective, accountable and transparent public financial management. Cross-cutting reforms in PFM will be addressed by the reforms to the national system which will be extended where necessary and appropriate to the subnational system. The aim will be to strengthen budget formulation, execution and control, improve public financial reporting, strengthen public procurement and develop capacity in PFM.
- 16. The project is the first stage in a multiyear strategy for budget reform. GOI is putting together a multi-year public financial reform strategy with an action plan which lays out the reforms that will be undertaken in each stage. The project builds on the support that GOI has requested from the donors in the first stage of implementation of their reforms strategy. The primary target group is resource managers and their superiors in the Ministry of Finance (MoF) and Ministry of Planning and Development Cooperation (MoPDC), as well as the line ministries. Effective Project implementation will require international experts to work alongside with these key GoI officials in Iraq on the practical tasks that need to be supported and strengthened.

III. Summary of Project Components¹

- 17. The Project design reflects the agreements between GOI, the Bank, and the IMF, as expressed in the Public Financial Management Action Plan. The project components are briefly described below (with details provided in Annex 1.)
- 18. Component 1. Strengthening budget formulation and implementation (US \$3.95 million). The overall objective of this component of the project is to lay a stronger foundation-building on older procedures and accepted Iraqi norms--for credible annual budgeting framed by a medium-term perspective, and complemented by more rigorous selection and preparation of investment projects within a public investment programming process consistent with national development strategy and detailed sector strategies: execution including procurement. Activities include:
 - Develop detailed sector strategies for two key ministries : Ministry of Education and Ministry of Water Resources
 - Strengthen investment project preparation and appraisal
 - Strengthen the capacity of the Economic Department of MoF
 - Improve the process of annual budget formulation and budget classification and strengthen

In the Allocation table in Annex 4, and in the Grant Agreement, the bulk of the Unallocated has been included in the Consultant Services category, as this category represents the majority of the downstream activities; this reduces the Unallocated to less than 10% of the Grant. The Mid-Term Review Supervision Mission is expected to provide an updated Summary Cost Table, for the files, describing in adequate detail the subsequent expenditures.

¹ The component cost totals represent the best estimates for the cost of completing the 'upstream' consultant outputs within each component. However, they do not account for the numerous "downstream" activities which will arise from the consultant outputs. Prior to those outputs, it is not possible to accurately estimate the costs for these activities. For this reason, a large portion (15%) of the total Grant is Unallocated (see also Annex 3).

- public financial regulatory framework
- Improve content of and adherence to budget call circular
- 19. **Component 2. Strengthening Public Sector Procurement (US\$ 3.2 million).** Improvements to the systems of Public Procurement are crucial to ensure successful budget execution. This Component would include:
 - Supporting the public sector procurement system
 - Developing sector specific standard bidding documents
 - Establishing a procurement information and monitoring system
 - Strengthening the capacity of key Iraqi implementing institutions, NGOs, and private sector in public procurement
- 20. **Component 3. Strengthening Budget Execution and Implementation (US \$2.33 million).** This includes the provision of technical support to improve administrative and functional aspects of GoI's budget execution operations. Activities include:
 - Introduce improved cash release system
 - Assess multiple treasury system in KRG
 - Introduce new commitment control system
 - Improve financial reporting
 - Assess the internal financial control system, including the role of the Inspectors General
 - Upgrade content and functionality of MOF website
 - Create internal MoF Network
 - Capacity development of line ministries to enhance their ability to implement investment projects
- 21. Component 4. Capacity Development and Project Management. (US \$3.0 million). This component will ensure coordination of the training and capacity building provided in the first three components of the project. The component also foresees a focused strengthening of the MoF's internal training department, in order develop the department's longer-term capacity to provide comprehensive 'in-house' training The project would finance international and local advisory services (with a small provision for office equipment essential for the effectiveness of the project), as well as training and capacity building directly related to the envisaged reform measures.
- 22. **Bank-executed part of the Grant**. At the request of the Recipient, a portion of the Project has been allocated for Bank-executed technical assistance (TA) to support the implementation of the Grant. In addition to the advisory services to be provided the Bank-executed part of the Grant will allow the Project to support the efforts of the Board of Supreme Audit (BSA) to reinforce their operational capacities. Specifically, support would be provided for advanced training of BSA staff in public finance, legal issues, accounting, auditing, etc. In addition, support could be provided for developing the capacity of the BSA to conduct performance audits.

IV. Eligibility for Processing under OP/BP 8.00

23. To date all Projects in Iraq have been prepared under OP/BP 8.00, in accordance with both the previous Interim Strategy Notes for Iraq. Use of emergency procedures is also the default option under the ISN3. The proposed Project is fully consistent with OP 8.00 criteria. It will address the following priorities (as defined in para.4 of O.P.800): (i) preserving or restoring essential services; (ii) establishing and/or preserving human, institutional and/or social capital; and (iii) supporting measures to mitigate

potential effects of imminent emergencies or future emergencies or crises in countries at high risk.² While PFM *per se* is not a sector typically associated with emergencies, it is critical to sustainable longer-term reconstruction in Iraq. Several studies, by the Bank, the IMF, USAID, DFID, and others, indicate that deficiencies in financial management are leading to poor budget execution and difficulties in accelerating the pace of reconstruction.

24. In the particular case of this Project, time is truly of the essence: the Project will be funded through the ITF, and the donors have stipulated that the project should be approved and implemented as soon as possible. Therefore, speed of preparation has been crucial, in order to ensure sufficient implementation time to achieve core Project objectives prior to the termination of the ITF in December 2013.

V. Consistency with Country Strategy (CAS or ISN)

25. The Project is fully consistent with the Third Interim Strategy Note for Iraq (ISN-3) in that it is designed to help Iraq use its resources more effectively and transparently. The Project supports one of the three themes of the third ISN for Iraq, namely, "improving governance and the management of public resources, including human, natural and financial".

VI. Expected Outcomes

26. The eventual outcome of the Project is that relevant government authorities in Iraq, at all levels, have new systems in place, including the appropriate training framework, to enable them to provide more effective, efficient, and transparent, management of public resources. Below are a few intermediate indicators for progress towards this outcome. Further details (still to be agreed at Negotiations with Iraqi counterparts) are contained in the Results Framework in Annex 2:

Component 1 – Strengthening Budget Formulation and Implementation

- New Budget Circular designed
- Draft Sector Strategy prepared for one or two key sectors
- Draft Medium-Term Forecasting Framework developed

Component 2 – Strengthening Public Sector Procurement:

- Strengthen the proposed procurement institutional system
- Standard bidding documents created for key sectors
- Master Implementation Manual developed
- Procurement Bulletin Board developed
- Build the capacity of the Public Procurement Regulatory Authority, key implementing institutions, Controlling institutions and Private Sectors.

² The World Bank, Towards a New Framework for Rapid Response to Crises and Emergencies, revised March 2007

Component 3 – Strengthening Budget Execution and Implementation:

- Rules and procedures for cash release system developed and agreed
- Diagnostic study on multiple treasury model completed
- New rules and regulations for commitment control system developed and agreed
- Assessment of roles/mandate of Inspector Generals completed
- IT Requirements for MoF Internal Network defined, and technical specifications developed

Component 4 – Capacity Development and Project Management:

- Assessment of training needs completed
- Assessment of the capacity of the existing Training Institute in Bagdad completed
- Time-bound comprehensive training plan with strategies and modes for training defined
- Targeted groups identified
- Curriculum prepared and courses initiated

D. APPRAISAL OF PROJECT ACTIVITIES

- 27. *Fiduciary aspects*. The financial management and procurement aspects of the project are described below and in detail in annexes 4 and 5, respectively.
- 28. **Environmental Assessment.** Safeguard policy in Iraq is directed by the Environmental and Social Screening and Assessment Framework (ESSAF) (as revised in April 2006), which proscribes special procedures to account for the continuing instability in the country. The proposed Project finances international and local advisory services as well as training and capacity building directly related to the envisaged reform measures under its scope. The Project is rated as Category 'C' in the Bank's Environmental Assessment rating system, which means that the Project "is likely to have minimal or no adverse environmental impact", and no safeguard policies are considered triggered.

Lessons learned and reflected in Project design

- 29. The Bank's experience in implementing projects in *post-conflict* countries has highlighted the importance of simple and flexible project design. Iraq presents additional challenges because it is still a country experiencing conflict and the security situation and institutional weaknesses demand that project design not be overly ambitious. Travel to Iraq is still constrained by security considerations for both staff and consultants while local capacity remains limited.
- 30. Therefore, the proposed project focuses on a few critical activities deemed achievable in a relatively short timeframe. In each component, the focus is on relatively straightforward "process" interventions, capacity building and donor coordination. These design features are based on lessons from the last few years of experience with projects in Iraq as well as the lessons from PFM projects in post-conflict situations.

E. IMPLEMENTATION ARRANGEMENTS AND FINANCING PLAN

I. Implementation Arrangements

31. The Ministry of Finance, as the grant recipient, will have primary responsibility for overseeing project implementation and ensuring the Bank's guidelines and procedures are adhered to (primarily fiduciary aspects, including procurement management, financial management, monitoring and evaluation (M&E), and reporting to the World Bank and other relevant agencies). To facilitate this day-to-day

Project implementation, a dedicated Project Management Team (PMT) has been established within the MoF. The PMT head has been identified and approved by the MoF and participated in project preparation together with the FO and PO. Formal legal establishment of the PMT with notification to the Bank was confirmed between the Bank and the GOI during Project Negotiations.

- 32. The PMT shall be comprised of at least three full-time dedicated staff persons. A project manager will serve as the key interlocutor for the Bank's Task Team Leader and to ensure consistency between the beneficiary departments within the Ministry and between the MoF, MoPDC, and line ministries participating in the Project. The project manager will be supported by a Financial Officer (FO) and a Procurement Officer (PO). The FO and PO will manage the daily financial management and procurement activities of the project as outlined in the sections below and in further detail in Annexes 4 and 5, respectively. In addition, the PMT shall be supported by Component Technical Teams (CTTs) formed from representatives of the participating ministries, and containing technical staff able to contribute in particular to creating the technical documents (e.g. Requests for Proposals, Terms of References, technical specifications, etc.) required for procurement of the services. In addition, small, ad hoc, teams are to be formed in the Ministries of Planning in Baghdad and KRG, and in the beneficiary line ministries, to properly coordinate project activities with the PMT.
- 33. Further details on Project implementation arrangements are contained in Annex 6,

Implementation arrangements for Component 2: Strengthening public sector procurement

- 34. This component will be undertaken in close coordination, collaboration, and under the direction of Department of Government Policy at MOPDC and with the Procurement Regulatory Authority (PRA) when the new Procurement law will be enacted, while in parallel MOF would need to nominate focal points/technical teams from KRG, MoH, MoE, and Electricity and any other relevant ministry to consult and work closely with the international consulting firm for the preparation of sectoral BDs, RFP and NPM.
- 35. In addition, the MOF PMT will identify focal points from procurement Public Contracting Department (PCD) established under the Higher Economic Committee to work closely with the PMT and to identify trainees to receive training for procurement prior review for large contracts. MoF will also identify focal points from the Integrity Commission and Board of Supreme Audit (BSA) to build the capacity of their staff on post procurement review.
- 36. Currently, the procurement law as finalized by the inter-ministerial committee chaired by the MoPDC, Office of Government Public Contract Policy (OGPCP), assisted by the World Bank has been submitted to the Shura Council as the first step towards ratification and enactment. Furthermore, a set of five standard bidding documents for Goods, Works and Services has been prepared using funds from the ITF Second Capacity Building Project (CB2) and transmitted to the Government of Iraq for use. Component 2 of the Project constitutes a follow-up on the achieved activities related to reforms of procurement system. Hereinafter is a phasing of these activities that should be implemented in parallel to the endorsement of legal framework by the legislative and executive bodies in GoI. The table below illustrates the phasing of activities financed under Component 2

Table 2. Sequencing of Activities under Component 2: Strengthening Public Sector Procurement

No	Activity	Beneficiary
	First phase	
1	Prepare Sector standard bidding documents in addition to the standard prequalification documents and evaluation forms.	Procuring Entities e.g. MOE, MOH, and MOPDC/OGPCP, PRA
2	Finance a study tour for a group of personnel of a country that had similar reforms.	PRA, PMT, KRG, PCD
3	Provide required equipment (IT and furniture)	Main Procuring Entities
4	Develop a Procurement Bulletin Board with on-line publishing of procurement advertisement of procurement opportunities, request for proposals, as well as contract awards.	MOPDC/ OGPCP, PRA
5	Assessment of training needs	MOPDC/ OGPCP, PRA
	Second Phase	
6	Develop the National Procurement Manual (NPM)	Procuring Entities, PRA
7	Dissemination and training workshop upon completion of the NIM.	Procuring Entities, PRA
8	Establish a central archive in the PCD to improve a complete soft and hard record keeping of procurement files	PCD
9	Provide technical Assistance to relevant institutions (e.g. Procurement Regulatory Authority (PRA), to develop policy notes for the treatment of complaints and the regulations of blacklisting	PRA
10	Develop curriculums/training modules for procurement training and for procurement audits. Additionally, the assignment includes: • Training of Trainers (TOT) • TOT to a number of staff of on Procurement Audits and post reviews • Conduct training for the PCD related to prior review requirements.	Procuring Entities, BSA, General Inspectors offices, and PCD
11	Launch of training program for trainees from private and public sectors to be carried out by Trainers with supervision by the international expert.	Procuring Entities, NGO, and Private sector

Implementation of the World Bank Executed Part of the Grant

37. Capacity building and TA to support the GOI's work on reform of the overall PFM system will be provided through a smaller, companion grant, executed by the World Bank. This companion grant will provide the financial resources for on-the-job training, formal courses and technical assistance for all four

project components, for all actors and institutions involved in strengthening the PFM system in Iraq, specifically including the BSA. This will complement the TA and training provided within the recipient-executed components, such that all PFM institutions are kept fully informed of the ongoing changes to the system, and all benefit from the capacity building.

- 38. The Bank-executed component is also considered essential in bringing together experts/donors/bank staff and GOI officials to help customize each component to fit both Iraq's requirements and the current situation. For example, activities in Component 1 on strengthening capacity of economic directorate need to conform to drastic dip in revenues in the middle of the year and in strengthening their ability to work within this changed revenue framework. This is the opposite of the prevailing situation in 2008, and such changes are likely to continue to happen in the future. The Bank-executed component will allow just-in-time assistance to deal with such changes. It will also allow the Bank to convene all donors working on these areas to review the work that the various consultants will be doing; such meetings would be held midway through each piece of work and the work redesigned if required.
- 39. Responsibility for implementation of the capacity building and technical support rests with the World Bank. World Bank staff will coordinate closely with the PMT, MoF, MoPDC, appropriate line ministries, and other partners throughout Iraq, to ensure the capacity building and technical support activities are appropriate and timely and that the grant resources are used to the maximum benefit of the project.

II. Financial Management Arrangements

Financial Management

- 40. The public financial management difficulties in Iraq include weak budgeting and fragmented accounting, accompanied by incomplete and inaccurate financial reporting; weak Government employees' financial management capacities and poor internal controls; and underdeveloped internal and external audit functions. The uniqueness of the Iraq situation is that these are all present at once, complicated by the country's security conditions and the lack of a functioning financial sector that is capable of providing routine financial services. In addition, the fact that MOF has limited experience with implementing projects, managing contracts and coordinating such technically and geographically wide-dispersed soft activities add up to the high assessed financial management risk. Each deficiency potentially could adversely affect the implementation of the project.
- 41. To mitigate any implication of the weak public financial management system and the identified project risks on assurance that the projects funds are spent as intended, efficiently and economically, the following FM arrangements were put in place: (i) centralizing the FM function within the Project Management Team (PMT) authority and the designation of a competent financial officer, supported by an accountant and internal controller; (ii) the Fiduciary Monitoring Agent (FMA) regular monitoring of projects' FM performance and physical checks; (iii) close support and frequent capacity building initiatives by the Bank and the Fiduciary Monitoring Agent (FMA); (iv) the documentation of the procedures on internal controls, flow of information, and other in a project implementation manual (PIM) prepared based on the Master Implementation Manual (MIM); (v) simplified parallel accounting and reporting to give timely information on the project financial performance and status; (vi) independent external auditor acceptable to the Bank to provide an independent opinion of the project financial statements; and (vii) simple flow of funds arrangements mainly relying on direct payments.
- 42. The PMT will be responsible for preparing the Quarterly Interim un-audited financial reports (IFRs) as part of the quarterly project progress reports, and submitting them to the Bank within one month from the quarter then ended. The format of the reports will be agreed upon during the negotiations. These

reports consist of a statement of sources and uses of funds by component; statement of uses of funds by category of expenditure, both comparing actual and planned expenditures; a list of cumulative contracts' commitments.

43. The PMT will also be responsible for preparing the Annual Project Financial Statements (PFS), and submitting an audited PFS with the independent auditor opinion to the Bank not later than six months after the end of each fiscal year. The PFS include: (i) statement of sources and uses of funds by component; (ii) statement of uses of funds by category of expenditures, both comparing actual and planned expenditures; and (iii) list of contracts' commitments. For that purpose, an external independent auditor, acceptable to the Bank, will be engaged to carry out the annual financial statements audit in accordance with international standards of auditing, issue the required independent opinion, and prepare the management letter. The auditor will be granted access to the project documents at the PMT, MOF and any relevant entity. The audit TORs include performing a Statement of Expenditure (SOE) review for the audit period covered. The audit report and management letter will be submitted by the PMT to the Bank not later than six months after the end of each fiscal year. An escrow account will be used to pay the auditor after the project's closing date.

III. Procurement Arrangements

- 44. Procurement subject to Bank tendering requirements will consist principally of consultancy and training services, which shall be carried out in accordance with the World Bank's "Guidelines: Selection and Employment of Consultants by World Bank Borrowers" dated May 2004 and revised in October 2006. A relatively small amount of essential office, IT and communication equipment, and software may also be procured under the project, which shall be subject to the World Bank's "Guidelines: Procurement under IBRD Loans and IDA Credits" dated May 2004 and revised in October 2006. Any additional provisions stipulated in the grant agreement will equally guide procurement under the project. Detailed arrangements, including thresholds for procurement methods and prior review by the Bank, are presented in Annex 5.
- 45. Consultancy and Training services. The project finances mainly consultants' services to the Ministry of Finance and selected line Ministries. It is expected that many of the services will be contracted to individual local and international consultants for which the selection will follow the procedures stipulated in Section V of Bank's Consultant's Guidelines. However, where appropriate, firms will be contracted to provide services for a range of activities.
- 46. *Goods*. Any goods essential to the success of the project may also be financed. It is expected that these would be procured through National Competitive Bidding or shopping for off-the-shelf products.
- 47. Operating Costs. The operating costs to be financed under the project would include: (i) maintenance of office equipment; (ii) office supplies, utilities, and office administration costs, including translation, printing and advertising; (iii) communication costs; (iv) costs associated with the production of bidding documents; and (v) commercial bank charges. The procurement of these items would follow the Borrower's administrative procedures, satisfactory to the Bank. The project would not finance the salaries of the Borrower's civil servants.
- 48. Procurement process. The PMT, under the oversight of its project manager, would be responsible for the procurement of goods and services financed by the grant. A procurement officer will be specifically recruited to the PMT to manage the process, including the preparation and updating of the procurement plan, managing expressions of interest and requests for proposals (RFP), evaluation of proposals, and contract award and management. The PMT project manager will send to the Bank all requests for "no objection" on contracts, which are subject to prior review (as defined by the procurement thresholds in Annex 5), before contract signature. For procurement supervision in the field, the Fiduciary

Monitoring Agent (FMA) proceeds with physical inspections, procurement post reviews, and organizes on the job procurement training for PMT staff, attends supervision mission. FMA also participates in supervision missions with the Bank and project team on procurement aspects, and provides regular procurement reporting and fact sheets.

49. The overall procurement risk for the project is High, due to the overall situation in Iraq and the low capacity of the implementing agency to implement procurement.

IV. Disbursement Arrangements

- 50. The proceeds of the grant will be disbursed through standard disbursement procedures, as outlined in the Bank's "Disbursement Guidelines for Projects," by means of reimbursements, special commitments and direct payments. The supporting documentation will be retained by the PMT, will be made available to the Bank during its supervision missions, and will be reviewed during the annual audit of the financial statements.
- 51. Fund withdrawal will follow standard disbursement procedures, as outlined in the Bank's "Disbursement Guidelines for Projects," by means of reimbursements and replenishment of the DA based on documented SOEs, special commitments and direct payments. The supporting documentation will be retained by the PMT, will be made available to the Bank during its supervision missions, and will be reviewed during the annual audit of the financial statements.

V. Anti-corruption

52. The Project will be carried out in accordance with the provisions of the "Guidelines on Preventing and Combating Fraud and Corruption in Projects Financed by IBRD Loans and IDA Credits and Grants", dated October 15, 2006 ("Anti-Corruption Guidelines").

VI. Project Supervision and Monitoring

- 53. The PMT will be responsible for the daily project implementation. The PMT will prepare quarterly progress reports, including updates on the indicators identified in Annex 2. The World Bank Task Team leader will follow up on implementation matters regularly as part of the ongoing dialogue with the Ministry of Finance. The World Bank's Senior Public Sector Specialist, resident in the Bank's office in Baghdad, will provide comprehensive day-to-day assistance to the counterpart teams. In addition, the team leader is supported by a strong and experienced fiduciary and operational team in the World Bank's Offices in Beirut and Amman, as well as from World Bank headquarters in Washington. Supervision missions will be carried out quarterly for the first two years, in accordance with prevailing Bank practice at the time (dependent on security situation). During the second two years, supervision may be carried out only twice/year (semi-annually) depending on project progress.
- 54. As noted also in para. 57 above, the World Bank ITF engages a Fiduciary Monitoring Agent (FMA) to help the Bank verify physical implementation and compliance with the fiduciary policies of the Bank. The FMA verifies the delivery of goods and services, visits the project management team on a regular basis, and reports its findings to the Bank and the PMT. The FMA also participates in supervision missions with the Bank and project team.
- 55. The closing date of the project is June 30, 2013.

F. PROJECT RISKS AND MITIGATING MEASURES

- 56. Clearly, the fragile security situation is the greatest risk to the Project. Although recent months indicate some measure of improved security, the situation could deteriorate, with a negative impact on the ability of the consultants to provide support to system design, and to the Bank to adequately supervise the Project. Clearly, this risk is beyond the control of the program. If the security situation does deteriorate, the program will need to be revisited in order to determine how best to proceed.
- Additionally, there is a risk that the capacity building efforts would fail to make a lasting impact. Capacity building programs in post-conflict countries can fail to make a lasting impact in a variety of ways: (i) poor design of programs due to inability of access; (ii) lack of cohesion of the programs; (iii) turn around and lack of ability to retain trained staff; (iv) wrong participants attending the training; (v) lack of follow-up activities with the participants to ensure the applicability of what they have learned; and (vi) lack of ownership of the activities. This risk is mitigated by the emphasis on Iraqi ownership of Project activities and emphasis on capacity building for Iraqi PFM staff. Component 4 is aimed at developing sustainable institutional arrangements to provide training in PFM at all levels of government, by setting up Institutes within the country and twinning them with other suitable training institutes. This will also reduce this risk by allowing the training program to be designed in Iraq while providing access to modern PFM practices and curriculum.
- 58. Another significant risk that the project faces is the likelihood that few international consultants other than those already engaged in Iraq will apply. While the Bank team will liaise with other Bank teams that work in PFM and in other fragile states to expand the pool of applicants who apply including those from the region this may still prove to be an impediment to the satisfactory completion of the project. Project design attempts to mitigate the risk by grouping several subcomponents together to make the packages more attractive to firms which would be large enough to field large teams with a wider range of specialists.
- 59. In addition, the difficult authorizing environment in Iraq makes decision-making a lengthy process. The project has therefore been designed keeping political economy considerations in mind. Thus only the most necessary agencies have been included in the project. Moreover, considerable preparation time has been spent in setting up implementation arrangements that involve the key players in the various agencies, and including them in decision-making when necessary. In addition, because passing legislation has proven to be difficult in Iraq, new legislation is not the main focus of the project, and passing legislation is not a prerequisite for the provision of technical assistance associated with it. Instead, TA is either provided simultaneously, or, rather than legislation, the project focuses on developing new guidelines that fulfill gaps until legislation can be put in place.

G. TERMS AND CONDITIONS FOR PROJECT FINANCING

- 60. The project is a grant from the Iraq Trust Fund, and the disbursement percentage will be 100 percent. Retroactive financing will not be provided.
- 61. There is one Condition for approval of the Project by the Bank's Regional Vice President: a Project Management Team (PMT) with composition and terms of reference satisfactory to the World Bank, has been established by the MoF. This condition has been met. There are no Conditions for Project Effectiveness.

Annex 1 Republic of Iraq Public Finance Management Project Detailed Description of Project Components

Component 1: Strengthening budget formulation and implementation (US \$3.95 million). The overall objective of this component of the Project is to lay a stronger foundation--building on older procedures and accepted Iraqi norms--for credible annual budgeting framed by a medium-term perspective, and complemented by more rigorous selection and preparation of investment projects within a public investment programming process consistent with national development strategy and detailed sector strategies. "Quick wins" in terms of visible improvements in specific services and acceleration of the execution of investment projects can be expected, but the outcome of a major and sustained improvement in the efficiency of public financial resources in Iraq is a longer-term challenge that will require follow-up, consolidation and extension over the longer term.

To achieve these objectives, the following activities will be undertaken.

(a) Develop detailed sector strategies.

Develop detailed strategies for sectors, beginning with two key pilot sectors (Ministry of Water Resources and Ministry of Education), based on the overall country development strategy. Three to four international development experts will be hired to work in MoPDC and interact with the concerned line ministries and another two experts in KRG, for same purpose.

(b) Strengthen investment project preparation and appraisal.

- i. Review and modernize, as needed, provisions and procedures for the preparation and appraisal of large projects.
- ii. Set criteria for appraising medium-size and small projects. Define autonomous technical mechanism for MoPDC to verify the correct application of project preparation and appraisal procedures.

Two to three resident international experts in project appraisal and cost-benefit analysis will be hired to conduct and provide oversight of feasibility studies. One or two international public investment programming experts will be also hired for this and to work on public investment programming.

(c) Strengthen the capacity of the Economic Department of MoF with respect to macro-economic, fiscal and expenditure projections.

- i. Establish new macroeconomic and fiscal analysis cell within the Economic Policies division of the Economic Department of MoF, and generally modernize the Department.
- ii. Improve methodology of revenue forecasts and fiscal marksmanship. Review and update legislation on income and oil revenue taxation.
- iii. Formulate rolling forecasts of major economic and functional categories, covering same period as the investment program and set parameters, criteria and design for establishing single Iraqi database of economic, fiscal and financial information, and required IT systems.

The following experts will be hired for this purpose: an international public finance expert to work in the MoF and another in KRG, both attached to the single national macroeconomic cell; an international tax expert to work with the Tax Commission and an international company with demonstrated competence in economic, fiscal and financial information technology to work within the MoF.

(d) Improve the process of annual budget formulation and budget classification and strengthen the public financial regulatory framework.

- i. Review and modify, as appropriate, the budget instructions, the budget calendar, and provisions for consultations with the public, as well as advise on the progressive introduction in the budget instructions of "scientific" current expenditure ceilings for the sectors.
- ii. Assemble complete inventory of older and recent budget and financial regulations, to identify and remove duplications, gaps and inconsistencies and draft a streamlined budget manual.
- iii. Implement the GFS 2001 classification.
- iv. Identify and install appropriate software for automated budget preparation and updating in the Budget Department of MoF

One international expert will be hired to advise MoF and interact closely with the line ministries and agencies.

(e) Improve content of and adherence to Budget Call Circular (BCC).

- i. Redesign the budget call circular as necessary, to include clear specification and step-by-step instructions of what is expected in response from Ministries, Provinces and Region, e.g. budgets, justifications, forecast of operating and capacity building costs.
- ii. Provide specific training to finance and budget departments at ministries and other appropriate spending units on how to respond properly to the BCC.
- iii. Provide ongoing quality control as the new BCC is implemented for the first time.

Ideally, this will be done by the same consultant providing advice on the budget strategy ((d) above). Alternatively, this would require one international consultant, assisted by one local consultant, to work closely with budget departments of MoF and MoPDC, and line ministries and agencies (as above).

Component 2: Strengthening Public Sector Procurement (US \$3.2 million). The objective of this component is to support the ongoing efforts within Iraq to reform the overall system of public procurement. As of September 2008, a draft Public Procurement Law has been processed through the Shura Council. It is expected that discussions on the law will continue until end-2009, after which the final version will be passed. The Project is therefore well-positioned to support its implementation. To achieve the objectives, the following activities will be undertaken:

• Support the public sector procurement system.

- O Provide technical Assistance to relevant institutions (e.g. Procurement Regulatory Authority (PRA), to develop policy notes for the treatment of complaints and the regulations of blacklisting according to the issued procurement law and implementing regulations. An international attorney with expertise in this area will be hired by the PMT for that purpose.
- Finance a study tour for a group of personnel from the PRA, PMT, KRG and the Central Procurement Committee (to become the new Public Contracting Department (PCD). This activity will permit studying a successful reform of a country in ECA or East or South Asia that had similar challenges.
- Establish an archive system in the PCD to improve a complete soft and hard record keeping of procurement files subject to its prior review. The PFMP will finance the procurement of IT equipment: PCs, server, scanner, and photocopier in addition to archiving software. The central archive will be furnished with proper filing shelves sufficient for hard filing of procurement contracts
- Provide required equipment (IT and furniture) to procurement units of the main procuring entities procuring/ ministries in Baghdad and KRG. IT equipment for each unit will include PCs, scanner, server, photocopier, obtain off-shelf or new) software for database and archiving.

• Develop sector specific standard bidding documents

- Prepare standard bidding documents for the ministries of Health (pharmaceutical drugs), Education (printing of textbooks and educational materials), and Electricity for the supply and installation of plants and equipments of big electrical and mechanical installations; in addition to the standard prequalification documents and evaluation forms.
- O Develop National Procurement Manual (NPM) to include comprehensive procedural regulations and instructions to serve as users guide for the entire procurement process. A specialized consulting firm will be hired for this purpose to develop these documents and the sector specific bidding documents. A technical Iraqi committee would be formed by an inter-ministerial committee and would review and revise the MIM to be used by all Iraq ministries and agencies.
- Upon completion of the preparation of the NPM, the consulting firm will ensure a
 dissemination and training workshop. It is expected that the NPM shall be prepared as
 part of MIM developed for projects financed by the World Bank.

• Establish a procurement, information and monitoring system

- O Develop a Procurement Bulletin Board with on-line publishing of procurement advertisement of procurement opportunities, request for proposals, as well as contract awards. The website in both Arabic and English will comprise the relevant set of regulations and periodic procurement reports and data base. An international IT expert assisted by a local expert will be hired for this purpose.
- O The control and update of the Procurement Bulletin Board will be housed within the Procurement Regulatory Authority where an information tracking software will be developed to enable: (i) data collection to feed-in required data for the Bulletin Board, (ii) monitoring the procurement processes and contract awards, and (iii) reporting on procurement activities to Government. The software will form as a base for future improvement of an E-procurement system.

• Strengthen the capacity of key Iraqi implementing institutions, NGOs and private sector in public procurement

- Conduct training for the PCD on use of the new procurement law, regulations and standard bidding documents in addition to main technical aspects related to prior review requirements.
- Hire an international expert to develop curriculums/training modules for procurement training and for procurement audits. Additionally, the assignment includes:
 - Assessment of training needs
 - Training of Trainers (TOT) of a number of staff for the National Center for Consultancy and Management Development
 - TOT to a number of staff of Board of Supreme of Audit and General Inspectors offices, and Integrity Commission on Procurement Audits and post reviews
 - Launch of training program for trainees from private and public sectors to be carried out by Trainers with supervision by the international expert.
- O To ensure continuity and reach a target of capacity building objective, the PFM Project will finance hiring individual trainers to be trained as mentioned above and ensure training of government procurement officers. The trainers will adhere to the Center for Consultancy and Management Development under the supervision of the PRA. The objective is to train the procurement officers from the different procurement units in ministries and other public entities.

Component 3: Strengthening Budget Execution and Implementation (US \$2.33 million). The objective of this component is to improve various administrative and functional aspects of GOI budget execution operations. The outcome of these changes will be to ensure smoother and more transparent flow of funds, with more rigorous oversight. As with Components 1 and 2, significant training and capacity building is foreseen within this component.

- (a) **Introduce Effective Cash Release System.** This subcomponent will assist MoF to design a new system of cash releases to spending units, based on actual needs as shown on frequently updated forecasts, according to schedules prepared by relevant ministries and departments. The entire set of activities listed below would be undertaken by one international consultant, contracted for 8 person-months over a 2-year period, with input from a local consultant, for the same duration. The consultancy would be overseen by MoF staff, and MoF staff would participate in all aspects of carrying out the study and implementing the recommendations.
 - i. Define and agree on a 'Conceptual Framework'/model for cash management and cash release (for both operations and investment).
 - ii. Develop rules and procedures.
 - iii. Undertake capacity building/training exercises in MoF, MoPDC and up to five (5) line ministries selected as pilot ministries for introduction of the new system.
 - iv. Pilot the new system in up to five (5) line ministries (ministries to be determined once items (i) and (ii) are completed).
- (b) Assess Multiple Treasury Model on basis of system in KRG. Because of the relatively dispersed population, and hence dispersed municipal authorities, within some of the provinces, it has been proposed that in some provinces, multiple Treasury offices be opened. It is anticipated that this would facilitate more efficient execution of the capital budgets, as municipal authorities could access Treasury authorities more directly, as well as ease the burden for MoF and control cash in hand by minimizing the number of 'spending units' financed by MoF. Since KRG operates more than one treasury although it is one region, a diagnostic study of the arrangements is proposed. The diagnostic study, analyzing the system now in place in KRG, would require approximately 6 person-months of international consultants, and 24 person months of local consultants (1 consultant/Province for 6 months each).
 - i. Conduct diagnostic study of KRG multiple treasury model. The study will recommend an appropriate model (multiple or single), keeping in mind the different situations within the provinces.
- (c) Introduce Commitment Control System. A new system is required in order to more closely monitor commitments. This will take some time, and the Project seeks to assist GOI in the key 'front-end' actions. To that end, international consultant would be mobilized, for 8 personmonths over a 1.5-2 year period to:
 - i. Define and agree on a new Conceptual Framework for commitment control. The study would define current and expected responsibilities of all relevant agencies, and evaluate all categories and subsets of expenditures.
 - ii. Following the above, new detailed rules and regulations would be developed, in line with the new Conceptual Framework.
 - iii. Capacity building, largely in the form of awareness raising and some training on the new rules and regulations, would be carried out with relevant staff.
 - iv. *If time permits*, the new system would be piloted in two ministries. Suggested ministries include Municipalities and Public Works, Water Resources

- (d) **Improve Financial Reporting**. An additional monthly reporting requirement for spending units would be introduced, detailing the outstanding stock of advances paid by SUs. This would allow better decisions on cash release to SUs. One International consultant would be required for 8 person-months, to:
 - i. Develop and agree on system to measure and report all financial and fiscal performance, including procedural guidelines and forms; test in three ministries initially; and thereafter implement throughout GoI
 - ii. Carry out a Training Needs Assessment, identifying persons to be trained.
 - iii. Develop training materials.
 - iv. Train "Master Trainers"
- (e) Assess Internal Financial Controls, including roles of Internal Auditors and Inspectors General (IGs). One factor in delays in budget execution is the multiplication of auditors and supervisors. Internal auditors carry out pre- as well as post-disbursement audits (either all or samples of disbursements, for compliance with regulations and the law). IGs are now assuming similar functions, and it is not now clear how the mandates overlap. Further, internal auditors report to Minister, but IGs do not, and a question has therefore been raised as to how, or even whether, internal auditors be linked to IG functions? The picture is also variable from one ministry to the other. There are also cases of overlap between IG and BSA.

This sub-component will:

- i. Assess the current framework of the IGs as they relate to the work of internal auditors. In particular, mandates will be assessed, with particular reference to implementation of the control function. The assessment will explore ways to more efficiently divide the work of these control bodies, to avoid duplication and overlap. Likely ministries to be focused on are Health and Education; Water Resources; and one KRG ministry TBD.
- ii. Assess the skills and capacities of the IG staff, internal auditors and other functions of internal controls.
- iii. Identify what needs to be done to strengthen the system.
- (f) **Upgrade content and functionality of MOF website**. The MoF current website is not being used to its full potential, for either internal (MoF, SUs, other agencies) or external (public and civil society) requirements. This subcomponent will upgrade the website, relying primarily on local expertise (1 person-month at start of Project) (with perhaps 3-5 person-days of international advice).
 - i. Review website and identify improvements
 - ii. Identify new content for site, e.g. rules, regulations, reports, public announcements on budget, etc.
 - iii. Keep site updated.
- (g) **Create Internal MoF Network**. At present, the MoF departments are somewhat fragmented in terms of their ability to effectively share information. This subcomponent would create the internal networking capacity for such sharing to take place, in order that MoF operations become more efficient.
 - i. Assess existing IT environment. This assessment must include how the current system links to the FMIS being developed under a separate contract.
 - ii. Assess information and processing flows between departments.
 - iii. Develop functional requirements (technical specifications), including interface with FMIS
 - iv. Obtain (either off-the-shelf or new design) software, and hardware (to be decided after assessment)

v. "Roll out" the network (whether on pilot basis or complete to be decided after assessment).

Tasks i. and ii. above would require 3 person-months each, for two international consultants, one IT specialist, and one a functional specialist. Ministry IT staff would also participate in these tasks, but would not be paid by the Project. The remaining tasks would be undertaken by Ministry IT staff, not paid by the Project. A contingency will be added to the costing of this subcomponent, to account for at-present unknown software requirements.

Component 4: Capacity Development and Project Management (US \$3.00 million): Training is critical for all activities listed under previous project components. Training Needs Assessments will be conducted to identify and define those training needs more precisely. Importantly, this component foresees a focused strengthening of the MoF's internal training department, in order to lay the foundation to develop the department's longer-term capacity to provide comprehensive 'in-house' training - in general, it is expected that the bulk of training should be conducted under the aegis of the finance training institute in Baghdad, in "twinning" arrangements with a similar high-quality training institution in another country. Each training event should include, when appropriate, a mix of staff from the line ministries and the central ministries of finance and planning, including staff from KRG. It is expected that the international experts selected be responsible for advising the competent ministry on all aspects of required training in that area.

Specifically, this component will assist in: i) the provision of targeted training and other capacity building specifically connected to the other components of the project; and ii) developing the long-term 'in-house' training capacity of the MoF's 'Institute of Finance'. At present, all training done for MoF staff goes through this center and that will likely be the case for the foreseeable future. Therefore, beyond the individual training actions needed for the individual activities within the Project, the MoF wishes to develop their own internal capacities for ongoing training of their staff, and others. Most of the shorter-term training would be undertaken as part of the relevant contracts (per the activities noted in the other components), and many of these training would be channeled through and organized by the Institute of Finance with short-term contributions by international experts as required. Alongside formal courses, coaching and mentoring would be an explicit core requirement in the TORs of international experts as well as the local consultants. Also, the experienced budget staff and local consultants in the MoF are expected to contribute and interact regularly with the line ministry staff responsible for budget matters. Finally, a series of workshops would be organized, to bring together MoF, line ministry, procurement and accounting staff, and if appropriate concerned donors, to brainstorm about practical problems in budget execution and to find solutions consistent with existing legislation.

The project would finance international and local advisory services (with a small provision for office equipment essential for the effectiveness of the project), as well as training and capacity building directly related to the envisaged reform measures. The Training Needs Assessment is expected to identify, *inter alia*, current capacity; capacity goals, persons to be targeted by training (under a training of trainers model), subjects/courses required (such as Budget management; Introduction to macroeconomic and financial programming; Performance measurement; Monitoring and evaluation; policies and procedures of major donors; Cash forecasting and cash management; Debt management and debt sustainability modeling; Other topics directly related to the implementation of the budget reforms). The output of this early exercise will be a comprehensive strategy for delivery of long-term training programs.

Note on Technical Assistance: Discussions during Project preparation between the GOI counterpart teams and the Bank have clearly indicated both the need for, and desirability of, international technical assistance. However, the Bank also believes that the Project should serve to catalyze internal Iraqi

capacity, in the civil service, as well as in the private sector. Therefore, Project design attempts to optimize the use of local Iraqi expertise in all tasks.

Annex 2 Republic of Iraq Public Finance Management Project Results Framework and Monitoring

PDO	OUTCOME INDICATOR	USE OF OUTCOME INFORMATION
The Project Development Objective is to support the Government of Iraq's efforts to develop more effective, accountable and transparent public financial management	 Component 1: Capital budget execution rate increases by at least 10 percentage points Component 2 Outstanding balances in Spending Units decline by 30 percentage points, as a share of the budget Component 3: At least 50% of contracts above threshold awarded competitively Component 4: Ministry of Finance training institute providing training in all operational aspects of PFM project 	Monitor progress on overall PFM reform, with particular reference to planning next phases, whether through Bank/other donor, or internal GoI resources
INTERMEDIATE OUTCOME	INTERMEDIATE OUTCOME INDICATOR	USE OF RESULTS MONITORING
Component 1: Strengthening Budget Formulation and Implementation	 Draft sector strategies completed and submitted to all relevant parties for comment/revision/etc. New procedures in place for project preparation and appraisal New macro-economic and fiscal 'team' established within MoF Economic Policy Division New budget instructions approved and guidelines ready New BCC in use 	 Improved macroeconomic programming and policy analysis to guide revenue and expenditure choices Building the foundation for systematic linkage between policy and the budget, in a multi-year perspective. Improving results in major expenditure programs. Improving the efficiency of public investment.
Component 2: Strengthening Public Sector Procurement	 Standard Bidding Documents finalized National Procurement Manual finalized Procurement Bulletin board being fully implemented, and housed within Procurement Regulatory Agency Training Needs Assessment completed, training curriculum developed and first round of 'Train-the-trainers' completed 	Improve transparency and efficiency of public procurement

INTERMEDIATE OUTCOME	INTERMEDIATE OUTCOME INDICATOR	USE OF RESULTS MONITORING
Component 3: Strengthening Budget Execution and Implementation	 First round of training on new cash release system completed with selected pilot ministries Detailed rules and regulations for new commitment control system developed New financial/fiscal performance system developed, and tested in three ministries Training materials developed for financial/fiscal performance system, and training of Master Trainers carried out Assessment of IG system completed, and documentation provided clarifying mandate of internal controllers Website being regularly updated IT assessment completed, and functional requirements for upgraded system developed 	Continuous improvement in ability of public agencies to provide their mandated services, through improved execution of their approved budgets
Component 4: Capacity Development and Project Management	Training program fully in place	Upgrade the capacity of the MoF to deliver new training to their own, and other relevant government employees, responsible for carrying out the government's spending program

Annex 2 Republic of Iraq Public Finance Management Project Arrangements for Results Monitoring

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Results Indicators	Baseline	YR1	YR2	YR3	YR4	Frequency and Reports	Data Collection Instruments	Responsibility for Data Collection
COMPONENT 1:								
a) Detailed Sector Strategies completed	Limited strategic planning	Strategy formulation teams for 2 pilot sectors constituted, and baseline data collection completed	Draft strategies completed and submitted to all relevant parties for comment/revision/etc	Final strategies adopted by appropriate formal governmental procedures	End-Project: Selected line ministries employing new strategies for comprehensive sector budget planning	End of PY1, mid PY2	Strategy documents in progress GoI regulations as published Consultant reports	MoF, MoPDC, PMT
b) Improved project preparation and appraisal procedures in place	Unclear and fragmented project preparation rules/procedures hindering efficient and cost-effective project implementation	Provisions and procedures for the preparation and appraisal of large projects reviewed and, if appropriate, draft modernization, completed Draft criteria for appraising medium-size and small projects completed	New procedures in place and being utilized in GoI Project implementation	New procedures in place and being utilized in GoI Project implementation	End-Project: 10 % improvement in capital budget execution performance,, as measured by MoPDC and other relevant reviews	Semi- annually, and End- Project	Procedural documents in progress GoI regulations as published GoI financial performance reports Consultant reports	MoF, MoPDC, PMT, IG, other internal audit

Results Indicators	Baseline	YR1	YR2	YR3	YR4	Frequency and Reports	Data Collection Instruments	Responsibility for Data Collection
c) Capacity of Economic Department of MoF Strengthened, in areas of macroeconomic, fiscal and expenditure projections	No work unit within the MoF specialized in macroeconomic and fiscal analysis Revenue forecasting methods outdated, particularly considering fluctuations in oil prices	autonomous technical mechanism for MoPDC to verify the correct application of project preparation and appraisal procedures, defined Identify staff and formally establish a new macroeconomic and fiscal analysis 'team' with the Economic Policy Division of the Economic Dept. of MoF Assess needs for modernization of the Economic Dept. Completed draft new methodology for revenue forecasting and	Staff trained in new analytical procedures Modernization completed (minor works, small goods) New forecasting methodology approved and being utilized: 20% improvement in realism of expenditure projections and non-oil revenues Oil revenue taxation framework discussed by relevant authorities.	New team able to provide accurate, timely analyses 30% improvement in realism of expenditure projections and non-oil revenues	40% improvement in realism of expenditure projections and non-oil revenues	Semi- annually	Consultant reports GoI regulations as published GoI financial performance reports	MoF, MoPDC, Ministry of Oil, IG and other internal controls

Results Indicators	Baseline	YR1	YR2	YR3	YR4	Frequency and Reports	Data Collection Instruments	Responsibility for Data Collection
d) Annual budget process improved, and public financial regulatory framework strengthened	Budget instructions fragmented and not sufficiently clear and framework for expenditure "ceilings" not in use. As a result the budget calendar is not adhered to.	Review completed of legislation on income and oil revenue taxation Review completed of budget instructions, budget calendar, and provisions for public consultations Inventory completed of older and recent budget regulations; duplications and gaps identified	Mid-PY2: Draft completed of new streamlined Budget Manual End PY2: New Budget Instructions approved along with Guidelines (together with instructions and new calendar if necessary) ready for use for 2011 Budget Year Ministry staff (across GoI) trained on use of new manual; this includes staff at regional level	Budget calendar adhered to. 35% improvement in compliance of ministry/agency budget requests (based on realism, timeliness and completeness of submission, etc.) Ongoing training as needed	Budget calendar adhered to. 50% improvement in compliance of ministry/agency budget requests (based on realism, timeliness and completeness of submission, etc.) Ongoing training as needed	Semi- Annually	GoI regulations as published GoI financial performance reports Consultant reports	MoF, MoPDC, IG and other internal controls, line agencies
e) Budget Call Circular (BCC) redesigned	Current BCC difficult to properly complete, as it does not provide sufficient instructional clarity for ministries/agencies	BCC redesigned, and first round of training for spending units completed	End PY2: New BCC in use throughout GoI including soft budget ceilings. Additional trainings completed as needed	Ongoing QA/QC of first year of BCC leads to improvements as needed	New BCC with hard budget ceilings issued.	Annually	Consultant reports GoI regulations as published	MoF, PMT

Results Indicators	Baseline	YR1	YR2	YR3	YR4	Frequency and Reports	Data Collection Instruments	Responsibility for Data Collection
component 2: a) Sector- specific standard bidding documents developed b)Provide required equipment(IT and furniture) to main procuring entities	SBDs not common practice	End PY1: Finalize draft of SBDs for: i) MoH (pharma. drugs) ii) MoEduc (printing of textbooks and educ. materials) iii) MMPW (pre qualification documents iv) MinElect. (supply/install. of plants/equip.)	Establishment of procurement regulating authority for public procurement. By mid-PY2; enhance the capacity of procuring entities by providing IT equipment By mid-PY2, completion of relevant training on new SBDs By End-PY2, development of NPM	Test the new SBD as pilot in target ministers, get feedback from ministries and introduce improvement By End-PY3, finalization and dissemination of NPM	New SBDs in use in target ministries. Improved procurement efficiency, transparency, and economy, in target ministries, as measured by data on the method used to award public contracts available	Annually	Consultant reports PRA reports Donor reports	MoF, PRA, PMT, Donors
b) Procurement information and monitoring system established	Limited procurement information available on-line in real-time	End-PY1: 'Procurement Bulletin Board' (website) operational	Procurement Bulletin Board being fully implemented, and housed within Procurement Regulatory Agency – providing information to	Development of the bulletin board towards single portal website for all procuring entities for advertisement notices and	Future options for E-procurement developed (software and hardware requirements specified)	Annually	Website	PRA, PMT

Results Indicators	Baseline	YR1	YR2	YR3	YR4	Frequency and Reports	Data Collection Instruments	Responsibility for Data Collection
			contractors, as well as data collection, monitoring, and reporting capacity	award notices.				
c) Capacity of key agencies, NGOs, private sector, strengthened	Existing procurement regulations will change when new law comes into force; substantial training will be required	Training Needs Assessment carried out	By mid PY2: developing New training curricula based on new law – By mid PY2 establishment of training program	Mid PY03: first round of training- of-trainers completed	Mid-PY4: Curricula revised based on training outcomes Longer-term training plan in place	Annually	Consultant reports Training evaluations	PRA, MoF, PMT
COMPONENT 3:								
a) New cash release system introduced	Current cash release system inefficient, does not respond to actual needs	Define and agree on the Conceptual Framework (CF)/model for cash management/ cash release Develop new rules and procedures	Mid-PY2: MoF approval of new rules and procedures Mid-PY2: Reach agreement on (up to) 5 pilot ministries in which to introduce the new system End PY2: First round of Capacity building/training completed, for MoF, MoPDC, and (up to) 5 pilot ministries	New system introduced as pilot in the selected ministries Ongoing training	New system demonstrates 30% improvement in the coherence between cash releases and actual needs	Semi- annually	Consultant reports GoI regulations as published GoI financial performance reports	MoF, PMT, MoPDC, other line ministries participating in pilot

Results Indicators	Baseline	YR1	YR2	YR3	YR4	Frequency and Reports	Data Collection Instruments	Responsibility for Data Collection
b) Multiple Treasury Model Assessed	Limited number of Treasury offices hamper efficient cashflow and budget execution	End PY1: Diagnostic study of provincial treasuries completed, including recommendations for new model				End of PY1	Consultant reports GoI regulations as published	MoF, Treasury(ies), PMT
c) New commitment control system introduced	Commitments are not monitored adequately	End PY1: New Conceptual Framework (CF) for commitment control defined and agreed	New detailed rules and regulations developed, based on CF Capacity building program carried out with relevant staff (largely to be awareness raising and some training on new rules/regulations)	End PY3: new system piloted in two ministries (Ministries TBD, but likely Municipalities and Public Works; and Water Resources Additional trainings on the new rules will be carried out, to prepare ministries for 'roll out' of the system in future	New system rolled out to at least 4 total sector ministries Ongoing training	Semi- annually	Consultant reports GoI regulations as published Training reports	MoF, PMT
d) Financial reporting improved	Current reporting does not adequately detail the outstanding stock of advances	End PY1: New system for financial and fiscal performance measurement developed and agreed	New system tested in three ministries Training materials developed Training of "Master Trainers" completed	New system in place, leading to 20% reduction in unused, outstanding balances in Spending Units Ongoing training	New system being implemented throughout GoI 30% reduction in unused, outstanding balances in Spending Units	Semi- annually	Consultant reports GoI regulations as published GoI financial performance	MoF, PMT, line agencies

Results Indicators	Baseline	YR1	YR2	YR3	YR4	Frequency and Reports	Data Collection Instruments	Responsibility for Data Collection
		Training Needs Assessment carried out			Ongoing training		reports Training reports	
e) Internal financial controls assessed, with particular reference to Inspector General (IG) function	Overlapping functions between IGs and other internal auditors; unclear mandates and reporting responsibilities	End PY1: Assessment completed of current IG framework Assessment completed of skills, capacities, of IG staff, internal auditors and other internal control functions	Identification completed of needs for system improvement, including clarification of mandate of internal controllers			Annually	Consultant reports IG evaluation reports Donor feedback	MoF, MoPDC, IG, PMT, Donors
f) Functionality of MoF website upgraded	Website underutilized, both for internal and external purposes	End PY1: Website updates completed, with new content for both internal and external audiences, as deemed appropriate by consultant review/report	Website being regularly updated with new rules/regulations/proc edures/ public announcements/etc. as necessary	Website being regularly updated with new rules/regulations/p rocedures/ public announcements, etc. as necessary	Website being regularly updated with new rules/regulations/pro cedures/ public announcements/etc. as necessary	Annually	Website	MoF, PMT

Results Indicators	Baseline	YR1	YR2	YR3	YR4	Frequency and Reports	Data Collection Instruments	Responsibility for Data Collection
g) Internal MoF IT network upgraded	MoF departments fragmented in their information- sharing ability	End PY1: Assessment completed of current IT environment, to include: i) assessment of links to ongoing FMIS work (under separate Project funded by USAID); and ii) assessment of information and processing flows between depts.	Functional requirements for upgraded system, including for links with FMIS, developed	Procurement started for new software and hardware This should occur regardless of whether it is through Project financing, internal GoI resources, or other donors	New software and hardware are in place and contributing to improved efficiency of MoF operations Plans in place for rollout of system in next phase	Semi- annually	Consultant reports Technical specifications	MoF, PMT
COMPONENT 4:								
MoF's internal training department strengthened, able to deliver wide range of training	Limited capacity in MoF training department	Mid-PY1: Twinning arrangement signed with international training institute End PY1: Training Needs Assessment completed	Capacity assessment of MoF Training Department completed Training program fully in place, supporting all aspects of Project operations, as well as other professional development as appropriate	Training program continuing to provide targeted training according to needs; program refined based on feedback from PY2	Training program continuing to provide targeted training according to needs; program refined based on feedback from PY3. Long-term business plan for sustainable operations of the MoF training department developed and approved	Semi- Annually	Twinning institute reports (particularly Training Needs Assessment) Training evaluations	MoF (training institute)

Annex 3 Republic of Iraq Public Finance Management Project Summary of Estimated Costs¹

	Cost (US \$millions)
Component 1: Strengthening budget formulation and	
implementation	
a) Capacity strengthening of the MoF Budget Department	1.45
- Four to six international (10 person months) and two to three local	
consultants (5 person months each)	
b) Improve budget strategy, Improve content of and adherence to	2.50
Budget Call Circular (BCC), Introduce budget ceilings, Develop	
detailed sector strategies	
- International consulting firm, total of approx. 50 person-months, both	
international and local consultants	
Total Component 1	3.95
Component 2: Strengthening Public Sector Procurement	
a) Develop SBDs and RFPs, and carry out training	0.42
- International consulting firm, approx. 12 person-months, 1 or 2	U.42
international consultants (3 person-months each), supported by 2 local	
consultants(3 person-months each), supported by 2 total	
b) Develop Procurement Bulletin Board	0.25
- Individual consultants: One international (4 person-months) and One	0.23
local (4 person-months)	
c) Develop National Master Implementation Manual	0.31
c) Study tour for 15 staff of RA + PCD+ SBD + KRG	0.15
d) TA for RA for complaints and black-listing	0.15
- Individual consultant, international, 3 person-months	0.13
e) Training of 10 staff of POD in Prior Review	0.070
- Individual consultant, international, 1 person-month	0.070
f) Training needs assessment and preparation of training materials for	0.45
the Procurement Department	0.15
- International consulting firm, 9 total person-months, both	
international and local consultants	
g) Training of Trainers program	0.45
- Individual consultants: One international (4 person-months) and One	
or Two local (4 person-months)	
h) Establish a central archive in the PCD to improve a complete soft	0.95
and hard record keeping of procurement files subject to its prior review.	
The PFM Project will finance the procurement of IT equipment: PCs,	
sever, scanner, and photocopier in addition to archiving software	
Total Component 2	3.2
Component 3: Strengthening Budget Execution and	
Implementation	0.75
a) Introduce Effective Cash Release System Individual consultants: Two international (6 person months) and 2	0.75
- Individual consultants: Two international (6 person-months) and 2 local (30 person-months)	
tocai (50 person-monins)	

b) Enhance Treasury Functions in the Provinces	0.44
- Individual consultants: One international (4 person-months) and One	
or two-local (5 person-months)	
c) Introduce Commitment Control System	0.26
- Individual consultants: One international (2 person-months) and One	0.20
local (3 person-months)	
d) Improve Financial Reporting	0.36
- Individual consultants: One international (3 person-months) and One	
or Two local (4 person-months)	
e) Create Internal MoF Network	0.12
- Individual consultants: One international (1 person-months) and One	
local (2 person-months)	
f) Assessment of Internal Financial control system, including the IGs	0.40
- International consulting firm, 9 total person-months, both	
international and local consultants	2.22
Total Component 3	2.33
Component 4: Capacity Development and Project Management	
a) Capacity Development of the MoF Training Institute	3.00
- International training institute, in formal twinning arrangement with	3.00
MoF Training Institute: initial Capacity Assessment, development of	
training modules, training of trainers, followed by ongoing technical	
support throughout life of Project	
Total Component 4	3.00
D : 435	
Project Management and Auditing	0.16
a) Individual consultants for technical and procurement support, on asneeded basis	0.16
b) Project Audit	0.14
- International auditing firm	V.21
c) Operating Costs	0.30
d) Limited IT and office equipment for PMT	0.10
Total Project Management and Auditing	0.70
<u>, , , , , , , , , , , , , , , , , , , </u>	
Subtotal ALLOCATED	13.18
TTU4-3	2 92
Unallocated (contingencies) ²	2.82
Bank-executed Companion TF	2.00
Dank-executed Companion 14	4.00
GRAND TOTAL	18.0
UMID IVIAL	10.0

Note 1: Due to the difficulty in mobilizing consultant assets in Iraq, Project activities have been grouped, to the maximum extent appropriate (based on technical needs), in order that contract values are high enough to attract sufficient bids. The estimated costs presented above include all travel, living allowances, security costs, insurances, etc. The exceptions are the cases which are very specific, and would be more appropriately handled by an individual consultant.

Note 2: The large Unallocated amount indicated in this table is appropriate: the sub-component cost estimates do not include the numerous "downstream" activities which will arise from the consultant outputs represented by the costs above. Prior to those outputs, it is not possible to accurately estimate the costs for these activities. The Mid-Term Review Supervision Mission is expected to provide an updated Summary Cost Table, for the files, describing in adequate detail the subsequent expenditures. In the Allocation table in Annex 4, and in the Grant Agreement, the bulk of the Unallocated has been included in the Consultant Services category, as this category represents the majority of the downstream activities.

Annex 4 Republic of Iraq Public Finance Management Project Financial Management and Disbursement Arrangement

FINANCIAL MANAGEMENT ARRANGEMENTS

Country Financial Management Context

A Country Financial Accountability Assessment (CFAA) has not yet been undertaken for Iraq; however, to compensate for not performing the CFAA, the Bank had prepared an internal report³ that had been designed to inform the Bank's project teams on the structural weaknesses of the Iraqi public financial management system and to assist them in anticipating problems that could occur during the implementation of the Bank-financed projects. Overall, the public financial management difficulties in Iraq are similar to those in many other countries and had been very well known by the Bank. These include weak budgeting and fragmented accounting, accompanied by incomplete and inaccurate financial reporting. Government employees' financial management capacities are weak and internal controls are poor. Internal and external audit functions are in a nascent state, and cannot realistically be relied upon to redress the situation. The uniqueness of the Iraq situation is that these are all present at once, complicated by the country's security conditions and the lack of a functioning financial sector that is capable of providing routine financial services. Each deficiency potentially can adversely affect the implementation of the Bank financed projects. The Government of Iraq has started to take measures, including through a planned Bank's financed operation, to reform the public financial management system; however this reform is a long term activity that will be finalized over number of years.

Many other assessments and reports⁴ had been undertaken by the Bank and the other donors over the last four years that confirmed that assessment and led to defining Iraq as one of the "high risk-weak control environment countries" that requires special attention, from the Bank, at various levels.

Portfolio Context

Fifteen grants funded by the Iraq Trust Fund (ITF) are currently being implemented by Iraqi agencies. Various line ministries and governmental entities are the recipients of the ITF grants financing the projects. Five projects funded by IDA credits are also currently being implemented with the Ministry of Finance, as representative of the Government of Iraq, being the borrower. However, related line ministries are delegated the responsibility of the projects; implementation. Country Financing Parameters have been approved for Iraq in September 2005 allowing up to 100% financing of project expenditures, including taxes. Except for two, all projects are 100% financed by either the ITF or IDA with the implementing entities providing their staff time and effort and some operating costs. All projects are implemented within the framework of the Iraqi public sector regulations complemented by the Bank policies and procedures as agreed on in the related legal agreements. A Master Implementation Manual (MIM) was developed by a consulting firm hired by the Bank to document the general implementation, procurement, and financial management policies and procedures applicable to managing projects in Iraq. As the Bank staff had limitation in being able to functionally be in Iraq to regularly supervise the projects, a Fiduciary Monitoring Agent (FMA) was hired to help the Bank in supervising the projects' (ITF-financed and

"Financial Management Accountability Assessment"

4 IME World Bank "Enhancing Sound PEM Short to

³ "Financial Management Accountability Assessment"

⁴ IMF-World Bank "Enhancing Sound PFM-Short- to Medium-Term Reforms report, "Public Expenditure and Institutional Assessment", and the "Sub-national Public Financial Management", and the Corruption Perception Index

recently the IDA-financed) implementation, including the monitoring of the procurement and FM performance and compliance with the required procedures. The FMA is guided by agreed Terms of Reference (as per the ITF donor agreements for ITF-financed projects) and has received training from the Bank on procurement and FM guidelines and procedures. To perform its responsibilities, the FMA visits project sites and project management teams (PMTs) and reports (monthly and quarterly) issues to the Bank's task teams as they arise, and recommends actions to be taken by the PMTs and the task teams.

Portfolio Financial Management Arrangements

To mitigate any implication of the weak public financial management system has on assurance that the projects funds are spent as intended, efficiently and economically, the following FM arrangements were generally put in place in projects: competent financial officer as part of the project management (PMT) to take FM responsibilities; close support and frequent capacity building initiatives; simplified clear procedures documented in a project implementation manual (PIM) prepared based on the MIM; simplified parallel accounting and reporting systems; independent external auditor acceptable to the Bank to provide an independent opinion of the project financial statements; the FMA regular monitoring of projects' FM performance and physical checks; and simple flow of funds arrangements mainly relying on direct payments and recent piloting of the advance method accounting and reporting arrangements.

Portfolio FM Performance and Disbursement Status

The main issues that are being monitored very closely by the Bank to improve the portfolio FM performance are: the weak capacity, instability, and turnover of the projects' staff; the weak audit profession and reliance on one auditor; and the general weak control environment affecting the degree of assurance provided. On the disbursement part, the projects have been experiencing delays in getting payments to Iraq due to the inefficient banking system. The Bank is currently finalizing another ITF-funded project to support the undergoing reform of the banking sector in Iraq.

Project Implementation Arrangements

Organization

The total estimated cost of the Project is US \$18 million, to be funded by: i) US \$16 million from the Iraq Trust Fund (ITF), to be recipient-executed; and ii) US \$2 million from the ITF, to be Bank-executed. The Ministry of Finance, as the grant recipient, will have primary responsibility for overseeing project implementation and ensuring compliance with the Bank's guidelines and procedures on fiduciary aspects, monitoring and evaluation, as well as the reporting to the World Bank and other relevant agencies. To facilitate this day-to-day Project implementation, a dedicated Project Management Team (PMT) has been established and will reside at the MoF. The PMT will be overseen by the MoF and the Minister of Finance will be informed of progress under the project on a regular basis and consulted as needed. In addition to the PMT, each component will be supported by a dedicated Component Technical Team (CTT), which will be responsible for ensuring fulfillment of technical requirements, particularly preparation and evaluation of procurement documents, as well as monitoring consultant performance. The CTTs will report directly to the PMT Director. The Ministries of Planning and Development Cooperation in Baghdad and Kurdistan, and line Ministries selected for direct assistance, will establish smaller Project Implementation Teams to handle day-to-day Project-related tasks. As for component 2 (Strengthen public sector procurement, it will be undertaken in close coordination, collaboration, and under the direction of Department of Government Policy at MOPDC.

Staffing

A financial officer, supported by an accountant and an internal controller, will be responsible for the project centralized FM responsibilities, as agreed during project preparation, including maintaining financial records, reviewing, processing and ensuring duly authorization of consultants and vendors' payments, submitting duly signed withdrawal applications to the Bank to claim disbursements, and preparing periodic reports and financial statements. This financial team had been identified and had participated in the appraisal mission. Adequate training will be provided to the financial team on World Bank FM and Disbursement guidelines and procedures during the supervision missions.

Risks and Mitigation Measures.

The assessment of the financial management (FM) arrangements proposed by MOF was undertaken during meetings held in Amman and Beirut and based on a number of documents provided by MOF. The purpose of the assessment is to confirm that the FM arrangements for this project are acceptable in providing reasonable fiduciary assurance that the proceeds of the Grant are used for the purposes for which it was granted with due regard to economy, efficiency and the sustainable achievement of the project's development objectives. In addition, it helps in defining the areas that need additional arrangements or enforcement of controls. The documentation of the assessment is available in the project files. Based on the result of the assessment, the FM risk, as a component of the fiduciary risk, and which is a combination of country, entity and project specific factors is **high**. The following are the identified FM risks and the relevant mitigating measures. With these measures in place, the project would have acceptable project FM arrangements; however, in Iraq the residual risk will remain high:

Project FM Risk	Rating	Mitigating Measure	
Based on FM arrangement			
Limited knowledge by the MOF of the Bank's guidelines and procedures.	Н	Designating a PMT that will be equipped with competent and committed members, including a Financial officer.	
Limited internal control environment and procedures and possibility of the PMT not being delegated the suitable level of authority to perform duties.	Н	Agree on the associated control environment and procedures and document them in a Project Implementation Manual, based on the Master Implementation Manual.	
Limited accounting and reporting systems in providing timely and comprehensive information.	M	Using a parallel accounting and reporting system that can capture the project financial activities and generate the IFRs and Annual project Statements.	
Limited flow of funds process and expected payment delays, especially for individual local consultants.	M	MOF to open a project account with a sufficient project-life advance to make payments from and get reimbursed from the Bank.	
Limited physical existence of the Bank staff in Baghdad and limited independent verification function.	Н	The Iraq FMA hired by the Bank to monitor the project implementation, procurement and FM performance based on existing TORs. The Bank will perform frequent SPN missions outside Iraq.	
Limited access to competent external auditors in Iraq and delay in the selection process.	Н	Agree on detailed audit TORs and use fixed cost method for the selection of the auditors. The process should start right after project effectiveness.	

H = High Risk; S = Substantial Risk; M = Modest Risk; N = Low or Negligible Risk

Project FM Risk	Rating	Mitigating Measure
Based on project activity		
Limited experience at MOF of implementing and managing projects due to the nature of the ministry activities.	Н	Providing intensive training on procurement and FM procedures and ensuring the PMT follows the PIM.
Difficulty of managing technically and geographically wide-scope components and maintaining proper communication and coordination with the different stakeholders.	Н	Agree on flow of information with the various stakeholders and document in the PIM.
Inherent difficulty of assessing the acceptability of consulting and training services (the main core of the project), based on which payments would be made.	M	Each component will be supported by a dedicated Component Technical Team (CTT), which will be responsible for ensuring fulfillment of technical requirements, particularly preparation and evaluation of procurement documents, as well as monitoring consultant performance.
Inherent difficulty of ensuring that the right persons had been chosen to attend project-financed workshops, actually attended, and benefited as intended, in addition to the inherent risk associated with related expenditures such as per diem and travel cost,	M	Strengthening the monitoring and evaluation function at the PMT.
Possibility of having the same activities covered by initiatives of other donors.	Н	In order to ensure the project is being implemented in a manner consistent with the GoI's overall reform efforts, the PMT will be overseen by the MoF and the Minister of Finance will be informed of progress under the project on a regular basis and consulted as needed.
Overall FM risk	Н	

H = High Risk; S = Substantial Risk; M = Modest Risk; N = Low or Negligible Risk

Internal Controls

The project's financial controls will be documented in the project implementation manual that will customize the Iraq Master Implementation Manual to the needs of the project. This PIM will clearly disclose each PMT member responsibilities, the payment verification, authorization and execution processes, authority limits, physical receipt and control of equipment, as well as relationship lines with the different stakeholders. The expenditure cycle will follow controls specified in the manual and will include the following steps: (i) technical approval by the spending department of each entity and the Component Technical Team; (ii) administrative approval by the PMT Director; (iii) issuance of payments will be made upon receipt of supportive documentation and written requests signed by authorized officials; (iv) the accuracy and consistency of the payment requests will be verified by the financial officer. The project will finance mainly consultants' services. These can be classified either as delivering a set of output, or as supporting the delivery of an output. Payments will be made against the delivery of outputs for the first category, as detailed in their contracts. While for the second category of consultants, payment will be made against the submission of a time sheet and a summary of activities performed during the period invoiced.

Independent Verification:

The FMA will monitor the performance of the project implementation, procurement and financial management periodically and share reports with the Bank and MOF. The external auditor will report as well, in his management letter, on any deficiency in the FM system and controls that is considered pertinent, and will provide recommendations for its improvement.

Budgeting:

The PMT will maintain a project budget and detailed disbursement plan per quarter. This plan will be developed based on the initial procurement plan, implementation schedule and estimated payments cycles, and revised upon need. It will be used as a monitoring tool to analyze budget variances and manage cash.

Accounting:

Based on the number of the contracts and the frequency of payments, spreadsheet applications will be used to record the project's financial transactions and generate reports. Procedures for protecting the data and preventing losses will be maintained. The IFMIS being implemented at MOF linking all ministries is still in progress and not finalized yet, so no reliance can be made on it, in terms of electronic processing.

Financial Reporting:

The PMT will be responsible for preparing the following:

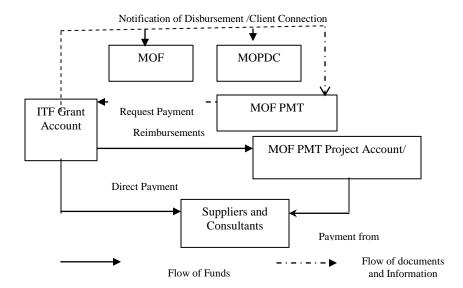
- Quarterly Interim un-audited financial reports (IFRs) as part of the quarterly project progress
 reports, and submitting them to the Bank within one month from the quarter then ended. The
 format of the reports will be agreed upon during the negotiations. These reports consist of a
 statement of sources and uses of funds by component; statement of uses of funds by category of
 expenditure, both comparing actual and planned expenditures; and a list of cumulative contracts'
 commitments.
- Annually Project Financial Statements (PFS), and submitting an audited PFS with the independent auditor opinion to the Bank not later than six months after the end of each fiscal year. The PFS include: (i) statement of sources and uses of funds by component; (ii) statement of uses of funds by category of expenditures, both comparing actual and planned expenditures; and (iii) list of contracts' commitments.

Auditing Arrangements:

An external independent auditor, acceptable to the Bank, will be engaged to carry out the annual financial statements audit in accordance with international standards of auditing, issue the required independent opinion, and prepare the management letter. The auditor will be granted access to the project documents at the PMT and MOF. The audit TORs include performing a Statement of Expenditure (SOE) review for the audit period covered. The audit report and management letter will be submitted by the PMT to the Bank not later than six months after the end of each fiscal year. An escrow account will be used to pay the auditor after the project's closing date.

Funds Flow:

The project disbursement methods are disclosed under the Disbursement arrangements and in the Disbursement Letter. In addition to some equipment and small operating cost, the project will finance mainly consultants' services to the MOF and selected line Ministries. With the exception of a large-scale twining arrangement for long-term training and capacity building, it is expected that a majority of the services will be contracted to individual local and international consultants. However, where appropriate, a firm may provide services for a range of activities. Based on the experience so far with flow of funds performance of current Iraq projects, and to achieve the needed efficiency, the Bank will directly pay beneficiaries with bank accounts outside Iraq. For beneficiaries with bank accounts inside Iraq, MOF will provide a sufficient project-life advance to be deposited in a project account, from which the PMT will make payments and periodically claim reimbursement from the Bank. The PMT will make payments to individuals in various locations in Iraq and Kurdistan through branches of commercial banks.



Supervision

To-date, security conditions have limited Bank staff travel to and within Iraq, and most supervision missions have been undertaken from an alternative location. However, the security situation shows signs of improvement, and it is likely that during the Project implementation period, more regular Bank staff visits to Iraq will be possible. Regardless of the location of supervision, close monitoring of financial management arrangements will be conducted throughout the project life. Supervision during the first year

will be conducted about 4 times a year. The project FM team will continue to get periodical training on FM arrangements.

The FMA will monitor the project implementation, procurement and FM performance and compliance with the required procedures. It will visit the PMT periodically and will offer advise and on-the job training in addition to reporting periodically issues to the Bank task team as they arise, and recommend actions to be taken by the PMT and the task team. To perform its responsibility, the FMA will be granted regular access to the project documents at the PMT and different relevant entities.

FM Action Plan

Action	By Whom	Date
Designate financial officer, accountant and internal controller	MOF/PMT	By appraisal (Done)
Prepare financial management chapter of PIM	MOF/PMT	Two months after effectiveness
Financial team to get adequate initial training	MOF/PMT	During project launch
Start external independent auditor	MOF/PMT	Two month after effectiveness

DISBURSEMENT ARRANGEMENTS

The Grant of US\$18 million is expected to be fully disbursed by June 30, 2013. The Bank's strategy in Iraq has been become more flexible in selecting the entities to implement the Bank-financed or administered projects. For the past four years, the Bank has chosen to have the projects implemented through the Iraqi Ministries (rather than stand alone units outside government structures), ensuring that appropriate and effective financial controls are in place over the use of funds provided by the Bank, while at the same time working together to strengthen the Ministries' own financial control processes and procedures. While this strategy has worked for some ministries, it had caused considerable project delays for others, due to the limited capacity and the existing inefficient systems. For this project and due to the staff capacity and availability at MOF, a Project Management Team will be designated to manage the project. Taking into consideration the high risk environment assessed for the project, including the assessed high financial management risk, the disbursement arrangements will compensate by continuing to use appropriate disbursement methods. The disbursement methods used will be:

- O Direct Payments to consultants and suppliers for eligible expenditures, for disbursements over US\$25,000. These payments will be made to accounts at commercial banks capable of receiving funds transferred from the international banking system.
- Reimbursement to the MOF for eligible expenditures paid from the MOF resources. The MOF will submit reimbursement applications once per quarter, or whenever expenditures reach US\$25,000 or more.
- Special Commitments to facilitate payments under Letters of Credits for prior review contracts for the importation of goods as agreed in the procurement plan.

Continued training on Bank disbursement arrangements will be provided to the existing MOF PMT and financial counterpart at MOF, if needed. Supporting documents, e.g., copies of invoices and receipts, or Statement of Expenditures (SOE) are required to be provided with all requests to disburse funds. These

documents, including the Statement of Expenditures (SOE) thresholds are detailed in the Disbursement Letter. The original copies of the supporting documentation will be maintained by the MOF and made available for review by Bank representatives upon request.

- 1. Country Financing Parameters (CFP) were approved for Iraq in September 2005. The CFP allow for the financing of 100 percent of eligible project expenditures.
- 2. The allocation of the proceeds of the Grant by expenditure category is as follows:

	Expenditure Category	US\$ m	Financing Percentage
1	Goods	0.10	100%
2	Consultants services and training	14.00	100%
4	Incremental Operating Expenses	0.30	100%
5	Unallocated	1.60	
	Total	16.00	

Estimated of	lisbursem	ents (Bank	k FY/US\$M)				
FY	2009	2010	2011	2012	2013		
Total Grant	1.0	5.0	11.0	16.0	18.0		

Note: Bank FY is July 1 through June 30.

Annex 5 Republic of Iraq Public Finance Management Project Procurement Arrangements

General

- 1. Procurement for this project will be carried out in accordance with the World Bank's "Guidelines: Procurement under IBRD Loans and IDA Credits" dated May 2004 and revised October 2006; and "Guidelines: Selection and Employment of Consultants by World Bank Borrowers" dated May 2004 and revised on October 2006, and the provisions stipulated in the Trust Fund Grant Agreement. The general description of various items under different expenditure categories is given below. For each contract to be financed by the Grant, the procurement methods or consultant selection methods, estimated costs, prior review requirements, and time frame are agreed between the Recipient and the Bank project team in the Procurement Plan (PP). The PP will be updated at least annually or as required to reflect the actual project implementation needs and improvements in institutional capacity. A General Procurement Notice will be published in dgMarket and in UNDB and will be revised at least annually. In addition procurement procedures and sample bidding documents can be found in the MIM and the PIM.
- 2. Procurement of Works: no procurement of works is envisaged under this project.
- 3. <u>Procurement of Goods</u>: Goods procured under this project would include: IT and communication equipment and office furniture and archives. The procurement will be done using Bank's SBD for all ICB and National SBD agreed with the Bank and included in the ITF Master Implementation Manual (MIM). Shopping procedures and will also be carried out following MIM forms for the Request for Quotations.
- 4. <u>Selection of Consultants:</u> Consultants' services procured under this project will include selection of consultants to provide services related to: (i) strengthen budgeting formulation and implementation, (ii) strengthen public sector procurement, and (iii) strengthen treasury operations, financial control, accounting and reporting. The services will include also; the development of Iraq MIM, RFP and Sectoral SBDs, and Develop Procurement Bulletin Board with on-line publishing and Information Tracking system. International or local individual consultants will be selected to carry out technical assistance assignments and/or training of trainers activities. The will also assist the PMT in project implementation in the areas of training and support of MOF staff in procurement, financial management, project management and other contract administration as needed.
- 5. For consulting firms, the selection methods will mainly be Quality and Cost-Based Selection (QCBS) and Quality Based Selection (QBS) for values above US\$200,000. For values less than US\$200,000 other methods can be envisaged such as selection based on Consultants Qualifications (CQ), selection based on Fixed Budget, Least Cost selection. For individual consultants, the selection will follow the procedures explained in Section V of Bank's Guidelines for the selection and employment of consultants.
- 6. For QCBS and QBS, and any other selection process of international consulting firm, Bank's standard request for proposals and standard evaluation forms will be used. For the selection of local/regional consulting firms, RFP and evaluation forms included in the ITF Master Implementation Manual will be used. The different selection methods will be indicated in the PP with clear indication for activities subject to prior review by the Bank. Shortlist of consultants for services estimated to cost less than US\$200,000 equivalent per contract may be composed entirely of national consultants in accordance with the provision of paragraph 2.7 of the Consultant Guidelines. The selection of individual consultants

will be done in conformity with Section V of the Guidelines: Selection and Employment of Consultants by World Bank Borrowers.

Assessment of the agency's capacity to implement procurement

- 7. In 2005, the World Bank conducted an Operational Procurement Review (OPR) of the public procurement system in Iraq to help enhancing the Bank's knowledge of the overall procurement system in Iraq. The OPR revealed that procurement environment which prevailed in Iraq during the last two decades was different from the norms of acceptable international practice. The major issue facing public procurement now in Iraq is the current uncertainty of public procurement laws and regulations that causes high risk within weak control environment. The risk essentially roots in the lack of good laws and regulations, modern standard documentation, lack of trained concerned staff in procurement using Bank guidelines and international sound procurement practice, and the lack of law enforcement which would increase the risk management. Since the completion of the OPR, MOPDC had issued sets of procurement regulations in April 2007 and May 2008.
- 8. In addition an assessment of MOF's capacity to implement project procurement was conducted in March 2006 by the Bank's procurement specialist through discussion with MOF staff before the pre-appraisal/appraisal mission and reviewed by the team's Senior Procurement Specialist. The assessment was carried out based on the form of questionnaire of the Bank responded to by the Counterpart delegates attended the identification mission and complemented by the additional information sent later and related to organizational structure, staffing, record keeping, and procurement management cycle and contract administration.
- 9. Based on the existing information on the overall environment for procurement in Iraq and in particular within MOF, the overall procurement risk assessment is judged to be **high**, which therefore requires the assignment of a dedicated and qualified procurement officer to the project, as well as the provision of intensive formal and on-the-job training to the PMT on procurement and project management. In addition, the MIM and PIM are expected to provide significant guidance to PMT procurement staff.

Identified Risks

10. The assessment revealed a number of weaknesses in the system which included in the table below as well as measures had been taken into account in the project design:

Summary of Procurement Risk Assessment

Description of risk	Rating of risk	Mitigation measures	Rating of residual risk
MOF lacks experience in Bank procurement procedures	Н	Appointment or Recruitment of procurement officer with the appropriate experience to assist the PMT implementing the activities financed by the Project. TORs for these positions have been communicated to the MOF to start selecting key staff. In addition, Training on basic procurement is already started and will continue during the project launch workshop as	Н

		well as during the project implementation	
Lack of applicable laws and regulations	Н	Follow the ITF MIM which would provide aligned and explicit methodology consistent Bank's procurement and selection procedures.	M
Inability of World Bank procurement staff to supervise project in the field because of security situation	Н	Prior review of all activities. Review outcomes by technical experts within Bank task team. The use of the FMA to help the Bank monitor the implementation progress of the project as well as the recipient's compliance with Bank procurement, financial management and also provides on-the-job training, TA, and support to the project management staff.	Н
Delays in implementing the procurement plan due to lack of experience in procurement planning and the security conditions in Iraq	Н	Close supervision of the Bank staff and the FMA from the field as well as off Iraq. Frequent training and on the job training will be provided	Н
Corruption in procurement	Н	Lowering threshold for prior review. Frequent review of files by the FMA as well as spot physical inspection by the FMA. Closing monitoring of corruption indicators in procurement and implementation.	Н
Average	Н		Н

H: High; M: Moderate and L: Low.

The overall project risk for procurement is **High.**

Procurement Plan

11. MOF, at appraisal, prepared a Procurement Plan (PP) (Annex 5A) for project implementation which provides the basis for procurement packages and methods to be used in this Project. This plan has been agreed on between the MOF, MOPDC delegates and the Bank at negotiations, and will be available in the project's database and on the Bank's external website. The PP will be updated in agreement with the Project Team as required to reflect the actual project implementation needs and improvements in institutional capacity.

Recommendations and Action Plan to Build the Agencies' Capacity

- A procurement officer and monitoring officer from MOPDC who had good experience working
 on Bank's financed projects was assigned to the PMT to be responsible for all procurement
 aspects during implementation. Those two officers had received both formal and ad-hoc
 procurement training under other bank's financed projects
- Training sessions will be carried continue throughout project implementation by the Bank's FMA in Baghdad. The target audience is MOF, MOPDC, and PMT staff, and other employees of the MOF involved in procurement or the evaluation process;
- A PIM will be prepared on the basis of the MIM to provide standard procurement documents, evaluation reports, progress reports, filing requirements that will be followed throughout project implementation;
- The thresholds for prior review by the Bank are set at a low level, to allow Bank staff to provide hands-on training to staff of the PMT;
- A Project Launch Workshop, attended by all project stakeholders, will be held in Arabic (or with Arabic translation) soon after Grant signing.
- 12. To enhance implementation preparedness of the project, the PMT and the Bank mission have discussed during the preparation of the Project and agreed on immediate actions to be carried out as indicated in the following action plan:

No	Action	Agency involved	Technical Support	Time line
1	Assign Project Procurement	PMT	Bank send TORs	October 08
	Specialist			
2	Nominate technical teams/focal	PMT		January 09
	points from MOPDC, MoH, MoE,			
	Electricity, KRG to consult with the			
	international expert for the			
	preparation of sectoral BDs			
3	Project Launch Workshop	PMT/Bank		September 09
4	Carry out capacity building on Bank	Bank Monitoring	Bank PS to	October 09
	procurement procedures and mainly	Agent	coordinate	
	the selection of consultants according			
	to ITF MIM. Workshop to be carried			
	out in Baghdad			

Annex 5.A Republic of Iraq Public Finance Management Project: Draft Procurement Plan – Selection of Consultants

Procure- ment System Ref. #	Location/ Description of Assignment		Selectic Meth	on od Review by Bank Prior / Post	Adverti- sement EOI/ Readiness Date	Invitation for RFPs Date	Contract Award Date	Comple- tion Date	Comments
2. CONSULTANTS' SEF	RVICES								
2.1 Component 1. Stren	ngthen budgeting formulation and impleme	entation							
PFM.C-I.IND.01-03	Strengthen the capacity of the Budget Department of MoF (international and local consultants)		IC	PRIOR	15-Jan-09		22-Feb-09	27-Sep-09	
PFM.C-I.QCBS.01	Improve budget strategy, Improve content of and adherence to Budget Call Circular (BCC), Introduce budget ceilings, Develop detailed sector strategies		QCBS	PRIOR	15-Jan-09	17-Mar-09	19-Jun-09	05-Feb-10	
Subtotal for 2.1									
2.2 Component 2. Stre	ngthen public sector procurement								
PFM.C-II.QCBS.01	Develop SBDs, RFP, Training		QCBS	PRIOR	15-Mar-09	30-Apr-09	02-Aug-09	28-Mar-10	
PFM.C-II.IND.01-02	Develop Procurement Bulletin Board (international and local consultants)		IC	PRIOR	15-May-09		22-Jun-09	30-Oct-09	
	Study tour for 15 staff of RA + PCD+ SBD + KRG			POST*				22-Jul-09	
PFM.C-II.QCBS.02	Develop NIM		QCBS	PRIOR	15-Sep-09	31-Oct-09	02-Feb-10	28-Sep-10	
PFM.C-II.IND.03-04	TA for RA for complaints and black-listing			POST*	15-Oct-09		20-Nov-09	05-Dec-10	
PFM.C-II.IND.05	Training of 10 staff of POD in Prior Review								
PFM.C-II.QCBS.02	Assessment training needs, Establish curriculums/training modules for procurement training and procurement audit		QCBS	PRIOR	15-Sep-09	15-Nov-09	17-Feb-10	06-Sep-10	
PFM.C-II.IND.06-12	Recruitment of Trainers of the National Training Center to carry out training programs		IC	POST*	01-Oct-09		06-Nov-09	21-Nov-10	
Subtotal for 2.2									

Annex 5.A Draft Procurement Plan – Selection of Consultants- 2

2.3 Component 3. Strei	ngthen treasury operation, financial contr	ol, accounting and	I reporting						
PFM.C-III.IND.01-03	Introduce Effective Cash Release System (international and local consultants)		IC	POST*					
PFM.C-III.IND.04-06	Enhance Treasury Functions in the Provinces		IC	POST*					
PFM.C-III.IND.07	Introduce Commitment Control System		IC	POST*					
PFM.C-III.IND.08	Improve Financial Reporting		IC	POST*					
PFM.C-III.IND.09	Create Internal MoF Network		IC	POST*					
PFM.C-III.QCBS.01	Assess Internal Financial Controls including Internal Auditors and Inspectors General		QCBS	PRIOR	15-Mar-09	29-Apr-09	21-Jun-09	08-Jan-10	
Subtotal for 2.3									
2.4 Capacity Building									
PFM.C-IV.QCBS.01	Capacity Building Needs Assessment – Current capacity, capacity goals within the outline of the project, target personnel, training modules**		QCBS	PRIOR	15-Jan-09	17-Mar-09	19-Jun-09	10-Jul-10	
Subtotal for 2.4									
2.5 Consultants for Pro	pject Management (PMT Team) & Auditing								
PFM.C-IV.IND.01-05	Technical and Procurement Support		IC	POST*					
PFM.C.AUD	Auditing Firm		TBD	PRIOR	15-Jun-09	15-Aug-09	17-Nov-09	22-Nov-12	
Subtotal for 2.5									
GRAND TOTAL									

Legend:

QCBS = Quality and Cost-based Selection (in accordance with sections 2.1 - 2.28 of the Guidelines)

LCS = Least-Cost Selection (in accordance with section 3.6 of the Guidelines)

CQS = Selection Based on consultants' Qualifications (in accordance with section 3.7 of the Guidelines)

IC = Selection of Individual Consultants (in accordance with sections 5.1 - 5.4 of the Guidelines)

SSS = Single Source Selection in accordance with sections 3.09 - 3.13 of the Guidelines

NA = Not Applicable

Notes:

All cost estimates include contingencies

*\ Prior review for the first three contracts and all contracts above \$ 50,000

** the cost estimate for this contract will be revised as the terms and scope of works develops

Annex 5.A Republic of Iraq Public Finance Management Project Draft Procurement Plan – Procurement of Goods

Procurement System Ref. #	Location/ Description	Estimated No. of Packages	Procurement Method	Review By Bank (PRIOR / Post)	Submis- sion/ Readiness Date	Invita- tion Date	Expected Bid- Opening Date	Contract Award Date	Comple- tion Date	Comments
1. Goods										
PFM.C-II.NCB.01	Establish Central Archive for RA (PCs+ scanners +server + Archive)	1	NCB	PRIOR	1-Sep-09	22-Sep-09	20-Oct-09	4-Dec-09	15-Aug-10	
PFM.C-II.NCB.02	IT Equipment of Procurement Units in Several Ministries.	1	NCB	PRIOR	1-Oct-09	22-Oct-09	19-Nov-09	3-Jan-10	20-Jul-10	
PFM.C-II.SH.01-05	IT and Office Equipment for PMT	TBD	SH	PRIOR /POST	1-Jun-09	18-Jun-09	30-Jun-09	2-Aug-09	1-Sep-09	
PFM.C-II.SH.01-06	Software for Automated Budget Preparation	TBD	SH	PRIOR /POST	1-Aug-09	18-Aug-09	30-Aug-09	2-Oct-09	1-Nov-09	
Total										
Legend:		Notes:								
ICB = International Competitive B	Bidding (in accordance with section 2 of the Guidel	All co	ost estir	nates inclu	ıde contingen	cies				
	lding (in accordance with section 3.3 of the Guidelin									
TBD = To Be Determined		Color K	•							
	with section 3.5 of the Guidelines)			Plan" inp						
NA = Not applicable					a past date)					
		R/A	= A Rev	ised input	(a future date)				

Annex 6 Republic of Iraq Public Finance Management Project Implementation and Monitoring Arrangements

I. Implementation Arrangements (see also Organizational Chart in III. below)

- 1. The Ministry of Finance, as the grant recipient, will have primary responsibility for overseeing project implementation and ensuring the Bank's guidelines and procedures are adhered to (primarily fiduciary aspects (procurement management, financial management, monitoring and evaluation (M&E), and reporting to the World Bank and other relevant agencies)). To facilitate this day-to-day Project implementation, a dedicated Project Management Team (hereinafter PMT) has been established within the MoF. The PMT head has been identified and approved by the Ministry of Finance and has been participating in project preparation together with the FO and PO. Formal legal establishment of the PMT with notification to the Bank shall be confirmed between the Bank and the GOI during Project Negotiations.
- 2. The PMT shall be comprised of at least three full-time dedicated staff persons. A project manager will serve as the key interlocutor for the Bank's Task Team Leader and to ensure consistency between the beneficiary departments within the Ministry, and between the MoF, MoPDC, and line ministries participating in the Project. The project manager will be supported by a Financial Officer (FO) and a Procurement Officer (PO). The FO and PO will manage the daily financial management and procurement activities of the project as outlined in the sections below and in further detail in Annexes 4 and 5, respectively.
- 3. As described above in the main text and in Annexes 4 and 5, the PMT shall be responsible project implementation including all aspects of financial management, procurement, disbursement, and monitoring and evaluation arrangements under the project. For procurement, the PMT (primarily the PO) will prepare bidding documents or requests for proposals based on technical specifications or ToRs provided by, or developed with, the Component Technical Teams (CTTs, see below), conduct tenders, organize evaluation committees, and process payments to consultants and contractors after acceptance and approval of the goods, works or services by the CTTs. CTT members and/or other identified specialists will be invited by the PMT to participate in proposal and bid evaluations.
- 4. In order to ensure the project is being implemented in a manner consistent with the GoI's overall reform efforts, the PMT will be overseen by the MoF and the Minister of Finance will be informed of progress under the project on a regular basis and consulted as needed. The PMT is also expected to liaise regularly with the FMA, to ensure that their findings are able to fully complement the PMT's work, and improve Project performance. In addition, the MoPDC will be kept regularly informed of Project progress, and will participate in multiple aspects of Project implementation, as appropriate.
- 5. Component Technical Teams (CTTs). Each component will be supported by a dedicated Component Technical Team (CTT), which will be responsible for ensuring fulfillment of technical requirements, particularly preparation and evaluation of procurement documents, as well as monitoring consultant performance. The CTTs will report directly to the Director of the PMT, and are considered to be within the PMT structure. However, this is only for the purposes of Project implementation, and does not change any individual's reporting responsibility within their own ministry structure.
- 6. Considering that the CTTs are likely to be made up of staff from multiple ministries, they will operate as a "virtual office": they will carry out regular communications via telephone, fax and e-mail, and will meet regularly on a schedule and in locations to be specified in the PIM. Each CTT will be

supervised by a Component Coordinator (CC), to be appointed from within a relevant line ministry benefiting from the Project. It is expected that the existing "focal points" from relevant participating ministries will take on the role of CC, but the exact persons for Project implementation are still to be determined. The staffing mix of the CTTs will be determined based on evaluation of technical needs for each component, but it is likely that two to three persons will be needed, on an ad hoc basis, e.g. not full-time. As highlighted below, these persons should be existing civil servants from the relevant ministries.

7. It is also expected that the Ministries of Planning in Baghdad and Kurdistan, and line Ministries selected for direct assistance, will establish smaller, *ad hoc*, Project Implementation Teams to handle day-to-day Project-related tasks. The work of these teams will not be on a full-time basis, and the teams are not be expected to be large, i.e. these are likely to be one or two persons who, in addition to their regular jobs, will serve as a dedicated focal point for liaison and coordination with the PMT, FMA, and other Project implementation bodies. **All implementation teams are expected to be staffed by existing GoI civil servants, with limited external consultant input on an 'as needed' basis**.

Implementation of the World Bank Executed Sub-Project

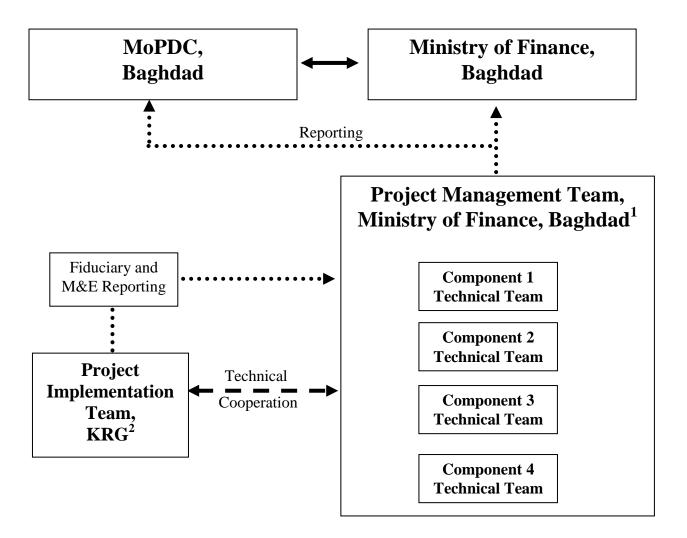
- 8. Capacity building and technical assistance to support the GOI's work on reform of the overall PFM system will be provided through a smaller, companion grant, executed by the World Bank. This companion grant will provide the financial resources for on-the-job training, formal courses and technical assistance for all three project components.
- 9. Responsibility for implementation of the capacity building and technical support rests with the World Bank. World Bank staff will coordinate closely with the PMT, MoF, MoPDC, appropriate line ministries, and other partners throughout Iraq, to ensure the capacity building and technical support activities are appropriate and timely and that the grant resources are used to the maximum benefit of the project. The following pro-forma implementation plan summarizes key actions under the project.

Key Activities	Responsible Agency	Implementation Schedule
Project process		
• Effectiveness	MoF	July 31, 2009
Project Completion	MoF / PMT	February 28, 2013
Closing Date	World Bank	June 30, 2013
Financial Management		
• Establishment of DA	MoF	
 Selection of external auditor 	MoF / PMT	
• Interim Financial Reports	PMT	
Annual financial Audit	PMT / External Auditor	
Recruitment of Consultants		
• PMT staff	MoF	
 Advisory Services 	PMT	
Supervision		
Project Supervision	Task Team	Ongoing
 Formal supervision missions 	World Bank	Semi-annually, starting
~	FMA	October 2009

I. MONITORING ARRANGEMENTS

Monitoring. Results monitoring will be undertaken by the PMT in conjunction with the beneficiary entities within MoF, the line ministries, and the FMA.

II. Project Organizational Chart



Note 1: PMT to be responsible for day-to-day management, and all fiduciary aspects, of Project operations. To be comprised of, *inter alia*, Director; Procurement Spec.; FM Spec.; Exec. Secy.; M&E Spec.; Training Coord. These positions ideally to be filled with existing GoI Civil Servants, but consultants may be recruited from time to time. The Director is under the authority, and reports to the Minister of Finance, with additional administrative reporting to the MoPDC.

• Component Technical Teams to be comprised of representatives from relevant line ministries and will be responsible for technical aspects of Project operations, particularly procurement - drafting of Tech. Specs., RFPs, EOIs, etc. and monitoring/QA/QC of consultant outputs. The technical teams report to the Director of the PMT.

Note 2: PIT in KRG will be responsible for liaising with the Component technical teams to ensure technical inputs meet needs in KRG, and will be responsible for reporting to PMT Director on Project activities in KRG.

Annex 7 Republic of Iraq Public Finance Management Project Project Preparation and Appraisal Team

Monali Chowdhurie-Aziz	Sr. Public Sector Specialist (TTL)	MNSED
Nazaneen Ali	Procurement Specialist	MNAPR
Mona El-Chami	Sr. Financial Management Specialist	MNAFM
David A. Bontempo	Operations Analyst	ECSSD
Yahia Said	Sr. Public Sector Specialist	MNSED
Abduljabbar Hasan Al Qathab	Sr. Procurement Specialist	MNAPR
David Biggs	Sr. Public Sector Specialist	MNSED
Ruxandra Burdescu	Young Professional	PRMPS
Pierre Messali	Sr. Financial Management Specialist (Consultant)	MNAFM
Mira Merhi	Consultant	MNSED
Salvatore Schiavo-Campo	Consultant	IEGSE

Annex 8 Republic of Iraq Public Finance Management Project

Documents in Project File

- 1. Public Expenditure and Institutional Assessment (PEIA) 2 volumes
- 2. Sub-National Public Financial Management: A Diagnostic Report, November 2007
- 3. Fiscal Sustainability Policy Note, 2007
- 4. Rebuilding Iraq: Economic Reform and Transition, February 2006
- 5. Joint Bank/Fund Staff Report on PFM in Iraq, 2005
- 6. Evaluation of the IMF Technical Assistance Sub-Account for Iraq, March 2008

Annex 9a Republic of Iraq Public Finance Management Project

Statement of Loans and Credits (as of December 31, 2008)

Difference between Expected and Actual Disbursements

Proj ID	FY	Project	IDA	TF	Undisb.	Cancel.	Orig.	Frm. Rev'd
P087734	2007	Emergency Electricity	124.0	0.0	126.7	0.0	57.0	0.0
P087734	2007	Emergency Electricity	0.0	6.0	5.55	0.0	2.0	0.0
P087735	2006	Emergency Road Rehabilitation	135.0	0.0	132.2	0.0	56.1	0.0
P087881	2005	Emergency Community Infrastructure	0.0	20.0	1.5	0.0	20.0	23.1
P087907	2005	Emergency School Construction & Rehab.	0.0	60.0	27.1	0.0	60.0	51.7
P087910	2005	Emerg. Water, Sanitation & Urban	0.0	110.0	77.1	0.0	90.0	90.3
P087912	2005	Emerg. Baghdad Water Supply	0.0	65.0	48.3	0.0	65.0	50.0
P091305	2005	Iraq Emergency Health Project	0.0	25.0	11.0	0.0	25.0	18.4
P091344	2005	Emergency Private Sector Development	0.0	65.0	27.9	0.0	55.0	55.0
P094650	2008	Emergency Water Supply	109.5	0.0	101.3	0.0	1.6	0.0
P096234	2006	Third Emergency Education Project	100.0	0.0	105.1	0.0	99.8	7.4
P096774	2006	Iraq Emergency Disabilities Project	0.0	19.5	15.2	0.0	19.5	16.0
P098979	2007	Household Survey and Policies for Poverty	0.0	5.5	0.1	0.0	5.1	4.8
P099059	2007	Dokan & Derbankdikhan Emerg. Hydropower	40.0	0.0	41.2	0.0	17.5	0.0
P099295	2007	Emergency Social Protection Project	0.0	8.0	6.8	0.0	7.4	4.5
P099809	2007	Emergency Environment Management	0.0	5.0	4.8	0.0	2.6	0.4
P100726	2007	ESCRP - Additional Financial (Marshland)	0.0	6.0	2.3	0.0	5.8	3.8
P107438	2007	PCF Primary Healthcare in Marshlands	0.0	0.6	0.5	0.0	0.0	0.0
P107698	2008	KRG Emergency Health Response	0.0	8.7	8.3	0.0	0.0	0.0
P109296	2008	Emerg. Comm. Infr. Rehab. Add Finan.	0.0	26.0	26.0	0.0	0.0	0.0
P110600	2008	Consultative Service Delivery Initiat.	0.0	1.0	0.3	0.0	0.0	0.0
		Total:	508.5	431.3	769.3	0.0	589.4	325.4

Annex 9b Republic of Iraq Public Finance Management Project

Projects Financed by the ITF and Bank

World Bank (ITF and IDA-Financed) Projects Overview of Contracts and Disbursements as of June 2009

Project	Grant Amount (US\$ m.)	Grant Signature Date	Project Age (yrs)	Tenders or RfPs ¹ Issued (US\$ m.)	Committed Amount ² (US\$ m.)	Disbursed (US\$ m. & %)
ITF projects						
First Capacity Building Project (Bank-executed)	2.5	Jan. 2004	0.6	2.5	2.5	2.5 (100%)
Textbook provision project	38.8	May. 2004	2.6	38.8	38.8	38.8 (100%)
School Construction & Rehabilitation	60.0	Oct. 2004	4.2	49.4	54.9	32.9 (55%)
Second Capacity Building (Bank-executed)	7.0	Nov. 2004	4.0	#N/A	5.6	5.6 (80%)
Health Rehabilitation	25.0	Dec. 2004	4.1	25.0	22.1	14.0 (56%)
Baghdad Water Supply & Sanitation	65.0	Dec. 2004	4.1	62.2	55.5	16.7 (26%)
Private Sector Development	65.0	Dec. 2004	4.1	54.2	57.2	37.1 (68%)
Water Supply, Sanitation & Urban Reconstruction	110.0	Dec. 2004	4.1	92.7	71.9	32.9 (30%)
Community Infrastructure	20.0	Dec. 2004	4.1	20.0	19.7	18.5 (93%)
Disabilities	19.5	Nov. 2005	3.1	16.3	9.6	4.3 (22.1%)
Household Survey TA (Bank-executed)	3.6	May. 2006	2.7	#N/A	2.2	2.2 (61.1%)
Social Protection	8.0	Jun. 2006	2.6	4.2	3.1	1.2 (1.5%)
Household Survey & Policies for Poverty Reduction	5.5	Jul. 2006	2.4	3.9	5.1	5.4 (98%)
Marshlands School Constuction	6.0	Oct. 2006	2.2	5.9	6.0	3.7 (62%)
Environment Management	5.0	Nov. 2006	2.3	1.9	1.6	0.2 (4%)
Electricity Reconstruction	6.0	Apr. 2007	1.8	3.1	3.1	0.5 (8%)
Community Infrastructure (Supplemental Grant)	26.0	Apr. 2008	0.7	23.2	3.6	0.0 (0%)

Regional Health Emergency Response	8.7	Jun. 2008	0.5	0.2	0.5	0.4 (5%)
Banking Sector Reform	10.0	Apr. 2009	0.2	0.0	0.0	0.0 (0%)
Total ITF-financed	481.6		2.8 (ave.)	403.5	363.0	216.9
Percent of Total				84%	75%	45%
IDA Projects						
Third Emergency Education	100.0	Nov. 2005	3.1	#N/A	#N/A	0.02 (0.0%)
Road Reconstruction	135.0	Jun. 2006	2.5	#N/A	#N/A	11.41 (9%)
Dokan & Derbandikhan Hydropower	40.0	Dec. 2006	2.1	#N/A	#N/A	0.9 (2%)
Emergency Electricty	124.0	Mar. 2007	1.8	#N/A	#N/A	0.0 (0.0%)
Emergency Water Supply	109.5	Jun. 2008	0.0	#N/A	#N/A	0.0 (0.0%)
Total IDA-financed	508.5		1.9 (ave)			12.3
Percent of Total				0%	0%	2%

¹ RfPs = Requests for proposals (for consultancy services)

ANALYTICAL AND ADVISORY ACTIVITIES 1. Policy Papers

Title	Delivery to Client
Energy	
Oil and Gas Sector Reform - Background Paper	Jun. 2004
The Fiscal System for a National Oil Company in Iraq	Mar. 2007
Federal Aspects of Petroleum Regulation and Management in Iraq	Mar. 2007
Private Sector Participation in Iraq Electricity Generation	May 2007
Oil and Gas Sector Policy Note	Feb. 2008
Finance	
Financial Sector Notes	Apr. 2005
Housing Construction and Finance	Feb. 2007
Women in the Economy: Microfinance for Women in Iraq	Oct. 2007
Private Sector Development	
Building a Sustainable Investment Climate in Iraq	May 2005
Project Management	
Financial Management	Apr. 2005
Operational Procurement Review	Jun. 2005
Master Implementation Manual	Oct. 2005
Public Administration	
The Role of Civil Service Commissions in the Management of the Public Sector – Lessons for Iraq	Mar. 2005
Iraq's Evolving Inter-Governmental Structures: Implication for Local Service Delivery	May 2005

²Committed Amount is the sum of the value of the grant in signed contracts and disbursed against operating costs 3 Tenders Issued and Commitments are for only for active projects (excluding First Cap Building & Textbooks)

State-Owned Enterprise Reform	May 2005
Iraq Country Economic Memorandum (also in Arabic)	May 2005
Food Security and Safety Nets in Iraq (Reform of the Public Distribution System)	Jun. 2005
Leveraging WTO accession to Design a Strategy of Economic Reforms for New Iraq	Jun. 2005
Briefing Book for the Government of Iraq (in 2 volumes)	May/Jul. 2006
Improving the Management of the Public Distribution System (Food Rationing)	Sep. 2007
Public Financial Management	
Public Financial Management (jointly with IMF)	May 2005
Payroll Issues Report (separate from PFM Report)	May 2005
Iraq Payroll Policy Note (Public Sector Management)	Apr. 2006
Fiscal Sustainability Note	Mar. 2007
Sub-National Public Financial Management	Nov. 2007
Public Expenditure and Institutional Assessment	Jun. 2008
Social Sector	
Social Protection Policy (executive summary available in Arabic)	May 2005
Pension System Reform	Jun. 2006
Country Social Analysis	Jun. 2008
Water	
Iraq Water Resources Assistance Strategy	Jun. 2006

2. Technical Assistance and Training Programs

Title	Date Held
Education	
Governance, Financing and Reform in Higher Education in a Post Conflict	Jun. 2004
Environment	
National Education Strategy Workshop (jointly with UNESCO and UNICEF)	Feb. 2008
Energy	
Oil and Gas Sector (jointly with IMF)	Jan. 2005
Oil and Gas in Federal Structures (jointly with UNAMI)	Apr. 2006
Oil Training Course (jointly with USTDA)	Apr. 2006
Workshop on Private Participation in the Electricity Sector	May 6 & 7, 2007
Finance	
Payment System (jointly with IMF)	Jul. 2004
Banking Supervision and Regulation (jointly with IMF)	Jul. 2004
Micro-Finance Conference and Policy Dialogue	Dec. 2005
DL Sessions in Micro-Finance for Women	Apr. 2006
Housing Finance	May 2006
Health	
National Health Accounts Capacity Building Workshop	May 2004
Seminar on Needs-Based Master Planning / Facility-Based Health Systems Planning	May 2004
WBI Flagship Course on Health Systems Development and Sustainable Financing	Jun. 2004
Health Financing Workshop	Nov. 2004
Study Tour to Bosnia – War Victims Rehabilitation Project *	Sep. 2006
Private Sector Development	
Investment Climate – Trade Facilitation, Legal Systems	Apr./May 2004
State-Owned Enterprise Privatization Strategy	Dec. 2004
Investment Promotion (Dublin) *	Jun. 2005
Training Workshop for the Iraqi Business Community on Procurement *	Nov. 2006
Project Management	
Environment and Social Safeguard Policies *	Mar./Apr. 2004/
	Mar. 2007

Title	Date Held
Project Management: Procurement and Financial Management (ongoing) *	2004-2008
Procurement and Financial Management *	Apr. 2005
Workshop on Master Implementation Manual, comprising project management,	•
procurement and financial management *	Jan. 2006
Training Workshop on Public Procurement *	Jul. 2006
Financial Management and Disbursement Workshop for Project Financial Officers *	Jun./Sep./Oct. 2007
National Procurement Technical Assistance (ongoing) *	Dec. 2007
Training in Public Procurement Reform *	Jan. 2008
Public Administration	
State-Owned Enterprises	Apr./May 2004
Macroeconomics in Transition Countries (Granada, Spain)	Jul./Aug. 2004
Infrastructure Regulations *	Jul./Aug. 2004
Formulation of the National Development Strategy	Sep. 2004
Statistical Capacity Needs Assessment Workshop *	Dec. 2004
Iraqi Labor Markets (ILO-led, Bank Staff participation)	Dec. 2004
Regional Capacity Building Program in Gender and Economic Policy, Statistics	May 2005
Sector Reform, Restructuring, Public Private Partnerships, and Economic Regulation	May 2005
International Trade Statistics	Jul. 2005
Modern Methods in Survey Fieldwork *	Jan. 2006
Budget and Planning Capacity for the Judiciary *	Mar. 2006
Iraq's Federalism (jointly with UNAMI)	Apr. 2006
Anti-Corruption *	Jul. 2006
Emergency Preparedness Training *	Aug. 2006
Policy Dialogue on Constitutionalism *	Nov. 2006
Improving the Management of the Public Distribution System – Food Rationing *	Mar./Jun./Sep. 2007
Utility Reform	May 2007
Macroeconomic Modeling and Forecasting *	Mar. 2007
Capacity Building of the Iraq Higher Judicial Council *	Sep. 2007
How to Develop a PRSP *	Apr. 2008
Study Tour for the Iraqi Constitutional Review Committee *	Jun. 2007
Rule of Law Workshop *	Jul. 2008
Needs Assessment Workshop for the Committee for the Enhancement of Statistics *	Dec. 2004
Multi-Topic Household Survey Core Course *	Jan./Apr. 2005
Sampling Core Course *	Feb. 2005
Household Surveys *	Mar./Sep. 2005
Iraq Household Socio-Economic Survey (IHSES) Workshops *	Apr./Jun./Jul. 2006/
	Jan./May 2007
General Data Dissemination System Workshop (jointly with IMF) *	May 2005
Advanced Topics in Household Survey Design *	Jun. 2005
Data Management *	Jun. 2005
Data Analysis Training 2 and 3 *	May/Sep. 2007
Customizing Survey Instruments to Local Conditions – Pre-Testing Questionnaire Instruments *	Sep. 2005
Designing Smart Data Entry Programs *	Oct. 2005
Household Survey Local Supervisor Training 1 and 2 *	Jun./Jul. 2007
Inter-Ministerial Poverty Committee Workshop *	Sep. 2007
Living Standards Measurement Survey Course *	Jan. 2008
Diving Januarus measurement survey course	[Jan. 2000

Title	Date Held
Public Financial Management	
Fiscal Federalism (jointly with IMF) *	Dec. 2004
Public Financial Management (jointly with IMF) *	Feb. 2005
Payroll Reform	Jun. 2005
Fiscal Federalism in Iraq (jointly with UNAMI) *	May 2006
Local Budgeting and Financial Management *	Aug. 2007
Sub-National Public Financial Management Workshops *	Feb./May 2007
Independent External Auditors Workshop	Jun. 2007
Audit and Accountability Workshop with Board of Supreme Audit *	Aug. 2007
Workshop on Fiscal Federalism and Local Service Delivery *	May 2007
Workshop on Government Accounting *	Nov. 2008
Social Sector	
Pensions – Improving Administration *	May 2005
Social Protection Core Course *	Nov. 2004
Pensions Workshop *	Dec. 2004
Labor Markets and Social Safety Nets *	Jan. 2005
Social Protection Strategy *	Oct. 2005
Pension Reform (jointly with IMF) *	Aug. 2006
Conference on Economic Growth and Protecting the Vulnerable *	Jun. 2007
Pension Policy Technical Assistance Workshop *	Apr. 2008
Urban	
Roads Network Planning and Management (Birmingham)	Apr./May 2004
Urban Management, Resettlement and Reconciliation in post-war Lebanon	May/Jun. 2004
Comprehensive City Development Planning *	Jun./Jul. 2006
Telecommunications	
Telecommunications Sector Reform *	Mar. 2004
Telecommunications Policy *	Jun. 2007
Telecom Technical Assistance *	Mar. 2008
Water	
Water and Sanitation Study Tour *	Jun. 2005
Iraq Water Resources Assistance Strategy Workshop *	May 2006

^{*} ITF-funded activities.

Annex 9c Republic of Iraq Public Finance Management Project

Iraq Public Finance Management Action Plan

No.	Issue	2009	2010	2011	2012	Type of assistance		
	Capital Budgeting							
	Budget Preparation							
1	Review of budget strategy and exposure to international practice	√				International experts will review Iraqi practice and provide advice. Iraqi officials will be exposed to international norms by means of workshops and/or a study tour.		
2	Exposure to international practice on development of MTFF	√				Iraqi officials will be exposed to international norms by means of workshops and/or a study tour. International experts will advise Iraqi budget officials on a methodology and process tailored to Iraqi circumstances. Relevant training courses will be introduced as part of a comprehensive capacity development strategy covering all aspects of budget reform.		
3	Budget ceilings for line ministries	V				Advice will be provided on the process, content and communication strategy for the introduction of budget ceilings for current and capital expenditure. Training of budget officials will take place in central ministries, line ministries, governorates and districts.		
4	Review of Budget Call Circular in the light of international best practice and suggest improvements	√				International experts will advise the GoI on improving the content of the BCC to bring it more in line with modern international practice.		
5	Introduce Budget Manual (including guidance and instructions)		√			International experts will review all existing budget regulations and procedures and facilitate the development of a comprehensive Budget Users Manual, allowing for the incorporation of revised procedures over time.		

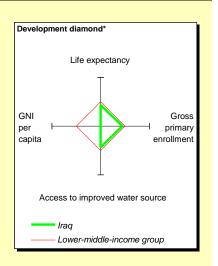
No.	Issue	2009	2010	2011	2012	Type of assistance
6	Pilot medium term financial planning in MOE and Ministry of Municipalities and Public Works		✓			International advisers will work in the Ministries of Finance, Planning, Education and Municipalities to guide the process of introducing medium term financial planning on a pilot basis. Workshops will be used to develop awareness, knowledge and key skills
7	Move to implement functional classification		✓			Advice will be provided by international experts on the development of a functional budget classification in parallel to functionality developments in the IFMIS
	Budget Execution, Cash Management and Reporting					
8	Effective monetary plan defining actual department needs according to schedules prepared by the ministries and departments.	✓				Accounting Department will inform the concerned bodies in order to prepare and follow up with the schedules to provide the .cash needed
9	Make use of provincial treasuries as they represent MOF, and include multiple treasuries within the same province, if necessary, according to the number of affiliated departments as applied in many countries and in Kurdistan region (e.g. Erbil, Dohuk: 5 treasuries). The aim is to facilitate works, ease burden over MOF, and control .cash in hand by minimizing number of units financed by MOF		✓			This requires habilitating treasury buildings by providing them with furniture and work requirements such as computers; and developing the employees in this respect in .order to have efficient staff
10	.Introduce commitment control system			✓		
11	.Consider amending Financial Administration Law	√				A committee has been formed at Prime .Ministry to follow up with this issue
12	Issue unified accounting instructions to apply the accounting system and provide accounting treatments and records of accounting .documentation	V				.A committee formed for this purpose
13	Address and follow up with the issue of advances and outstandings appearing on Accounting Department records and concerned .departments		√			This requires forming a committee tasked with preparing the schedules of outstandings and working on processing them either by settlement or writing-off
14	Use internet system to post all data and laws issued by MOF, as well as all MOF activities	✓				.MOF website has been created
15	Capacity building: design specialized courses to improve activities of Budget Department, Accounting Department, as well as other .supporting departments	√				Prepare advanced and intensive training programs in the fields of budget and accounting; and improve managers and .employees
16	Create an internal network at MOF, linking Budget, accounting, communication, and public debt functions in order to facilitate and		√			The network aims to develop MOF activities and support it in terms of providing its

No.	Issue	2009	2010	2011	2012	Type of assistance
	.exchange information					.requirements such as computers from WB
17	.Improve and expand application of IFMIS	✓				Hold for time being. The work will resume
						according the implementing contractor, and a
						.committee has been formed in this respect
	Public P	rocure	ment			
18	Essential ratification of the Public Procurement Law to follow the	✓				
	standard protocol for presenting new legislation initially to the					
	Council of Ministers and Shorra Council at the Ministry of Justice,					
	and subject to the Council's vetting of the new law, to the Council of					
	Representatives for alignment with other national laws					
19	a decision on enactment of the implementing regulations would fill	✓				This requires a conference to finalize the
	in the details for the procedures authorized by the enacted Law of					implementing regulation in both Arabic and
	Public Contracts; The regulations would be subject only to the					English version to include the inter
	approval of the Council of Ministers					ministerial committee members and the
						Bank's Procurement Team
20	a decision on enactment the standard bidding documents to be issued	\checkmark				The Bank would need the Bank sending the
	to all procuring entities					final version of SBD's to the government of
						Iraq and then the government of Iraq takes
						the necessary action to enact these SBD

Annex 10: Iraq at a glance

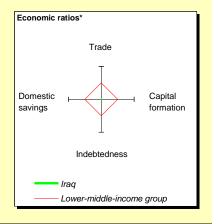
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9	/ 1	7	ľŪ

POVERTY and SOCIAL	Iraq	M. East & North Africa	Lower- middle- income
2007	00.0	040	0.407
Population, mid-year (millions)	29.0	313	3,437
GNI per capita (Atlas method, US\$)		2,794	1,887
GNI (Atlas method, US\$ billions)		876	6,485
Average annual growth, 2001-07			
Population (%)	2.0	1.8	1.1
Labor force (%)		3.6	1.5
Most recent estimate (latest year available, 2001-07)			
Poverty (% of population below national poverty line)			
Urban population (% of total population)	67	57	42
Life expectancy at birth (years)	59	70	69
Infant mortality (per 1,000 live births)	37	34	41
Child malnutrition (% of children under 5)	7		25
Access to an improved water source (% of population)	77	89	88
Literacy (% of population age 15+)		73	89
Gross primary enrollment (% of school-age population)	99	105	111
Male	109	108	112
Female	90	103	109



KEY ECONOMIC RATIOS and LONG-TERM TRENDS

		1987	1997	2006	2007
GDP (US\$ billions)		43.7	10.1		
Gross capital formation/GDP					
Exports of goods and services/GDP					
Gross domestic savings/GDP					
Gross national savings/GDP				••	
Current account balance/GDP					
Interest payments/GDP					
Total debt/GDP					
Total debt service/exports Present value of debt/GDP				••	
Present value of debt/exports					
Trobert value of destroxports					••
	1987-97	1997-07	2006	2007	2007-11
(average annual growth)					
GDP		-2.3			
GDP per capita		-4.7			
Exports of goods and services					

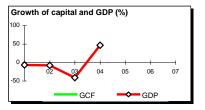


STRUCTURE of the ECONOMY

(average annual growth)

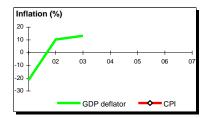
Agriculture

	1987	1997	2006	2007
(% of GDP)				
Agriculture		8.8		
Industry		74.7		
Manufacturing		0.7		
Services		16.5		
Household final consumption expenditure General gov't final consumption expenditure				
Imports of goods and services				
imports of goods and scribes	••	••	••	••

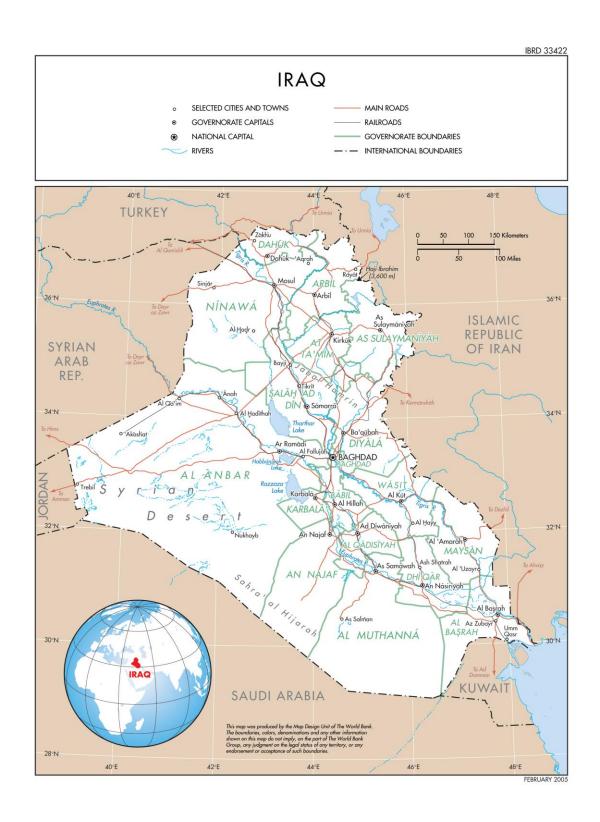


1987-97	1997-07	2006	2007
	0.2		

PRICES and GOVERNMENT FINANCE	1987	1997	2006	2007
Domestic prices (% change)	1307	1337	2000	2001
Consumer prices				
Implicit GDP deflator				
Government finance				
(% of GDP, includes current grants)				
Current revenue				
Current budget balance				
Overall surplus/deficit			••	
TRADE				
	1987	1997	2006	2007
(US\$ millions)				
Total exports (fob)			••	
n.a. n.a.				
Manufactures				
Total imports (cif)				
Food				
Fuel and energy				
Capital goods				
Export price index (2000=100)				
Import price index (2000=100)				
Terms of trade (2000=100)		••	••	
BALANCE of PAYMENTS				
	1987	1997	2006	2007
(US\$ millions)				
Exports of goods and services				
Imports of goods and services				
Resource balance			••	
Net income				
Net current transfers				
Current account balance				
Financing items (net)				
Changes in net reserves	-7			
Memo:				
Reserves including gold (US\$ millions)				
Conversion rate (DEC, local/US\$)	0.3	1,471.0		
EXTERNAL PERT I RECOURSE ELOWS				
EXTERNAL DEBT and RESOURCE FLOWS	1987	1997	2006	2007
(US\$ millions)	1301	1331	2000	2007
Total debt outstanding and disbursed				
IBRD				
IDA			••	
Total debt service				
IBRD				
IDA				
Composition of net resource flows				
Official grants				
Official creditors				
Private creditors				
Foreign direct investment (net inflows) Portfolio equity (net inflows)				••
i ortiono equity (net innows)		•		



Annex 11: Map



Iraq Public Expenditure and Institutional Assessment

Volume 2

Public Expenditure and Financial Accountability (PEFA) Assessment Public Financial Management Report

June 2008

Middle East and North Africa Region Social and Economic Development Group



Document of the World Bank

Vice-President:	Daniela Gressani
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ABBREVIATIONS AND ACRONYMS

AGA Autonomous Government Agency

BSA Board of Supreme Audit

CCCI Central Criminal Court of Iraq

COI Commission of Integrity
CPA Coalition Provisional Authority

CSR Civil Service Reform

DFID Department for International

Development

FML Financial Management Law

GoI Government of Iraq
IG Inspector General

IDA International Development

Association

IFMIS Iraq Financial Management

Information System

MDA Ministries, Departments and Agencies

MENA Middle East and North Africa

MoEMinistry of EducationMfFMinister for FinanceMoFMinistry of Finance

MoHC Ministry of Housing and Construction

MoOMinistry of OilMoPMinistry of PlanningOFFPOil For Food Program

PEFA Public Expenditure and Financial

Accountability

PEIA Public Expenditure and Institutional

Assessment

PFM Public Financial Management

USAID United States Agency for International

Development

UST United States Treasury

PUBLIC EXPENDITURE AND FINANCIAL ACCOUNTABILITY (PEFA) ASSESSMENT PUBLIC FINANCIAL MANAGEMENT REPORT

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Overview of the Indicator Set

A. PFM-OUT-TURNS: Credibility of the budget		Score
PI1	Aggregate expenditure out-turn compared to original approved budget	D
PI2	Composition of expenditure out-turn compared to original approved budget	C
PI3	Aggregate revenue out-turn compared to original approved budget	A
PI4	Stock and monitoring of expenditure payment arrears	D
B. KE	Y CROSS-CUTTING ISSUES: Comprehensiveness and Transparency	
PI5	Classification of the budget	C
PI6	Comprehensiveness of information included in budget documentation	D
PI7	Extent of unreported government operations	D+
PI8	Transparency of inter-governmental fiscal relations	D
PI9	Oversight of aggregate fiscal risk from other public sector entities.	D
PI10	Public access to key fiscal information	D
C. BU	DGET CYCLE	
C(i) P	olicy-Based Budgeting	
PI11	Orderliness and participation in the annual budget process	С
PI12	Multi-year perspective in fiscal planning, expenditure policy and budgeting	D+
C(ii) I	Predictability and Control in Budget Execution	
PI13	Transparency of taxpayer obligations and liabilities	В
PI14	Effectiveness of measures for taxpayer registration and tax assessment	С
PI15	Effectiveness in collection of tax payments	D+
PI16	Predictability in the availability of funds for commitment of expenditures	C+
PI17	Recording and management of cash balances, debt and guarantees	С
PI18	Effectiveness of payroll controls	D+
PI19	Competition, value for money and controls in procurement	D+
PI20	Effectiveness of internal controls for non-salary expenditure	D+
PI21	Effectiveness of internal audit	D+
C(iii)	Accounting, Recording and Reporting	
PI22	Timeliness and regularity of accounts reconciliation	C+
PI23	Availability of information on resources received by service delivery units	D
PI24	Quality and timeliness of in-year budget reports	D+
PI25	Quality and timeliness of annual financial statements	D+
C(iv)	External Scrutiny and Audit	
PI26	Scope, nature and follow-up of external audit	Not Rated
PI27	Legislative scrutiny of the annual budget law	D
PI28	Legislative scrutiny of external audit reports	D
D. DO	NOR PRACTICES	
D-1	Predictability of Direct Budget Support	D
D-2	Financial information provided by donors for budgeting and reporting on project and program aid	D+
	Proportion of aid that is managed by use of national procedures	D

Summary Assessment

- (i) Integrated assessment of PFM performance
- 1. Using a four-point rating scale, the assessment produces the following results summarized in Table 1.

Table 1: Abbreviated Summary of PEFA Indicator Scores

PEFA Score	Number of Indicators
A	1
В	1
С	8
D	20 (note 1)
Not Rated	1 (note 2)
Total	31 (note 3)

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

Note 2 – due to inadequate information

Note 3 – comprises 28 system indicators and 3 donor indicators

- 2. The large number of performance indicators awarded the lowest possible score (D) indicates that there is scope for substantial improvement in many priority aspects of the Iraqi national PFM system. The analysis suggests that reform is required in the following areas:
 - **Budget Credibility** (**PI-1 to PI-4**) aggregate expenditure out-turns have repeatedly shown significant variances from budget and better monitoring of expenditure payment arrears is required
 - Comprehensiveness and Transparency (PI-5 to PI-10) there is a significant level of unreported government operations and weak oversight of fiscal risk arising from the activities of other public sector entities
 - *Policy-Based Budgeting (PI-11 and -12)* a multi-year perspective in financial planning and budgeting is largely absent
 - Predictability and Control in budget execution tax collection procedures need
 to be strengthened, payroll controls are weak, procurement procedures lack
 competition and inadequate controls and weaknesses exist in internal audit
 - Accounting, Recording and Reporting (PI-22 to PI-25) resources received by service delivery units are often problematic and there are deficiencies in the quality and timeliness of annual financial statements
 - External Scrutiny and Audit (PI-26 to PI_28) weaknesses exist in terms of timely submission of audit reports to the Council of Representatives and followup on audit recommendations.
 - **Donor Assistance** (D1-D3) donors do not perform well against the PEFA indicators in that the financial information they provide is untimely, incomplete and not delivered in line with the GoI's budget cycle or in a breakdown consistent with the Government's classification system. In addition, national procedures are bypassed for almost all development assistance projects and programs.
- (ii) Assessment of the impact of PFM weaknesses
- 3. PFM systems have three objectives: macro-fiscal discipline, strategic allocation of resources, and operational or technical efficiency. These three

objectives are linked. Fiscal discipline is the basis without which neither a strategic allocation of resources nor operational efficiency is possible.

4. The findings of the strengths and weaknesses of the current PFM system in **Iraq** have the following implications in terms of these three objectives.

Macro-fiscal discipline

5. In recent years, high world oil prices have enabled the Government of Iraq (GoI) to generate much higher revenues than budgeted. Consequently, the GoI has experienced no difficulty in financing a growing level of public expenditure but has in fact been able to accumulate significant reserves of foreign currency through its budget surpluses. As long as oil prices remain buoyant, maintaining macro-fiscal discipline will pose few problems, but measures need to be taken to contain recurrent expenditure and achieve a higher level of capital investment budget execution.

Strategic allocation of resources

6. Strategic resource allocations in Iraq suffer from the lack of a medium term perspective to budgeting and financial planning. Although a strategic medium term fiscal perspective exists in conjunction with the International Compact for Iraq (ICI), it is difficult to see the connection between this and annual resource allocations. Budgeting continues to be primarily an annual exercise. The problem is compounded by the lack of effective integration between the recurrent and investment budgets both at the aggregate level and at the sectoral level.

Operational efficiency

- 7. A major issue in Iraq over the last three years has been the low capital investment budget execution rate which has prevented the effective development of essential public services. The difficult security situation has clearly been an important factor but there are also systemic PFM issues associated with budget formulation and implementation, Whilst at times there have problems with the release of allocations that have limited the accessibility of budget funds to ministries and governorates, there is also a major issue in terms of the inefficient use of funds that have been released but remain idle in the bank accounts of spending units.
- (iii) Prospects for reform planning and implementation
- 8. The strategic context for a PFM reform process has been set by the International Compact for Iraq (ICI). This provides a firm foundation for a Government-led reform process that can be supported in a sustained and integrated manner by Iraq's international development partners. As a basis for monitoring progress, detailed actions are set out in the Joint Monitoring Matrix (JMM) that supports the ICI. One major component of the JMM concerns the effective management of public resources in the interests of the people of Iraq.
- 9. Within this component, the GoI commits itself to the objective of aligning Iraqi PFM and procurement system with sound international practice. In order to establish the analytical framework within which PFM reform can take place, the GoI has been working as a priority action with the World Bank to complete the Public Expenditure and Institutional assessment (PEIA) to evaluate the performance of the national PFM system as a basis for prioritization of PFM reform programming.

- 10. A range of international organisations has been providing support to PFM reform and capacity development over the last three or four years. These include the International Financial Institutions, the United Nations, the United States, the United Kingdom and the European Commission. Much of the multilateral aid has been channeled through the International Reconstruction Fund Facility for Iraq (IRFFI). The US Government has worked on a number of PFM issues through the US Treasury, US Agency for International Development (USAID), State Department and Department of Defense, while the UK Government through its Department for International Development (DFID) has been actively involved in supporting economic and financial management. The UNDP has managed a program of support to the Board of Supreme Audit as well as providing support to anti-corruption initiatives. The World Bank has provided a number of workshops on specific aspects of PFM. The IMF has been providing technical assistance in support of its Stand By Facility. The need now is to co-ordinate these initiatives under a coherent program of support to a GoI led PFM reform strategy and action plan.
- 11. In designing such a program, careful attention need to be paid to the unusually difficult circumstances that face a fragile state like Iraq which has been so severely affected by conflict since 2003. Many crucially important public institutions have been devastated by the destructive effects of war and insurgency on their capacity. Large numbers of key staff have been lost to the Iraqi public service. A sustained effort over the medium term backed by Iraq's international development partners will be necessary to rebuild the capacity required for a well performing PFM system. This will require appropriate incentives to help create an enabling environment for PFM modernization.

Introduction

Objective of the PFM-PR

12. The purpose of the PEFA assessment is to document the results of a joint effort between the Government of Iraq and the World Bank, supported by the Governments of the United Kingdom and the United States to develop an objective assessment of the Iraq's Public Financial Management (PFM) systems.

Process of preparing the PFM-PR

13. The Iraqi national PFM system has been assessed jointly by the Government of Iraq (GoI) and the World Bank, with support from the UK and USA, using the framework developed under the Public Expenditure and Accountability (PEFA) Program. A number of activities have contributed to the data collection and analysis that underpin the assessment. Most notably, ten workshops were held between July and November 2007 in Baghdad. The workshops covered the key dimensions of a PFM system: i) Budget Credibility, ii) Accounting, Recording and Reporting, iii) Financial Management Information Systems, iv) Comprehensiveness and Transparency, v) Procurement, vi) Policy based Budgeting and Predictability in Budget Execution, vii) Accounting Frameworks, viii) Control in Budget Execution, ix) External Scrutiny and Audit and Donor Practices, and x) Capital Investment Budgeting.". Other workshops forming part of the PEFA process have taken place in Amman, Jordan.. These have

included two workshops with the top management of the national and Kurdish Boards of Supreme Audit.

- 14. The main GoI partner in the assessment is the Ministry of Finance (MoF). In addition, several other government agencies have also played an active part in the work. These include the Board of Supreme Audit (BSA), the Ministry of Planning (MOP), the Ministry of Education (MoE) and several of the Inspectors General (IGs).
- 15. This assessment is an integral part of the World Bank's Public Expenditure and Institutional assessment (PEIA), a major piece of analytical work that is designed to pave the way for a comprehensive PFM reform program supported by the Bank and other donors.

Methodology

- 16. The PEFA methodology is set out in the Public Finance Management Performance Measurement Framework (available in various languages at www.pefa.org). It is based on 28 indicators covering a country's PFM system, and 3 indicators addressing the interaction of donors with a country's budget process and PFM system. PEFA assessments provide a snapshot picture of the effectiveness of PFM systems at a particular point in time and therefore provide a good basis for measurement of their improvements over time. They do not provide, however, for an indepth analysis of the causes of existing weaknesses. This is provided in the accompanying volume of the PEIA.
- 17. Each indicator is scored on a scale from A to D. The basis for these ratings is the minimum requirements set out in the methodology. Many indicators include two or more dimensions, which are scored using methods M1 or M2. For method M1 the weakest link is decisive, i.e. the overall rating is based on the dimension with the lowest score. For M2 an average of the sub-ratings is used to arrive at the score for the overall indicator (see the PEFA Framework, "Scoring Methodology").

Scope of the assessment

18. The PEFA assessment focuses primarily on the national level of a country's PFM system. At the national level, it seeks to cover the entire PFM system, including cross-cutting and overall issues, the revenue side, the budget cycle from planning through execution to control and auditing; and the interaction of development partners with the PFM system. Some of the indicators are designed to probe into how the national level interacts with sub-national governments and with public service providers at the local level as well as the financial relationships with public enterprises.

Country Background Information

Description of country economic situation

19. **Iraq is one of the world's largest producers of oil, exports of which dominate the country's economy and** public **finances.** It has suffered politically and economically since the early 1990's first as a result of the isolation of the regime from the international community, then through the turmoil and insecurity that has engulfed the country since the arrival of international armed forces in April 2003. There are signs that the country may be starting to emerge from the worst of these troubles, but a great deal needs to be done to revitalize economic, political and social institutions.

Economic situation

- 20. The Executive Board of the International Monetary Fund (IMF) recently approved a successor Stand-By Arrangement (SBA) for Iraq for an amount equivalent to SDR 475.36 million (about US\$744 million). The previous SBA had been approved by the IMF's Executive Board on December 23, 2005 The successor arrangement is designed to support Iraq's economic program over the next 15 months through March 2009. As before, the funds can only be drawn down in the event of an emergency.
- 21. **Despite difficult political and security conditions, the GoI was successful in keeping its economic program on track in 2006-07.** Inflation fell sharply, reflecting the GoI's tough monetary and fiscal policy stance and the appreciation of the dinar. Direct budgetary fuel subsidies were eliminated, except on kerosene, and private fuel imports liberalized. The recently enacted amendments to the pension law have made the pension system fiscally sustainable. Efforts have been made to operationalize a new chart of accounts and budget classification system and the payments system has been modernized.
- 22. Despite showing signs of improvement in in recent months, the security situation remains a major obstacle for investment and reconstruction, hampering oil production and economic growth. In addition, much remains to be done to modernize financial management of the government and the central bank, and to reform the banking system.
- 23. In 2008, the GoI aims to allocate resources towards investment, including in the oil sector, and to improve the provision of public services, while containing current government spending, notably on the wage and pension bill. The program—which envisages an increase in economic growth, a further reduction in inflation, and an increase in net international reserves—will also encompass priority structural reforms, including actions to strengthen administrative capacity and governance.
- 24. The Central Bank of Iraq (CBI) will continue to strengthen its accounting and reporting framework. The central bank also aims to expand the coverage of the payments system, strengthen the supervisory framework for commercial banks, and adopt reserves management guidelines. The GoI has made a significant effort to settle arrears and conclude debt agreements with private and official creditors are commendable. However, further progress is needed to resolve the remaining non-Paris Club claims.
- 25. The 2008 program envisages an increase of oil output to 2.2 mbpd, and overall GDP growth to reach 7 percent. Annual consumer price inflation is targeted to decline to 12 percent.
- 26. The 2008 government budget makes room for sizable investment while maintaining fiscal sustainability and the continuedavoidance of direct fuel subsidies. Improving project implementation, facilitated by greater local participation and reduced bureaucracy, will be a central aim of the GoI, but progress is likely to

continue to be uneven and patchy. On the recurrent expenditure side, spending on the Iraqi security forces and public sector remuneration are expexted to continue to grow rapidly, causing total expenditure to rise by an annual average over the period 2008-09. This growth in spending will be mitigated, however, by the removal of most fuel subsidies that was implemented in June 2007. Overall, large fiscal surpluses will continue, increasing from an estimated US\$ 14 billion in 2007 to perhaps \$20 billion in 2008.

Description of budgetary outcomes

Fiscal performance

Central Government Budget (as % GDP)				
	2004	2005	2006	
Total Revenue	79.6	107.4	80.4	
- Own Revenue	70.5	79.5	67.9	
- Grants	9.1	27.9	12.5	
Total expenditure	120.7	96.5	69.4	
- Non-interest	119.8	96.3	68.8	
- Interest	1.0	0.2	0.6	
Aggregate deficit (incl. grants)	-41.2	10.9	11	
Primary Deficit	-40.2	11.1	11.6	
Net financing - external	41.2	5.9	-5.4	
-internal	-1.4	-10.4	-3.9	

Allocation of Resources

Actual budgetary allocations by economic classification (% total expenditure)				
()	2004	2005	2006	
Current Expenditure	81.6	79.9	75.5	
- Wages and salaries	7.7	14.7	16.7	
- Pensions	2.3	6.2	5.2	
- Goods and services	36.7	41.0	33.4	
- Interest Payments	0.8	0.2	0.9	
- Transfers	31.1	14.0	14.9	
-Other	3.0	3.9	4.4	
Capital Expenditure	18.4	20.1	24.5	

Source: IMF SBA Brief

Description of the legal and institutional framework for PFM

- 27. Having been devastated by conflict during the past 5 years, Iraq's institutional arrangements for PFM have become the subject of considerable uncertainty and volatility. New organizations have been created and significant changes have been made to the legal and regulatory framework without the full understanding and acceptance of those public officials responsible for managing the country's public finances.
- 28. The key recent law is the Financial Management Law and Public Debt Law (Order Number 95 of the Coalition Provisional Authority) of 2004. The law emphasizes the principles of transparency, comprehensiveness and unity (the latter requiring that all government resources be directed to a common pool to be allocated

and used for public expenditure according to the priorities of the government). Although this is a generally sound piece of legislation, there are in practice difficulties with its application due to the lack of awareness, understanding and, in some quarters, acceptance of the changes it introduced vis-à-vis previous practice.

29. Primary responsibility for PFM rests with the Ministry of Finance, although important roles are also played by the Ministry of Planning (in relation to the capital investment budget), the Board of Supreme Audit (in relation to the external audit of the public sector and accounting standards) and the Inspectors General (internal audit in government departments). The Council of Representatives (the Iraqi Parliament) is also seeking to strengthen its contribution to effective PFM through enhanced budget scrutiny facilitated by a proposed budget office. Iraq's constitutional commitment to a federal state has led in the last two annual budgets to far greater decentralization of public spending to sub-national government in the form of the governorates and the Kurdistan Regional Government (KRG). Outstanding issues in the KRG concern the completion of merging two administrations, including the Ministry of Finance and Board of Supreme Audit.

Assessment of the PFM Systems, Processes and Institutions

Budget credibility

30. The credibility of the budget is important to various users of government financial information, including the general public, civil society, domestic and foreign investors, parliament and government officials who are responsible for implementing the budget. A budget is deemed to be credible if the differences between the actual revenues and expenditures for the budget period and the originally approved estimates are relatively small. These differences measure the budget variance, which is a good measure of the overall performance of the PFM system at a high level. This comparison is the basis of PI1 of the PEFA Framework.

PI 1: Aggregate expenditure out-turn compared to original approved budget

PI 1	Scoring method M1:	D
	In (two or) all of the last three years the actual expenditure exceeded the initially budgeted amount by more than 15% of budgeted expenditure.	

Aggregate expenditure outturn compared to the original approved budget for 2004-2006 is shown in Table 1 below.

Table 1: Aggregate expenditure out-turn compared to original approved budget (in billion Iraqi dinars)

	Budg	Budget Out-turns FY Change		ange	
	2004	2005	2006	2004-05	2005-06
Budget					
Revenue	19,259	28,959	45,392	50%	57%
Expenditure	20,286	35,996	50,963	77%	42%
Budget Surplus (+)/Deficit (-)	-1,028	-7,037	-5,571	585%	-21%
Estimated Actuals					
Actual Revenue	26,594	36,656	49,264	38%	34%
Actual Expenditure	28,821	26,453	34,590	-8%	31%
Actual Surplus (+)/Deficit (-)	-2,227	10,203	14,674	-558%	44%
% Overshot (+)/Undershot (-) for	ecast				
Revenue	38%	27%	9%	-30%	-68%
Expenditure	42%	-27%	-32%	-163%	21%
Deficit	117%	-245%	-363%	-310%	48%

Source: Ministry of Finance

31. The data in above table shows large aggregate budget variances on expenditure, a high level of overspending in 2004 having been reversed in 2005 and 2006, when major under-spending, mainly in the capital investment budget occurred. Capital budget implementation was very limited in 2005 and 2006, with execution rates as low as 23% and 25% respectively. On the basis of unconfirmed figures, the situation was much better in 2007 when the capital budget execution rate may have reached 66%. While this improvement is welcome, there is still much to be done to improve investment budget performance. Table 2 below gives more detailed information on the investment budget.

Table 2: Functional Analysis of Capital Investment Expenditure

		2007			2006			2005	
Functional Head	Original Budget	Forecast - Oct 07	Deviation	Original Budget	Est Actual	Deviation	Original Budget	Est Actual	Deviation
Oil	2,875	1,754	39%	4,657	214	95%	4,500	165	96%
Regions' Development (excl KRG)	2,623	828	68%						
Kurdish Region	2,013	2,013	0%	750	790	5%	750	772	3%
Electricity	1,745	1,733	1%	1,741	401	77%	440	214	51%
Public Works	558	422	24%	552	122	78%	252	101	60%
Health	431	22	95%	50	26	49%	60	27	55%
Housing & Construction	383	191	50%	312	136	56%	365	101	72%
Education	366	21	94%	28	24	15%	100	2	98%
Water Resources	330	267	19%	300	137	54%	276	180	35%
Higher Education	259	51	80%	60	23	61%	50	11	78%
Communications	193	108	44%	248	1	100%	200	-	100%
Labour and Social Affairs	141	68	52%	20	8	60%	27	10	63%
Transportation	133	28	79%	154	6	96%	145	23	84%
Baghdad Municipality	120	55	54%						
Planning	100	41	59%	38	36	6%	45	1	98%
Agriculture	63	17	73%	36	3	91%	26	1	96%
Defence	60	7	88%	500	304	39%	-	-	0%
Interior	50	5	89%	100	10	90%	-	-	
Industry and Minerals	42	50	20%	16	10	36%	14	13	9%
Youth and Sports	38	25	34%	386	264	32%	176	110	37%
Remainder	188	53	72%	968	403	58%	449	225	50%
Total expenditure deviation	12,710	8,371	34%	9,963	2,522	75%	7,495	1,732	77%
Composition variance	12,710	8,371	44%	9,963	2,522	75%	7,495	1,732	78%

Source: MoF for 2005 and 2006 and MoP for 2007 - data for 2007 is not verified and essentially release data

PI 2: Composition of expenditure out-turn to original approved budget

PI 2	Scoring method M1:	С
	Variance in expenditure composition exceeded overall deviation in primary expenditure by 10 per cent in no more than one of the last three years	

32. For a government budget to be a useful policy statement, it is necessary for the composition of actual expenditure to be close to the original budget. Table 3

shows the variance in expenditure composition of the Iraqi national budget for the last three years. It is supported by detailed calculations in Attachment 1. Only in one year (2006) was the weighted average of the variance in excess of the total deviation (cf. PI 1) greater than the threshold of 10%; the merits a score of C. Since the situation has been improving over time, an upward arrow is included in the score. The comparisons are shown for all heads of expenditure and for the largest ten heads; the resultant score is the same.

33. The score indicates that reallocations between budget administrative lines (i.e. ministries) have not significantly contributed to the variance in expenditure composition beyond the variance resulting from changes in the overall level of expenditure. This essentially means that a ministry's overall budget has not been adversely affected by in-year reallocations between ministries. However, it will be interesting to see the effect in 2007 of the reallocations that took place in the mid-year review. This has reallocated funds away from those ministries whose capital budget expenditures fell significantly short of their allocation as at the mid-year point.

Table 3: Variance in expenditure composition of State Budget

	For PI-1		For PI-2
Year	Total exp. Dev	Total exp. Var (compositi on)	Var in excess of total dev.
All Functional/Admi	inistrative	Heads	
2004	42.1%	54.4%	12.3%
2005	26.5%	30.2%	3.7%
2006	32.1%	33.0%	0.9%
10 Largets Function	al/Admini	strative Hea	ads
2004	38.7%	50.6%	11.9%
2005	26.0%	29.2%	3.2%
2006	31.0%	32.0%	1.0%

PI 3: Aggregate revenue out-turn compared to original approved budget

PI 3	Scoring method M1:	A
	Actual domestic revenue collection was well above the defined threshold of 97% in all of the past three years.	

34. Over the last three years, aggregate revenue out-turn did not go below 97% of budget revenue forecasts, thus scoring an A - the highest possible score. This reflects both the Government's prudential revenue forecasting approach as well as the unanticipated sustained increase in the world price of oil, which effectively began in 2004. As Table 4 below shows revenue out-turns have consistently overshot forecasts, although accuracy of annual forecasts have been improving..

Table 4: Aggregate Revenue Performance

		For PI-3	
Vaan	Total rev. dev.	Total rev. var	Var in excess
Year		(comp'n)	of total dev.
2004	38.1%	41.9%	3.8%
2005	26.6%	35.4%	8.9%
2006	8.5%	16.2%	7.7%

35. Given Iraq's dependence on oil revenues, it is unsurprising that the positive revenue budget variances are essentially the result of the surplus of actual oil prices over budgeted prices over the last three years. This aspect more than outweighs the fact that oil exports have been lower than forecast. Table 5 contains the relevant data.

Table 5: Oil Export Revenues

	2004	2005	2006
Oil Revenue forecasts			
Price /bl (US\$)	21.00	26.00	46.61
Export Producton mbl/d	1.6	1.8	1.7
Forecast (US\$ m)	12,264	17,082	28,071
Forecast (ID b)	18,396	25,623	42,106
Oil Revenue out-turns			
Price /bl (derived)	33.04	44.22	53.26
Export Producton mbl/d	1.4	1.4	1.5
Out-trun (US\$ m)	16,884	22,597	29,161
Out-turn (ID b)	25,326	33,896	43,741
Oil Revenue out-turns: deviat	ions		
Price	57.3%	70.1%	14.3%
Export Producton	-12.5%	-22.2%	-9.1%
Revenue Out-turn	37.7%	32.3%	3.9%

PI 4: Stock and monitoring of expenditure payment arrears

PI4	Scoring method M1:	D
	(i) The stock of arrears is unlikely to exceed 10% of total expenditure (Not rated)	D
	(ii) There is no reliable data on the stock of arrears	
	from the last two years. (D)	

- 36. The absence of reliable data on the stock of arrears from any of the last three years makes it impossible to award a score higher than D to this indicator. Due to the agreements made with Paris-Club and non-Paris Club creditors, there are no arrears on debt servicing for reconciled debt. However, Iraq does not utilize any standard form of commitment accounting nor are there adequate systems in place to track expenditure arrears. Given the absence of data it is not possible to estimate the level of arrears with a high level of confidence.
- 37. Iraq has a strong history of centralized controls in budget execution, which has likely prevented any substantial build up of uncontested arrears. Given the historical practice by Government officials to commit public resources only when funds are available and only when approvals have been provided at various levels, the stock of arrears is likely to be low. For the second dimension, there is no reliable data on the stock of arrears from the last two years nor has there been any comprehensive ad hoc exercise to estimate the stock of arrears within the last two years. Hence, a score of D is given.
- 38. There are anecdotal reports that payments from letters of credit are taking an unreasonable amount of time. While payments of letters of credit (L/C) increased significantly from US\$2.6b in 2004 to US\$8.4b 2006, the stock of L/Cs have plateaued at around US\$3b (see Table 9). The 2006 stock represents approximately 14% of actual expenditure, however, it is understood that most of the stock is held on behalf of the oil and trade ministries and that any unpaid amounts are awaiting evidence of completion. Consequently, for the purpose of this indicator, letter of credit based arrears is unlikely to have a significant impact on the total stock of arrears.
- 39. Overall, the originally approved GoI is a rather reliable instrument of government policy. Revenues have been consistently exceeding budgeted amounts by

a significant margin, whereas actual expenditure, especially on capital investments, has consistently been well below budget. The inevitable consequence has been large budget surpluses in the last two years, leading to a big increase in the stock of cash reserves in the Development Fund for Iraq, held in New York. Table 6 below summarises the growth of cash balances.

Table 6: GoI Cash Flow and Balances: 2004-2006 (US\$m)

	2004	2005	2006
DFI Cash Flow Balance	4,923	1,360	2,327
MoF Cash Flow Balance	-	1,008	278
Minsitries Cash Balances	tba	tba	tba
GoI Stock of Cash Reserves	4,923	7,291	9,895

Source: IAMB Audits

Comprehensiveness and transparency

PI 5: Classification of the budget

PI 5	Scoring method M1:	С
	The budget formulation and execution is based on administrative and economic classification using GFS standards	

40. **GFS-based economic classifications are now being used during Budget formulation** in addition to primary administrative classifications. Consequently, a score of C is appropriate (see Table 7). Budget execution accounting systems used by ministries and governorates are, however, currently using the legacy Chart of Accounts (CoA). These are subsequently mapped to the GoI's new GFS-based classification system by the MoF in Baghdad.

Table 7: Scoring for Indicator 5: Budget Classification

Budget	Budget	GFS/COFOG	
Formulation	Execution	Classification Standards	
Yes	Yes	Administrative	
Yes	Yes	Economic	
No	No	Sub-functional	
No	No	Sub-programs mapable to sub-functional	
No	No	Functional	
Score	Score	Overall Score	
C	С	C	

PI 6: Comprehensiveness of information included in budget documentation

PI 6	Scoring method M1:	D
	Share of the information listed below in the budget documentation most recently issued by the Government: only 2 of the 9 information benchmarks fully met	

41. The assessment examines which of nine pieces of "good practice" information are included in the budget documentation submitted to the Parliament. In Iraq, four of these are included in the GoI budget papers, but they tend to be partial rather than complete (for example, key budget tables are frequently missing). These four elements are: i) key macroeconomic assumptions; ii) fiscal balance; iii) consistent reporting of current and budget year; and iv) summarized data for revenue and expenditure (see Table 8). Given the partial nature of some of the information a score of "D" is appropriate.

Table 8: Documentation Elements in the 2007 Annual Budget Papers

Budget Documentation Elements	Included	Comments
Macro-economic assumptions, including at least estimates of	Yes	Oil price, production and exchange rate assumptions only.
aggregate growth, inflation and exchange rate.		Inflation and growth assumptions partial.
2. Fiscal deficit, defined according to GFS or other internationally	Yes	Investment inflows (loans for investment) not calculated
recognized standard.		
3. Deficit financing, describing anticipated composition.	No	Partial. Note letters of credit issue. Description of loan
		financed projects suppored by development partners - but
		does form part of the consolidated budget.
4. Debt stock, including details at least for the beginning of the current	No	Absent. Note letters of credit
year.		
5. Financial Assets, including details at least for the beginning of the	No	Absent
current year.		
6. Prior year's budget outturn, presented in the same format as the	No	Absent
budget proposal.		
7. Current year's budget (either the revised budget or the estimated	Yes	Revised budget provided. Estimated actuals not provided.
outturn), presented in the same format as the budget proposal.		
8. Summarized budget data for both revenue and expenditure according	Yes	Summarised data provided
to the main heads of the classifications used (ref. PI-5), including data		•
for the current and previous year.		
9. Explanation of budget implications of new policy initiatives, with	No	Only general descriptions provided. Estimates of budget
estimates of the budgetary impact of all major revenue policy changes		impact of major new policy absent.
and/or some major changes to expenditure programs.		
Score	С	

42. While oil forecast assumptions are provided, other macroeconomic assumptions presented have limited usefulness as these are not used in a mediumterm fiscal or macroeconomic framework, nor are they utilized by budget holders in the formulation of budget submissions. Key elements missing in the budget papers include: i) deficit financing tables, ii) debt stock; iii) financial assets, iv) prior year's budget outturn; and iv) new policy budget implication tables. While budget papers refer to cash reserves and carryovers as financing the budget deficit, the composition and presentation is insufficient. Estimates of carryovers, outstanding letters of credits and other cash reserves should be provided. Comprehensiveness would also require that barter transactions and loans be reflected in the financing table associated with a consolidated budget

PI 7: Extent of unreported government operations

PI 7	Scoring method M1: (i) The level of unreported (other than donor funded projects) constitutes more than 10% of total expenditure.(D)	D+
	(ii) Complete information about practically all donor-funded projects is included in fiscal reports. (A)	

- (i) The level of extra-budgetary expenditure (other than donor funded projects) which is unreported (Score = D)
- 43. **The level of** unreported **government operations is very significant.** For 2006, estimates of the value of oil production used to subsidise the supply of electricity supply and locally refined oil products was around 30%, well over the 10% threshold for a score of "D" (see Tables 9 and 10). This is a priority area for fiscal reporting reform, as relatively simple measures will significantly increase the levels of comprehensiveness and transparency.

Table 9: Estimates of Barter Transactions and Off-Budget Subsidies (ID bn)

Item	Year				
	2006	2005	2004		
Oil related barter transactions - external	263	268	517		
Oil resources used for electricity generation and fuel subsidies	10,142	6,779	5,022		

Source: IAMB audits, MoF and IMF publications

44. Estimates of the valuation of retained revenues by local and provincial councils are unavailable. It has been estimated that some governors' offices collect less than 5% of their operating revenues from retained stamp and rental fees¹. However, collection and remittance of local and federal taxes and other service fees and charges is unclear. While the Government has a strong system of control for the opening of bank accounts, it is understood that there may be unmonitored Government bank accounts at lower levels of government. A move to a true Treasury Single Account (TSA) would greatly assist the GoI in monitoring bank balances and ensure only duly authorised accounts are opened and maintained. Further research will be needed to investigate anecdotal reports of collection of unreported and non-remittance of government revenues

Table 10:	Scoring f	for First	Dimension ((PI 7)
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	Year	Unreported Govt Ops	Total Exp (ID b)	% Total Exp.	Score
As at end	2006	10,405	34,590	30.1	D
As at end	2005	7,047	26,453	26.6	D
As at end	2004	5,539	28,821	19.3	D

- (ii) Income/expenditure information on donor-funded projects which is included in fiscal reports (Score = A)
- 45. **Donor funded project expenditure is significant and income/expenditure information is publicly available.** For dimension (ii), a score of "A" was given as the level of donor financing represents around 22% of total government expenditure in 2006 (25.6% in 2005 and 57.7% in 2004). The level of financial information related to

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¹ See World Bank, 2007, "Subnational Public Financial Management: A Diagnostic Report"

donor financed projects included in GoI fiscal reports is sufficient, although it is not provided in a complete and timely fashion. The latest fiscal report on donor projects produced by the GoI was tabled at the recent IRFFI conference in Bari, Italy in October 2007. Fiscal reports are available to the general public on-line using the MoP Development partner Assistance Database (DAD), though the completeness of the data is questionable².

Table 11: Scoring for Second Dimension (PI 7)

Donor financing information in		Yea	
fispart	200	200	200
s Grant	6 7,66	5 6,73	4 16,62
Hinan ced	5 -	3 6	6 -
Fina net it	7,66	6,79	16,62
tUtal	5	3	6
Total reported donomate	7,66	6,79	16,62
TotafikanovingDonor (not	3 ,66	6 ,79	\$ 6,62
Spending inkind	5	3	6
Total Goy.	34,59	26,45	28,82
% Dorox Loan '	0.0	3 0.9	10.0
projects Scor	A %	A%	Α%
Is donor funding e	22	25	58
significant?	%ke	% e	%(e

^{*}DAD reports all assistance as grant projects. Most of these would normally be classified as inkind due to the absence of standard grant agreements.

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² DAD access is available at: http://www.mop-iraq.org/dad.

PI 8: Transparency of inter-governmental fiscal relations

PI 8	Scoring method M2:	С
	(i) Use of transparent and rule-based systems in the horizontal allocation among Sub-National Governments (SNGs) of transfers from national government (A)	
	(ii) Timeliness of reliable information to SNGs on their allocations from central government (D)	
	(iii) Extent to which consolidated fiscal data is collected and reported for general government according to sectoral categories (D)	

- (i) Use of transparent and rule-based systems in the horizontal allocation among Sub-National Governments (SNGs) of transfers from national government 46. The GoI now employs transparent and rules based systems in the horizontal allocation among SNGs of unconditional and conditional transfers from central government (both budgeted and actual allocations). The system for transfers to the KRG is a population based rule after accounting for national public goods. While the system is unsustainable if applied to all regions and provinces, the transparency of intergovernmental fiscal relations has improved significantly. Horizontal allocation of certain resources to the provinces also utilizes a population based weighting method. While transparency of in-kind transfer allocations is a key issue, it is excluded from analysis for scoring purposes of the first and third dimension. Consequently, a score of "A" is applicable (see Table 12)
- 47. The status of the conditionality of sub-national transfers is unclear. While it is understood that transfers to the KRG are essentially unconditional, transfers to the Governorates seem to display characteristics of both conditional and unconditional transfers. Transfers to the KRG only require reporting of expenditure to allow MoF to consolidate reports and to facilitate the estimation of Iraq' System of National Accounts by COSIT. While the appropriation structure for transfer to Governorates imply conditionality requirements similar to ministries, the recently introduced practice of allowing governorates to retain unspent funds, suggests that the transfers are essentially an unconditional grant to a general/sub national government unit.

Table12: Scoring for First Dimension (PI 8)

		2006			
SN Governments	Rules-Based	Budget	Est. Actual		
KRG (Original budget)	Yes	4,275	3,749		
Provincial Allocations	Yes	84	-		
(original budget)					
Ninawa	Yes	303	303		
Anbar	Yes	146	146		
Babil	Yes	167	167		
Baghdad	Yes	754	754		
Qadisiyah	Yes	111	111		
Maysan	Yes	99	99		
Basrah	Yes	258	258		
Tameen	Yes	122	122		
Sad	Yes	123	125		
Wasit	Yes	109	111		
Kurdish Provinces	Yes	189	196		
Muthana	Yes	64	69		
Najaf	Yes	109	118		
Karbala	Yes	84	93		
Dhi-Qar	Yes	195	248		
Diyala	Yes	91	149		
In-kind allocations	No				
(excluded)					
Total value of horixonta	7,282	6,818			
Horizontal budget trans	7,282	6,818			
% of rules based transf	ers	100%	100%		
	Score	A	A		

(i) Timeliness of reliable information to SNGs on their allocations from central government for the coming year (Score = A)

48. **Information to the SNGs on allocations for the coming year is relatively reliable and timely.** For the 2007 budget process, dialogue with the KRG and provinces occurred, although final allocations were not agreed until after the start of the fiscal year (and the same situation has obtained in 2008, with considerable political debate over the 17% allocation to the KRG). Hence a score of D is given. While a more transparent system is in place, an improvement in the sequencing and scope of stakeholder consultation is warranted

Tuble 10. Scotling for Second Dimension (110)					
Time when SNGs provided with information	Status				
Before the start of the detailed budgeting process.	No				
Ahead of completion of SN Budget	No				
Before the start of the SN Fiscal Year	No				
After SN budgets have been finalized (2007 budget)	Yes				
Score	D				

Table 13: Scoring for Second Dimension (PI 8)

- (ii) Extent to which consolidated fiscal data (at least on revenue and expenditure) is collected and reported for general government according to sectoral categories (Score = D)
- 49. While consolidated sub-national fiscal data is collected, it is not yet reported according to sectoral categories. A score of D was given for the third dimension since the Government is yet to publish consolidated sub-national fiscal data according to sectoral categories in annual reports (see Table 14). In 2006, fiscal data was collected using the legacy accounting system, which does not yet include functional or sectoral information.

Table 14: Scoring for Third Dimension (PI 8)

2006	Central Go Repor		Consolidate	d Reporting	AR - Months after end	Type of Budget Class'n	Type of Actuals Class'n	Budget Clas'n Consistency	Actuals Clas'n Consistency
2000	Budget (ID b)	Est Act (ID b)	Budget (ID b)	Est Act (ID b)	FY	system	system		
KRG (Original budget)	4,275	5,298	4,275	5,298	19	Other	Other	No	No
Provincial Allocations	84	84	84	-	19	Other	Other	No	No
(original budget)									
Ninawa	303	303	303	303	19	Other	Other	No	No
Anbar	146	146	146	146	19	Other	Other	No	No
Babil	167	167	167	167	19	Other	Other	No	No
Baghdad	754	754	754	754	19	Other	Other	No	No
Qadisiyah	111	111	111	111	19	Other	Other	No	No
Maysan	99	99	99	99	19	Other	Other	No	No
Basrah	258	258	258	258	19	Other	Other	No	No
Tameen	122	122	122	122	19	Other	Other	No	No
Sad	125	123	125	123	19	Other	Other	No	No
Wasit	111	109	111	109	19	Other	Other	No	No
Kurdish Provinces	196	189	196	189	19	Other	Other	No	No
Muthana	69	64	69	64	19	Other	Other	No	No
Najaf	118	109	118	109	19	Other	Other	No	No
Karbala	93	84	93	84	19	Other	Other	No	No
Dhi-Qar	248	195	248	195	19	Other	Other	No	No
Diyala	149	91	149	91	19	Other	Other	No	No
Total	7,429	8,305	-	-	19				
% Reported		•	0%	0%			•	Score	D

PI 9: Oversight of aggregate fiscal risk from other public sector entities

P	I 9	Scoring method M1:	D
		(i) Extent of central government monitoring of Autonomous Government Agencies and Public Enterprises (D)	
		(ii) Extent of central government monitoring of SNG's fiscal position (D)	

- 50. Under Section 8 of the FML on Public Corporations, AGAs and PEs are required to submit fiscal information. The following are the three key reports required by these entities:
 - Monthly accounts submitted to the competent ministry 10 days following the end of each month.
 - Semi-annual accounts submitted to the Minister of Finance no later than July 15th.
 - Audited final accounts submitted to the Minister of Finance no later than March 31st of the year following the fiscal year ended.
- 51. In practice, there is an absence of fiscal and audit reports for AGAs and PEs, nor is there a central consolidation of these entities' fiscal risks. Similarly, there appears to be no effective monitoring of the fiscal position and associated fiscal risks of AGAs and PEs. It is also understood that sub-national governments can generate fiscal liabilities for the Government of Iraq. Accordingly, a score of "D" is applicable for both dimensions.

PI 10: Public access to key fiscal information

ΡΙ	Scoring method M1:	D
10	Number of the elements of complete information listed	
	below to which the public have access (0 out of 6)	

- 52. This Indicator assesses whether information on fiscal plans, positions and performance of the government is easily accessible to the general public, or at least to the relevant interest group. Six elements of information to which public access is essential are considered.
- 53. In Iraq, while the Government does provide public access to certain fiscal information, the public does not have *complete or timely* access to key fiscal information. The 2006 annual budget papers were not available to the public at the time of transmittal to the Council of Representatives (CoR), either through a citizen's guide to the budget or on a central web-site. The MoF does, however, provide access to budget documentation on request. While on-line access to the Development Assistance Database (DAD) is available it is understood that most Iraqis do not have access to the internet nor are they aware of the DAD facility. In year, year-end and audit reports have not been available to the public since 2003. Awards of significant contracts and information on the level of resources to primary service units are not published in one easily accessible website or published in local newspapers. Table 15 provides an overview of the key areas where information is occurring and demonstrates how the score of D was obtained.

Table 15: Scoring for PI-10

Budget Docume	ntation	Include	Comment
1. Annual Elegaents cumenta	ation: A complete set of	d Partial	2007 Budget Not Available on website at time of
documents can be obtained l	by the public through		transmittal. No hard copies distributed. Budget papers
appropriate means when it is	s submitted to the		are available on request from MoF and CoR.
legislature			-
2. In-year budget execution	reports: The reports are	No	In-Year Reports Not routinely available
routinely made available to	the public through		
appropriate means within on	e month of their		
completion.			
3. Year-end financial statem	ents: The statements	No	Year-end financial statements for 2004, 2005 or 2006
arade available to the public	through appropriate means		Not Available - as at Nov 2007
within six months of comple	eted audit.		
4. External audit reports: Al	l reports on central	No	2004 Audits Not Available - as at Nov 2007
government consolidated op	erations are made available		
to the public through approp	riate means within six		
months of completed audit.			
5. Contract awards: Award of	of all contracts with	Partial	Contract Awards not available easily. Some
xbb e approx. USD 100,000	equiv. are published at		mahstataed.
least quarterly through appro	opriate means.		
6. Resources available to pri	mary service	Partial	Education service information is available on request.
Information is publicized the	rough appropriate means at		Some information published.
least annually, or available u	ipon request, for primary		
service units with national c	overage in at least two		
sectors (such as elementary	schools or primary		
brialitis).	•		
,	Scor	D	

Policy-based budgeting

PI 11: Orderliness and participation in the annual budget process

PI 11	Scoring method M2:	C
	(i) Existence of and adherence to a fixed budget calendar (B)	
	(ii) Clarity/comprehensiveness of and political involvement in the guidance on the preparation of budget submissions (D)(iii) Timely budget approval by the legislature (C)	

(i) Existence of and adherence to a fixed budget calendar

54. A fixed budget calendar exists but adherence to it is mixed. The Financial Management Law provides the key dates for the annual budget process, which provides sufficient time, just over six weeks, for ministries, departments and agencies (MDAs) to prepare detailed budget proposals. Delays occur in key elements of the budget calendar. A score of "B" is given for the first dimension (see Table 16) because MDAs are allowedmore than 4 weeks to cubmit their detailed estimates

Table 16: Scoring for first dimension of PI11

Finanical Management Law (CPA # 95)	FML Deadline	BCC	2007 - Est Act.	,	Comments
Finance Minister reports to CoM:	31 May	-	30 Jun	(days) 30	Month only specified in Law
Fiscal priorities for coming year	31 May		30 Jun	30	General priorities
Aggregate and Ministry spending limits					Absent
Final accounts for previous year					Absent
Progress against current year's budget					Absent
Finance Minister issues budget circular:	15 Jun		30 Jul	45	Month only specified in Law
Guidelines and objectives of fiscal policy					General guidelines
Key economic parameters (from					Absent
macroeconomic framework)					
Spending limits					Absent - ceilings discussed
					administratively with MoF, MoPDC
					and line agencies
Spending units use budget circular as the					Limited
basis for preparing their budget request					
Ministries send budget submission, based	31 Jul	15-Aug	30 Sep	61	Month only specified in Law
on budget circular, to Finance and Planning					
Submission includes:					
Recurrent and capital outlays for budget year					No forward estimates
and following two years					
Revenue from core activities					Included
Personnel requirements, multi-year					Staffing profiles included, mulityear
commitments, foreign currency transactions					commitments and foreign currency
					transations absent
					Frequent revisions to proposed
					spending limits
Finance and Planning and Development	31 Aug	05-Sep	15 Sep	15	Month only specified in Law
Coordination Ministers hold talks with line	_				
Ministers to agree estimates					
If no agreement, matter referred to CoM					CoM initiated changes to proposals
Finance Minister sends draft to CoM	30 Sep		01 Nov	32	CoM initiated changes to proposals
Finance Minister submits draft Budget, as	10 Oct	1	14 Nov	35	goo to proposato
endorsed by CoM, to the Legislature.					
Budget Passed by the Legislature.	31 Dec		12 Jan	12	
Time for MDA Preparation: Law	6.6	Weeks	8.9	4.7	Average Delay (weeks)
Budget Preparation Manual	No	Budget	Delays	Reasonab	le Time for MDAs
	l .	Calander Unclear	Yes	Yes	Budget Circular inconsistent with FML
		Coore	_		

- (ii) Clarity/comprehensiveness of and political involvement in the guidance on the preparation of budget submissions
- 55. Content of the Budget Call Circular (BCC) and budget guidance is deficient, although sufficient time is provided to MDAs to prepare budget submissions. For the 2007 budget process, MDAs were provided with around two months for budget submission preparation. The BCC provides general policy direction instructions and the deadline for the submission of budget proposals to the MoF. The BCC also provides the time period (just over two months) for negotiations between the MoF and MoP and line ministries and staffing profile table and budget proposal templates.
- 56. The BCC is issued late and does not provide sectoral or administrative expenditure limits. An investment budget circular is also prepared by the MoP, which provides additional guidance on information requirements for investment projects. The MoP collates and approves project requests at official level and forwards results to the MoF for consolidation A detailed budget manual has not been issued. Consequently, a score of "D" is given for the second dimension (see Table 17).

Table 17: Scoring for Second Dimension (PI-11)

Budget Circular							
Clarity	Compreh-	CoM Approval of ceilings					
	ensiveness						
Unclear Limited		Limited/Late					
Score	С						

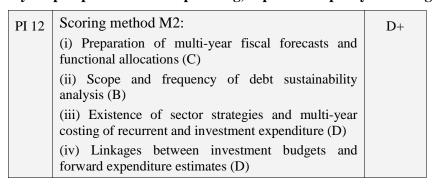
(iii) Timely budget approval by the legislature (C)

57. Approval of the budget by the legislature did not occur before the commencement if the fiscal year in the last 3 years. Consequently, the score for the third dimension is "D" (see Table 18). The 2008 Budget is likely to be passed by the legislature before or soon after the start of the 2008 fiscal year since the Budget Bill was approved by the CoM on 13 November and subsequently transmitted to the CoR, with the first reading completed on 19 November and second readings on 27 November and 5 December. This represents a 65% improvement in the timeliness of transmittal to the CoR compared to the 2007 Budget process.

Table 18: Scoring for Third Dimension (PI-11)

Budget Year	Budget Approval Date by CoR	Months after start of FY
FY07	08-Feb-07	1.3
FY06	28-Jan-06	0.9
FY05	12-Jan-05	0.4
FY04	01-Nov-03	-2.0
Scoro	C	

PI 12: Multi-year perspective in fiscal planning, expenditure policy and budgeting



(i) Preparation of multi-year fiscal forecasts and functional allocations

58. Forecasts of fiscal aggregates are prepared on the basis of main economic categories for four years. Forecasts by function of government of sector are not yet constructed systematically. The first multi-year forecast based on economic classifications that was consistent with the Budget is documented in the International Compact with Iraq. The Government envisages that the medium-term forecasts will continue to be published within the ICI annual update reports and eventually in the Budget papers. Linkages between multi-year estimates and subsequent setting of annual budget ceilings are not yet occurring. Consequently, a score of "C" is considered appropriate (see Table 19).

Forecasts of fiscal aggregates Economic Functional/sector No of FE Years Links between classification classification multi-year estimates and budget ceilings No >=3 No Yes Score \mathbf{C}

Table 19: Scoring for First Dimension (PI-12)

- (ii) Scope and frequency of debt sustainability analysis
- 59. On request by the GoI, Debt Sustainability Analysis (DSA) was undertaken in May 2004 by the IMF. This analysis was primarily for external debt, however, domestic debt was also considered. It is understood that the GoI has undertaken some analysis of domestic debt³ in respect to large and small private creditors. The World Bank assisted the GoI in May 2007 with a fiscal sustainability assessment, which incorporated a review of external debt sustainability. DSA updates also occur regularly as part of the Government's program with the IMF. Consequently, score of B was considered appropriate for this indicator (see Table 20)

Table 20: Scoring for Second Dimension

DSA						
External	Domestic	No Years EDSA	No Years DDSA			
		Undertaken	Undertaken			
Yes	Yes	3	1			
Score	В					

- (iii) Existence of sector strategies and multi-year costing of recurrent and investment expenditure
- 60. Sector strategies that are established within a multi-year costing of recurrent and investment expenditure framework are absent. Some strategic plans exist for a number of ministries (e.g. Ministry of Agriculture, Ministry of Education, Higher Judicial Council, the Juvenile Reform Department within the Ministry of Labour and Social Affairs, Ministry of Defence and the Ministry of Justice). The Rule of Law working group is progressing development of a sector strategy. Through this joint PEIA, the MoF and MoP are also in the process of developing a medium-term PFM reform program that will be costed in terms of operating and investment expenditure, with resources allocated from various sources including the Government's Budget, multilateral agencies and bilateral arrangements. The GoI also established a general policy foundation to develop sector strategies, within the context of the NDS and the ICI. Systems are being developed by the MoP that are expected to support multi-year costing of recurrent and investment expenditure.

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³ Domestic debt is debt owed to creditors resident in the same country as the debtor, and denominated in local currency.

Strategy Tupe Costing Consistency Costing Fiscal Est. Act Sector Type with fiscal Value Forecast foecast (Budget 05 only) General Public Services Strategy/Prog None No 11,821 9,961 Defence Strategy/Prog Partial. No 1.844 1.438 Public Order and Safety Strategy/Prog Partial No 1,292 1,224 10,643 **Economic Affairs** Strategy/Prog Partial No 8,345 None No 101 132 **Environmental Protection** None Housing and Community Strategy/Prog Partial No 715 667 Development Health None Partial No 1,417 1,130 Recreation, Culture, None Partial No 100 100 Religion 1,236 1,493 Education Strategy/Prog Partial No Total 0% 29,426 24,233 Score

Table 21: Scoring for Third Dimension (PI-12)

61. Reform of the Government budget preparation process and integration of key elements of the Budget will be needed to ensure that strategies that do get developed are properly costed and considered within the annual budget process. For scoring purposes, a "D" is considered appropriate as only a few sector strategies have been prepared and none of them have substantially complete costing of investments and recurrent expenditure (see Table 21).

(iv) Linkages between investment budgets and forward expenditure estimates Table 22: Scoring for Fourth Dimension (PI-12)

	Investmen	nts			
Sector Strategy	Selected on basis of Sector Strategy	Recurrent Cost	Sector Allocations	FE inclusion	
General Public Services	Partial	No	No	No	
Defence	Partial	Partial	No	No	
Public Order and Safety	Partial	Partial	No	No	
Economic Affairs	Partial	Partial	No	No	
Environmental Protection	Partial	No	No	No	
Housing and Community	Partial	Partial	No	No	
Development					
Health	Partial	Partial	No	No	
Recreation, Culture,	No	No	No	No	
Religion					
Education	No	Yes	No	No	
Social Protection	No	Yes	No	No	
Is the Budgeting for investm	nent and recurrent expe	enditures sepa	rate processes	Yes	
with no recurrent cost estim	ates being shared?				
Score	D				

62. Linkages between investment budgets and forward expenditure estimates are not yet observable. While, some projects are selected based on sector plans, and some of these have recurrent cost implications estimated, these estimates are not shared during operations budgeting. Moreover, the forward estimates that do exist are not developed from such costings. Consequently, a score of "D" is appropriate for the fourth dimension (see Table 22).

Predictability and control in budget execution

PI 13: Transparency of taxpayer obligations and liabilities

PI 13	Scoring method M2:	В
	(i) Clarity and comprehensiveness of tax liabilities	
	(B)	
	(ii) Taxpayers' access to information on tax liabilities and administrative procedures (B)	
	(iii) Existence and functioning of a tax appeals mechanism (B)	

(i) Clarity and comprehensiveness of tax liabilities

- 63. Transparency of taxpayer obligations and liabilities concerns the environment in which taxation revenue administration functions. Revenue sources from most countries are from taxation activities. However, countries like Iraq present a different situation where revenue resources are mostly derived from non-tax activities (e.g. for selling petroleum and petroleum products). Therefore, it is essential that there should also be transparency surrounding the environment in which non-tax revenue is collected and reported.
- 64. The GoI's tax revenue base represents around 5% of general revenue or approximately 2% of GDP. The Government is working towards increasing the tax base by improving the effectiveness of the tax and customs administrations.
- 65. The General Commission for Taxation (GCT) and the General Commission for Customs (GCC) are responsible for revenue administration in Iraq. The Ministry of Oil, through the State Organisation for Oil Products and Gas Distribution (SOOPGD), is responsible for administering the hypothecated excise tax on sales of domestic fuels.
- 66. The legal framework for taxation is established around five major taxes, which represent over 90% of all tax revenue. Five additional minor taxes are also in place. Tax on international trade is the most significant source of revenue (30% of tax revenue). Reports indicate that half of all individual income tax (27%) is paid by Government officials. Corporate income tax is less than half of personal income tax collections. The existing consumption tax raises around 15% of all tax revenue but is limited to levies on services provided by deluxe and first class hotels and restaurants. A fuel excise tax on petrol, diesels and LPG is estimated to raise a further 10% of all taxation revenues. The tax is hypothecated to finance the State-owned fuel distribution network and is in essence a user charge.
- 67. Tax legislation is clear and comprehensive for three of the five major taxes. While exemptions and deduction provisions exist, they are clearly specified in legislation and discretionary powers are either strict or limited. However, the lack of procedural documentation that guides officials during assessments exposes the system to an appearance of unfairness. Consequently a score of B is given for the first dimension (see Table 23).

Table 23: PEFA Scoring for First Dimension (PI-13)

Direct Tax (Individual and wage withholding) Direct Tax (Individual and wage withholding) Unit Ins Ta Th Pri Re an Sales Tax Ho Re Re Ins	ustom Law No (23) of 1984, Custom tariff law to (77) of 1955, CPA Order Number 54 - Trade iberalization Policy 2004, CPA Order Number					tax forecast)
wage withholding) inc With Ins Ta Th Pri Re an Sales Tax Ho Re Re Ins	8 - Reconstruction Levy, CPA Order Number 0 - Amendments To Reconstruction Levy, CPA order Number 12 Recinded	Commission for Customs	Yes	Yes	Limited	94% 30%
Sales Tax Ho Re Re Ins	acome Tax Law No. 113 of 1982 (Corporate tome tax, Wage Witholding tax, Contracts /ithholding Tax, Individual Income Tax), astructions No.(1) of 2005 Concerning Income ax Deduction by Direct Deduction Method, he System of Depreciation and Elimination for rivate, Mixed and Cooperative Sectors egulation No. 9 of 1994, CPA Orders No. 37 and 49 of 2004	General Commission for Taxes / Ministry of Finance (civil service employee income tax)	Yes	No	Strict	27%
CF	otel Tax (Resolution No. 36) Republic of Iraq evolutionary Command Council 5/4/1997, esolution No. 36 of May 4th 1997 and Fiscal istructions No. 7 of 1997, Car sale fee in coordance with Resolution Number 80 of 1998, PA Orders No. 37 and 49 of 2004	General Commission for Taxes	Yes	Yes	Limited	16%
Direct Tax (Corporate and As contract withholding)	s per direct tax above	General Commission for Taxes	Yes	Yes	Strict	12%
Co and Ec	aw Number 9 of 1939, Revolutionary ommand Council Resolution No. 82 of 1996 and the Order No. 66 of 1999 issued by the conomic Affairs Committee, CPA Orders No. 7 and 49 of 2004	Ministry of Oil, SOOPG	No	No	Substantial	8%
Minor Taxes Real Estate Rental Tax La yea	aw of the Real Estate Tax (No. 162) for the ear 1959 and its amendments including CPA orders. No. 37 and 49 of 2004	General Commission for Taxes	Yes	No	Strict	6%
Real Estate Transfer Tax Re	esolution No. 120 of 2002, CPA Orders No. 7 and 49 of 2004	General Commission for Taxes	Yes	No	Limited	
Vacant Land Tax Th	he Vacant Land Tax Law No. 26 of 1962	General Commission for Taxes	No	No	Limited	
by	theritance Tax Law No. 64 of 1985 (repealed y law No. 22 of 1994 and still valid for cases nat occurred during its validation period).	General Commission for Taxes	No	No	Limited	
Agricultural Land Tax Ag	gricultural Land Tax (Law No. 60 of 1961)	General	No	No	Limited	

(ii) Taxpayer access to information on tax liabilities and administrative procedures 68. Income and import tax payers have generally easy access to comprehensive, user friendly and up-to-date information on major taxes and administrative procedures. Bilingual websites are available and provide easy access to income and customs legislation and user friendly guidance. Half the income tax payers are civil servants, which helps with access to those without internet access. Withholding tax arrangements allow easy compliance. The GCC and GCT are both well represented throughout Iraq with offices at the Governorate level. The sales tax levied on services provided by deluxe and first class hotels and restaurants is very clear, since it is a flat 10% tax on specific hotels and restaurants. The sales tax collection process is clear and simple to administer. The excise tax on fuels is also easy to comply with, as the tax is included in the official prices for petrol, diesel and LPG. Minor taxes, such as the real estate, rental and transfer taxes, inheritance tax and agricultural land tax are not included in this assessment, however, they are understood to be more complex to administer. Consequently, a score of "B" is given.

Table 24: PEFA Scoring for Second Dimension (PI-13)

Taxes	Easy access	Comprehensive	Up-to-date information	User friendly/ education campaigns
Customs Tax	Yes	Yes	Yes	Yes
Direct Tax (Individual and wage withholding)	Yes	Yes	Yes	Yes
Direct Tax (Corporate and contract withholding)	Yes	Yes	Yes	Yes
Sales Tax	Yes	Yes	Yes	Yes
Excise Tax (including petrol)	Yes	Yes	Yes	Yes
Other taxes				
Real Estate Rental Tax	Yes	No	No	Yes
Real Estate Transfer Tax	Yes	No	No	Yes
Vacant Land Tax	Yes	No	No	Yes
Inheritance Tax	No	No	No	No
Agricultural Land Tax	No	No	No	No
Score	В			

- (iii) Existence and functioning of a tax appeals mechanism
- 69. The Income Tax Law No. 113 of 1982 outlines the appellate process and establishes the Appeal Committee and Cassation Panel. Appeal Committee members are appointed by the Minister for Finance. The Cassation Panel is headed by a judge from the Court of Cassation and two members who are director generals from the MoF and one member from each of the Iraqi Commercial Chambers Union and the Iraqi Industries Union.
- 70. A straightforward appeals process is clearly documented in the legislation and involves three levels. The first level is that an appellant can object to an assessment in writing to the GCT, which the GCT can accept if it so determines. If the GCT rejects the objection, the appellant can appeal the decision through the Appeals Committee. The third level is invoked if the Appeals Committee rejects the objection and the appellant brings forward the objection to the Cassation Panel. A detailed assessment of effectiveness of operation and fairness could not be determined without an in-depth review of documentation. However, it is understood that the appeals process is functioning and there have been no well publicised cases of appeals being sought or rejected (even with the MoF's increased efforts to contain levels tax evasion). An arbitration system is not in place for taxation matters. However, this procedure is outside the scope of this indicator. Nevertheless, establishment of formal procedures for resolution of disputes outside the courts is a useful judicial policy approach that saves time and money. A similar appeals process is understood to be operation in the GCC. A score of "B" is appropriate (see Table 23).

Table 23: PEFA Scoring for Third Dimension (PI-13)

Tax Appeals System	Established	Transparent administrative procedures	Appropriate checks and balances	Independent institutions	Appropriate checks and balances	Effectively operating	Satisfactory Fairness
Appeal Committee and Cassation Panel - Income Tax Law	Yes	Yes	Yes	Yes	Yes	Partial	Partial
Score		В					

PI 14: Effectiveness of measures for taxpayer registration and tax assessment

PI 14	Scoring method M2:	С
	(i) Controls in the taxpayer registration system (C↑)	
	(ii) Effectiveness of penalties for non-compliance with registration and declaration obligations (B)	
	(iii) Planning and monitoring of tax audit and fraud investigation programmes (D)	

- (i) Controls in the taxpayer registration system
- 71. **Individual and company taxpayers are registered in the GCT's computerized database system.** The Government's process for registration requires basic linkages. All companies are required to register with the Business Registry (BR) of the Ministry of Trade (MoT). The BR Number is not mandatory but facilitates sharing of information between the GCT and MoT. Linkages to other registration and licensing functions are weak. Every tax payer in the database, both individual and corporate, has been issued with a Taxpayer Identification Number (TIN). As at August 2007, an additional 1,696 companies have been added to the database with the total of around 22,000 companies registered. Also in 2007, 9,350 new individual income tax payers have been registered and issued with a TIN.
- 72. **New software and** computerization **for the GCT is being progressively rolled out**. The MoF has allocated ID0.5 billion (US\$0.4 m) to purchase new computers as part of its tax administration reform program. The program involves establishing a comprehensive tax communication network throughout Iraq to facilitate more timely and comprehensive tax collection and information services. Currently the score is "C", however, as the wider Tax network becomes operational it is expected that the score should rise to "B".
- (ii) Effectiveness of penalties for non-compliance with registration and declaration obligations
- 73. Enforcement powers and sanctions for non-compliance with tax related legislation are in place and are sufficient to provide key incentives for compliance with tax rules. Actual compliance, however, should be improved with more consistent administration and better systems. The low levels of compliance, as reflected by the low tax effort, are believed to be due to passive rather than active non-compliance. The security situation since 2003 has not provided the environment to enable easy compliance or active collection.
- 74. Consistency and more activity in taxation administration are appearing. That the public administration is becoming more active in the taxation area is evidenced by.: i) the MoF's increased efforts to contain levels tax evasion and success in increasing

levels of tax collections; ii) the significant increase in the number of company and individual Taxpayer Identification Numbers issued; and iii) increased financial commitments to tax administration reform as highlighted by the MoF's allocation of resources for computers and software. The score for this dimension is "B".

(iii) Planning and monitoring of tax audit programmes

75. Tax audits and fraud investigations are undertaken on an ad hoc basis (Score =D). Self assessed tax liabilities and payments are audited by the GCT and GCC using an ad-hoc but risk-based like auditing approach. Audit selection is confined to identifying unregistered taxpayers, with some targeting, and those taxable activities that involve significant revenue generating potential. The Government intends to continue its efforts to reduce tax evasion and increase voluntary compliance. Improving information systems will enhance audit planning and improve effectiveness. The Government is considering other reform options to improve monitoring, auditing, and enforcement.

PI 15: Effectiveness in collection of tax payments

PI 15	Scoring method M1:	D+
	(i) Collection ratio for gross tax arrears (Not rated)	
	(ii) Effectiveness of transfer of tax collections to the Treasury (B)	
	(iii) Frequency of complete accounts reconciliation of tax assessments, collections, arrears and transfers to the Treasury (D)	

- (i) Success in collecting tax arrears (proportion of the amount outstanding at the beginning of the year actually collected during the year)
- 76. In Iraq, the importance of taxation for revenue generation is currently much less than in other countries. Nevertheless, appropriate⁴ broadening of the revenue base by increasing the tax effort is important for the Government to reduce the impact of oil price fluctuations on fiscal policy⁵. In this regard, the Government has commenced development of a medium-term tax reform strategy with technical assistance provided by development partners, including the IMF. In particular, reforms being considered are the introduction of a flat rate consumption tax and administration strengthening.
- 77. **Estimates of levels of tax arrears are not yet available.** Tax arrears are the amounts overdue by tax payers, once the assessment has been finalized and payment timeframes have lapsed. Part of tax arrears may represent disputes between tax payers and revenue administration authorities. The GCC, GCT and the Accounts Department within the MoF report actual tax collections to the Minister for Finance on a monthly basis. Currently, the value of tax assessments and arrears are not included in that report.
- 78. To promote timely estimation of tax arrears, systems are being established and reform measures are currently being considered by the MoF, GCT and GCC. Tax administration is improving with a 16% increase in collections as compared to last year (as at August 2007). This increase is more likely to be due to the increase in the number of taxpayers than a reduction in tax arrears, given the current Government

⁴ It has been argued that countries affected or coming out of conflict should attempt to maintain a low tax base if possible.

⁵ Stabilization funds are a key measure to mitigate the effects of fluctuations in the world price of oil prices on fiscal policy.

priorities in the area (i.e. to increase taxpayer registration and target tax evaders). The MoF has also identified that political, administrative and security instability have been the major constraints in progressing taxation reform in recent years. Moreover, the MoF indicated that improved stability in the political environment and administration is cause for increased optimism for better outcomes from reform and operational efforts.

- 79. It is likely that the total amount of tax arrears is significant and the debt collection ratio⁶ in the last fiscal year was below the 60% threshold for a score of D. Information is not yet available to estimate the debt collection ratio as systems are not sufficiently established so the dimension is not rated. It is possible that data may indicate far better performance given that tax arrears are based on an actual assessments lodged with the revenue authority and an actual payment made by the taxable person.
- (ii) Effectiveness of transfer of tax collections to the Treasury by the revenue administrations
- 80. In 2006, the system for transfer of tax collected by the GCT to the MoF was that all tax payments had to be made in Baghdad and all payments were to be deposited in the Commissions' sub-account of the MoF. Consequently, the score for the GCT in 2006 is an A. For 2007, however, this score is likely to fall significantly as the Government is keen to increase the level of compliance by making it easier for tax payers to make assessed payments in the area where they live. This measure is therefore likely lead to a situation where revenue collection reports and cash transfers to the MoF will occur monthly or less regularly. Under legislation, however, each employer is required to deduct the due tax from employee salaries and pay it to the GCT within 15 days of the next month.
- 81. Under the Section 4.9 of the FML, all receipts must be credited to the Treasury Consolidated Account and paid into the Treasury Single Account. Under Section 9.7, government agencies are required to submit reports on realized receipts (and executed payments) to the Minister for Finance within 30 days following the end of each month. Revenue transfers to the treasury at the governorate level are through actual cash deposit to the MoF's governorate treasuries. Trial balance reports indicate that transfers do occur on regular basis in accordance the FML. For payments of taxes on Government salaries, this is handled within the MoF accounting procedures, and so is essentially an automatic process. Consequently, the likely score for 2007 is likely to be a "C".
- 82. **For the GCC, border** transactions **follow a similar process**. Timeliness depends on location. Consequently, a score of "B" is given for the GCC in 2006. Overall therefore, a score of B is given for 2006.
- (iii) Frequency of complete reconciliations of tax assessments, collections, arrears records and Treasury receipts
- 83. Complete reconciliation of tax assessments, collections, arrears and transfers to Treasury does not take place annually or is done with more than 3 months' delay. There is no comprehensive system in place to reconcile tax assessments, collections, arrears records and receipts. The system used by the Accounts Department of the MoF, GCC and GCT, is the trial balance reporting method, designed primarily for liquidity accounting. While this system allows reconciliation of transfers and collections it does not identify arrears or assessments. Systems are developing in agencies that will

⁶ Debt collection ratio = Assessed taxation arrears collected/total assessed tax arrears in a given time period.

improve reconciliation. Progress on system development will be essential to improve the "D" score for this dimension.

PI 16: Predictability in the availability of funds for commitment of expenditures

PI 16	Scoring method M1:	C
1110	(i) Extent to which cash flows are forecast	C
	and monitored. (C)	
	(ii) Reliability and horizon of periodic in-year	
	information to MDAs on ceilings for	
	expenditure commitment. (C)	
	(iii) Frequency and transparency of	
	adjustments to budget allocations, which	
	are decided above the level of	
	management of MDAs. (C)	

(i) Extent to which cash flow are forecast and monitored

- 84. This indicator primarily assesses the extent to which the MoF provides timely and consistent information on 'availability of funds' to MDAs. Timely and consistent information allows MDAs confidently to commit resources⁷ without risk of default, inadvertently compromising the government's cash position and/or breaching appropriation limits. The quality of cash flow planning, monitoring and management partly determines the predictability of the availability of funds. The degree of predictability is also determined by how transparent in-year reallocation adjustment processes are, since unanticipated events that impact on actual revenue collections and expenditures often occur. Transparent processes provide incentives to budget well, plan and monitor cash requirements and report timely and accurately.
- 85. The indicator focuses on MoF performance, but it also provides important information on the credibility of MDA budgets. Predictability in the availability of funds is determined by the behaviour of both the MoF and MDAs. Credible MDA budgets facilitates realistic MDA cash requirement forecasting and reporting, which inturn facilitates central cash flow forecasting and reporting. Credible MDA budgets also mitigate the frequency of in-year requests for adjustments to budget allocations. (See also indicator 20 for Iraq's system of commitment controls, which is essentially through liquidity management rather than true commitment monitoring.)
- (i) Extent to which cash flows are forecast and monitored
- 86. The FML and annually issued budget execution instructions outlines the reporting process that are critical for effective cash forecasting and monitoring. The FML establishes the main system for accounting and reporting as the "Treasury General Ledger" (TGL), which is required to be based on double entry principles. The following are key provisions in the FML and the Instructions for Executing the Federal Budget (2007 IEFB) that refer to cash forecasting.
 - FML Section 9.7: MDAs are required to submit reports on realized receipts (and executed payments) to the Minister for Finance within 30 days following the end of each month. It also requires that consolidated monthly budget

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⁷ The FML defines a commitment as an undertaking to make an expenditure following the conclusion of a binding agreement that will result in a payment. It goes on to say that a commitment will terminate at the end of the life of the appropriation and unspent appropriations will lapse at the end of the financial year except for what has been ordered and received.

execution reports on receipts and payments reports be published and distributed widely.

• IEFB 2007

- Section 1.1: Requires that agencies to provide TGL reports to the MoF in "Trial Balance" form⁸.
- Section 1.2: requires MDAs to provide monthly cash flow forecast reports and specifies the scope of such reports.
- Section 1.4: MDAs are required to provide monthly unified use of funds reports to the MoF.
- Section 4.4: Requires the MoF to report to the MoP within 30 days of the end of each month. MoP reconciles these reports with project implementation reports provided by agencies.
- 87. **The Government** essentially **employs a top-down and bottom up approach to liquidity management.** The top down stage utilized by the Accounts Department and Cash Management Unit of MoF in Baghdad is essentially a process of monitoring the following three elements:
 - Overall cash position as reported by the CBI;
 - Actual and forecast cash in-flows obtained from information contained in monthly reports by the MoO, CBI, MoP and MoF departments (e.g. GCC, GCT; Debt Management Unit (DMU) and Budget Department); and
 - Actual cash out-flows from cash releases by the MoF to MDA accounts held in the CBI and MoF Governorate accounts.
- 88. The bottom up approach introduces two additional elements. These element rely on the timely provision of annual and monthly reports by MDAs and are as follows: i) actual cash spending as reported by MDAs and MoF treasuries located in the Governorates; and ii) updates to the annual and monthly cash requirement forecasts reported by MDAs.
- 89. In practice and as an MoF priority, liquidity is assessed at the beginning of the year and prior to in-year release of cash allocations. Cash for employee compensation is automatically released on the on the basis of 1/12th of Budget appropriation allocations. Release for other expenditures are based on cash requirements and are not subject to time constraints, i.e. it is possible for an MDA to receive full access to their appropriation at the beginning of the year should a sufficient and compelling case be presented.
- 90. The Government's liquidity position has not been constrained due to the low levels of budget expenditure execution rates and overshooting of budget revenue forecasts (see Table 24). Consequently, the MoF and MDAs have not been under pressure to focus on improving the quality of cash flow forecasting, even though a strengthened system would facilitate improvements in budget execution and budget preparation.

Table 24: Government Cash Reserves

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Trial balance reporting is the traditional reporting format that reconciles recorded expenditures with bank balance transactions

	2004	2005	2006
DFI Cash Flow Balance	4,923	1,360	2,327
MoF Cash Flow Balance	-	1,008	278
Minsitries Cash Balances	tba	tba	tba
Cash Balance at End of Year	4,923	7,291	9,895
Next FY Budget Balance	-3,714	-7,669	-10852
Cash Reserves for Next FY	1,209	-378	-957

- 91. A cash flow forecast was prepared for the 2007 fiscal year and key elements have been updated but the frequency of updates is uncertain. The updates have been based on actual cash inflows and outflows reported by central agencies and MDAs. Improvements in the comprehensiveness of cash flow forecasting updates is constrained by the provision of timely and complete information from MDAs. The bottom-up cash flow forecasting approach is not yet delivering the needed information. Trial balance reconciliations are also taking longer due to the implementation of the new GFS based classification system and discrepancies between reconciliations between project implementation reports provided to the MoP and TGL reports provided to the MoF by MDAs. Consequently a "C" is given for this dimension.
- (ii) Reliability and horizon of periodic in-year information to MDAs on ceilings for expenditure commitment
- 92. In the case of the 2007 Budget, the Government decided that, in order to improve budget execution performance, it would moderate internal controls and liquidity management practices. One measure was the relaxation of allocation release processes. There are two forms of allocation releases and three different allocation releases procedures. Allocations can either be in the form of: i) *cash transfer* to an MDA specified bank account held at the CBI or other authorised bank; or ii) an *authority to draw* on MoF accounts managed by central or governorate treasuries. The three types of allocation release processes are as follows:
 - For employee compensation: Allocation is released automatically every month at the rate of 1/12th of the employee compensation amount as apportioned in the Annual Budget Law. The Budget Department issues the authorisation at the beginning of the year to the CMU in the Accounts Department for action. After confirming liquidity levels (and unallocated appropriations during the year) the Accounting Department issues the allocation authority⁹. Changes to the 1/12th procedure are also approved by the Budget Department in consultation with the Accounts Department. The Budget Department checks the Budget establishment control list if appropriate.
 - For other operational budget allocations: Releases are based on MDA requests. As a minimum, requests are included in the monthly reporting cycle through the trial balance reports, unified use of funds reports and cash forecast statements. MDAs can request allocations for any period length based on their cash forecasts and compelling justification. The process steps

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⁹ Either through an instruction to: i) the CBI to transfer funds from the MoF central account to the sub-account of the MDA; or ii) an MDA treasury or MoF Governorate treasury providing the authorization to draw on MoF treasury sub-accounts.

- for the issuance are essentially the same as above except for the time periods and less involvement of the Budget Department.
- For investment budget allocations, the process involves MDAs, MoP and MoF. MDAs providing unified performance reports to the MoF, which includes information on use of funds for investment budgets. To secure allocations and meet oversight reporting requirements, MDAs also report to the MoP using prescribed forms on all approved projects in their investment budgets. MoP requires economic and technical feasibility reports of all projects and copies of correspondences related to project execution (e.g. direction to proceed and verification of works provided). Project reports are provided at the beginning of the year after the Budget has been passed and determines the initial cash and allocation requirements. These reports are tend to be quarterly, but can be updated more frequently. In-year investment budget releases are secured when the MoP writes to the MoF informing of their approval of satisfactory project progress. MoP's memorandum also prescribes the amount needed for release in accordance with the agreements with the MDA. After confirming the project is an approved budget, there is sufficient level of unallocated funds in the MDA investment budget, and reconciliation with any unified reports received, the MoF then issues the cash transfer or authority to draw as appropriate. Once actioned, MoF then informs the MoP.
- 93. There are opportunities to simplify and streamline the allocation and cash release processes. The existing process may be compromising the predictability of actual availability of funds to allow timely commitment of expenditures. It is understood that, while significant improvements have been demonstrated on allocation releases and investment budgeting, there remain reporting problems. Moreover, timelags are occurring as a result of the time needed to resolve disagreements between the MoF. MoP and MDAs.
- 94. **MDAs are officially allowed to plan and commit expenditure for at least six months in advance** in accordance with the budgeted appropriations. In practice however, it should be noted that a) there is no commitment system in place and b) MDAs plan and commit expenditure at best on a quarterly basis. Current levels of predictability of resource availability appear not to be a result of low quality or untimely information provided by the MoF to MDAs. It seems to be a more systemic issue concerning planning, the lack of commitment controls and reporting. Consequently a "C" is given for this indicator

(iii) Frequency and transparency of adjustments to budget allocations, which are decided above the level of management of MDAs

- 95. **Rules for in-year adjustments are clear.** These are contained in the FML and temporary amendments reflected in the 2007 Budget Law and supported by issued instructions. Section 9.8 of the FML provides the scope and limits to in-year adjustments. Essentially, the laws provide detailed and precise the conditions for in-year adjustments:
- 96. While minor adjustments to budget allocations are frequent, the adjustment approval process is well administered. It is understood that over 3,000 minor in-year adjustments took place in 2006. Most of these, however, were multiple reallocations

within MDAs and increases on request of MDAs. These reallocations (by value) were predominately for transfers to employee compensation financed by reduction in the goods and services and non-financial assets of the respective MDA's operational budget. Two clarifications were required for erroneous presentations in the 2006 Budget table for pensions under the MoF's General Activities of the State Budget and the Ministry of Construction's Investment Budget (see Attachment 2). The high frequency and scope of within-MDA adjustments is an indicator that improvements during budget preparation and establishment list control procedures are needed. That said, the results indicate that fiscal discipline is established in terms of in-year adjustment procedural compliance.

- 97. **Significant decreases (by number) are rare.** Other expenditures for the MoF's General Activities of the State program, was the by far the most significant decrease at just under ID 300 billion in aggregate, representing 7% of the original allocation. There were only two other significant decreases to line items that occurred: the Other Expenditures budget of the Ministry of Interior and the Assets Maintenance budget for the General Activities of the State program. Each decreased by just over 25 billion in aggregate.
- 98. **Fourteen (14) MDAs had their allocations increased** in aggregate, which were basically funded by the decrease in the allocation of the MoF's General Activities of the State program. Only one minor breach of in-year budget reallocations was identified with the Ministry of Culture having their appropriation increased over the allowed limit by ID3.6 billion.
- 99. Overall, significant in-year adjustments to budget allocations take place infrequently and are fairly transparent. Consequently, a score of "C" is appropriate for this indicator

PI 17: Recording and management of cash balances, debt and guarantees

PI 17	Scoring method M2:	С
111/	(i) Quality of debt data recording and	C
	reporting. (C)	
	(ii) Extent of consolidation of the	
	government's cash balances. (C)	
	(iii) Systems for contracting loans and issuance	
	of guarantees. (C)	

(i) Quality of debt data recording and reporting

100. The legal basis for government borrowing is defined in the Constitution and the Financial Management Law and Public Debt Law of June 2004 (CPA Order No. 95). The constitution provides the exclusive authority to the Government for negotiating, signing and ratifying debt policies. The FML prescribes administrative authorities and duties related to: i) the issuance of public debt and securities, ii) the payment of outstanding debt; iii) fiscal agents and depositories; and iv) matters concerning debt and securities management. The Law provides a special appropriation, which is indefinite and permanent, to the Minister for Finance for the purpose of buying, redeeming, or refunding Government Debt Securities and for paying interest on securities.

- 101. In 2005 the MoF established a Debt Management Unit (DMU) to support the Accounts Department and senior management within the MoF. The DMU is the centralized government authority to contract new external and domestic debt. The issue and redemption of Government debt securities is managed by the CBI acting as the agent for the GoI. The Government has sought and received assistance from the IMF and the World Bank in this area. The GoI provides debt management data as part of its agreement with the IMF on a Stand-By Arrangement program.
- 102. **Debt management is a core Government priority** due to significant debt issued by former administrations. The Iraqi authorities agreed with the Paris Club on November 21, 2004 to a debt reduction for Iraq, equivalent to 80 percent in net present value (NPV) terms, to be achieved in three stages subject to the approval and completion of standard IMF programs.
- 103. **The Government has reduced its external debt stock by over 30%** (see Table 25). Irrevocable debt reductions totalling 60% ¹⁰ of Paris Club debt was secured in 2004 and 2005 in accordance with the terms of the agreement with the Club. A remaining 20% reduction is contingent on successful completion of the final review of the third year of IMF standard programs (end-December 2008). Iraq has also resolved some of its debt to non-Paris Club creditors and most private creditors' claims. Iraq has singed agreements with non-Paris Club creditors totalling \$3.4 billion and settled more than \$19.7 billion claims submitted by private creditors. Negotiations to resolve debt with non-Paris Club continues. The Government hopes that further negotiations will be facilitated by the Special Purpose Vehicle (SPV), which the Government established in March 2007 and provides single securitization of restructured debt to official creditors.

Table 25: Estimates of External Debt Stock (US\$ Billion)

- 11/2 1 - 1 - 1 - 1 - 1 - 1 - 1 - 1 - 1 - 1				
External Debt Stock	2004^	2007		
Paris Club official creditors	42.6	20.7		
Non-Paris Club official creditors	67.7	64.3		
Private creditors	20.7	4		
Multilateral creditors and others	0.9	1.4		
Total debt	131.9	90.4		

104. **Domestic and** foreign **debt records are complete, updated and reconciled quarterly.** Data quality is considered fair, but some gaps and reconciliation problems. Management and statistical reports are not sufficiently comprehensive. Consequently, a score of "C" is given (see Table 26)

Table 26: Scoring for First Dimension (PI-17)

Debt Item	Timeliness			Completeness			
	Qualit	Records	Records	Debt Service	Debt Stock	Operations ^	Statiscal
	R/ecords	Updated	Reconciled				Reports
Foreign Debt	Yes - fair	Yes - fair	Quarterly	Ye	Ye	N	Ϋ́e
Domestic Debt	Yes - high	Yes - fair	Monthl	y e	y ′e	N	3 ∕e
			у	S	S	0	S
C	•						

^ Terms and conditions of issue, conversion, maturity, payment, and interest rate

(ii) Extent of consolidation of the government's cash balances

¹⁰ Valued at around \$25 billion at the time of the Government's agreement with the Paris Club.

- 105. The system for the consolidation of cash balances is assessed against timeliness and completeness. "Timeliness" here means cash balances are consolidated daily and "completeness" means all cash balances of the Government are consolidated. Cash balance requiring reconciliation include: a) the central cash position of the MoF; b) the cash position of other Government agencies; and c) extra-budgetary sources. A Single Treasury Account (TSA) is critical for timely and complete reconciliation. A TSA can be computerized for improved timeliness and accuracy or linked through manual systems.
- 106. **The Government does not yet operate a Treasury Single Account (TSA)**, even though the FML defines the Government's TSA as "a bank account, or a set of linked bank accounts, of the government through which all government receipts and payments are channelled". Due to the non-computerization of the banking and payments system much of TSA operations are handled manually. Controls in the opening, maintaining and closing of Government bank accounts are strengthening.
- 107. **The GoI's system for reconciliation and consolidation is founded on the "Trial Balance" method of reporting.** Trial balance reporting is the Governments traditional reporting format that reconciles recorded expenditures and receipts with bank balance transactions (see PI-16 for more information). Regular monthly reporting by most MDAs using the trial balance system allows the Government to know its essential cash position on a monthly basis, although it is understood that some difficulties are experienced with reconciliation of Governorate based accounts. Cash positions of accounts held at CBI can be provided on a daily basis. Calculation of most government cash balances take place at least monthly and the system allows for the consolidation of bank balances. Consequently, score of "C" is appropriate.
- (iii) Systems for contracting loans and issuance of guarantees.
- 108. The Government's debt management system within the MoF is essentially manual, supported by spreadsheets. The system within the CBI is computerized. The legal basis for issuing and contracting is defined in the Constitution and the Financial Management Law and Public Debt Law of June 2004 (CPA Order No. 95) (see the first dimension above). The Government has a debt policy that includes no new borrowing from the CBI as part of its program with the IMF. This policy has been complied with since inception. The Government does roll over treasury bills; however, this does not constitute new lending. The Government administers various microcredit and SME investment credit schemes, which are outside the scope of this dimension; as they primarily involve revolving funds. They are mentioned here as they constitute a fiscal risk if fund management is weak.
- 109. Iraq became a member of the World Bank's Multilateral Investment Guarantee Agency (MIGA) on October 21, 2007¹¹. The Government has also approved the signing of agreements with the Islamic Development Bank's Islamic Corporation for the Insurance of Investment and Export Credit (ICIEC). It is assumed

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Iraq will become a full member of MIGA once the ratification process is complete and its initial capital contribution is received by MIGA.

that no guarantee has been issued recently in the Government¹². Most guarantee related issues in Iraq are related to project payments and are handled through letters of credit. 110. **The DMU is the centralized government authority to contract new external and domestic debt.** The Minister for Finance is the Government authority for buying, redeeming, or refunding Government Debt Securities and for paying interest on securities. This authority is delegated in part to the DMU. The issue and redemption of Government Debt Securities is managed by the CBI acting as the agent for the GoI. 111. **Central** government's **contracting of loans and issuance of guarantees are made within limits for total debt and total guarantees, and always approved by a single responsible government entity. This rating assumes that no guarantee has been**

PI 18 Scoring method M1:

(i) Degree of integration and reconciliation between personnel records and payroll data.

(D)

(ii) Timeliness of changes to personnel records and the payroll. (D)

(iii) Internal controls of changes to personnel records and the payroll. (D)

(iv) Existence of payroll audits to identify control weaknesses and/or ghost workers. ©

PI 18: Effectiveness of payroll controls

issued recently in the Government. Consequently a score of C is appropriate.

(i) Degree of integration and reconciliation between personnel records and payroll data

112. Reconciliation between establishment lists and MDAs' payroll records occurs infrequently and integrity of payroll and personnel data is undermined by the lack of complete personnel records and a comprehensive personnel database in the MDAs (see PI-16(ii) for discussion on in-year controls). Pre and post-transaction payroll control is weak. It has been reported that disbursement reconciliation in respect of deductions, transfers and ledger postings seems to be broadly acceptable in terms of process design. However, in practice it has proven difficult to determine how processes are actually implemented. Consequently, a score of "D" is given.

113. Current payroll processes and procedures are not able to guarantee allocation of funds or that payments are not being made "ghost¹³," employees. Existing systems have also made it difficult to assess current and future liabilities of pension policies, since meaningful estimates require critical data on certain items, such as establishment numbers, ages, grades, length of service, and dependents and beneficiaries.

114. **MDAs** predominantly **use a manual payroll system**, however some computerized systems do exist, though they are unique stand alone and do not connect to other applications. The manual system in MDAs are either book based systems or book-based supported by spreadsheet or outdated database applications. The MoF uses an internally

¹² Implicit guarantees may have emerged with some project agreements.

¹³ A ghost employee may be a fictitious employee on the payroll one who is no longer employed (e.g. for death, retirement, resignation or termination)

developed Fox Pro system, while the Ministry of Industry and Minerals use an internally developed Access application. The Ministry of Oil uses a COBOL mainframe application developed in the 1960s.

- (ii) Timeliness of changes to personnel records and the payroll
- 115. Delays in processing changes to payroll and nominal roll are often significantly longer than three months and require widespread retroactive adjustments. Mainly due the reasons mentioned in the previous and subsequent dimensions, timeliness of changes to records is seriously compromised. Consequently, a score of "D+" is given.
- (iii) Internal controls of changes to personnel records and the payroll.
- 116. The foundation for an effective establishment control system is in place within the context of the annual budget process. However, the lack of computerized systems, and standard coding structures, compromises the integrity of both the manual and any computerized personnel database that is in place. This makes it difficult for the authorities to control changes and monitor and report on establishment compliance. 117. Specific problems in payroll management have been identified and include the following:
 - MDAs use separate payroll applications, with only limited classification and reporting standards;
 - Almost all civil servants are paid in cash and consequently pay dates vary from ministry to ministry to ease pressure on banking systems;
 - Signature sheets are often not countersigned at the point of payment, nor are unclaimed funds routinely identified and returned to ministerial treasury departments;
 - Instances of managers collecting salaries on behalf of employees have been reported;
 - Related legislation is not clear with different interpretations being reflected by MDAs;
 - The process for validation of payments is weak. Cash disbursement of salary though a three-person payment committee is the standard method. There is no standard process for returning unclaimed funds to the MoF;
 - There is no common civil service employment number. Consequently, employee transfers require termination and rehiring and meaningful employee history is unavailable; and
 - There is no standard coding structure, which causes data aggregation problems causing reporting to be a resource task.

Given these problems, a score of D is justified.

- (iv) Existence of payroll audits to identify control weaknesses and/or ghost workers
- 118. Some partial payroll audits have been undertaken by the BSA and Inspector Generals, who have identified significant problems identified above. MDA audit

procedures generally review monthly variances rather than undertake any form of systematic, random or compliance checks. The BSA has procedures for performance audits which involve more detailed analysis of payroll control (BSA Audit Directive 18). Some payroll surveys and analysis have also been commissioned by the World Bank and others on request of the Government. As discussed above, a civil service census is also underway, which should help provide the basis for improved controls and data and better payroll auditing. Consequently a score of C is appropriate

PI 19: Competition, value for money and controls for non-salary expenditure

PI 19	Scoring method M2:	D+
	(i) Evidence on the use of open competition for award of contracts that exceed the nationally established monetary threshold for small purchases (percentage of the number of contract awards that are above the threshold). (D)	
	(ii) Extent of justification for use of less competitive procurement methods. (C)(iii) Existence and operation of a procurement complaints mechanism. (C)	

- (i) Evidence of the use of open competition for award of contracts that exceed the nationally established monetary threshold for small purchases (percentage of the number of contract awards that are above the threshold)
- 119. **Insufficient data exists to assess the method used to award public contracts.** Although it was stated in recently published regulations that open competition is one of the procurement methods to be used by Iraqi procuring entities, a score of "D" is assigned as data is not yet available on the number of contracts above the threshold procured on the basis of open competition.
- (ii) Extent of justification for use of less competitive procurement methods 120. Less competitive procurement methods such as direct contracting or single source selection should be used only in exceptional circumstances such as for: i) standardization of equipment or spare parts; ii) proprietary equipment; iii) critical items related to performance guarantee; iv) and natural disasters. Contract extensions should also be limited to 15% in value. A risk assessment is needed on procurement processes within the context of current and changing security environment and existing and draft legislation. Moreover, guidance on when security conditions and other situations are sufficient reason for use of less competitive methods is urgently required.
- 121. **Regulatory requirements establish that open competition as the preferred method of procurement.** Justification for use of less competitive methods is however weak. Under the current implementing regulations, direct invitation requires a minimum of three bidders for invitation. This method is to be used when "warranted" by reasons such as "secrecy" or "need for speed of execution". It is understood that these reasons are to be defined by the MoP in future instructions. Preliminary guidance issued

constitutes a significant fiduciary risk. The regulations also specify that single source is to be used only for the supply of goods or projects or for "specialized maintenance" projects and MDAs must first obtain "fundamental" approvals before commencing this form of procurement. It is unclear on what basis "fundamental approvals" would be given. Purchasing committees are used for commodities and services whose values are less than 50 million ID.

- 122. There are three procurement approval bodies that are required to assess justifications and processes followed for less competitive methods. 1) Executing Ministries and Provinces have "Tender Analysis and Recommendation Committee (TARC)", which analyze tenders; and "Central Committees" chaired by Governors, deputies, and members of the concerned directorates. 2); Ministry of Planning and Development Cooperation promulgates procurement, contracting and investment budget execution regulations. 3) The High Contracting Committee reviews and approves proposed contracts above a certain threshold amount. Inspectors General and the Board of Supreme audit also undertake procurement audits. Information on number and type of justification issued is not yet available, although MoP have indicated that the security situation is often cited for justification of project delays and procurement method selection.
- 123. A score of "C" is be assigned to this criterion since justifications for use of less competitive methods are listed in the recently published regulation, although they are weak. Moreover data is not available to assess whether less competitive methods of procurement are justified in accordance with regulatory requirements required for a score of B
- (iii) Existence and operation of a procurement complaints mechanism 124. The recently published regulations highlight the procurement complaints process with clear time frame for resolution of complaints. However, it has not been tested as there has been no procurement complaints submitted so far. Under Order 87, the MoP is given the role to make determinations on contractor protests and claims in accordance with existing regulations. Consequently a score "C" is awarded for this criterion.

PI 20: Effectiveness of internal controls for non-salary expenditure

PI 20	Scoring method M1:	D+
	(i) Effectiveness of expenditure commitment controls. (D)	
	(ii) Comprehensiveness, relevance and understanding of other internal control rules/ procedures. (C)	
	(iii) Degree of compliance with rules for processing and recording transactions. (C)	

(i) Effectiveness of expenditure commitment controls

125. **No real expenditure commitment control procedures exist**. Such controls as exist are based on liquidity management procedures, contract specification rules, sanctions and oversight. Legacy commitment controls have been weakened to facilitate

budget execution performance. The controls do not comprehensively cover all expenditures and they are occasionally violated. Consequently a score of "D" is appropriate

- (ii) Comprehensiveness, relevance and understanding of other internal control rules/ procedures
- 126. Verification rules for non-salary expenditure consist of a basic set of documentary and approval requirements. Investment budget verification guidance is issued, however, guidance on what constitutes appropriate documentary evidence is lacking. The MoP requires submission of all verification documentation and correspondence with contracting entities associated with an investment project. Multiple approvals are required (including project manager, DGs, ministers, MoP and MoF) according to the type and value of expenditure payment. Verification rules for non-salary operational budget expenditure are based on pre-transaction audit method. Current information management systems are not sufficient to cope with the number of transactions required to improve verification control and compliance monitoring 127. Accounting (payment) controls for non-salary expenditure are also founded upon pre-transaction audit principles and consist of a basic set of compliance **checks.** Multiple approvals are also required, though approval requirements are limited. Payment control requirements are different according to payment type. For the investment budget for example, there are five different forms of payments: i) contract advances; ii) letters of credit; iii) allowable administrative costs; iv) payment of contractor invoices and return of bid or performance bonds. Investment budget payment controls consist of a basic pre-transaction review, which checks that: i) the project is in the budget; ii) sufficient funds are available; ii) the payment is consistent with the relevant contract; and iii) invoice is in the proper format. Checking that a competent person has signified that the goods have been received and that the service has been performed as expected, and that the creditor is correctly identified does not formally occur While key components of essential payment control systems are in place, current information management systems are not sufficient to cope with the number of transactions required to significantly improve payment control and compliance monitoring.
- 128. Other key non-salary controls are undeveloped. They include; i) procurement process controls (e.g. monitoring of appropriateness of procurement method); ii) rules for the prevention and detection of mistakes and fraud (internal and external audit are assessed in following indicators); iii) the safeguarding of information and assets (e.g. lack of guidance on asset registration); and iv) specification of quality standards for accounting and reporting. Some guidance has been issued on the requirement for the safe storage of information. There are rules for allowable expenses, incentives and bonus payments, however, documentation requirements and guidance on these is limited.
- 129. Non-salary expenditure control rules and procedures consist of a basic set of rules for processing and recording transactions. Multiple approvals at every stage of the transaction is often required. The rules are only partially relevant. It is evident that rules are understood generally by those directly involved in their application. Some rules and procedures may be excessive, such multiple approval requirements, while other controls are deficient, such as accurate identification of creditors and vendors.

Control rules are basically relevant to Iraq's situation, however, certain high risk points are not adequately monitored (e.g. letters of credit payments and verification of valid commitment). The system does not have an excessive number of financial controllers and there is only minimal computerization involved in processes. Accordingly, the control system may be inexpensive but the level of effectiveness is unclear. The score of "C" is appropriate

- (iii) Degree of compliance with rules for processing and recording transactions 130. Existing rules are generally complied in the majority of transactions, but simple procedures are followed and the use of emergency provisions is believed to be frequent. Consequently a score of "C" is given. At the payment (accounting) control stage it is unclear whether all aspects of control procedures are properly followed. Compliance with liquidity management and payment controls rules are generally adhered to and monitored by the MoF. It is understood that MDA performance varies considerably between MDAs, within MDAs and Governorates. Central agencies report that there are compliance problems, due mainly to civil service experience, capacity or security constraints. In addition, there appears to be a consistent lack of identification and recording of contract vendors, which constitutes a significant fiduciary risk. Compliance with letters of credit payment procedures is a key cause of payment delays, although disputes on verification requirements are often cited. Assessment of compliance with other rules such allowable expenditures, return of bid bonds, advance payments is difficult due an absence of documentary evidence, however, reports by the Inspector Generals and the BSA indicate that compliance is low.
- 131. **Verification controls for investment budget are generally followed** although documentary evidence is often lacking. Furthermore, internal procedures differ due to diverse interpretation of guidance or lack of experience. Multiple verification approvals are required. This does necessarily increase assurance that services or goods have been delivered as expected. The quality of verification is uncertain due.
- 132. At the verification stage of the operation budget, documentary evidence is also often deficient, although the MoF does not require this for the operational budget since responsibility is delegated to MDAs, consistent with FML provisions.
- 133. Compliance with other key non-salary controls is low. It is understood that procurement processes often call on less completive methods. It is uncertain whether justifications are appropriate. Safeguarding of information and assets is weak. Compliance with existing standards for MDA accounting and reporting is inconsistent. There are rules for allowable expenses, incentives and bonus payments, however, documentation requirements and guidance is limited. While minor adjustments to budget allocations are frequent, the adjustment approval process is well administered (see the third dimension of indicator number 16). These other controls are key components of effective internal control systems.

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PI 21	Scoring method: M1	D+
	(i) Coverage and quality of the internal audit	
	function. (C)	
	(ii) Frequency and distribution of reports. (C)	
	(iii) Extent of management response to internal	
	audit findings. (D)	

(i) Coverage and quality of the internal audit function

134. According to Section 11 of the FML 95/2004, it is the responsibility of budget executors to establish arrangements for accounting and internal control of the transactions of spending units and sub-units under their jurisdiction. The FML also empowers the Minister of Finance to prescribe internal control arrangements, accounting procedures, standards and timelines. The Minister may also issue special orders to spending units including all levels of sub-national government (SNG) for the submission of financial reports and final accounts. Within each agency, there is a Directorate that performs *ex-ante* control (or pre-disbursement "audit"). These Directorates are headed by a Director General who is meant to be independent of the minister concerned. S/he is responsible for ensuring that there is a budge allocation and of clearing each stage in the expenditure cycle (commitment and payment order) to ensure its regularity and legality according to prescribed criteria (correct documentation, proper application of procurement or wages rules, correct budget classification).

The Inspector General System

- 135. **The IG system in Iraq is modeled** on **that of the USA.** There are currently 37 IGs, of whom 31 are in ministries and 6 in other organizations like the Central Bank of Iraq. The IG is meant to provide regular assessments of the adequacy and effectiveness of the organization's decision-making, risk minimization and internal control processes. The IG is also the main point of contact for Iraq's Supreme Audit Institution, the Board of Supreme Audit (BSA). The IG Office is to provide information on the status of execution of its internal audit plan, and to co-operate with the BSA in ensuring follow-up of BSA audit recommendations. The IGs are responsible for conducting internal investigations within their organization when necessary. Cases of fraud, theft, embezzlement or corruption are ported to the Commission on Public Integrity (CPI). The IG's office acts as the conduit for any organizational documents and assistance required by the CPI.
- 136. **Before 2004, there was no system of internal audit as such in Iraq.** There were General Inspectors in the previous regime, however, they were there more as informants for the regime, rather than internal auditors. The only equivalent office was a field audit unit operating within the Ministry of Finance Accounting Department. At the request of the Minister of Finance, it performed ex-post audits of selected ministries and other public entities.
- 137. **There are substantial capacity development needs in the IG departments.** Although they are operational in government departments and other bodies, there are serious concerns regarding their ability at their current stage of development to apply

modern internal audit practices and international auditing standards. Consequently, a score of C is awarded to this dimension of internal controls.

(ii) Frequency and distribution of reports

138. The Inspectors General issue reports with recommendations to the Minister, who may either accept or reject the report. Reports that address cases of fraud are required to be copied to the Commission of Integrity (the former Commission on Public Integrity). Score: C

(iii) Extent of management response to internal audit findings

139. **Follow-up on IG reports appears to be limited.** If the Minister rejects the report, there is no further action by the IG. Even if the Minister does accept the report and its recommendations, there is no follow up by the IG to see if the recommendations have been actually implemented. Score: D

Accounting, recording and reporting

PI 22: Timeliness and regularity of accounts reconciliation

PI 22	Scoring method M2:	D+
	(i) Regularity of bank reconciliations. (C)(ii) Regularity of reconciliation and clearance of suspense accounts and advances. (D)	

(i) Regularity of bank reconciliations

- 140. **Reconciliation of accounts directly controlled by MoF is adequate**. However, problems emerge with the regularity and quality of reconciliation of indirectly controlled accounts. Where MoF's Accounts Department has direct control of bank accounts in terms of payments and deposits, monthly and full reconciliation is at a detailed level and usually occurs within 4 weeks. Reconciliation problems, such as timeliness and completeness of reports on accounts managed by MDAs and other entities, occur frequently. Problems experienced appear to be due to the delegated arrangements for reconciliation through trial balance¹⁴ reporting arrangements. The probable cause is that bank account statements are not submitted with trial balance reports for verification. This constitutes a serious fiduciary risk.
- 141. Reconciliations of most MoF managed bank accounts are conducted regularly on a monthly basis. Not all accounts are suitably reconciled and the monthly reconciliation process usually takes longer than 4 weeks. Quarterly reconciliation is usually materially complete within 8 weeks. Consequently a score of C is appropriate.
- (ii) Regularity of reconciliation and clearance of suspense accounts and advances

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¹⁴ Trial balance reporting is the traditional reporting format that reconciles recorded expenditures with bank account transactions.

- 142. The GoI has a number of different types of suspense and advance accounts. At the assignment level, suspense accounts are used by MoF to transfer appropriation allocations to MDAs or MoF managed Bank accounts. At the expenditure accounting level, MDAs use four types of suspense and advance accounts as follows: i) contract advances; ii) letters of credit iii) bid or performance bonds; and iv) petty cash. Suspense accounts are also held by MDAs and the MoF for Government projects financed or co financed by the World Bank. DFI accounts are also a type of suspense account used by the Government for certain receipts, transfers and expenditure.
- 143. **Reconciliation of assignment suspense accounts takes place at least quarterly and often monthly.** These are generally completed within a month. Clearance of these accounts takes place annually in general, within around two months of the end of the year. Clearance of transfers to provinces and the KRG is unclear as the procedures for deeming final appropriations¹⁵ have not been finalized.
- 144. Frequency of reconciliation of suspense accounts at the MDA expenditure accounting level is determined by the type of suspense account. The reporting process is incorporated within the trial balance liquidity management system. Reconciliation of petty cash usually occurs on a monthly basis. Reconciliation of contract advances and performance bonds usually occurs on a quarterly basis. Clearance of these occurs at least annually within two months of end of period, although some accounts have uncleared balances brought forward.
- 145. The frequency of reconciliation and clearance of suspense accounts for letters of credit (L/C) is uncertain. Analysis of the letters of credit process has been undertaken. There are particular points in the process that are either: i) not clear; ii) not clearly documented for accounting purposes; or iii) not well understood by those who are or should be involved.
- 146. Reconciliation and clearance of most suspense accounts and advances take place annually in general, within two months of end of year, but a significant number of these accounts have uncleared balances brought forward. Reconciliation and clearance of high valued suspense accounts, such as those associated with L/C's, takes place annually with more than two months' delay or less frequently. Consequently a score of "D" is appropriate.

PI 23: Availability of information on resources received by service delivery unit

PI 23	Scoring method M1:	D				
	i) Collection and processing of information to					
	demonstrate the resources that were actually					
	received (in cash and kind) by the most					
	common front-line service delivery units (D)					

For example, rules governing population and revenue outturns, reporting obligations and end-of-year adjustment process.

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- (i) Collection and processing of information to demonstrate the resources that were actually received by the most common front-line service delivery units
- 147. Routine data collection systems are not yet in place that provide reliable information on all types of resources received in cash and in-kind by primary schools or primary health clinics. While relatively reliable data exists on budgets and expenditures for MDAs at the provincial level, obtaining and reporting on more detailed information is either absent or too resource intensive to collate. At the school and hospital level, data is readily available on the amount of salaries allocated and spent on teachers and health care workers. However, data on allocations and expenditures to these service delivery units for critical operating expenditures, such as pharmaceuticals, medical supplies, text books and equipment is not readily available. While MDAs do hold this type of data in some form, systems are not in place to produce timely and reliable information on these important resource flows.
- 148. Investment budgets and expenditures are available for school and hospital rehabilitation projects supported by development partners. However, budget, disbursement and expenditure reports from development partners are not in the appropriate form, either in terms of the time-period (i.e. fiscal years) or in accordance with economic, functional or provincial classification. The GoI's investment budget for schools and hospitals is available at the project level. While data is maintained by both the MDA concerned and the MoP, reports on these allocations and out-turns are not yet published.
- 149. **MoP** is developing two investment project reporting systems that are well placed to capture and report on investment budget projects at the service delivery unit level. The Development Assistance Database (DAD) has been "operational" since 2005. Unfortunately the data is outdated as there has only been one effective update (completed in 2006). The Capital Budget Reporting and Tracking (CBRT) system is a project management tool that is founded on legacy project management systems. The MoP is also considering incorporating added functionalities, such as procurement tracking and consolidated investment budget and execution reporting. It is developing quickly and there are encouraging signs that officials at the provincial level and even service delivery units will be able to view and update data. Whichever system becomes operational or the primary source of information, the classification system will need to be aligned with the MoF's and BSA's classification and accounting standards. This will facilitate improved resource allocation and reporting as the ministers for Finance and Planning will be able to determine sector allocations, project inconsistencies and medium term financial implications of such projects.
- 150. Comprehensive or sample surveys have not yet been undertaken to assess the level of resources received in cash and in kind by either primary schools or primary health clinics. While a poverty assessment survey is underway, it will not provide sufficient information on resource flows to service delivery units in the field.
- 151. A score of "D" is appropriate, given that there remains no comprehensive system of data collection that is operational for the reporting of resource flows to key

service delivery units, and that education and/or health PETS have not yet been undertaken

PI 24: Quality and timeliness of in-year budget reports

PI 24	Scoring method M1:	D+
	(i) Scope of reports in terms of coverage and compatibility with budget estimates. (C)	
	(ii) Timeliness of the issue of reports. (D)	
	(iii) Quality of information. (C)	

(i) Scope of reports in terms of coverage and compatibility with budget estimates

152. Comparison with budget is possible for most administrative and economic classifications of the budget, but comparisons are only possible at the payment stage. Given current financial management systems, comparison of expenditure commitments and the budget is not yet possible. MDAs provide "trial balance" reports, which separate expenditures for employee compensation, goods and services and nonfinancial assets. MoF is directly responsible for producing in-year reports for almost all the other economic expenditure classifications (i.e. Interest, Subsidies, Grants, Social Benefits, Other Expenditures and Pension payments). The appropriation to the KRG is treated essentially as an unconditional block grant, which does not require reclassification in the GoI's in-year or out-turn reports 16. The investment budget is aggregated in the annual federal budget. Consequently, it is not possible to compare budget and in-year performance at a more detailed economic classification level for investment budget expenditures (e.g. acquisition of non-financial assets and consultancy projects). Overall then, a score of "C" is appropriate

(ii) Timeliness of the issue of reports

153. The in-year reporting process follows a monthly cycle through the MoF's "trial balance" reporting method, although more complete reports are prepared quarterly. Quarterly reports are supposed to be presented to the High Economic Committee within 8 weeks of end of quarter but longer delays are common... The MoP also produces quarterly reports for the High Economic Committee on Investment Budget execution. The accounting treatment reflected in these reports, however, appears to differ from MoF standards. MoP information is sourced from MDAs on request of the MoP. The timeliness of MoF and MoP consolidated reports is determined by the timeliness and completeness of reports from MDAs and deconcentrated MoF provincial treasuries (and currently operates with a two-month time lag). A score of D is appropriate

(iii) Quality of information

154. There are concerns about the accuracy of information in quarterly reports. Data quality concerns are associated with: i) fragmentation of the investment and

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Reconciliation of final deemed appropriations to the KRG is needed and depends on final revenue outturns and revenue sharing modalities and agreements.

operational budgets; ii) opaque accounting treatment for certain expenditure items (including suspense accounts); and iii) the implementation strategy for the roll-out of the GoI's new GFS-based classification system. The concerns, however, do not substantively undermine the usefulness of reports.

- 155. Fragmentation of the investment and operational budgets is causing some duplication in the reporting of investment expenditures. While instructions have been issued to minimise the risk of fragmentation problems in reporting, it is evident that MDAs report regularly to the MoP using different methods for expenditure accounting. Moreover, it is clear that the High Economic Committee relies on these MoP produced reports to initiate corrective action. Differences in accounting treatments include differences in time periods for reporting (MoP often receives reports for different time periods for consolidated reporting) and some differences in economic classifications associated with the acquisition of non-financial assets.
- 156. There are concerns that investment expenditure reports include a mixture of commitments and actual expenditures. Apparently, values of signed contracts may be inadvertently included as expenditure in MoP reports, due to opaque guidance. This has been evident with substantive differences between MoF unified reports and MoP reports.
- 157. The implementation arrangements for the roll-out of the new GFS based classification system is having unintended consequences for perceived data quality. While the legacy classification system is still being used by MDAs, the MoF is producing in-year reports using the new classification system. This does not materially impact on MDA operational expenditures, since the MoF is responsible for executing and reporting around 85% of the former "transferred expenditures¹⁷" budget chapter. Nevertheless, the lack of separation and clarity associated with the accounting of investment expenditures has increased uncertainty of data quality and has extended delays during the consolidation process.
- 158. A score of "C" is considered appropriate, since reports are produced monthly and quarterly. Although some concerns are emerging about processes that increase the risk of substantively inaccurate data being used, these concerns do no yet fundamentally undermine the basic usefulness of the reports.

PI 25: Quality and timeliness of annual fiscal statements

PI 25	Scoring method M1:	D+
	(i) Completeness of the financial statements.	
	(C) (ii) Timeliness of submission of the financial	
	statements. (C)	
	(iii) Accounting standards used. (D)	

[.] Interest, Subsidies, Grants, Social Benefits, Other Expenditures (e.g. contingency reserve and compensation payments to Kuwait) and Pension payments.

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(i) Completeness of the financial statements

159. Section 11.7 of the FML outlines the scope of information of annual financial statements. The section requires the following to be included:

- External audit report from the Board of Supreme Audit;
- A statement of differences between budgeted and executed receipts and payments and on the financing of any deficit or the use of any surplus;
- A statement of spending from contingency reserves;
- Opening and closing balances of the Treasury Consolidated Account and a summary of movements for the year;
- A statement of all federal government borrowings for the year, and the total debt outstanding, including any payment arrears;
- A statement on federal government guarantees issued during the fiscal year;
- A statement on all borrowings by regional governments and governorates;
- A statement on outstanding amounts on capital contracts and retentions (carryovers) due on contracts;
- A statement on letters of credit entered into for which funds have been placed but for which goods have not been received; and
- A statement on all guarantees by regional governments and governorates.

160. Section 5.4 of the Law requires that the BSA be provided with additional information on the operations of the petroleum revenue account. Since the President of the BSA is the chair of the COFE, the BSA is effectively provided with timely access to this information. Section 14 outlines what information is required to be delivered to the BSA with the financial statements and include the following:

- Approved federal budget and any supplementary budgets, and any accompanying documents (e.g. in-year adjustments);
- Results of all internal audits;
- Quarterly and annual reports on loans, borrowings, guarantees, and debt;
- Final accounts of public corporations and the results of all audits; and
- Any other documents, information and explanation requested by the Board of Supreme Audit in connection with the performance of its audit functions.

161. A consolidated government statement is prepared annually, although it is not fully complete. Complete information on all assets and liabilities is not provided in the annual consolidated financial statement. In addition, information on revenue, expenditure and bank account balances is not always comprehensive as some accounts remain unclosed due to ongoing investigations into unresolved discrepancies associated with trial balance reports. These omissions, however, are not likely to be material. The reconciliation processes for bank balances and suspense accounts are a key area of concern (see PI-22 for more information). Other information required by the FML, as indicated by *italics* in the list above, are not yet included in the reports. Consequently a score of "C" is considered appropriate

(ii) Timeliness of submission of the financial statements

- 162. Section 11.6 of the FML requires that annual final accounts of the federal budget be submitted to the BSA for external audit by 15 April of the succeeding year. This timeframe of 3½ months is very tight. Provision of annual financial statements for external audit within six months is considered best practice.
- 163. Annual financial statements are provided to the BSA within 6 months of the end of the fiscal year. However, the statements are often not sufficiently complete as a number of MoF initiated clarifications and corrections are made after the statements have been transmitted to the BSA. For the 2004 and 2005 fiscal years, substantively final statements were provided within 15 months. For 2006, substantively final accounts were provided to the BSA within 10 months. Consequently, a score of "C" is considered appropriate

(iii) Accounting standards used

- 164. Annual financial statements are presented in a consistent format over time, although with only limited disclosure of financial reporting and accounting standards followed. While accounting standards have been established for the private sector, they have not yet been formally established for public sector accounting.
- 165. Iraq's public sector accounting and reporting standards have been developed over many years and have been reflected in different subordinated legislation, which has since been rescinded, and ad-hoc guidance. The move to GFS based classification system in 2007 has also delayed the adoption of national standards for public sector accounting and financial reporting and introduced inconsistency in the presentation of financial statements. It should be noted that the GoI reclassified appropriations for the 2006 budget according to the new classification system. This facilitated comparison of the 2006 and 2007 budgets. Consequently, a score of "D" is appropriate.

External scrutiny and audit

PI 26: Scope, nature and follow-up of external audit

PI 26	Scoring method M1:	D+
	(i) Scope and nature of audit performed (including adherence to audit standards) (B)	
	(ii) Timeliness of submission of audit reports to the legislature (D)	
	(iii) Evidence of follow up on audit recommendations (D)	

(i) Scope and nature of audit performed

166. Iraq's SAI, the Board of Supreme Audit (BSA) is widely recognized as the country's premier public accountability institution. It has a long history, having been established in 1927, well-trained staff and reasonable capacity to carry out its mandate. Recognizing the need to adopt modern auditing approaches, the BSA invests significant resources in research and development and is an active member of international and regional SAI bodies, such as INTOSAI and ARABOSAI. Although these activities help to mitigate the adverse effects of years of the international isolation

of Iraq, BSA top and senior management acknowledge the need for support from the international development community in terms of applying contemporary government audit standards, practices and techniques. With this in mind, donors such as the UNDP and World Bank have been supporting BSA's strategic planning and capacity development programs.

167. **The BSA's mandate is far-reaching.** It is empowered to conduct the full range of audits, namely certification, financial, compliance and value for money (VFM)/performance audits. Its remit extends to sub-national as well as national government and embraces public enterprises as well as civil society organizations in receipt of public funding. It covers all sectors dealing with the public funds whether income or expenditure. Discussions with the BSA's top management indicate that all these audits are carried out in a carefully planned manner and subject to stringent technical quality control from the centre. There are some constraints, however, caused not least by the harsh security environment in which the BSA has been operating in recent years. In particular, BSA's work at the sub-national level has been hampered by difficulties in accessing records and personnel in certain parts of Iraq. There are also specific issues relating to the Kurdistan Regional Government, where currently two separate BSAs operate, each of them suffering from a severe dearth of experienced auditors. These two organizations are scheduled to merge shortly, but they will continue to suffer from lack of capacity for the foreseeable future. Overall, a score of "B" is justified.

- (ii) Timeliness of submission of audit reports to the legislature
- 168. While the competence of the (national) BSA to discharge its functions is broadly sound, there has been, and continues to be a major weakness in Iraq's public accountability arrangements in terms of the timeliness of submission of audit reports to the Council of Representatives. No annual audit report has not been submitted to the COR for the past 3 years thus preventing the legislature from exercising its essential scrutiny function over the Executive. A score of "D" is therefore appropriate
- (iii) Evidence of follow-up on audit recommendations
- 169. Follow-up action to audit reports by the Executive is a critical link in the public accountability chain. Given the absence of timely audit reports referred to above, this aspect of public accountability needs to be significantly strengthened. It is encouraging, therefore to note, that the BSA has expressed a strong interest in working with civil society to promote social accountability, a topic that has been discussed in two recent World Bank sponsored workshops with senior officials from the national and Kurdistan BSAs. For now, however, a score of "D" is merited.

PI 27: Legislative scrutiny of the annual budget law

PI 27	Scoring method M1:	D+
1121	(i) Scope of the legislature's scrutiny (C)	Di
	(ii) Extent to which the legislature's procedures	
	are well-established and respected (D)	
	(iii) Adequacy of time for legislature to respond	
	to budget proposals (B)	
	(iv) Rules for in-year amendments to the budget without prior legislative approval (D)	

- 170. Under the Constitution, legislative authority is vested in two bodies; the Council of Representatives (CoR) and the Council of Union. The CoR consists of 275 members who are elected for four year terms. The CoR approves federal laws, oversees the Executive, ratifies treaties, and approves nominations of specified officials. It elects the president of the republic, who selects a prime minister from the majority coalition in the Council¹⁸. The Council of Union, or Federation Council (Majlis al-Ittihad), is to consist of representatives from Iraq's regions. Its precise composition and responsibilities are not defined in the Constitution and are to be determined by the CoR. (i) Scope of the legislature's scrutiny
- 171. The legislature's review covers details of expenditure and revenue, but only at the stage where the Annual Budget Bill has been tabled by the Government. The Finance Committee reviews the Budget and provides a report to the CoR, which is discussed at the 2nd Reading of the Annual Budget Bill. The legislature's review covers some fiscal policies on an ad-hoc basis through reports from sector specific committees. Some fiscal policy questions are also raised by various CoR members not on a committee. Budget documentation does make it difficult for the CoR to undertake detailed analysis. The reviews do not include a detailed assessment of the Government's medium term fiscal framework or medium term fiscal priorities as a medium-term perspective is not yet included in the Budget papers and do not form part of the Annual Budget preparation process. While the CoR does review some Government programs, such as social security (PDS and SSN) and fuel subsidization, more specific reviews of program or government function (e.g. primary school education, emergency health care and maternal health) can not be readily undertaken given the current content and structure of the Annual Budget papers. Consequently, a score of "C" is considered appropriate.
- (ii) Extent to which the legislature's procedures are well-established and respected 172. The CoR has 24 standing committees; 10 providing oversight functions and 14 providing more sector specific review functions. The CoR has two primary committees for the review of the annual budget law, although all the standing committees have an interest in reviewing aspects of the Budget. While the committees' responsibilities cut across each other, the Economics, Investment and Reconstruction Committee is primarily responsible for reviewing fiscal and economic policies, while the Finance Committee is primarily responsible for reviewing budget allocations and deficit financing strategies.
- 173. The committees are formally provided with the Annual Budget Bill after the Bill has been introduced by the Government and after its first reading. The Committees then formally meet to discuss and agree recommendations to be presented at the plenary for the 2^{nd} reading (see the Bylaw of Iraqi Council of Representatives). During the 2^{nd} readings, CoR members have an opportunity to raise issues and ask the Minister for Finance specific questions concerning the Bill.
- 174. The Finance and Economic Committees do not yet have procedural documents that guide the review process. Tools and check lists for financial analysis have not yet been developed to support the Committees during review. Coordination arrangements with other committees, including the Legal, Oil and sector committee, are informal.

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¹⁸ During an initial period, a three-member Presidential Council elected by the Council of Representatives will carry out the duties of the president of the republic.

- 175. Some procedures exist for the legislature's budget review, but they are not comprehensive and only partially followed. The Bylaw of Iraqi Council of Representatives is the only procedural document that guides review arrangements. The Bylaw includes internal organizational arrangements and establishes standing committees. The procedures also outline crucial reporting and negotiation procedures within the CoR and between the CoR, its committees and the Government. A score of "C" is appropriate.
- (iii) Adequacy of time for the legislature to respond to the Government's proposals 176. The time periods to which the CoR is to provide a response to budget proposals are enshrined in the FML and the By-Law of the Iraqi CoR. Under Section 6.2 of the FML the Government is to submit in the month of May to the CoR "a report on the priorities for fiscal policy for the next fiscal year, including the proposed total limit on spending and the limits for each individual spending unit". The Budget Call Circular (BCC) is to be issued in June. This provides the CoR between 1-2 months to review fiscal aggregates early in the budget preparation cycle, which is sufficient time for the CoR to provide comments to the Government prior to the issue of the BCC. Under Section 6.8 of the FML the Government is also required to submit to the CoR by 10 October the draft Annual Budget Bill. This gives the CoR up to 2 ½ months for review of detailed budget estimates. Under Article 22 of the By-law of Iraqi CoR on Plenary Meetings, the CoR is to convene and continue sitting until the Annual Budget is approved.
- 177. Since 2004 the CoR has had on average just less than 2 months to consider detailed budget estimates prior to approval of the Annual Budget Law (see Table 27). The CoR has not yet been provided with fiscal aggregates early in the budget preparation cycle in any fiscal year. Given that the CoR has had at least one month to review the budget proposals, and legislation provides at least 2 months for review of annual budget proposals and early access to fiscal aggregates, a score of "B" is appropriate

Table 27: Duration from submission of the budget papers to the CoR to approval

Budget Year	Draft Budget Transmitted to the CoR (Est)	Budget Approval Date by CoR (Est)	Duration (Months)
FY08^	14 Nov 2007	07-Jan-08	1.8
FY07	14 Dec 2006	08-Feb-07	1.9
FY06	01 Dec 2005	28-Jan-06	1.9
FY05	20 Nov 2004	12-Jan-05	1.8

- (iv) Rules for in-year budget amendments by the Executive
- 178. Rules for in-year budget adjustments without ex-ante CoR approval are clear. These are contained in the FML and temporary amendments reflected in the 2007 Budget Law and supported by issued instructions. Section 9.8 of the FML provides the scope and limits to in-year adjustments. Essentially, the laws provide the following conditions for in-year adjustments:
 - a) a maximum of 5% (10% as temporarily amended by the 2007 Budget Law) of an MDA's total appropriation (annual or supplemental) can be reallocated to another MDA providing that no funds are reallocated to another MDA's investment budget;

- b) a maximum of 5% of an MDA's total appropriation can be reallocated within the operational budget providing that no funds are reallocated from the MDA's investment budget for this purpose;
- c) a maximum of 5% of an MDA's total appropriation can be reallocated to the MDA's investment budget; and
- d) a maximum of 5% of the non-interest Budget can be provided to MDAs for urgent and unforeseen expenditures financed by the contingency reserve (the 2007 Budget Law introduced a 25 billion ID limit for each case);
- e) On a provisional amendment basis to the FML, an MDA's investment budgets can be reallocated to any MDA's investment budget¹⁹ if the MDA fails to execute 25% of their allocations by the end of the first half of the 2007 fiscal year (projects delayed due to security constraints are exempt); and
- f) A supplementary budget can be introduced to the CoR for more significant in-year adjustments "only on the basis of a significant and unexpected change in economic circumstances or national priorities" (FML Section 7.5).
- 179. Clear rules exist for in-year budget amendments by the Government and are partially respected. Temporary provisions, however, allow extensive administrative reallocations. The increase of 5 percentage points to 10% for the amount an MDA's appropriation can be reallocated to another MDA is considered high. The FML's provision is consistent with international standards (item "a" above). Similarly, the theoretical reallocation of an MDA's total investment budget should it not have executed 25% by mid-year provides excessive authority for reallocation without ex-ante approval by the legislature. Expansion of the expenditure without ex-ante approval is not allowed and is respected (see PI 16.iii). There appears to be no practice of submitting supplementary budgets to the CoR for its approval. Consequently, a score of D is given.

PI 28: Legislative scrutiny of external audit reports

PI 28	Scoring method M1:	D
	(i) Timeliness of examination of audit reports by the legislature (D)	
	(ii) Extent of hearings on key findings undertaken by the legislature (D)	
	(iii) Issuance of recommended actions by the legislature and implementation by the executive (D)	

180. Authority and requirements for legislative scrutiny of the external audit reports is contained in the Constitution, Bylaw of the CoR, the FML and BSA Law. Article 61 of the Constitution states that the CoR is the competent authority to monitor the performance of the Government. Section 11.6 of the FML requires that the BSA's external audit report (and final accounts) for a specific fiscal year be submitted

¹⁹ The Law is silent on whether funds can be transferred to operational budgets in this instance.

to the CoR by June 30 of the follow fiscal year. Section 11.7 specifies the details that need to be included in final accounts. Section 11.8 requires that after the CoR has approved the final accounts (and considered the BSA's audit report) that the final accounts "be published in the Official Gazette and made publicly available". Section 14 of the FML requires the Minister of Finance to provide certain information to the BSA to facilitate external auditing. Article 31 of the Bylaw of the CoR requires the CoR to approve the final accounts (and review of external audit reports). Article 92 of the Bylaw also establishes the CoR's Integrity Committee as being responsible for reviewing, monitoring and following up on audit reports. Under Article 3.4 of BSA Law of 1990 (and Section 2.5.5 of CPA Order 77/2004:) the BSA is to establish procedures for preparing and submitting to CoR, the BSA's Annual Plan and Annual Report within 90 days of the end of each fiscal year²⁰. These reports alert the CoR to the non-finalization of final accounts and audits as appropriate.

181. At the time of writing, external audit reports and final accounts have not been tabled with the CoR. Consequently, examination of audit reports by the legislature does not take place, there are no in-depth hearings conducted by the legislature and there are no formal recommendations being issued by the CoR. A score of "D" is therefore appropriate for each of the three dimensions on timeliness, extent of hearing and issuance of recommendations

Donor practices

D 1: Predictability of direct budget support

D 1	Scoring method M1: The actual disbursement fell short by more than 15%	Not rated
	in at least two out of the past three years.	Tated

182. In 2003 and 2004, Iraq received less than 1% of assistance in the form of direct budget support. Since then, Iraq has not received any direct budget support (see Table 28). When Budget support was provided, fiscal forecasts were not given to the GoI, which was consistent with donor pledging and budget arrangements at the time.

Table 28: Direct Budget Support – Committed and Disbursed by Fiscal Year (USD 'm)

Assistance Type/	Thematic Area -	200	3	20	04	20	05	20	06
Donor		Com.	Dis.	Com.	Dis.	Com.	Dis.	Com.	Dis.
Direct Budget Support									
Korea	Governance and Democracy	4.7	4.7	-	-	-	-	-	-
Spain	Economic Development	-	-	5.0	5.0	-	-	-	-
Total Assistance		1,078.0	361.9	4,574.2	3,237.3	4,105.6	3,544.1	4,869.2	3,146.1
Source: DAD									

183. Iraq's development partners do not yet provide budget estimates for disbursement of project aid at stages consistent with the government's budget calendar or in a breakdown consistent with the GoI's budget classification. Major donors also do not provide budget estimates for disbursement of project aid for the GoI's coming fiscal year, nor do they provide this information at least three months prior its start. Development partners do provide annual updates on commitments and disbursements, although reporting is not consistently classified. Given the lack of budget support, this indicator is not rated.

Article 5.2.1a of BSA Draft Law 2005 extends the reporting deadline to the CoR from 90 days to 120 days at the end of each fiscal year.

D 2: Financial information provided by donors for budgeting and reporting on project and program aid

D 2	Scoring method M1:	D
	(i) Completeness and timeliness of budget estimates by donors for project support (D)	
	(ii)Frequency and coverage of reporting by donors on actual donor flows for project support (D)	

(i) Completeness and timeliness of budget estimates by donors for project support

184. Iraq's development partners do not yet provide budget estimates for disbursement of project aid at stages consistent with the government's budget calendar or in a breakdown consistent with the GoI's budget classification. Major donors also do not provide budget estimates for disbursement of project aid for the GoI's coming fiscal year, nor do they provide this information at least three months prior its start. Development partners do provide annual updates on commitments and disbursements, although reporting is not consistently classified. Consequently, a score of "D" is appropriate.

(ii) Frequency and coverage of reporting by donors on actual donor flows for project support

185. **Iraq's development partners do not provide quarterly reports within two month of end-of-quarter** on **all disbursements made** for at least 50% of the externally financed project estimates. Nor do they provide information consistent with the GoI's budget classification system. Consequently, a score of "D" is appropriate

D 3: Proportion of aid that is managed by use of national procedures

D 3	Scoring method M1:	D
	Proportion of aid that is managed by use of national procedures	

186. National procedures are bypassed for almost all development assistance projects and programs. Development partners are not yet using the same national procedures used for Government funds for banking, authorization, procurement, accounting, audit, disbursement and reporting. Some progress towards the use of banking, authorization and auditing procedures has been achieved. For example, the World Bank uses Government Bank accounts for project special accounts (advance accounts), which are opened in accordance with MoF standards. The MoP and the ISRB authorize both Government and Donor investment projects, although the systems are different for donor projects. The BSA is now becoming increasingly responsible for auditing development partner projects and work is underway for the BSA (through the COFE) to take over oversight of the DFI from IAMB. Iraq's development partners are working to strengthen procurement arrangements, which should allow greater use of national procurement procedures once new legislation and systems and are operational.

187. Government funds are channelled into donor systems. Through the DFI, special arrangements are established that allow Government funds to be used according to non-national systems. Although this is understandable given the need to execute a massive budget, such an approach weakens institutions and enshrines potentially inappropriate practices for an Iraqi context.

Country specific issues

- 188. Two key PFM issues in Iraq are worthy of emphasis, namely oil revenue management and capital investment budget implementation. In terms of oil revenue management, at this juncture the Development Fund for Iraq (DFI) plays de facto the role of an oil fund. All proceeds of export sales of petroleum, petroleum products and natural gas from Iraq are deposited into the DFI. Oil revenues above the estimated price set in the budget accrue to the DFI. However, the decision-making process regarding the use of all the money that accrues to the DFI over that which goes into the budget is not clear. In similar situations, several countries dependent on hydrocarbon revenues have smoothed the revenue streams that finance public expenditures by establishing oil stabilization funds, or sovereign wealth funds. Others have set up heritage funds that pass on proceeds from natural resources to future generations.
- 189. Discussions about creating such a fund are underway in Iraq but are tied to the larger discussion of how revenues will be shared. According to the Constitution strategic policy-making is a shared power between the federal level and oil-producing governorates and the regions. Many federations with significant natural resource revenues such as Canada, US, Australia and Russia, provide states with extensive ownership rights, with the federal government playing a leading and central role in all other salient aspects in relation to natural resources. The GoI has yet to decide whether these revenues will be used to minimize the transmission of oil price volatility to fiscal policy i.e. establish a stabilization fund, or whether it will act as a savings fund and address inter-generational issues. Nor is it clear whether the funds in the DFI are being invested such that benefits are maximized. At present, the Committee of Financial Experts audits the DFI. But the audit objectives are fiduciary in nature with no focus on ensuring that the resources are effectively managed. Moreover, several past audits of the DFI have pointed out concerns regarding inadequate controls over Iraq's oil and other aspects of the DFI's operations.
- 190. **Budget execution is constrained by a range of bottlenecks in the capital investment budgeting system.** These stretch from procurement and contract management through commitment, verification and payment to oversight. There have also been wide divergences in budget execution rates between ministries and between governorates. Only the relatively stable and more secure region of Kurdistan has been able to achieve a high level of budget implementation. One factor that does not appear to be a constraint at the national government level is cash liquidity. The evidence suggests that a large amount of cash is actually being drawn down from the DFI in New York and advanced to government spending units. However, the money is then not being spent; instead it has led to very large idle balances in the bank accounts of spending units. ²¹ Given the crucial importance of effective budget execution in terms of the delivery of essential public services, this area of PFM must be a priority for reform. The key issues are discussed in detail in chapter 2 of this report.

²¹ These have been estimated at ID 9.5 trillion at end-2007 (12 percent of GDP), equivalent to over US\$7.5 billion

191. One of the most significant challenges facing the GoI is to improve the integration of capital and recurrent budgeting. This common problem in PFM results in insufficient attention being paid to the recurrent costs of capital schemes and therefore significant difficulties in operating and maintaining expensive capital assets. Institutional arrangements are found to be important, with responsibilities for different aspects of budgeting being divided between the Ministry of Finance (MoF) and the Ministry of Planning (MoP). In Iraq, these difficulties are enhanced by large parts of the investment budget being financed and executed outside the budget by donors.

Government reform process

- 192. The strategic context for a PFM reform process has been set by the International Compact for Iraq (ICI). This provides a firm foundation for a Government-led reform process that can be supported in a sustained and integrated manner by Iraq's international development partners. As a basis for monitoring progress, detailed actions are set out in the Joint Monitoring Matrix (JMM) that supports the ICI. One major component of the JMM concerns the effective management of public resources in the interests of the people of Iraq.
- 193. Within this component, the GoI commits itself to the objective of aligning Iraqi PFM and procurement system with sound international practice. In order to establish the analytical framework within which PFM reform can take place, the GoI has been working as a priority action with the World Bank to complete this PEIA. to evaluate the performance of the national PFM system as a basis for prioritization of PFM reform programming.
- 194. In the JMM, the GoI undertakes to achieve an integrated and comprehensive budget and increase its strategic content. In support of this objective, agreed priority actions included the following:
- By end 2008, assign primary responsibility for all aspects of budget management to the MoF and clarify the role of other agencies
- By end 2008, capture in the budget all significant revenues and expenditures, including all subsidies and donor flows
- By end 2009, integrate the recurrent and investment budgets and establish a Treasury Single Account (TSA)
- 195. Several donors have been providing support to PFM reform and capacity development over the last three or four years. These include the International Financial Institutions, the United Nations, the United States, the United Kingdom and the European Commission. Much of the multilateral aid has been channeled through the International Reconstruction Fund Facility for Iraq (IRFFI). The US Government has worked on a range of PFM issues through the US Treasury, US Agency for International Development (USAID), State Department and Department of Defense, while the UK Government through its Department for International Development (DFID) has been actively involved in economic management. The UNDP has managed a program of support to the Board of Supreme Audit as well as providing support to anti-corruption initiatives. The World Bank has provided a number of workshops on specific aspects of PFM. The IMF has been providing technical assistance in support of its Stand By Facility. The need now is to co-ordinate these initiatives under a coherent program of support to a GoI led PFM reform strategy and action plan.

- 196. In designing such a program, careful attention needs to be paid to the unusually difficult circumstances that face a fragile state like Iraq which has been so severely affected by conflict since 2003. Many crucially important public institutions have been devastated by the destructive effects of war and insurgency on their capacity. Large numbers of key staff have been lost to the Iraqi public service. A sustained effort over the medium term backed by Iraq's international development partners will be necessary to rebuild the capacity required for a well performing PFM system. This will require appropriate incentives to help create an enabling environment for PFM modernization.
- 197. The area of public financial management (PFM) requires significant reform. The Government of Iraq's (GoI) budget lacks realism and credibility as spending on current expenditures is rising rapidly while capital budget implementation remains slow. The quality of expenditure reporting is uncertain and independent audits are not yet available.
- 198. Weak governance, including poor PFM, continues to weaken the ability of the state to deliver the public goods necessary to support human development. Since 2003 Iraq has made limited progress in reforming public expenditure policy and management, yet in order to implement an improved development agenda, Iraq will have to make much more progress on a number for key fiscal and institutional challenges. Weaknesses in the PFM system not only have high costs in terms of allocative and operational efficiency but also create unacceptably high levels of fiduciary risk to public funds. The cash-based payments system has emerged as a major constraint. Increasingly, budget execution has suffered from delays and an unpredictable release of funds, undermining operational planning and resulting in a likely build-up of arrears. The system is plagued by deficient accounting and reporting systems, leading to a weak control environment. The GoI will need to focus on improving budget execution, cash management, and the control environment, as well as strengthening tax and oil revenue administration.
- 199. The GoI has demonstrated its commitment to improving public sector governance by putting PFM issues at the heart of the socio-economic pillar of the **International Compact for Iraq.** Moreover, the GoI identified the World Bank's Public Expenditure and Institutional Assessment (PEIA) as a priority action under the Compact's Joint Monitoring Matrix (JMM) and has completed the workshops in line with the JMM benchmarks. The PEIA is intended to establish the foundation for the formation of a well structured Government-led medium-term PFM reform program. 200. It is hoped that a sector-wide approach (SWAp) in PFMcan be established through the ICI and the PEIA. Development partners (DPs)—AusAID, Canada, DFID, the EC, IMF, Italy, JBIC, Poland, USAID, UNDP, and the WB—have indicated a willingness to work more closely with the Ministry of Finance and Ministry of Planning to support the development of a Public Financial Management Reform Program (PFMRP), which will serve as the common reform program endorsed and supported by all partners in PFM. Moreover, the desire to work jointly in a SWAp—via a Partnership Principle Agreement that is being explored—to coordinate support in order to minimize transaction costs, improve the overall quality of TA provision, and to "speak with one voice." It is envisaged that through a PFM development partners working group, joint monitoring of progress against an agreed PFM performance management framework is achievable.

- 201. The strategic level objective of a GOI-owned medium-term PFM reform program would be to install much higher standards of management, accountability, efficiency, and effectiveness in the mobilization and utilization of all government financial resources. The reform program would aim to accomplish this objective by:
 - making the budget credible as a management instrument;
 - improving financial control and internal accountability; and
 - making the budget a reliable instrument of pro-poor policy implementation.
 - improving public and parliamentary scrutiny of public financial management
- 202. It is suggested that the primary objective of the first phase (or "platform") of the proposed Public Financial Management Reform Program should be to establish a more credible budget. In establishing credibility, measures would be introduced that are designed to:
 - Improve Budget Preparation;
 - Improve Realism and Sustainability of the Budget;
 - Facilitate Budget Execution;
 - Improve Reporting;
 - Strengthen Oversight;
 - Develop PFM Capacity; and
 - Improve Coordination, Monitoring and Evaluation.
- 203. The program will build on the PEIA work, which is intended to establish the foundation for the formation of a well structured Government-led medium-term PFM reform program. International experience emphasizes the importance of a properly sequenced and prioritized reform program. Promising results are emerging in some countries from the application of what has become known as the "Platform Approach" to be followed PFM reform programming. Applying this approach in Iraq would support the GoI in establishing a long-term vision for Iraq's PFM system and would aim to implement a package of measures or activities designed to achieve increasing levels ('platforms') of PFM competence over a manageable timeframe. Effectively this is a "building blocks" approach under which each platform is intended to provide a clear basis for launching to the next, based on the premise that a certain level of PFM competence is required to enable further progress to take place. The outcome would be a GoI-owned PFM reform program that presents a detailed, prioritized, and sequenced action plan to remedy the problems afflicting the PFM system by strengthening accountability and improving transparency, within the context of a medium-to-long term timeframe.
- 204. Based on the analysis of the PEIA an initial PFM Reform Program (PFMRP) of reform has been drafted following the "platform approach". The high-level objective of the first platform is to achieve a more credible and realistic budget. This platform might comprise the following seven key development objectives and supporting measures.
 - Improving Budget Preparation this would include improving budget comprehensiveness and integration, and enhancing budget guidance and compliance
 - Improving Realism and Sustainability of the Budget this would cover improving resource mobilization, cash and debt management, re-designing the

budget cycle and associated institutional arrangements, piloting program-based budgeting and Medium Term Expenditure Frameworks, and increasing the transparency of inter-governmental fiscal relations

- Facilitating Budget Execution this would include improving the ability of
 ministry staff to understand and implement their budgets, taking steps to avoid
 the accumulation of payment arrears, improving the process for approving
 supplementary budget credits and improving the regulatory and institutional
 framework for public procurement,
- Improving Reporting improving classification systems, reinvigorating the IFMIS implementation strategy, enhancing systems for recording donor aid flows, improving in-year financial reporting, piloting expenditure tracking, reviewing the reporting requirements of public corporations and improving the transparency of non-tax revenue
- Strengthening Oversight –improving the effectiveness of internal and external audit, improving legislative scrutiny and strengthening the regulatory and institutional framework for anti-corruption
- Developing PFM Capacity introducing motivational measures within central and line ministries, initiating integration measures between the MoF and MoP and establishing global partnership arrangements for key Iraqi public organizations
- Improving Co-ordination, Monitoring and Evaluation

205. Subsequent platforms might have the following high level objectives:

- Better Accountability greater focus on what is done with public money
- Improved Linkages of Policy to Budget Planning
- Integration of Accountability and Review

206. Further consultation with GoI departments and the Government's development partners will be needed to finalize the program. It is envisaged that a combination of bilateral and multilateral support would provide the required assistance to the GoI to progress the PFMRP. Multilateral assistance would include an initial grant from the European Commission of around \$20 million to finance key development measures not currently being supported. A World Bank project financed by the grant is currently being developed. The project and funds would be managed by the MoF and MoP, MoF and the BSA with Bank supervision.

Implementation Arrangements

207. Bilateral support for the PFMRP will involve existing implementation arrangements utilized by development partners. Key implementation arrangements that are expected to be utilized are the Provincial Reconstruction Team and Local Governance Support mechanisms.

208. While the security situation in Baghdad has improved significantly over recent months it remains critical for sustained success that creative project implementation arrangements be established for the World Bank supervised project. It is expected that implementation arrangements will involve a combination of on-site and off-site activities. As far as possible, capacity development workshops will

take place at the Adnan Palace in the "Amber Zone" of Baghdad, as per the PEIA workshops conducted between July and November 2007. This will be supplemented by extensive use of video-conferencing facilities enabling additional input from key international consultants unwilling to work for the GoI in Baghdad. It is expected that the GoI will choose to use a greater number of local experts or members of the diaspora who have strong links within Baghdad. Overseas study tours to provide exposure to modern international practice will also be considered as appropriate.

Attachment 1

Worksheet for PFM Performance Indicators PI-1 and PI-2

Table 1 - Fiscal years for assessment

Year 1 =	2004
Year 2 =	2005
Year 3 =	2006

Table 2

Data for year =	2004	Billions ID			
functional head	Original Budget	Est. Actual	difference	absolute	percent
Finance	16,009	23,354	7,345	7,345	45.9%
Health	1,421	684	(737)	737	51.9%
Education	816	1,143	327	327	40.1%
Public Work	309	342	33	33	10.5%
Housing and Construction	255	143	(112)	112	43.8%
Water Resources	218	183	(34)	34	15.8%
Justice	208	62	(146)	146	70.3%
Interior	187	1,177	990	990	528.3%
Higher Education	183	301	118	118	64.7%
NGOs	141	-	(141)	141	100.0%
Transportation	127	116	(12)	12	9.1%
Planning and Developmental Cooperation	70	50	(21)	21	29.4%
Foreign Affairs	67	81	14	14	21.0%
Agriculture	53	182	129	129	242.8%
Social Affairs	52	39	(14)	14	25.9%
Sciences and Technology	36	43	6	6	17.5%
Security Affairs	35	823	788	788	2265.4%
Youth and Sport	22	24	2	2	7.5%
Trade	15	16	1	1	6.3%
Culture	14	46	33	33	235.9%
21 (= sum of rest)	48	13	(35)	35	72.3%
total expenditure	20,286	28,821	8,534	8,534	42.1%
composition variance	20,286	28,821		11,037	54.4%

Table 3

Data for year =	2005				
functional head	Original Budget	Est. Actual	difference	absolute	percent
Finance	18,015	14,771	(3,244)	3,244	18.0%
Oil	4,581	240	(4,341)	4,341	94.8%
Kurdish Region	3,749	3,910	160	160	4.3%
Defence	2,000	1,649	(351)	351	17.5%
Health	1,537	761	(776)	776	50.5%
Education	1,268	1,407	139	139	10.9%
Interior	1,216	1,425	209	209	17.2%
Electricity	550	220	(330)	330	60.0%
Housing & Construction	436	167	(269)	269	61.7%
Higher Education and Scientific Research	360	390	31	31	8.5%
Water Resources	353	240	(113)	113	32.0%
Public Works	304	160	(144)	144	47.3%
Transportation	278	71	(208)	208	74.6%
Communications	209	9	(201)	201	95.9%
Labour and Social Affairs	153	152	(1)	1	0.5%
Council of Ministers	118	62	(56)	56	47.1%
Justice	116	72	(45)	45	38.3%
Presidency	108	70	(38)	38	35.3%
Planning and Development Cooperation	93	12	(82)	82	87.3%
Foreign Affairs	81	77	(4)	4	5.3%
21 (= sum of rest)	471	591	119	119	25.3%
total expenditure deviation	35,996	26,453	(9,543)	9,543	26.5%
composition variance	35,996	26,453		10,859	30.2%

Table 4

Data for year =	2006				
functional head	Original	Est.	difference	absolute	percent
	Budget	Actual			P
Finance	24,502	20,436	(4,066)	4,066	16.6%
Defence	5,164	2,118	(3,046)	3,046	59.0%
Oil	4,742	287	(4,455)	4,455	93.9%
Kurdish Region	4,275	4,507	232	232	5.4%
Interior	2,939	2,246	(693)	693	23.6%
Electricity	1,851	420	(1,431)	1,431	77.3%
Health	1,608	820	(788)	788	49.0%
Education	1,588	1,529	(59)	59	3.7%
Higher Education and Scientific Research	674	531	(144)	144	21.3%
Public Works	620	200	(420)	420	67.7%
Housing & Construction	396	197	(199)	199	50.3%
Water Resources	388	213	(175)	175	45.2%
Transportation	290	51	(239)	239	82.3%
Communications	260	11	(249)	249	95.6%
Labour and Social Affairs	244	74	(171)	171	69.9%
Council of Ministers	184	104	(80)	80	43.5%
Foreign Affairs	145	93	(52)	52	35.8%
National Assembly	130	81	(48)	48	37.3%
Presidency	108	99	(9)	9	8.6%
Justice	106	83	(23)	23	21.6%
21 (= sum of rest)	750	491	(259)	259	34.5%
total expenditure deviation	50,963	34,590	(16,373)	16,373	32.1%
composition variance	50,963	34,590		16,838	33.0%

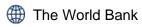
Table 5 - Results Matrix

	For PI-1		For PI-2
Voor	Total exp.	Total exp.	Var in
Year	Dev	Var	excess of
2004	42.1%	54.4%	12.3%
2005	26.5%	30.2%	3.7%
2006	32.1%	33.0%	0.9%

	No of years
PI 1	- Less than 5% deviation
	- Between 5% and 10% deviation
	- Between 10% and 15% deviation
	3_Greater than 15%
Score	D
	No of years
PI 2	2 less than 5% deviation
	1 greater than 5% deviation
	1 greater than 10% deviation
Score	C

Attachment 2: Sources of information

209. Much of the data and information was gathered during a series of 10 workshops held in the Adnan Place, Baghdad in the second half of 2007. These benefited from a high level of attendance and participation by a wide range of GoI officials. Other workshops in Amman, Jordan also provided valuable information. Outside the workshops information has been obtained from the Ministry of Finance, Ministry of Planning and Board of Supreme Audit as well from the IMF Stand By Arrangement reports.



Report No: ISR3016

Implementation Status & Results Iraq

IRAQ: Public Financial Mgmt Reform (P110862)

Operation Name: IRAQ: Public Financial Mgmt Reform (P110862)

Project Stage: Implementation

Status: ARCHIVED

Last Modified Date: 18-Apr-2011

Country: Iraq

Approval FY:

2009

Seq.No: 2

Product Line: Recipient Executed Activities

Region: MIDDLE EAST AND NORTH AFRICA

Lending Instrument: Emergency Recovery Loan

Implementing Agency(ies): Ministry of Finance

Key Dates

Board Approval Date	26-Jun-2009	Original Closing Date 30-Jun-2013	Planned Mid Term Review Date 18-Sep-2011	Last Archived ISR Date 22-Jun-2010
Effectiveness Date	20-Jul-2009	Revised Closing Date 30-Jun-2013	Actual Mid Term Review Date	

Project Development Objectives

Project Development Objective (from Project Appraisal Document)

The Project Development Objective is to support the Government of Iraq's efforts to develop more effective, accountable and transparent public financial management. Support will be provided for strengthening budget management, improving public financial reporting and control, strengthening public procurement, and establishing the tools, systems and institutions required to build capacity for effective public financial management.

Has the Project Development Objective been changed since Board Approval of the Project?

No

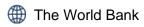
Component(s)

Component Name	Component Cost
Strengthening Budget Formulation and Implementation	3.95
Strengthening Public Procurement	3.20
Strengthening Budget Execution and Implementation	2.33
Capacity Development and Project Management	3.70
Unallocated	13.18
Bank-executed TF (Support to BSA; and Other TA/Capacity Building)	2.00

Overall Ratings

	Previous Rating	Current Rating
Progress towards achievement of PDO	Moderately Satisfactory	Moderately Satisfactory
Overall Implementation Progress (IP)	Moderately Satisfactory	Moderately Unsatisfactory
Overall Risk Rating		

Implementation Status Overview



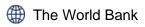
Implementation Progress has been rated as Moderately Unsatisfactory, based on continuing delays in getting the major consultancies started. That said, the mission noted good progress on efforts to procure the consultants for the five large packages, covering all project components and approximately 50% of project funds, and a sixth tender for the development of the MOF Website has just been initiated. Further details are in the 'Components' section.

With timely contract negotiations and efficient commencement of these contracts, the IP could be upgraded to Moderately Satisfactory during the next Supervision.

A recently completed Fiduciary Review carried out by UK DfID charts progress over the past three years in budget quality and credibility, budget linkages to policy priorities (Component I), budget execution, accounting and reporting and external controls (Component III). The review reported progress along the main aspects of the Public Finance Management Action Plan which serves as the basis for the project. Areas identified as in need of more attention in the short and medium term include commitment controls and cash release systems (Component III). Progress on Procurement (Component II) continues to lag due to delays in the adoption of the Procurement Law.

Results

Project Developme	nt Objective Indicators			
Indicator Indicator Name Component 1: Capital budget execution rate increases by at least 10 percentage points		Baseline	Current	End Target
		Value 0.00 Date 01-Feb-2010	Value 3.00 Date 07-Apr-2011	Value 10.00 Date 30-Jun-2013
Туре	Unit of Measure	Comment	Comment	Comment
Custom Indicator	Percentage	Limited strategic planning; unclear and fragmented project preparation rules/procedures hindering efficient and cost-effective project implementation	Iraq has developed a National Development Plan offering an overarching strategic planning framework. Guidelines for investment project preparations are in place but rarely implemented. Key challenges include weak capacity in project preparation at line ministriesand provinces and ad-hoc deviations from planning framework	
Indicator		Baseline	Current	End Target
Indicator Name Component 2: At lea competitively	st 50% of contracts above threshold awarded	Value	Value	Value
		Date	Date	Date
_		03-May-2010	07-Apr-2011	30-Jun-2013
Туре	Unit of Measure	Comment	Comment	Comment
Custom Indicator	Percentage	SBDs not common practice	No progress on SBD due to lack of progress on Procurement Law.	SBDs regularly in use



Indicator Baseline Current **End Target** Indicator Name Value Value Value Component 3: Outstanding balances in spending units decline by 30 0.00 10.00 10.00 percentage points, as a share of the budget Date Date Date 07-Apr-2011 30-Jun-2013 Unit of Measure Type Comment Comment Comment **Custom Indicator** Percentage Cash balances reduced by more 30% reduction in outstanding than 30% due to a review carried balances out with World Bank, IMF support Indicator Baseline Current **End Target** Indicator Name Value Value Value Ministry of Finance training institute providing training on all operational No Yes Yes aspects of PFM Project Date Date Date 01-Jan-2010 30-Jun-2013 30-Jun-2013 Type Unit of Measure Comment Comment Comment The indicator is from the PAD. In **Custom Indicator** Limited capacity in the training Yes/No institute, both human resources, fact, the training institute is and physical assets/curriculum planned to be providing training on all aspects of effective public finance management, not only in relation to the PFMP.

Intermediate Result	ts Indicators			
Indicator		Baseline	Current	End Target
Indicator Name		Value	Value	Value
Component 1 - Draft Sector Strategies completed and submitted to all relevant parties for comment/revision/etc.		Yes	Yes	Yes
		Date	Date	Date
		30-Jun-2009	07-Apr-2011	30-Jun-2013
Туре	Unit of Measure	Comment	Comment	Comment
Custom Indicator	Yes/No	Limited strategic planning	Basic strategic planning framework is in place through the National development Plan. Guidelines for Strategic planning are in place and used by most Ministries. Key challenges are frequent deviation from strategic (national and sectoral) plans to address ad-hoc needs.	new strategies for comprehensive sector budget planning



Indicator Baseline Current **End Target** Indicator Name Value Value Value Component 1 - New procedures in place for project preparation and No Yes Yes appraisal Date Date Date 30-Jun-2009 19-Sep-2011 30-Jun-2013 Unit of Measure Comment Type Comment Comment **Custom Indicator** Yes/No Unclear and fragmented project Guidelines for investment project 10% improvement in capital budget preparation rules/procedures preparation already in place. The execution performance, as challenge stems from lack of hindering efficient and costmeasured by MoPDC and other effective project implementation capacity at line ministries and relevant revies provinces to implement them. Investment budget execution already exceeded target. Baseline **End Target** Indicator Current Indicator Name Value Value Value Component 1 - New Budget Instructions approved and guidelines No Yes Yes ready Date Date Date 30-Jun-2009 19-Sep-2011 30-Jun-2013 Type Unit of Measure Comment Comment Comment **Custom Indicator** Yes/No Budget instructions have been Budget instructions have steadily Budget calendar adhered to. 50% improvement in compliance with fragmented and not sufficiently improved as have the ministries' clear, and framework for compliance with them as evidence ministry/agency budget requests expenditure 'ceilings' not in use. As by smaller gap between ceilings, (based on realism, timeliness and a result, budget not adhered to. submissions and approved budget completeness of submission, etc.) Indicator Baseline Current **End Target** Indicator Name Value Value Value Component 1 - New Budget Call Circular (BCC) in use No Yes Yes Date Date Date 30-Jun-2009 19-Sep-2011 30-Jun-2013 Type Unit of Measure Comment Comment Comment **Custom Indicator** Yes/No Current BCC difficult to properly Target met New BCC with hard budget ceilings complete, as it does not provide issued. sufficient instructional clarity for ministries/agencies



Indicator Baseline Current **End Target** Indicator Name Value Value Value Component 2 - Standard Bidding Documents finalized No Yes Yes Date Date Date 30-Jun-2009 19-Sep-2011 30-Jun-2013 Unit of Measure Comment Comment Type Comment **Custom Indicator** Yes/No SBDs not common practice SBD development ongoing but New SBDs in use in target progress is hampered due to ministries. Improved procurement delays in adoption of Procurement efficiency, transparency, and economy, in target ministries, as Law measuredby data on the method used to award public contracts available Indicator Baseline Current **End Target** Indicator Name Value Value Value Component 2 - Procurement Bulletin Board being fully implemented, No Yes Yes and housed within Procurement Regulatory Agency Date Date Date 30-Jun-2009 19-Sep-2011 30-Jun-2013 Type Unit of Measure Comment Comment Comment **Custom Indicator** Yes/No Limited procurement information No-progress Future options for E-procurement available on-line in real-time developed (software and hardware requirements specified) Baseline Indicator Current **End Target** Indicator Name Value Value Value Component 3 - First round of training on new cash release system No Yes Yes completed with selected pilot ministries Date Date Date 30-Jun-2009 19-Sep-2011 30-Jun-2013 Unit of Measure Type Comment Comment Comment **Custom Indicator** Yes/No Current cash release system No-progress New system demonstrates 30% inefficient, does not respond to improvement in the coherence actual needs between cash releases and actual needs



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Report No: ISR3016

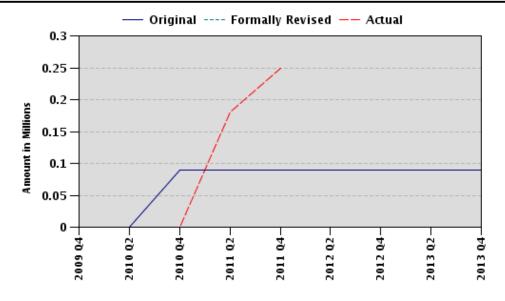
Data on Financial Performance (as of 06-Apr-2011)

P110862	TF-94552	Effective	20-Jul-2009	20-Jul-2009	20-Jul-2009	30-Jun-2013	
Project	Loan No.	Status	Approval Date	Signing Date	Effectiveness Date	Closing Date	
Financial Agreement(s) Key Dates							

Disbursements (in Millions)

Project	Loan No.	Status	Currency	Original	Revised	Cancelled	Disbursed	Undisbursed	% Disbursed
P110862	TF-94552	Effective	USD	16.00	16.00	0.00	0.25	15.75	2.00

Disbursement Graph



Key Decisions Regarding Implementation

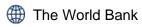
- * Completion of contract negotiations for major consultancies
- * Convening of teams for Commitment Control and Cash Release Systems
- * Hiring of Accountant

Restructuring History

There has been no restructuring to date.

Related Projects

P124388-Iraq PFM Project - BSA



Report No: ISR3016

Implementation Status & Results Iraq

IRAQ: Public Financial Mgmt Reform (P110862)

Operation Name: IRAQ: Public Financial Mgmt Reform (P110862)

Project Stage: Implementation

Status: ARCHIVED

Last Modified Date: 18-Apr-2011

Country: Iraq

Approval FY:

2009

Seq.No: 2

Product Line: Recipient Executed Activities

Region: MIDDLE EAST AND NORTH AFRICA

Lending Instrument: Emergency Recovery Loan

Implementing Agency(ies): Ministry of Finance

Key Dates

Board Approval Date	26-Jun-2009	Original Closing Date 30-Jun-2013	Planned Mid Term Review Date 18-Sep-2011	Last Archived ISR Date 22-Jun-2010
Effectiveness Date	20-Jul-2009	Revised Closing Date 30-Jun-2013	Actual Mid Term Review Date	

Project Development Objectives

Project Development Objective (from Project Appraisal Document)

The Project Development Objective is to support the Government of Iraq's efforts to develop more effective, accountable and transparent public financial management. Support will be provided for strengthening budget management, improving public financial reporting and control, strengthening public procurement, and establishing the tools, systems and institutions required to build capacity for effective public financial management.

Has the Project Development Objective been changed since Board Approval of the Project?

No

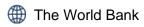
Component(s)

Component Name	Component Cost
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Strengthening Public Procurement	3.20
Strengthening Budget Execution and Implementation	2.33
Capacity Development and Project Management	3.70
Unallocated	13.18
Bank-executed TF (Support to BSA; and Other TA/Capacity Building)	2.00

Overall Ratings

	Previous Rating	Current Rating
Progress towards achievement of PDO	Moderately Satisfactory	Moderately Satisfactory
Overall Implementation Progress (IP)	Moderately Satisfactory	Moderately Unsatisfactory
Overall Risk Rating		

Implementation Status Overview



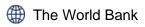
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Indicator		Baseline	Current	End Target
Indicator Name Component 2: At least 50% of contracts above threshold awarded competitively		Value	Value	Value
		Date	Date	Date
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Intermediate Result	ts Indicators			
Indicator		Baseline	Current	End Target
Indicator Name		Value	Value	Value
Component 1 - Draft Sector Strategies completed and submitted to all relevant parties for comment/revision/etc.		Yes	Yes	Yes
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Custom Indicator	Yes/No	Limited strategic planning	Basic strategic planning framework is in place through the National development Plan. Guidelines for Strategic planning are in place and used by most Ministries. Key challenges are frequent deviation from strategic (national and sectoral) plans to address ad-hoc needs.	new strategies for comprehensive sector budget planning



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Report No: ISR3016

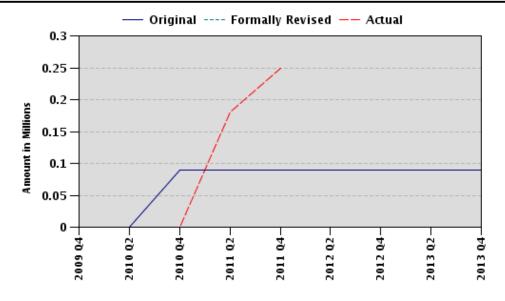
Data on Financial Performance (as of 06-Apr-2011)

P110862	TF-94552	Effective	20-Jul-2009	20-Jul-2009	20-Jul-2009	30-Jun-2013
Project	Loan No.	Status	Approval Date	Signing Date	Effectiveness Date	Closing Date
Financial Agreemen	it(s) Key Dates					

Disbursements (in Millions)

Project	Loan No.	Status	Currency	Original	Revised	Cancelled	Disbursed	Undisbursed	% Disbursed
P110862	TF-94552	Effective	USD	16.00	16.00	0.00	0.25	15.75	2.00

Disbursement Graph



Key Decisions Regarding Implementation

- * Completion of contract negotiations for major consultancies
- * Convening of teams for Commitment Control and Cash Release Systems
- * Hiring of Accountant

Restructuring History

There has been no restructuring to date.

Related Projects

P124388-Iraq PFM Project - BSA



Report No: ISR5663

Implementation Status & Results

Iraq

IRAQ: Public Financial Mgmt Reform (P110862)

Operation Name: IRAQ: Public Financial Mgmt Reform (P110862)

Project Stage: Implementation Seq.No: 3 Status: ARCHIVED Archive Date: 30-Apr-2011

Country: Iraq Approval FY: 2009

Product Line: Recipient Executed Activities Region: MIDDLE EAST AND NORTH AFRICA Lending Instrument: Emergency Recovery Loan

Implementing Agency(ies): Ministry of Finance

Key Dates

Board Approval Date	26-Jun-2009	Original Closing Date 30-Jun-2013	Planned Mid Term Review Date 18-Sep-2011	Last Archived ISR Date 30-Apr-2011
Effectiveness Date	20-Jul-2009	Revised Closing Date 30-Jun-2013	Actual Mid Term Review Date	

Project Development Objectives

Project Development Objective (from Project Appraisal Document)

The Project Development Objective is to support the Government of Iraq's efforts to develop more effective, accountable and transparent public financial management. Support will be provided for strengthening budget management, improving public financial reporting and control, strengthening public procurement, and establishing the tools, systems and institutions required to build capacity for effective public financial management.

Has the Project Development Objective been changed since Board Approval of the Project?

Component(s)

Component Name	Component Cost
Strengthening Budget Formulation and Implementation	3.95
Strengthening Public Procurement	3.20
Strengthening Budget Execution and Implementation	2.33
Capacity Development and Project Management	3.70
Unallocated	2.82
Bank-executed TF (TA to BSA on External Audit and to MOF on Budget Management)	2.00

Overall Ratings

	Previous Rating	Current Rating
Progress towards achievement of PDO	Moderately Satisfactory	Moderately Unsatisfactory
Overall Implementation Progress (IP)	Moderately Unsatisfactory	Moderately Unsatisfactory
Overall Risk Rating		

Implementation Status Overview

The PFM project was started in July 2009 and will be completed in June 2013. The total estimated cost of the Project is US\$18 million, to be funded by: i) US\$16 million from the Iraq Trust Fund, to be Recipient-executed; and ii) US\$2 million from the ITF, to be Bank-executed.

Under the Recipient-executed Trust Fund, there are four components: (1) Strengthening Budget formulation (2) Strengthening Public Procurement Systems (3) Strengthening Budget Execution. (4) Capacity Development and Project Management. Against a project cost of \$16 million, after the lapse of 50% project time, only \$446,000 (less than 3%) has been disbursed; \$6.92 million (43 %) has been contracted; and, \$2.73 million (17 %) is under process of being contracted. The Consultants contracted have begun their work and should be able to complete their task within the remaining project time. There are still \$6.35 million (39 %) remaining funds under the project for which no plan has been prepared.

Following major reasons can be attributed to the slow progress under the project:

- 1. Three major terrorist attacks on the Ministry of Finance since the project start in which the Ministry of Finance building was heavily damaged leading to change of offices of the Project Management Team (PMT) and consequent stress and fear in the minds of PMT staff.
- 2. 9 out of 11 staff of the Project Management Team (PMT), including the PMT leader, was working part-time on this project and were therefore not giving adequate attention to project implementation.
- 3. There was inadequate supervision and implementation support from the Bank side. There were delays in giving 'no objections' and the PMT was not given appropriate guidance at appropriate time leading to low disbursements, low commitments, large proportion of unplanned funds, and absence of an adequate M&E system.
- 4. There was inadequate supervision from the Ministry of Finance in so far as involvement of the Minister and high officials in steering the project is concerned. There was no stocktaking of the situation under the project and no directions issued by the ministry to take necessary corrective measures.

Under the Bank-executed Trust Fund, there are two components: (1) Capacity Building of Board of Supreme Audit (BSA); and, (2) Strengthening Budget Preparation. Against the project cost of \$2 million, \$692,000 (35 %) has been disbursed; \$386,000 (19 %) has been contracted; and, \$350,000 (17 %) is in the process of being contracted. Under this project, the Budget Strategy for 2012-2014; Budget Call Circular for 2011; Updation and Administration of IMF Model in the 2012 Budget process; Conduction of Trainings for the BSA Staff regarding Regularity Audit, Performance Audit, Risk based Audit, Integrity Audit, Procurement Audit, and Training of Trainers have been completed. The Clients are satisfied with activities of the Bank-executed Trust Fund.

The Bank Supervision Team is of the view that the project's impact would be significantly enhanced if an Integrated Financial Management Information System (IFMIS) is also implemented. Component 1 on Budget Preparation and Component 3 on Budget Execution Controls can deliver better results if implemented over an Information Technology based Integrated Financial Management Information System (IFMIS). The Government has requested the Bank to reallocate unplanned project funds for completing IFMIS. They have given an undertaking to provide the remaining funds from its own sources in regard to implementing IFMIS. It is also necessary from the point of view of utilizing the unplanned funds.

Locations

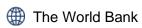
No Location data has been entered

Results

Project Development Objective Indicators



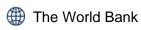
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Indicator Name	Core	Unit of Measure		Baseline	Current	End Target
Component 1 - Draft Sector Strategies completed and submitted to all relevant parties		Yes/No	Value	Yes	Yes	Yes
completed and submitted to all relevant parties for comment/revision/etc.			Date	30-Jun-2009	07-Apr-2011	30-Jun-2013
			Comments	Limited strategic planning	Basic strategic planning framework is in place through the National development Plan. Guidelines for Strategic planning are in place and used by most Ministries. Key challenges are frequent deviation from strategic (national and sectoral) plans to address ad-hoc needs.	Selected line ministries employing new strategies for comprehensive sector budge planning
Component 1 - New procedures in place for project preparation and appraisal		Yes/No	Value	No	Yes	Yes
oroject proparation and appraisal			Date	30-Jun-2009	19-Sep-2011	30-Jun-2013
			Comments	Unclear and fragmented project preparation rules/ procedures hindering efficient and cost-effective project implementation	Guidelines for investment project preparation already in place. The challenge stems from lack of capacity at line ministries and provinces to implement them. Investment budget execution already exceeded target.	10% improvement in capital budget execution performance, as measured by MoPDC and other relevant revies
Component 1 - New Budget Instructions		Yes/No	Value	No	Yes	Yes
approved and guidelines ready			Date	30-Jun-2009	19-Sep-2011	30-Jun-2013
			Comments	Budget instructions have been fragmented and not sufficiently clear, and framework for expenditure 'ceilings' not in use. As a result, budget not adhered to.	Budget instructions have steadily improved as have the ministries' compliance with them as evidence by smaller gap between ceilings, submissions and approved budget	Budget calendar adhered to. 50% improvement in compliance with ministry/ agency budget requests (based on realism, timeliness and completeness of submission, etc.)
Component 1 - New Budget Call Circular		Yes/No	Value	No	Yes	Yes
(BCC) in use			Date	30-Jun-2009	19-Sep-2011	30-Jun-2013
			Comments	Current BCC difficult to properly complete, as it does not provide sufficient instructional clarity for ministries/agencies	Target met	New BCC with hard budget ceilings issued.



Indicator Name	Core	Unit of Measure		Baseline	Current	End Target
Component 2 - Standard Bidding Documents finalized		Yes/No	Value	No	Yes	Yes
inalized			Date	30-Jun-2009	19-Sep-2011	30-Jun-2013
			Comments	SBDs not common practice	SBD development ongoing but progress is hampered due to delays in adoption of Procurement Law	New SBDs in use in target ministries. Improved procurement efficiency, transparency, and economy, in target ministries, as measuredby data on the method used to award public contracts available
Component 2 - Procurement Bulletin Board being fully implemented, and housed within		Yes/No	Value	No	Yes	Yes
Procurement Regulatory Agency			Date	30-Jun-2009	19-Sep-2011	30-Jun-2013
			Comments	Limited procurement information available on-line in real-time	No-progress	Future options for E- procurement developed (software and hardware requirements specified)
Component 3 - First round of training on new cash release system completed with selected		Yes/No	Value	No	Yes	Yes
pilot ministries			Date	30-Jun-2009	19-Sep-2011	30-Jun-2013
phot ministrics			Comments	Current cash release system inefficient, does not respond to actual needs	No-progress	New system demonstrates 30% improvement in the coherence between cash releases and actual needs
Component 3 - Detailed rules and regulations for new commitment control system developed		Yes/No	Value	No	Yes	Yes
tor new communerit control system developed			Date	30-Jun-2009	19-Sep-2011	30-Jun-2013
			Comments	Commitments are not monitored adequately	Efforts are underway to estimate commitments during 2012 budget preparations involving both the Ministry of Planning and the spending units.	New system rolled out to at least 4 total sector ministries



Component 3 - IT assessment completed, and Yes/No Value No Yes Yes functional requirements for upgraded system Date 30-Jun-2009 19-Sep-2011 30-Jun-2013 developed Comments MoF departments fragmented TORs issues for new Ministry New software and hardware in their information-sharing information portal. Equipment are in place and contributing ability delivered to restore IT activity to improved efficiency of MoF at ministry after terrorist operations Plans in place for attacks. World on going on rollout of system in next IFMIS development including phase support in drafting TORs and transition roadmap Component 4 - Training program fully in place Yes/No Value No Yes Yes 19-Sep-2011 Date 30-Jun-2009 30-Jun-2013 Comments Limited capacity in MoF No progress Training program continuing training department to provide targeted training according to needs; program refined based on feedback from PY3. Long-term business plan for sustainable operations of the MoF training department developed and approved

Data on Financial Performance (as of 15-Dec-2011)

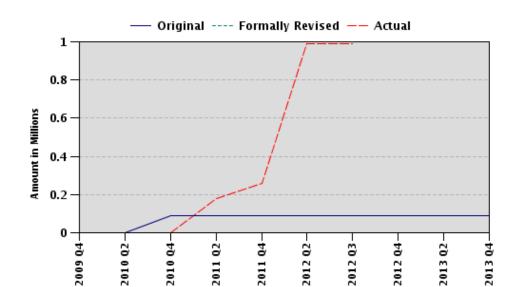
Financial Agreement(s) Key Dates

Project	Loan No.	Status	Approval Date	Signing Date	Effectiveness Date	Closing Date
P110862	TF-94552	Effective	20-Jul-2009	20-Jul-2009	20-Jul-2009	30-Jun-2013

Disbursements (in Millions)

Project	Loan No.	Status	Currency	Original	Revised	Cancelled	Disbursed	Undisbursed	% Disbursed
P110862	TF-94552	Effective	USD	16.00	16.00	0.00	0.99	15.01	6.00

Disbursement Graph



Key Decisions Regarding Implementation

- 1. The Government will establish a Steering Committee of the Project under the chair of the Finance Minister. The Committee shall include the PMT Leader, Director General Budget, Director General Accounts, Director General Planning, and Director General Training. The Steering Committee shall: (1) Approve the annual budget (2) Review the progress every six months and (3) Approve any Restructuring Plans.
- 2. The Government will appoint five full-time staff to function as the Component Leaders in respect of (1) Budget Preparation (2) Public Procurement (3) Budget Execution (4) Capacity Building (5) IFMIS.
- 3. As per government's request, the Bank team shall initiate a restructuring of the project by including IFMIS as the fifth component of the PFM Project. In the remaining one and half years of the project, the Budget Preparation, Budget Execution, and Final Accounts modules of IFMIS will be implemented. The target shall be to prepare the Budget of 2013 using IFMIS from June 2012 onwards and then use the Budget Execution and Final Accounts modules for Budget of 2013, from January 2013 onwards.

Restructuring History

The World Bank

There has been no restructuring to date.

Related Projects

P124388-Iraq PFM Project - BSA



Report No: ISR5663

Implementation Status & Results

Iraq

IRAQ: Public Financial Mgmt Reform (P110862)

Operation Name: IRAQ: Public Financial Mgmt Reform (P110862)

Project Stage: Implementation Seq.No: 3 Status: ARCHIVED Archive Date: 30-Apr-2011

Country: Iraq Approval FY: 2009

Product Line: Recipient Executed Activities Region: MIDDLE EAST AND NORTH AFRICA Lending Instrument: Emergency Recovery Loan

Implementing Agency(ies): Ministry of Finance

Key Dates

Board Approval Date	26-Jun-2009	Original Closing Date 30-Jun-2013	Planned Mid Term Review Date 18-Sep-2011	Last Archived ISR Date 30-Apr-2011
Effectiveness Date	20-Jul-2009	Revised Closing Date 30-Jun-2013	Actual Mid Term Review Date	

Project Development Objectives

Project Development Objective (from Project Appraisal Document)

The Project Development Objective is to support the Government of Iraq's efforts to develop more effective, accountable and transparent public financial management. Support will be provided for strengthening budget management, improving public financial reporting and control, strengthening public procurement, and establishing the tools, systems and institutions required to build capacity for effective public financial management.

Has the Project Development Objective been changed since Board Approval of the Project?

Component(s)

Component Name	Component Cost
Strengthening Budget Formulation and Implementation	3.95
Strengthening Public Procurement	3.20
Strengthening Budget Execution and Implementation	2.33
Capacity Development and Project Management	3.70
Unallocated	2.82
Bank-executed TF (TA to BSA on External Audit and to MOF on Budget Management)	2.00

Overall Ratings

	Previous Rating	Current Rating
Progress towards achievement of PDO	Moderately Satisfactory	Moderately Unsatisfactory
Overall Implementation Progress (IP)	Moderately Unsatisfactory	Moderately Unsatisfactory
Overall Risk Rating		

Implementation Status Overview

The PFM project was started in July 2009 and will be completed in June 2013. The total estimated cost of the Project is US\$18 million, to be funded by: i) US\$16 million from the Iraq Trust Fund, to be Recipient-executed; and ii) US\$2 million from the ITF, to be Bank-executed.

Under the Recipient-executed Trust Fund, there are four components: (1) Strengthening Budget formulation (2) Strengthening Public Procurement Systems (3) Strengthening Budget Execution. (4) Capacity Development and Project Management. Against a project cost of \$16 million, after the lapse of 50% project time, only \$446,000 (less than 3%) has been disbursed; \$6.92 million (43 %) has been contracted; and, \$2.73 million (17 %) is under process of being contracted. The Consultants contracted have begun their work and should be able to complete their task within the remaining project time. There are still \$6.35 million (39 %) remaining funds under the project for which no plan has been prepared.

Following major reasons can be attributed to the slow progress under the project:

- 1. Three major terrorist attacks on the Ministry of Finance since the project start in which the Ministry of Finance building was heavily damaged leading to change of offices of the Project Management Team (PMT) and consequent stress and fear in the minds of PMT staff.
- 2. 9 out of 11 staff of the Project Management Team (PMT), including the PMT leader, was working part-time on this project and were therefore not giving adequate attention to project implementation.
- 3. There was inadequate supervision and implementation support from the Bank side. There were delays in giving 'no objections' and the PMT was not given appropriate guidance at appropriate time leading to low disbursements, low commitments, large proportion of unplanned funds, and absence of an adequate M&E system.
- 4. There was inadequate supervision from the Ministry of Finance in so far as involvement of the Minister and high officials in steering the project is concerned. There was no stocktaking of the situation under the project and no directions issued by the ministry to take necessary corrective measures.

Under the Bank-executed Trust Fund, there are two components: (1) Capacity Building of Board of Supreme Audit (BSA); and, (2) Strengthening Budget Preparation. Against the project cost of \$2 million, \$692,000 (35 %) has been disbursed; \$386,000 (19 %) has been contracted; and, \$350,000 (17 %) is in the process of being contracted. Under this project, the Budget Strategy for 2012-2014; Budget Call Circular for 2011; Updation and Administration of IMF Model in the 2012 Budget process; Conduction of Trainings for the BSA Staff regarding Regularity Audit, Performance Audit, Risk based Audit, Integrity Audit, Procurement Audit, and Training of Trainers have been completed. The Clients are satisfied with activities of the Bank-executed Trust Fund.

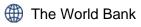
The Bank Supervision Team is of the view that the project's impact would be significantly enhanced if an Integrated Financial Management Information System (IFMIS) is also implemented. Component 1 on Budget Preparation and Component 3 on Budget Execution Controls can deliver better results if implemented over an Information Technology based Integrated Financial Management Information System (IFMIS). The Government has requested the Bank to reallocate unplanned project funds for completing IFMIS. They have given an undertaking to provide the remaining funds from its own sources in regard to implementing IFMIS. It is also necessary from the point of view of utilizing the unplanned funds.

Locations

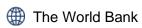
No Location data has been entered

Results

Project Development Objective Indicators



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for comment/revision/etc.			Date	30-Jun-2009	07-Apr-2011	30-Jun-2013	
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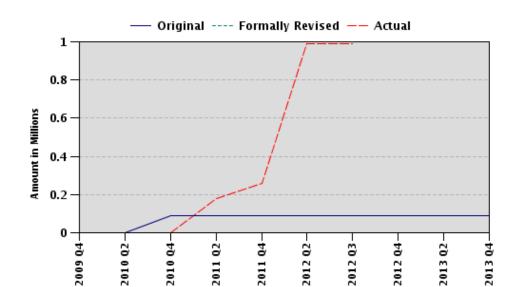
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Disbursements (in Millions)

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Disbursement Graph



Key Decisions Regarding Implementation

- 1. The Government will establish a Steering Committee of the Project under the chair of the Finance Minister. The Committee shall include the PMT Leader, Director General Budget, Director General Accounts, Director General Planning, and Director General Training. The Steering Committee shall: (1) Approve the annual budget (2) Review the progress every six months and (3) Approve any Restructuring Plans.
- 2. The Government will appoint five full-time staff to function as the Component Leaders in respect of (1) Budget Preparation (2) Public Procurement (3) Budget Execution (4) Capacity Building (5) IFMIS.
- 3. As per government's request, the Bank team shall initiate a restructuring of the project by including IFMIS as the fifth component of the PFM Project. In the remaining one and half years of the project, the Budget Preparation, Budget Execution, and Final Accounts modules of IFMIS will be implemented. The target shall be to prepare the Budget of 2013 using IFMIS from June 2012 onwards and then use the Budget Execution and Final Accounts modules for Budget of 2013, from January 2013 onwards.

Restructuring History

The World Bank

There has been no restructuring to date.

Related Projects

P124388-Iraq PFM Project - BSA

Implementing Accrual Basis National Accounting System in Korea

Paris, March. 2010

Jae-Hoon Yoo

Director General, Treasury Bureau

Ministry of Strategy and Finance, Republic of Korea



Contents

I. Current Status

- 1. Progress after the adoption of accrual accounting and double-entry bookkeeping
- 2. National accounting regulatory framework
- 3. Implementation results of national accounting system in 2009

II. Future Plans

- 1. Support the preparation of central government's financial statements
- 2. Establish a national accounting standards center
- 3. Develop accounting treatments on provisions, etc.
- 4. Enhance national accounting and settlement expertise
- 5. Develop a verification system for government financial information
- 6. Complete physical inspection on infrastructure



I. Current Status

1. Progress After the Adoption of Accrual Accounting and Double-Entry Bookkeeping

National Accounting Act enacted in Oct. 2007

- Accrual accounting and double-entry bookkeeping implemented for the entire government finance from 1 Jan. 2009
- Introducing financial statements based on accrual basis in addition to revenue and expenditure reports

National Finance Act and National Accounting Act revised in Dec. 2008

- Duplicated or fragmented settlement-related policies overhauled and financial report framework established
- FY 2011 general purpose accounting and special purpose accounting financial statements to be submitted to National Assembly

National Accounting Standards enacted in March 2009

Standards set for accrual-based accounting and valuation of assets and liabilities



I. Current Status

National Accounting Regulatory Framework

National Accounting Act and Enforcement Decree **National Accounting Standards Practical Supplementary Guidelines Accounting Standards**

for specific accounts

- -Financial reporting framework and components
- -Submission and preparation of financial report and its attachment
- -Establishment of a national accounting system committee
- -Preparation method of financial statements (statement of financial position, statement of financial operation and statement of changes in net assets)
- -Definition of assets and liabilities and valuation methods
- -Supplementary accounting standards for loan accounting and cost accounting
- -Practical guidelines for specific accounts
- Assets and liabilities in the statement of financial position
- · Gross cost of program, non-exchange revenue in the statement of financial operation



I. Current Status

3. Implementation Results of National Accounting System in 2009

- Completion of national accounting regulatory framework
 - National Accounting Standards enacted in March 2009
 - Two supplementary accounting standards and 12 practical guidelines for specific accounts
- Construction of the linkage system(dBrain) between budget and accounting
 - Automated journal entries and linkage system for agencies that do not use the dBrain system
- Physical inspection on public assets and preparation of opening statement of financial position
 - Physical inspection completed on government property, commodities and state claims (Nov. 2008 Jun. 2009)
 - Opening statement of financial position prepared and reconciled (Aug. Dec. 2009)
 - Physical inspection started on infrastructure (Sep. 2009 present)
- Enhancement of national accounting and settlements expertise
 - Extensive trainings conducted for accounting and settlements personnel and dBrain users (Aug. – Nov. 2009)



II. Future Plans

- 1. Support the preparation of central government's financial statements
 - Need to support each central government agency's financial statement preparation and to review their accounting treatments
 - Implement and operate an accounting and settlement support team consisting of private sector experts during settlement period

- 2. Establish a National Accounting Standards Center
 - Need to conduct in-depth research on national accounting system
 - providing interpretations of national accounting standards and inquiry service,
 development of financial indicators for accrual basis accounting and developing
 financial indicators for accrual basis accounting
 - * Commission the tasks of National Accounting Standards to professional organization



II. Future Plans

- 3. Develop Accounting Treatments on Provisions, etc.
 - Need to determine accounting treatments on provisions, which have been suspended in financial reporting based on the National Accounting Standards
 - Plan to develop the accounting treatment through public hearings with private-sector experts within 2010
 - * Determine the overall scope of provisions of pensions, insurances and guarantees as well as their valuation and accounting treatments

4. Enhance national accounting and settlement expertise

- Need to further develop national accounting and settlement expertise
 - Conduct in-depth education programs on national accounting for government officials in charge of accounting and settlement
 - Make a new post of accounting officer in recruiting government officials
 - Foster an expert pool in the private sector on national accounting by inserting national accounting into a CPA exam



II. Future Plans

5. Develop a Verification System for Government Financial Information

- Need to develop a system to verify government financial information using private-sector accounting experts in order to produce more transparent and reliable financial reporting
 - Consider preliminary review of government accounting treatments and financial statements, if necessary

6. Complete Physical Inspection on Infrastructure

- Need to perform valuation by type of asset based on physical inspection on infrastructure
 - Plan to reflect valuation results on financial statements (statement of financial position)
 - * Determine the adequacy of physical inspection through on-spot observation



Report No. 55061-MNA

Public Financial Management Reform in the Middle East and North Africa: An Overview of Regional Experience

Part I Overview and Summary

June 2010

Middle East and North Africa Vice Presidency



The World Bank

Abstract

This report surveys the experience of Middle East and North Africa countries on the topic of public financial management reform. Drawing upon a variety of sources, including Public Expenditure and Financial Accountability (PEFA) assessments, Country Financial Accountability Assessments, Public Expenditure Reviews, and other documents and reports—and augmented as necessary by interviews with leading reformers—the report seeks to address several major questions. How do MENA countries compare with other comparable countries at similar levels of development with regard to their PFM systems and practices? What has been the substantive content and thrust of PFM reforms in MENA over the last decade? Where have these reforms done well, and where have they struggled? What were the key ingredients for success or failure? Are there lessons in how these reforms were implemented that will be of value to other countries and the donor community?

Abbreviations

ACCT Treasury Central Accounting Unit (Algeria)

AfDB African Development Bank

AFMIS Accounting-based Financial Management System
AGES Automated Government Expenditure System

AP Autorisations de Programme

ARABOSAI Arab Organization of Supreme Audit Institutions
ASOSAI Asian Organization of Supreme Audit Institutions

BCC Budget Call Circular
BdL Central Bank of Lebanon
BSA Board of Supreme Audit (Iraq)

BSMP Budget System Modernization Project (Algeria)

CACI Central Inspection Agency (Syria)
CAO Compliance Advisor Ombudsman

CBE Central Bank of Egypt
CBI Central Bank of Iraq
CBY Central Bank of Yemen

CDR Council for Development and Reconstruction
CFAA Country Financial Accountability Assessment
CGED General Control of Expenditures Commitment

CGSP Public Services Audit Office (Tunisia)
CIB Central Inspection Board (Lebanon)

CMU Cash Management Unit

CNED National Fund of Equipment for Development CoA Chart of Accounts (Jordan)/Court of Accounts

(Lebanon)

COCA Central Organization of Control and Audit (Yemen)
COFC Central Organization for Financial Control (Syria)
COFOG Classification of the Functions of Government

COG Central Government

COI Commission of Integrity (Iraq)
COR Council of Representatives (Iraq)

CP Credits de Paiement

CPA Coalition Provisional Authority (Iraq)
CPAR Country Procurement Assessment Report

CPI Corruption Perception Index

CPIA Country Policy and Institutional Assessment
CSMP Civil Service Modernization Project (Yemen)

CST Central Sales Tax
DA Algerian Dinar
DB Budget Directorate

DFID Department for International Development

(United Kingdom)

DGCP General Directorate for Public Accounting (Tunisia)
DMFAS Debt Management Financial Analysis System

DPL Development Policy Loan
DPM Deputy Prime Minister

DPPR Development Plan for Poverty Reduction

DPR Detailed Project Report EC European Commission EdL Electricité du Liban

EFMIS Emergency Fiscal Management Reform

Implementation Support

ESW Economic and Sector Work

EU European Union

FAD Fiscal Affairs Department

FE Forward Estimate

FMIS Financial Management Information Systems

FRR Revenue Regulation Fund (Algeria)

FY Fiscal Year

GBD General Budget Directorate (Jordan)

GBO Budget Management by Objectives (Tunisia)

GCC Gulf Cooperation Council GCF Financial Audit Office (Tunisia)

GDDS Government Data Dissemination Standard

GDP Gross Domestic Product

GFSM Government Finance Statistics Manual

GFMIS Government Financial Management Information

System

GFS/COFOG Government Finance Statistics/ Classification of the

Function of Government

GID Integrated Expenditure Control System

GoE Government of Egypt
GoI Government of Iraq
GoJ Government of Jordan
GoL Government of Lebanon
GoY Government of Yemen

GPC General Party Congress (Yemen)
GTZ German Technical Cooperation

GU Governmental Unit

HCCAF High Commission for Administrative and Financial

Audit (Tunisia)

HIPC Heavily Indebted Poor Countries
HRC Higher Relief Commission (Lebanon)
ICI International Compact for Iraq
ICR Implementation Completion Report
ICRG International Country Risk Guide

ID Iraqi Dinar

IDA International Development Association

IDF Institutional Development Fund

IFMCA Institutional Financial Management Capacity

Assessments

IFMIS Iraq Financial Management Information System

IGF Inspectorate- General of Finance IMF International Monetary Fund

INTOSAI International Organization of Supreme Audit

Institutions

IPSAS International Public Sector Accounting Standards

ISDT Income and Sales Tax Department

ITD Income Tax Department

ITF Iraq Trust Fund JD Jordan Dinar

KRG Kurdistan Regional Government (Iraq)
LOLF Loi Organique Relative aux Lois de Finances

(Morocco)

LTO Large Taxpayer Office

MDCI Ministry of Development and International

Cooperation (Tunisia)

MDG Millennium Development Goals
MED Ministry of Economic Development

MEF Ministry of Economy and Finance (Morocco)

MENA Middle East and North Africa

MMSP Ministry of Public Sector Modernization (Morocco)

MOF Ministry of Finance MOH Ministry of Health

MOLA Ministry of Local Administration (Yemen)

MOP Ministry of Panning

MOPDC Ministry of Planning and Development Cooperation

(Iraq)

MOPIC Ministry of Planning and International Cooperation
MSAD Ministry of State of Administrative Development

(Egypt)

MTEF Medium Term Expenditure Framework
MTFF Medium Term Fiscal Framework
MTO Medium Taxpayer Office
NGO Non-Government Organization

NFTI National Fiscal Training Institute
NRA National Reform Agenda
NSSF National Social Security Fund

OBL Organic Budget Law

ODPM Office of the Deputy Prime Minister

OECD Organization for Economic Cooperation and

Development

OPM Office of the Prime Minister

PA Palestinian Authority

PAL Public Accounting Law (Lebanon)
PARL Public Administration Reform Loan
PARP Public Administration Reform Program
PCSC Complementary Plan for Support to Growth

(Algeria)

PDD Public Debt Department

PEFA Public Expenditure and Financial Accountability
PEIA Public Expenditure and Institutional Assessment
PEM-TA Public Expenditure Management - Technical

Assistance

PER Public Expenditure Review
PFM Public Financial Management

PFMAU Public Financial Management Advisory Unit

PIF Palestinian Investment Fund PIU Project Implementation Unit PLC Palestinian Legislative Council PPP Purchasing Power Parity

PRDP Preparation of a Development Plan
PSA Production Share Agreement

PSR Public Sector Reform
ROB Results-Oriented Budgeting

ROSC Report on the Observance of Standards and Codes SAACB State Audit and Administrative Control Bureau

(West Bank & Gaza)

SAI Supreme Audit Institutions

SDDS Special Data Dissemination Standards

SIGIR Special Inspector General for Iraqi Reconstruction

SOE State Owned Enterprise

SONATRACH Société Nationale pour la Recherche, la Production,

le Transport, la Transformation, et la

Commercialisation des Hydrocarbures s.p.a.

(Algeria)

SNG Sub-National Government

SPC Special Planning Commission (Syria)

STA Special Treasury Account
STD Sales Tax Department
Style Sales Tax Department

SU Spending Units

TGR Kingdom General Treasury (Morocco)
TSA Treasury Single Account (Egypt)

UNCAC United Nations Convention Against Corruption

UNDP United Nations Development Program
U.S.AID United States Agency for International

Development

VAT Value Added Tax WBG West Bank & Gaza

WGI World Governance Indicators

YER Yemeni Riyal

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Acknowledgements

We would like to gratefully acknowledge the assistance of many who contributed to this report. The first are the individual chapter authors, without whose insights, hard work and diligence it would not have been possible. They include Arun Arya, David Biggs, Robert Bou Jaoude, Elena Moraciella, David Shand and Daniel Tommasi. We would also like to thank a number of Lead and Senior Country Economists and Public Sector Specialists who provided valuable inputs and insights along the way, including Sebnem Akkaya, Jorge Araujo, Sherine el-Shawarby, Ndiame Diop, Khalid el Massnaoui, Santiago Herrera, Catherine Laurent, Jose Lopez-Calix, Stefano Paternostro and Yahia Khairi Said. Guenter Heidenhof provided valuable inputs and support at various stages of the preparation process. Stephen MacLeod provided inputs into the early stages of this effort.

Nithya Nagarajan drafted more detailed case studies of the tax, customs and public financial management reforms in Egypt and the West Bank and Gaza, assisted in the case of Egypt by Andrew H.W. Stone. These cases are part of a broader collaborative effort to identify and document promising examples of public sector reform throughout the Middle East and North Africa region, which is run jointly by the World Bank and the Dubai School of Government.

The peer reviewers included Richard Allen of the IMF's Fiscal Affairs Department, James Brumby and Salvatore Schiavo-Campo. We are grateful for the excellent research assistants who helped collect and analyze the data and prepare the final report, including Lida Bteddini, Lydia Habhab and Hala Hanna. Mavo Ranaivoarivelo helped in compiling the final document. Finally, we would like to thank Alex Sperling for providing logistical and organizational support with her usual grace, charm and efficiency. We wish her well in her new assignment with the Bank's Legal Department.

Support for this effort came from the Norwegian Governance Trust Fund and Governance Scale-Up Funds from the Middle East and North Africa Vice Presidency. Additional support for a number of the Public Expenditure and Financial Accountability (PEFA) exercises came from the European Union, including Morocco and Tunisia. The Jordan PEFA exercise was entirely funded and conducted by the European Union.

This piece is dedicated to the memory of John Wetter, our colleague who worked extensively on issues of macroeconomic stability, fiscal sustainability and public financial management in a number of countries throughout the Levant. His wit, wisdom and humor are missed.

Mark E. Ahern Robert P. Beschel Jr.

Executive Summary

Introduction

One of the most important functions governments perform is that of mobilizing and deploying financial resources to achieve their objectives. According to the most recent World Bank data, governments throughout the Middle East and North Africa (MENA) region spent approximately \$407 billion dollars in 2007 in delivering their policy, regulatory and service functions. The way in which this money is spent has huge implications for their broader development trajectory. For example, a one percent efficiency gain in Egypt's budget for 2009 would yield \$637 million dollars—enough resources to build 40,000 schools, pave 4,500 kilometers of highway, or recruit an additional 600,000 doctors. It is therefore not surprising that issues of public financial management, or PFM, have been at the heart of governance reform programs in virtually all of the countries in the region.

For governments to perform their spending function well, their PFM practices should meet certain well-established criteria. Government spending should be affordable, in that it takes place within a framework that ensures expenditure is consistent with monetary and fiscal policy objectives and sustainable in the long term. Governments should optimize the allocation of public resources between different sectors and expenditure categories in a way that reflects their policy priorities, including sustainable growth as well as human and social development. Such expenditure should be efficient, in that it maximizes output for a given set of inputs, and effective, in that it supports the successful realization of the government's goals. It should also be transparent; conducted in accordance with the relevant laws and regulations; and undertaken with appropriate checks and balances to ensure financial probity.

While such objectives are relatively straightforward, their realization can be anything but. In many MENA countries, PFM reforms have been on the agenda for a decade or more. This report seeks to reflect upon this experience to date and better understand the nature of the PFM challenges confronting these countries. This study surveys these reforms across ten Arab countries: Algeria, Egypt, Iraq, Jordan, Lebanon, Morocco, Syria, Tunisia, the West Bank and Gaza and Yemen. They were selected partly because they are places where the Bank has been heavily engaged on PFM issues and been able to gather a wealth of comparative information. They also represent an interesting cross-section of administrative traditions and different levels of development. At the high end, in 2007 Lebanon had a GDP per capita of \$6,017 and a life expectancy of 72 years, whereas at the other end of the spectrum, these figures stand at \$973 and 62 years for Yemen. Lebanon has around 38.3 internet users per 1,000 citizens, as opposed to only .9 for Iraq. Taken together, these countries are home to over two thirds of MENA's population and nearly one third of its GDP. Many of the findings from this analysis will be of relevance to other MENA countries as well.

Turning to the substance of PFM reforms, the study considers to what extent these countries dealing are with common problems stemming from similar administrative traditions and comparable levels of development, or unique challenges grounded within their own particular historical or bureaucratic experience. The analysis also seeks to understand the type of PFM reforms that have been implemented across the region in the last decade, including where these reforms have gone well, where they have not, and why. Beyond these questions, the study seeks to see if any broader conclusions can be drawn regarding the way in which these reforms have been implemented and how that has affected their success (or lack thereof). Are there tactical lessons about what works best during implementation from which future reformers can benefit? In what ways do broader political economy considerations shape and influence the challenge of PFM reform in MENA?

To review PFM reform across MENA, it is necessary to utilize a common approach to structure the analysis. In recent years, the Public Expenditure and Financial Accountability (PEFA) framework has become the most recognized and widely accepted tool for assessing the status of a given country's PFM system. This set of twenty eight (28) high level indicators measures performance against best practice in developed and developing countries and allows progress to be tracked over time. The indicators analyze performance in the six core areas of public financial management spanning the budget process: (1) credibility of the budget; (2) comprehensiveness and transparency; (3) policy-based budgeting; (4) predictability and control in budget execution; (5) accounting, recording, and reporting; and (6) external audit. The central government is the main area of focus, along with issues relating to the overall scrutiny of public finances. Activities of public enterprises and sub-national levels of government are not addressed directly.

While the PEFA indicators provide a point assessment of the PFM system for a particular country, the focus of this study is on the reforms to the system and what progress is being made as a result of these reforms. To gain this insight, the PEFA analysis has been augmented by a series of country chapters that are provided in Volume 2. These chapters were drafted along a common template to provide a more detailed picture of the PFM reform efforts in the countries of this study. These assessments have also sought to go beyond the "what" of PFM reform—where the analysis is organized around the six core PEFA areas—to capture some of the "how" and "why" of reform. This touches upon both strategies for implementation and broader political economy issues within a given country. These chapters have relied heavily upon desk studies of existing Bank and Fund documents, such as PERs, CFAAs, CPARs, IMF Fiscal ROSCs, as well as a variety of project-related documents.

In two cases of particularly interesting and far-reaching reform in MENA, the analysis relies on more detailed case studies. The first is Salam Fayyad's PFM reforms, which were implemented during his first tenure as Minister of Finance in the West Bank & Gaza from 2002 to 2005. The second are the reforms in tax and customs implemented in Egypt since 2005 under the tenure of Youssef Boutros Ghali. These reforms are singled out both because they were substantial in scope and are widely perceived to have made a material improvement to the existing systems.

MENA PFM Practices Compared Against Global Averages

Figure 1 below provides the summary results for the six PEFA exercises that have been completed for countries in the study. Assessments for the WBG and Syria were completed in 2006; Jordan in 2007; Iraq and Yemen in 2008; and Morocco in 2009. A PEFA analysis is currently underway in Tunisia, but has not been finalized. PEFA reviews have yet to be conducted for two other countries in this study: Algeria and Lebanon. The PEFA alpha scale has been converted to a numeric scale ranging from 0 to 4 to assist with comparisons, where 4 is the highest rating.

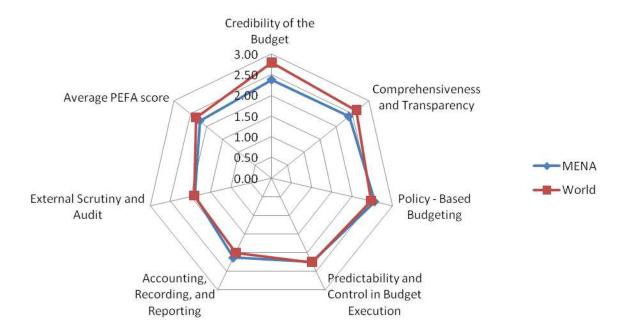
A comparative analysis was conducted as to where MENA countries stood vis-à-vis other countries at similar levels of development, in this case 19 lower middle income countries with GDPs from \$936 to \$3,075 per capita in 2007 who had recently completed a PFEA assessment. (Among the list of comparators were three countries from Africa; three from Latin America and the Caribbean; six from East Asia and the Pacific; and seven from Europe and Central Asia.)² The results are presented below.

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¹ Although a PEFA was presented for Egypt in October 2009, it remains preliminary, as the Government has not endorsed a number of the findings.

² The countries incorporated into this analysis include Congo Brazzaville, Lesotho, Swaziland, Dominican Republic, Paraguay, Peru, Indonesia, Samoa, Timor Leste, Tonga, Tuvalu, Vanuatu, Albania, Armenia, Azerbaijan, Kosovo, FYR Macedonia, Moldova and Ukraine.

Figure 1: MENA PEFA Averages Compared to Global PEFA Averages for Comparable Low Middle Income Countries



At an aggregate level, MENA's PFM systems are roughly comparable to those of other countries at similar income levels. As a whole, the region tends to fare a bit better on accounting, recording and reporting and a bit worse on credibility of the budget. Among the countries covered in this study, the highest ranked countries in aggregated PEFA rankings are Morocco and Jordan. They both have overall average scores of about B (2.87). On the lower end of the scale, West Bank and Gaza (WBG) and Iraq have PEFA Assessments that would average around a C- (1.5 to 1.6), although the formal PEFA assessments do not include minus (-) rankings. In terms of average scores for the six main categories, the tightest scores (i.e. the lowest standard deviation) were around credibility of the budget, indicating commonality among MENA countries on this dimension, whereas the largest average discrepancies were found in the area of budget comprehensiveness and transparency.

The Substantive Reform Agenda

This section is structured around 13 common categories of PFM reform grouped under six stages of the Budget cycle. The selection of categories follows that used by Matt Andrews in an earlier study using PEFA data; however the categories have been adapted to reflect common reform activity in the MENA region.³ Figure 2 sets out the different stages in the budget cycle and the reform categories considered at each stage

The choice of reform categories involved a number of compromises, and several important reforms that have close links to PFM (e.g. civil service reforms) are not considered. Determining whether to create separate categories for some wide-ranging reforms was also an issue. In particular, two common reforms—Medium Term Expenditure Frameworks (MTEFs) and treasury reforms—often cover a number of the above categories. These reforms are considered in their component parts during

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³ Andrews, *PFM in Africa, Where are We, How Did We Get There, and Where Should We Go?* See the following webpage: http://www.resultsfordevelopment.org/sites/default/files/resources/PFM-in-Africa-pdf.pdf.

the discussion. Conversely, reforms in budget transparency that occur at a variety of stages in the budget cycle (for example budget documentation, in year financial reporting, and end of year financial statements) are considered in a single category.

For each of the six stages of the budget cycle, the relevant PEFA scores are first reported, followed by an assessment of each of the reform areas relevant to this stage. For each reform area, the report briefly sets out the underlying objective of this type of reform before reviewing experience in different MENA countries. It then provides an assessment of what has worked and what has proven to be more challenging.

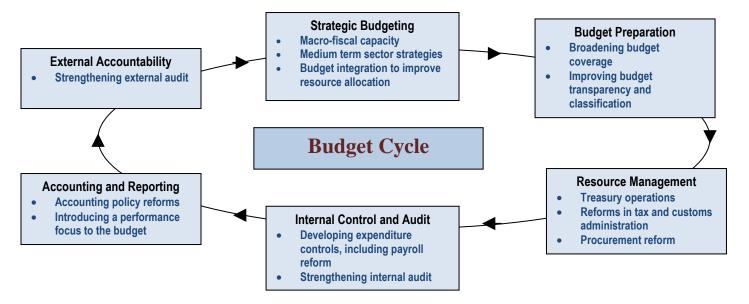


Figure 2: Reforms at Different Stages of the Budget Cycle

1. Strategic Budgeting

Macro-fiscal Capacity and Budget Sustainability. Having a unit in the Ministry of Finance to provide macroeconomic and fiscal (macro-fiscal) policy advice is important for good aggregate fiscal management. The Ministries of Finance in the region have traditionally not had this capacity but, in recent years, a number of countries have established units to provide macro-fiscal advice. The work is analytically demanding and attracting suitable staff within standard civil service contracts has proven to be a challenge. In view of this, many of the units initially focused on monitoring taxes and preparing monthly reports on budget execution. However, as they have increased their capacity, they have become more involved in budget preparation through developing a fiscal framework for the budget—although the link between these frameworks and the final budget is still not strong.

Focusing on Medium Term Expenditures at the Sectoral Level. In fiscal management, the cost of a policy in the next year is not always a good indication of the costs over time. To better manage the budget, a number of countries in the MENA region are attempting to develop "forward estimates" of expenditures at the sectoral level as part of Medium Term Expenditure Framework (MTEF) reforms. The reform is extremely resource intensive and, to date, the results have been disappointing. Often, the work has been carried out through pilot projects in various sectors with limited ownership from the Ministry of Finance. As a result, the estimates remain an analytical exercise which is not used in preparing the budget. Another weakness is that the analysis focuses only on project expenditures and

insufficient attention is paid to recurrent expenditures, which generally form the bulk of the budget. While the argument for developing sector based forward estimates to provide a medium term perspective is compelling, this is a major reform and should only be initiated once more basic improvements to the PFM system have been completed.

Budget Integration to Improve Efficiency of Expenditure. All countries in the region continue to have elements of dual budgeting, with separate arrangements for deciding the allocations for operating and capital expenditures. These arrangements impede efforts to get the best value for money from expenditures, as they risk gaps or duplication of expenditure; inconsistent expenditures; and the wrong mix of expenditures both in aggregate and at the level of activities. While some progress has been made to integrate the presentation of the budget, efforts to integrate other elements of budget management have largely been elusive. In countries with a separate planning ministry managing the capital budget, institutional resistance to consolidating budget management in the Ministry of Finance has been a particular problem. Where consolidation of budget management within the Ministry of Finance does occur, one of the main challenges is to ensure that the Ministry has the necessary analytical capacity to oversee the capital budget. For this reason, the transition needs to be carefully planned.

2. Budget Preparation

Broadening Budget Scope and Coverage. Ensuring broad budget coverage is important to make the budget effective both as a tool for fiscal control and allocating resources to the highest priority area. It is also important to ensure that there is effective accountability for public expenditure. Limitations in the scope of the budget are a general problem in the region as reflected in low PEFA scores for unreported government expenditure. The technical demands of this reform are not significant and good progress has been made where there is sufficient political commitment. However, there are strong incentives for those with expenditures outside the budget to resist the change, and a strategic approach needs to be taken to the reform that anticipates the likely resistance from these interests.

Improving Budget Transparency and Classification. Better information on budgeted expenditures can play an important role in building the credibility of the government's fiscal policy with the public, parliament and external financiers. Reforming the budget classification is an important component of this broader objective. Many countries in the region have taken steps to improve the transparency of the budget documents, update the budget classification, and introduce in-year budget reporting. These efforts have been among the most successful PFM reforms. One of the factors behind this success is that the reforms are seen as technical in nature and thus less susceptible to opposition from vested interests. The reforms also tend to rely on a small team of staff in the Ministry of Finance, which makes them better placed in an environment where the civil service has limited capacity. Moreover, once introduced the reforms have tended to become part of the fabric of the system and this has made them more enduring.

3. Resource Management

Developing Treasury Operations. A well functioning treasury system can minimize the government's net borrowing costs and reduce exposure to the risk of bank default. A number of the countries in the region have embarked on treasury reforms to improve cash management by establishing a treasury single account (TSA) at the central bank. While progress has been made, the coverage of the TSA is often not complete because the Ministry of Finance has not had the authority to consolidate some balances. A number of countries have set up units to prepare and maintain a cash plan, which can assist in aligning the borrowing and investment activity with the government's cash needs. However, too often the cash plans are not being actively used in cash management. Few countries have taken steps to improve debt management systems as part of treasury reforms.

Reforms in Revenue Administration: Tax and Customs. By improving the administration of the tax system, a government can increase the revenues it collects while enhancing the fairness of the system and reducing the cost of doing business for taxpayers. In general, MENA countries have made much better progress with tax administration reform than they have with expenditure management reforms. One reason for this is that Ministers of Finance have taken an active interest in the reforms as they are driven by a need to both increase revenues and improve the environment for doing business. Another factor is that tax administration is a distinct function within government and it has been possible to provide performance incentives to the staff of the tax authority that could not be applied generally across the public sector. One unhelpful consequence of this tactic has been that some of the better staff have moved to tax administration from expenditure roles within government, exacerbating existing capacity problems in these areas. For this reason, caution should be exercised in deciding whether to introduce incentives for tax administration in isolation.

Procurement Reform. The way in which the purchase of goods and services is controlled through the procurement process can help the government to minimize collusion and other corrupt practices. Improvements to the procurement procedures can therefore lower the cost of government expenditures. The procurement systems in the region are weak. Reforms have been attempted in a number of countries but the timescales for these reforms have been extended and the outcomes have been disappointing. The reforms often touch on areas of significant corruption and therefore can pose a threat to particular interests, which have strong incentives to delay or divert the process. The failure to make progress in large part reflects an unwillingness to confront these special interests.

4. Internal Control and Audit

Developing Expenditure Controls. Effective expenditure controls are important to support aggregate fiscal control, ensure that the allocation of resources reflected in the budget is followed, and that the government does not pay more than it needs to for goods and services. Because of the link to the transaction cycle, the controls are an important element in addressing corruption associated with government expenditure. The countries in the region tend to have extensive and time-consuming control systems (often evidenced by multiple approval signatures), but as evidenced in the PEFA assessments, these systems are not effective. Two key problems are that the overlaying controls diffuse accountability, and that they often only apply at the payment point rather than when expenditure is committed. Despite the problems being faced in the region, there have been relatively few attempts to streamline and strengthen the general control procedures. Progress has been made by some countries in payroll management, but this is uneven. The overall impression is that where there is a failure to make progress with improving expenditure controls, it is mainly due to a lack of genuine interest in the reforms from the authorities.

Strengthening Internal Audit. Internal audit aims at providing the executive with assurance of the quality of the financial management systems—in particular the implementation of financial controls and the management of risks. Most countries in the region have weak internal audit functions reflecting problems in both the scope of audit activity, and conflicts of interest where the auditor is also part of the control function. Internal audit has in general not been given a high priority for reform in part because it is an advanced PFM reform. But resistance to change can also come from existing auditors who are reluctant to be removed from the transaction control process when this is a source of corruption.

⁴ While internal audit can also provide comment on the value for money of expenditures, this is not generally a core function.

5. Accounting and Reporting

Accounting Policy Reforms. Accounting reforms can improve the reliability with which expenditures and cash balances are controlled, monitored and reported. Where accounting policies are aligned with international standards, there can be increased confidence in the integrity of the financial information presented. Experience with the reform of accounting systems in the region has been mixed. While most countries now operate double entry systems, there has been limited success in reforming accounting methodologies towards a consistent use of cash or accruals, as well as in applying international accounting standards. Because accounting reforms affect the work of many employees throughout the public sector, a strong commitment from the senior staff in the Ministry of Finance is essential if they are to be successfully introduced.

Introducing a Performance Focus to the Budget. The traditional input based budget does not provide policy makers with information on what goods, services, or policies are being financed by government expenditure. The idea of focusing on performance has been around for some time, and there is considerable interest in this reform from countries in the region. However, the successes to date are limited and the timeframe for the reform is proving to be extended. The reform is difficult in part because it relies on having many other elements of the PFM system operating at a reasonable standard. For this reason, even where the reform proceeds, every effort should be made to avoid conceptually sophisticated approaches and to ensure that the approach can be supported by the accounting systems.

6. External Accountability

Strengthening External Audit. External audit provides parliament with assurance on the adherence to financial laws, the reliability of the financial statements, and value for money in government expenditure. As such, it provides an essential discipline on the financial management of the executive. The PEFA assessments indicate that the external audit functions of countries in the region have a range of weaknesses characterized by a strong focus on transactions rather than systems, as well as conflicts of interest where the auditor is part of the ex-ante control system. In spite of the weaknesses in the audit bodies, there have been relatively few efforts to reform the external audit function, in part reflecting the relatively minor role played by parliaments in many countries in the region. While the focus of external audit is on providing assurance to parliament, the presence of an effective audit body can also support reforms in budget execution, by encouraging more discipline in the accounting practices. However, the success of efforts to build the capacity of the audit body will ultimately depend on whether the parliament is prepared to utilize the auditor's report.

Implementing Public Financial Management Reforms in MENA: An Emerging Set of Promising Practices?

Summarizing the discussion above, the following table breaks MENA's experience with PFM reform down along three dimensions. The first category is reforms that have typically been more successful, in that a number of MENA countries have been able to implement them effectively and achieve concrete, independently verifiable improvements. The third category is comprised of reforms that have been historically been more challenging, difficult and problematic. It does not mean that they have been impossible to implement, and some MENA countries may have been able to put in place certain elements of these reforms. But this is not common. The "mixed" category represents an area where generalizations across the region are difficult to make and the results are often more unique to a given country.

Table 1: Breakdown of Successful and Challenging PFM Reforms in MENA

Successful PFM Reforms	Mixed	Challenging PFM Reforms
Improving budget classification Improving budget transparency Reforms in tax and customs	 Enhance macro-fiscal capacity Budget integration Streamlining ex-ante control processes Commitment control Payroll management Treasury operations Reform of accounting systems Internal and external audit 	Medium term sector strategies Improving budget scope and coverage Introducing performance into the budget Procurement reforms Large information technology projects

The PFM reforms that have been particularly successful in MENA fall into two types: efforts to improve budget transparency and classification, and the reform of revenues, particularly tax and customs. Ironically, these represent two very different reforms. The first are relatively straightforward and technocratic in nature. An existing body of accepted practice exists to reform economic classification, such as in the form of the IMF's GFSM 2001, and there are incentives to align accounts along standard international practice to facilitate the production of comparable fiscal and economic data. While there may be some resistance to such reforms stemming from basic bureaucratic inertia, no fundamental interests are challenged or mandates threatened. Once implementation is complete, the reform becomes part of the fabric of the system and endures.

This is not true for reforms in tax and customs, where the stakes are much higher. Revenue agencies are often among the entities in government where problems of corruption are most pronounced, since their function places them in a position to extract rents from both firms and the general public. Efforts to restructure and reorganize such functions often encounter fierce resistance from both those on the inside and some on the outside. Yet if the challenges are great, the gains are often significant as well. For governments facing significant fiscal deficits, it is often more politically palatable to raise revenues—difficult as that may be—than to engage in painful cuts in expenditure. Such reforms are therefore able to garner the requisite high-level political support to see them through in spite of considerable opposition.

Unfortunately, on the other side of the spectrum are a host of reforms that are neither particularly easy to implement nor which bring the promise of substantial fiscal gains, at least in the short-term. Some, such as improving the scope and comprehensiveness of the budget, are not technically difficult to implement. However, as noted above, unless significant political capital is invested in overcoming bureaucratic resistance, these reforms are unlikely to move forward. Other reforms, such as the development of MTEFs and greater performance orientation into the budget, are often both technically demanding and run up against powerful vested interests. In many cases, their successful implementation may depend upon underlying systems, procedures and practices being in place that may not exist. It is therefore not surprising that their implementation is frequently delayed or halted. A variety of lessons have emerged from the individual case studies and the more detailed assessments of reforms in the WBG and Egypt. They are summarized below as the "Ten Principles of Implementation" for PFM reforms in MENA.

Box 1: Ten Principles of Implementation for PFM Reforms in MENA

- 1. Know the value—and limitations—of political economy analysis
- 2. PFM reform as means and not ends
- 3. Context matters, so swim with the current
- 4. The wisdom of "muddling through"— grand strategy versus incremental change
- 5. Establish basic systems before contemplating more advanced reforms
- 6. Whenever possible, keep reforms quick, simple and mutually reinforcing
- 7. Be wary of large financial management information systems
- 8. Internal challenges: leadership, coordination, skills and incentives
- 9. External stakeholders—useful, but don't count on them
- 10. Lessons for donors: be more strategic, selective, modest and flexible

Lesson 1: Know the Value—and Limitations—of Political Economy Analysis. In many areas of governance and public administration reform including PFM, there has been a rush to embrace the discipline of political economy analysis (PEA) over the last decade. The field is still evolving and precise definitions are elusive, but at its core PEA analysis embodies the important observation that political and bureaucratic factors matter. Would be reformers should not mechanistically seek to transfer approaches and practices that work well in one setting to other very different institutional contexts.

Yet beyond this basic and sensible warning, the PEA literature has relatively little to contribute when it seeks to address the most important questions in any reform initiative: what should be done, when does it need to happen, who should do it and how. Each reform experience is unique and endogenous to a particular time and country, as well as to an individual set of political, bureaucratic, institutional and personal dynamics. PEA may be valuable in highlighting constraints or identifying potential supporters, and it can help to inform decisions about what is to be done. But the trajectories of the most successful reforms in MENA bear little resemblance to the type of recommendations that a typical donor-supported PEA would generate. PEA is not a substitute for solid strategic decision-making, and even less for astute tactical maneuvering during implementation. More is likely to be gained by investing in greater tactical flexibility, in terms of field-based governance advisors and public sector specialists who can provide real-time advice and assistance in high risk, high engagement settings, than in trying to perform more rigorous political and bureaucratic analysis up-front.

Lesson 2: PFM Reform as Means and Not Ends. PFM reforms arise from a number of different motives, ranging from the need to respond to an emergency to individual ministers seeking to make a career for themselves as reformers. In the MENA region, the most farreaching reforms were implemented in response to an acute fiscal crisis and the need to fundamentally restructure tax practices to attract foreign investment. Under these circumstances, PFM reforms were effective in large part because they promised to be a solution—or at least part of the solution—to a broader set of problems. As such, senior political leaders were willing to push them through in the face of considerable resistance. Reforms that were implemented because they are consistent with emerging international best practice have typically lacked the staying power to overcome entrenched opposition.

Lesson 3: Context Matters, so Swim with the Current. A corollary of the observation that reforms are a means and not an end in themselves is the point that context matters. As noted above, two of the most far-reaching PFM reforms took place against a backdrop of an acute

financial crisis, which gave them profile and visibility. However, major reform agendas can stretch over years, whereas the political and economic conditions that give rise to them are typically subject to much shorter time horizons. If reforms are largely technical in nature, have a solid rationale behind them are supported by well-positioned champions within the relevant ministries, and if they avoid alienating powerful constituencies, then under most circumstances they can probably stay "under the radar screen" and survive the shifting political, economic and administrative sands. Lebanon was able to implement some important reforms in payroll management, for example, even in the midst of a chronic political crisis and the absence of a functioning parliament.

But Lebanon's experience is also instructive, in that when these reforms have needed to move beyond the realm of what could be implemented by a Ministry of Finance decree and required broader cabinet or parliamentary approval, they have stalled. There are no examples of more far-reaching PFM reforms that came to fruition if the broader political context was not supportive. Nor are there examples of where senior officials were able to isolate and protect major PFM reforms from major shifts in the broader political climate. Put succinctly, an ebbing tide grounds all large boats—regardless of how well they are designed or the skill and determination of the captain.

Lesson 4: The Wisdom of "Muddling Through"—Grand Strategy versus Incremental Change. To what extent are MENA PFM reform agendas driven by an overarching strategic framework or integrated plan, versus a more flexible and improvised approach that seeks to take advantage of opportunities when they emerge? The answer is not entirely straightforward. On the one hand, MENA does not suffer from an absence of strategic plans for upgrading systems and procedures. Furthermore, there have been examples of when countries would have benefited from adopting a more comprehensive approach to PFM reform. The lack of a more comprehensive approach can be particularly problematic in the development of integrated financial management information systems, for example.

Yet while such reform strategies can be valuable as a statement of intent, communicating priorities, securing donor support or providing political cover for a given set of activities, their role in actually shaping successful reforms can be modest. The development of such plans is no guarantee that they will be implemented expeditiously. In many MENA countries, roll-out has taken much longer than expected, with a number of components being dropped or modified along the way. Nor are such plans a prerequisite for success. Salam Fayyad adopted a flexible view to West Bank & Gaza's PFM reforms, recognizing that he could not determine *a priori* the sequencing of reforms or expect to have control over the entire process. Fayyad describes his approach as being, "patient, deliberate, methodical, and opportunistic, looking for an opening here and there." His approach was informed by a clear set of priorities, but utilized tactical flexibility in terms of the sequencing and timing of reforms. Aspects of Egypt's tax reforms evolved in much the same way.

Lesson 5: Establish Basic Systems Before Contemplating More Advanced Reforms. The temptation is often irresistible for governments and international advisors to strive for quantum improvements in performance by adopting some cutting-edge practices from OECD countries in a developing country context. More often than not, the result has been a litany of dashed expectations and failed reforms. In response, the Bank's Public Expenditure Management Handbook (1998) emphasizes the importance of "getting the basics" right before moving on to tackle more advance reforms.

The PFM reform experience within MENA largely bears this out. This has been particularly true with regard to two sets of initiatives that have been among the more technically advanced to be implemented to the region: the move to a Medium Term Expenditure Framework and the effort to introduce greater performance orientation into the budget process. As noted above, both have shown themselves to be complicated and problematic to implement, in part because their realization has relied upon a number of preconditions to be in place before they can be effective, and in part because other senior officials have been generally unwilling to allow themselves to be bound by such initiatives.

Lesson 6: When Possible, Keep Reforms Quick, Simple and Mutually Reinforcing. It is an accepted article of faith that major PFM reforms are difficult, complex undertakings that require years or sometimes decades to fully come to fruition. Laws and regulations must be drafted; longstanding practices restructured; political and administrative cultures changed; institutions built and capacities strengthened. To attempt such undertakings quickly, so the argument goes, is a recipe for poorly thought through implementation and eventual failure.

As with many managerial maxims, there is some truth to this contention. PFM reforms in a number of MENA countries, such as introducing MTEFs or greater performance orientation into the budget, do take a long time to implement. Yet there are also cases where reforms can be implemented quite quickly when the requisite political will exists. Reforms dedicated to expanding the scope and comprehensiveness and transparency of the budget, for example, can be implemented within weeks or months if the proper political will is in place. Furthermore, some of the more effective reforms were deliberately implemented with haste. Salam Fayyad wanted to generate confidence in the reform agenda by taking specific, quick steps that made an impression. He felt, rightly as it turned out, that reform would become more difficult with time. Otherwise, as has happened far too often in MENA, reform can become "business as usual" and lose any sense of priority or urgency.

A related question is whether to pilot reforms or roll them out whole. In MENA, pilot PFM reforms have been implemented in a wide variety of contexts. The answer to this question is highly contextual. On the positive side, pilots—particularly when combined with rigorous monitoring—provide an opportunity to gain valuable experience in identifying potential problems that could plague a set of PFM reforms and rectifying them before too much damage is done. This is particularly important when the roll-out is likely to be time-consuming and expensive, as is the case with large IT systems. However, in the absence of firm commitment to proceed with a given set of reforms, pilots can often become an excuse for delay and inaction. Sometimes it is preferable to roll out reforms broadly and accept that there will be challenges during the early stages of implementation. Pilots also tend to do better in administrations with a history of experimentation and innovation than those with fixed traditions embedded in a strong legal framework.

Lesson 7: Be Wary of Large Financial Management Information Systems. An integrated financial management information system (IFMIS) can offer great benefits for a variety of PFM activities, especially budget execution. All countries in the region have made some effort to introduce computerized systems to support PFM. In general, two different strategies have been adopted: (1) develop a "sophisticated" fully integrated IFMIS; or (2) use a simple customized IT system to support budget execution. While there are some small successes to date, most of the "sophisticated" projects have struggled to meet their implementation milestones, budgets and promised functionality. When things go wrong, such IT failures can be extraordinarily costly, as was illustrated with the recent failure of a \$30 million FMIS system in Iraq. A number of problems have undermined these large projects, but two

important concerns are weak project management arrangements and inadequate commitment and/or engagement of staff of the Ministry of Finance to the reform. Would-be reformers looking to import sophisticated IT solutions should proceed with caution in both MENA and elsewhere.

The second approach has been to develop simple computerized systems with limited functionality to help support budget execution. The systems are usually customized to fit the specific needs of the budget execution system of the country. They tend to have much lower initial development costs, and provided their objectives remain minimal, they may also be an efficient way of exposing officials only familiar with paper based operations to the potential of a future IFMIS. However, there are limitations to this approach. First, because the systems are developed to order, they often do not include standard functionality that has proven useful in other systems. Second, the systems tend to be less flexible in dealing with new user requirements than off the shelf systems. While the initial cost of the system may not be high, these costs increase over time as the system is reconfigured for new developments. For these reasons, the use of a simple system should be seen as a short term solution with the eventual aim of moving to an integrated system.

Lesson 8: Internal Challenges: Leadership, Coordination and Incentives. MENA's reform experience holds a number of important lessons as to how such reforms should be structured and organized. The most far reaching and successful reforms within MENA have been driven by powerful ministers of finance, whose role is pivotal in the process. Both Salam Fayyad in the West Bank & Gaza and Youssef Boutros Ghali in Egypt brought a combination of impressive technical expertise and a solid technical of the issues, along with considerable political and managerial savvy and sheer determination.

There is a wide array of stakeholders in any PFM reform initiative, including ministries, agencies, departments, sub-national entities, and state owned enterprises. The quality of coordination between these agencies and the MOF varies both within and between countries, but it is frequently problematic and occasionally dysfunctional. To cope with such problems, several countries have established inter-agency task forces and other mechanisms to facilitate coordination. Their structure and membership can vary without unduly compromising their prospects for success. More problematic is the fact that, while such coordinating bodies can be relatively easy to establish, in a number of cases they end up meeting only infrequently thus compromising the quality of implementation.

MENA countries have adopted a variety of approaches to gain access to the requisite expertise. Some have relied heavily upon project implementation units staffed largely by external experts, whereas others have sought to keep these reforms in-house. While each approach has its strengths and weaknesses, some general lessons have emerged. The first is that technically skilled and managerially adept leadership is required at the project management level—and such leaders need to be fully empowered—or the reforms are unlikely to succeed. Second, capacity constraints at the team level are often not taken seriously enough in designing reforms. Efforts to work around a lack of capacity by relying too heavily upon external experts or local staff recruited specifically for the task are a Faustian bargain; they need to be carefully planned and managed with a clear exit strategy in mind. Finally, MENA governments have often chronically under-invested in the careful monitoring of reforms.

Lesson 9: External Stakeholders—Useful, but Don't Count on Them. As a general rule, the Executive Branch is extremely powerful throughout MENA. Other stakeholders—be they

legislative or judicial branches, various civil society organizations, academics, think tanks, or the private sector—operate at a distinct disadvantage when it comes to influencing political and administrative decision-making. This is particularly true with regard to PFM reform, which is often viewed as a narrow, specialized and technocratic field.

Throughout the region, parliaments have been growing in influence but still typically lack the staff and committee structures that would allow them to provide detailed scrutiny to budget proposals. In a number of countries, their ability to revise or change budgets presented by the executive is limited, and the information they receive can be partial and fragmented. Their follow-up in areas such as audit reports is variable. With a few notable exceptions, they have typically not been a strong force for PFM reform, and some have even advocated approaches antithetical to sound PFM practice. If parliament's influence has been modest, that of the public has been virtually nonexistent. A few NGOs and think tanks may have pressed for greater budgetary openness and transparency, but there is no evidence that they have had any real influence over the shape or content of PFM reform programs to date.

Lesson 10: Lessons for Donors: Be More Strategic, Selective, Modest and Flexible. The donor community has been heavily although unevenly engaged in providing support to public financial management reforms throughout the MENA region. According to the OECD DAC database, approximately ten MENA countries received donor assistance for PFM reforms during the period from 2003 to 2007, with the lion's share going to Iraq, Morocco and Jordan. Other recipients included Algeria, Egypt, Lebanon, Syria, Tunisia, West Bank and Gaza, and Yemen. Total funding for PFM was around \$459 million during this five year period. The average was \$92 million, with considerable variation between years. While the data probably provides a rough proxy for relative levels of donor engagement, these figures reflect budget support operations with a PFM focus rather than dedicated resources for PFM reform. The latter is likely to be much more modest, probably averaging in the \$1 to \$5 million dollar range per country annually after adjusting for the odd major IT project. The bottom line is that PFM reform in MENA is not an area where the donor community has over-invested.

Many donor-supported reforms have been too ambitious, overstating the amount of political and bureaucratic support for reform; not fully aware of the role of legacy systems and whether the necessary preconditions were in place; and in general trying to do too much within too limited a period of time and without the required capacity. Donor modalities need to be developed to better respond to the dynamic nature of the PFM reform process. There is a role for the traditional project management framework when the reforms are large and enduring (and the sums involved substantial), which is designed to successfully manage a broad and diverse agenda and ensure appropriate accountability. But lengthy appraisal, consultant selection and mobilization procedures often result in delays and lost opportunities. As was noted in Lesson 4 above, the more successful PMF reforms tend to involve "strategic opportunism"—seizing upon opportunities rapidly as they emerge within a broader framework of clearly articulated priorities.

To exploit such opportunities as and when they occur, donors need to augment their traditional approaches with small, rapidly disbursing, carefully targeted aid. To do this will require several preconditions: (1) accurate, up to date knowledge of the situation on the ground, including the evolving political and bureaucratic dynamics; (2) talented, advisors who have technical skills, political and managerial savvy, and the trust of senior officials; (3) a well-articulated framework of PFM priorities; and (4) small amounts of discretionary resources that can be utilized quickly and flexibly to help facilitate implementation.

Chapter 1

Introduction:

Public Financial Management Reform in MENA and Beyond

In the early stages of the state, taxes are light in their incidence, but fetch in a large revenue...As time passes and kings succeed each other, they lose their tribal habits in favor of more civilized ones. Their needs and exigencies grow...owing to the luxury in which they have been brought up. Hence they impose fresh taxes on their subjects... sharply raise the rate of old taxes to increase their yield...But the effects on business of this rise in taxation make themselves felt. For business men are soon discouraged by the comparison of their profits with the burden of their taxes...Consequently production falls off, and with it the yield of taxation.

-- Ibn Khaldun (1332-1406) --

The Importance of Public Financial Management

One of the most important functions that governments perform is mobilizing financial resources and deploying them to achieve their objectives. According to the most recent World Bank data, governments throughout the Middle East and North Africa (MENA) region spent approximately \$407 billion dollars in 2007 in delivering their policy, regulatory and service functions. The way in which this money is spent has huge implications for their broader development trajectory. For example, a one percent efficiency gain in Egypt's budget for 2009 would yield US\$637 million dollars—enough resources to build 40,000 schools, pave 4,500 kilometers of highway, or recruit an additional 600,000 doctors. It is therefore not surprising that issues of public financial management, or PFM, have been at the heart of governance reform programs in virtually all of the countries in the region.

In the BBC parody of government life, *Yes Minister*, the consummate British bureaucrat, Sir Humphrey Appleby, once wryly observed: "the Treasury does not work out what it needs and then thinks how to raise the money. It pitches for as much as it can get away with and then thinks how to spend it." While such thinking has not been entirely banished from public sectors around the globe, the PFM agenda has moved quite a bit since this episode first aired in January 1986. Over the past two decades, there has been relentless pressure in both developed and developing countries to improve the quality of public expenditure and generate more value for money from government operations.

For governments to perform their spending function well, their PFM practices should meet certain well-established criteria. Government spending should be affordable, in that it takes place within a macroeconomic framework which ensures that the level of spending is consistent with the government's monetary and fiscal policy objectives and is sustainable in the long term. Governments should optimize the allocation of public resources between different sectors and expenditure categories in a way that reflects their policy priorities, including sustainable growth as well as human and social development. Such expenditure should be efficient, in that it maximizes output for a given set of inputs, and effective, in that it supports the successful realization of the government's goals. It should also be transparent; conducted in accordance with the relevant laws and regulations; and undertaken with appropriate checks and balances to ensure financial probity.

In many MENA countries, PFM reforms have been on the agenda for a decade or more. Some are seeking to implement basic financial management and information systems that will ensure resources are spent in a timely fashion for the purposes intended. Others are pursuing changes that will allow for greater efficiency and predictability in spending, along with an enhanced focus on performance and value for money. Many are dealing with issues such as enhancing transparency, ensuring adequate internal and external audit, or expanding the scope and comprehensiveness of the budget.

This report seeks to reflect upon this experience and better understand the nature of the PFM challenges confronting the countries of the MENA region. Turning to the substance of these reforms, it asks where are they performing well and where are they struggling? To what extent are these countries dealing with common problems stemming from similar administrative traditions and comparable levels of development, or unique challenges grounded within their own particular historical or bureaucratic experience? The analysis also seeks to understand the type of PFM reforms that have been implemented across the region in the last decade, including where these reforms have gone well, where they have not, and why.

Beyond these questions, the study seeks to see if any broader conclusions can be drawn regarding the way in which these reforms have been implemented and how that has affected their success (or lack thereof). How do broader political economy considerations shape and influence the challenge of PFM reform in MENA? Are there tactical lessons about what works best during implementation from which future reformers can benefit?

This report is divided into two volumes. The first volume summarizes the results and presents the conclusions of this analysis. The second provides the individual country case studies and templates upon which many of these conclusions are based.

Beyond MENA: The Lessons from Global Experience

The MENA PFM reforms have not taken place in a vacuum. Throughout the globe, a variety of reforms have been implemented over the past two to three decades under the general rubric of "New Public Management." The scope and content of these reforms has varied, but they have generally included providing greater responsibility and control over inputs to managers in exchange for greater accountability for outputs; moving to a multiyear framework in budget execution linked to realistic fiscal policy and revenue estimates; shifting from cash accounting to accrual accounting; and moving from compliance auditing to performance auditing, among others. Many of these reforms were introduced in OECD countries and then migrated to MENA and other developing countries in varying degrees—or at least attempts were made to transpose them. Against these trends, an opposing "getting the basics right" school emerged that emphasized the need for essential systems to be in place and functioning well before moving on to advanced reforms. PFM reforms in MENA and elsewhere have tended to reflect elements of both approaches—the desire to adopt more "cutting edge" practices across a range of fields and sub-fields, such as introducing more performance orientation, Medium Term Expenditure Frameworks (MTEFs), and financial management information systems, as well as the need to ensure that the essential prerequisites are in place first.

Issues of public finance reform have been at the core of the World Bank's work on governance for over two decades. A recent survey of support for public sector reform by the Bank's Independent Evaluation Group (IEG) reviewed the Bank's work on PFM issues

throughout the globe.⁵ The report noted that between 1990 and 2006 the Bank approved 467 lending projects with significant public sector reform components. Of these, public financial management was by far the most common theme, comprising 81 percent of the public sector projects approved during this period. PFM work was also heavily represented in Bank analytical and advisory activities and institutional development grants. Furthermore, the Bank's work on PFM issues has increased sharply since the 1990s.

The IEG report concluded that the Bank's increased PFM lending and analytical work can be linked with encouraging PFM improvements among borrowers, usefully adapting PFM tools from other jurisdictions and carrying out effective monitoring with robust assessment tools, such as PEFA. However, progress has been uneven. The report argued that Bank performance might have achieved greater success with deeper institutional and governance analysis, greater attention to addressing basic systems before moving to advanced PFM tools and techniques, and more Bank support and flexibility in working to improve country procurement systems. It also noted that some specific reforms, such as moving to a MTEF, have been successful in some contexts but challenging in many others.

Other assessments have sounded similar themes, arguing for both a widening and a deepening of reforms to engage a broader set of stakeholders while simultaneously underscoring the need for more attention to domestic politics and established practices and institutions. They have argued that PFM reform is a long-term endeavor, in which failure is often attributed more to implementation than the technical aspects of the program. Reforms such as MTEFs and expenditure controls have tended to move forward slowly, as have those involving large computerized information systems and the reform of audit institutions.

This analysis will argue that in a number of important areas, such findings are consistent with the experience of PFM reform in MENA. In particular, MENA countries have struggled to implement many of the PFM reforms that have been problematic elsewhere. Yet there are also important points of divergence, particularly with regard to the prescriptions for implementation. It may be that MENA poses some unique challenges that are not present elsewhere. Or it may be that our understanding of how such reforms are actually implemented in many countries around the globe needs to be further refined.

What is "MENA"? Selecting the Countries for this Study

At a broader level, the question of how to define the Middle East and North Africa region is a thorny one that raises a host of complex and occasionally contentious issues. The definition utilized in this analysis is a strictly bureaucratic one. The World Bank's Middle East and North Africa (MENA) region consists of 19 countries, stretching from Morocco in the west to Oman and Iran in the east. It includes Djibouti but not Mauritania or Sudan. As of 2007 (the most recent year for which statistics are available), average GNI per capita across the region is around \$2,795, a figure that places it roughly in the company of East Asia and the Pacific (\$2,190). It is well below Europe and Central Asia (\$6,013) and Latin America and the Caribbean (\$5,888), but ahead of South Asia (\$879) and Sub-Saharan Africa (\$966).

⁵ World Bank, Public Sector Reform: What Works and Why? 2008.

⁶ Ibid. p.51

⁷ Carole and Nico Pretorius, *Public Financial Management Reform Literature*, *United Kingdom Department for International Development Evaluation Working Paper*, 2009.

Table 2: Basic Statistics on MENA Countries Selected for PFM Analysis

			GDP	GDP per	Life Exp.		Internet use
	Country	Population	(US\$ mil.)	capita	at Birth	Literacy	per capita
1	Algeria	33,858,168	\$136,034	\$4,018	72	70	10
2	Egypt	80,060,540	\$130,473	\$1,630	70	71	15
3	Iraq	29,947,491	\$62,000	\$2,070	68	74	1
4	Jordan	5,718,855	\$17,005	\$2,974	72	90	21
5	Lebanon	4,162,450	\$25,047	\$6,017	72	87	38.3
6	Morocco	31,224,136	\$75,226	\$2,373	71	52	21
7	Syria	20,082,697	\$40,549	\$2,019	74	80	17
8	Tunisia	10,225,400	\$35,020	\$3,425	74	74	17
9	WBG	3,832,185	\$4,016	\$1,048	73	92	9
10	Yemen	22,269,306	\$21,658	\$973	62	59	1

Total 241,381,228 \$547,029 % of MENA 67.9% 31.5%

Source: World DataBank: http://databank.worldbank.org/ddp/home.do?Step=3&id=4Source: All data is for 2007 or most recent year available.

This study surveys PFM reforms across a range of ten countries in the Middle East and North African (MENA) region: Algeria, Egypt, Iraq, Jordan, Lebanon, Morocco, Syria, Tunisia, the West Bank and Gaza and Yemen. They were selected partly because they represent countries where the Bank has been heavily engaged on PFM issues and been able to gather a wealth of comparative information (although Syria is an example of a country where a diagnostic has been performed but the engagement has been more limited). They also represent an interesting cross-section of administrative traditions and different levels of development. Table 1.1 above captures a number of characteristics for each country, ranging from GDP per capita to literacy and life expectancy rates to internet penetration. At the high end, Lebanon has a GDP per capita of \$6,017 and a life expectancy of 72 years, whereas at the other end of the spectrum, these figures stand at \$973 and 62 years for Yemen. Jordan has around 38.3 internet users per 100 citizens, as opposed to only .9 for Iraq. Taken together, these countries are home to over 70 percent of MENA's population and just under a third of its GDP. Many of the findings from this analysis will be of relevance to other MENA countries as well.

To differing degrees, the largest group of countries shares a French colonial heritage, including Morocco, Algeria, Tunisia, Lebanon and Syria. The French colonial administration left behind a functioning bureaucracy and well-defined legal framework. In these countries, as in many other civil code jurisdictions, the law plays a prominent role in many facets of public administration, including PFM. Egypt, Jordan, West Bank and Gaza, Iraq and, to a lesser extent, Yemen experienced varying degrees of British colonization. This was more deeply rooted in the former People's Democratic Republic of Yemen (also known as South Yemen), where Aden was colonized from 1839 to 1967, and in Egypt, which was colonized from 1882 to 1923. As with French colonization, the most lasting legacy has tended to be the civil administration and the legal background. As late as the fall of Saddam Hussein in Iraq, for example, the budget director in the Ministry of Finance relied on manuals and regulations dating from the British era.

While these countries come from disparate legal and administrative backgrounds, they share a number of features in common. Their Arabic language and Islamic heritage support a shared sense of identity. Most achieved independence around the same time, and in a number of cases their constitutions and legal frameworks were derived from similar sources. Their public sectors tend to be large and expensive, reflecting the need to absorb excess employment, as well as the statist or dirigiste principles that encapsulated the prevailing wisdom during their political formation in the 1940s and 1950s. Political movements such as pan-Arabism, and political parties, such as the Ba'ath, often had cross-border connections, as did many of the royal families through ties of blood and marriage. All of these factors have reinforced a sense of collective identity.

Beyond these cultural and historical linkages, there are numerous integrative institutions that reinforce this sense of collective character within the MENA region. The most prominent is the Arab League, or to give it its correct title, the League of Arab States, which has 22 members. While the Arab League typically deals with broader political issues, it has on occasion addressed the "good governance" agenda as well through forums such as the Alexandria Declaration in May 2004. While focusing mostly on legal and political reforms, the declaration also contained references to minimizing bureaucracy and increasing government efficiency, as well as encouraging privatization programs and passing laws that would obligate authorities to produce economic data and make it available and easily accessible. Of more specific interest to PFM reform agenda are groups such as the Arab Organization of Supreme Audit Institutions (ARABOSAI), a regional group of INTOSAI with 21 members. The UNDP and OECD's MENA Initiative on Governance and Investment for Development has recently began establishing a network of senior budget officials patterned after similar networks in Central and Eastern Europe. These organizations promote good practice among members and hold regular meetings to discuss issues of mutual interest.

Using the PEFA Ranking to Evaluate PFM in MENA

To review PFM reform across MENA, it is necessary to utilize a common framework of analysis. In recent years, the Public Expenditure and Financial Accountability (PEFA) framework has become the most recognized and widely accepted tool for assessing the status of a given country's PFM system. This set of twenty eight (28) high level indicators measures performance against best practice in developed and developing countries and allows progress to be tracked over time. An additional three indicators are used to track donor practices in heavily aid dependent settings.

The indicators analyze performance in the six core areas of public financial management spanning the budget process: (1) credibility of the budget; (2) comprehensiveness and transparency; (3) policy-based budgeting; (4) predictability and control in budget execution; (5) accounting, recording, and reporting; and (6) external audit. The central government is the main area of focus, along with issues relating to the overall scrutiny of public finances. Activities of public enterprises and sub-national levels of government are not addressed directly.

PEFA was not initially developed to facilitate cross country comparisons, but it is increasingly being used for this purpose. Paolo de Renzio, for example, recently compared the results of 57 PEFA assessments conducted prior to August 2007, including three from the MENA region (Jordan, Syria and the West Bank and Gaza). Although at that point, the MENA sample was too small to draw any robust conclusions, de Renzio highlighted several interesting findings, including the large variation between average scores, the tendency for rankings to fall off as one progresses from budget

⁸ See http://www.arabosai.org/en/index.asp

⁹ Paolo de Renzio, What do PEFA Assessments tell us about PFM Reforms across Countries? Overseas Development Institute Working Paper No. 302, 2009.

formulation through implementation to audit and accountability, and the utility in focusing on more narrow comparisons across certain sub-sets of countries.

Table 1.2 provides the summary results for the six PEFA assessments that have been completed for countries in the study. Assessments for the WBG and Syria were completed in 2006; Jordan in 2007; Iraq and Yemen in 2008; and Morocco in 2009. A PEFA analysis is currently underway in Tunisia, but has not been finalized. It has yet to be conducted for two other countries in this study: Algeria and Lebanon. The PEFA alpha scale has been converted to a numeric scale ranging from 0 to 4 to assist with comparisons, where 4 is the highest rating. It should be noted that, while all PEFA assessments use the same framework, the scores reflect the judgment of the assessment team. Therefore undue weight should not be given to small differences across countries. Furthermore, PEFA is a tool that is applied to all countries—both developed and developing—which may also have an impact upon the MENA rankings.

A comparative analysis was conducted as to where MENA countries stood vis-à-vis other countries at similar levels of development, in this case 19 lower middle income countries with GDPs from \$936 to \$3,075 per capita in 2007 who had recently completed PFEA assessment. (Among the list of comparators were three countries from Africa; three from Latin America and the Caribbean; six from East Asia and the Pacific; and seven from Europe and Central Asia.)¹¹ The results are presented in Figure 3.

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¹⁰ Although a PEFA was presented for Egypt in October 2009, it remains preliminary, as the Government has not endorsed a number of the findings.

¹¹ The countries incorporated into this analysis include Congo Brazzaville, Lesotho, Swaziland, Dominican Republic, Paraguay, Peru, Indonesia, Samoa, Timor Leste, Tonga, Tuvalu, Vanuatu, Albania, Armenia, Azerbaijan, Kosovo, FYR Macedonia, Moldova and Ukraine.

Credibility of the Budget 3.00 2.50 Comprehensiveness 2.00 Average PEFA score and Transparency 1.50 1.00 0.50 -MENA 0.00 -World External Scrutiny and Policy - Based Audit Budgeting Accounting. Predictability and Recording, and Control in Budget

Figure 3: MENA PEFA Averages Compared to Global PEFA Averages for Comparable Low Middle Income Countries

At an aggregate level, MENA's PFM systems are roughly comparable to those of other countries at similar income levels. As a whole, the region tends to do a bit better on accounting, recording and reporting, and a bit worse on credibility of the budget. (See the Appendix for a more detailed breakdown.)

Execution

Reporting

Among the countries covered in this study, the highest ranked countries in aggregated PEFA rankings are Morocco and Jordan. They both have overall average scores of about B (2.87). On the lower end of the scale, West Bank and Gaza (WBG) and Iraq have PEFA Assessments that would average around a C- (1.5 to 1.6), although the formal PEFA assessments do not include minus (-) rankings. In terms of average scores for the six main categories, the tightest scores (i.e. the lowest standard deviation) were around credibility of the budget, indicating commonality among MENA countries on this dimension, whereas the largest average discrepancies were found in the area of budget comprehensiveness and transparency.

It is also interesting to note that there is a fairly high correlation between PEFA scores along various dimensions and the World Bank Institute's World Governance Indicators for controlling corruption in MENA (which, in turn, are tightly correlated with Transparency International's corruption rankings). The R² value is around .92 and the correlation coefficient is .86, indicating that states that do well on PEFA also tend to do well on controlling corruption. However, given the small sample size, it is more difficult to make judgments about causality even though the R² values and correlation coefficients are relatively high.

Though there is a large range in the overall country averages for the PEFA assessment, it is clear that the region as a whole has progressed in some areas more than others. This is best assessed at the level of sub-category because of the variability of scores within each category.

Where MENA has Ranked Consistently Higher

When reviewing the MENA region's individual PEFA scores, four dimensions stand out as areas of strength. They include aggregate revenue outturns compared to the original approved budget; the comprehensives of information included in budget document; the orderliness and participation in the budget process; and the transparency of taxpayer obligations and liabilities. Each is discussed in greater detail below.

Aggregate Revenue Outturn Compared to Original Approved Budget. Most countries scored solid A's (4.0) in this subcategory, which is part of the section "Credibility of the Budget." The exceptions were WBG and Syria, which both scored a B (3.0). This indicates that the countries were meeting, or exceeding, the forecast future revenue flows and therefore could be confident about financing the budget. Over-achieving the revenue projection often occurs where conservative assumptions are used—particularly when projecting petroleum revenues. While the PEFA system does not penalize countries that exceed the revenue projections included in the budget, it should be noted that this outcome can lead to a problems where the "excess" revenue is distributed as part of a supplementary budget during the year. This is the sub-category with the lowest standard deviation among all 28 indicators, indicating the tightest clustering among countries.

Comprehensiveness of Information Included in Budget Documentation. This sub-category falls within the section, "Comprehensiveness and Transparency." A number of countries scored A's (4.0) in this subcategory, but the average was reduced by very low scores for Syria and Iraq, which both scored a D (1.0). The scores suggest that the countries who have taken an interest in the issue have made good progress.

Orderliness and Participation in the Budget Process. Most countries scored well in this subcategory, which is in the section "Policy Based Budgeting." Yemen and Morocco stood out with A's (4.0), while the main exception was Iraq with a C (2.0). This indicates that budgets are generally prepared on time and follow a well defined process—although it makes no comment about the quality of the budget that is prepared.

Transparency of Taxpayer Obligations and Liabilities. This subcategory, which is in the section "Predictability and Control of Budget Execution," was an area in which the region did particularly well (scores of A's and B's for all countries).

Where MENA has Ranked Consistently Lower

There are a number of elements of the PEFA where the scores are consistently weak. They include the composition of expenditure outturns compared to the original approved budget; the effectiveness of internal audit; the quality and timeliness of annual financial statements; and external scrutiny and audit.

Composition of Expenditure Outturns Compared to Original Approved Budget. This subcategory is in the section "Credibility of the Budget" and received poor rankings. All countries scored a C (2.0), with the exception of Syria and Jordan which both scored D's (1.0). The low scores could reflect a number of problems. Either there are weaknesses in the budget that result in inappropriate allocations, or there are inadequate controls exerted during budget execution. This was the sub-category with the highest standard deviation, indicating the greatest discrepancy between countries.

Effectiveness of Internal Audit. This subcategory is within the section, "Predictability and Control in Budget Execution," and was consistently low throughout the region. The MENA countries scored between a C+ (2.33) and D (1.0). The subcategory, "Competition, Value for Money and Controls in

Procurement," is another area requiring improvement, with low scores for all countries other than Morocco and Jordan, which had B's (3.0).

Quality and Timeliness of Annual Financial Statements. This subcategory is part of the section, "Accounting, Recording, and Reporting," and had modest rankings throughout the region (between C+ and D+, or 2.33 and 1.33). The low score could reflect poor quality accounting systems, or the low importance attached to the external audit function.

External Scrutiny and Audit. This category of the PEFA assessment had the lowest average scores. The subcategories, "Scope, Nature and Follow-up of External Audit" and "Legislative Scrutiny of External Audit Reports" ranked low in every MENA country, ranging from a score of C+ to D. The exception was Yemen, which scored a B+ in "Scope, Nature, and Follow-up of External Audit." This reflects weaknesses in both the capacity of the external audit body and of the legislative body charged with follow up on the reports that are prepared, as well as the general preeminence of the executive vis-à-vis the legislative branches

Table 3: PEFA Scores for the MENA Countries in the Study

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	The To Sila late to the stand of the stand o											
	146	\$ 15	4	800.	II OSIN	7 82	0 54	Tunis	S CE	Sign	37 8	00
	Aggregate expenditure out-turn											
get	compared to original approved budget	NA	NA	1.00	4.00	NA	4 00	2.00	NA	3.00	1.00	2 50
ğ	Composition of expenditure out-turn									5.55		
Credibilty of the Budget	compared to original approved budget	NA	NA	2.00	1.00	NA	2.00	1.00	NA	2.00	2.00	1.67
ŧ	Aggregate revenue out-turn compared to											
ğ	original approved budget	NA	NA	4.00	4.00	NA	4.00	3.00	NA	3.00	4.00	3.67
₫	Stock and monitoring of expenditure											
ĕ	payment arrears	NA	NA	1.00	1.00	NA	2.33	NA	NA	1.33	-	1.42
Ŭ	Average score for Credibility of the											
	Budget			2.00	2.50		3.08	2.00		2.33	2.33	2.37
충	Classification of the budget	NA	NA	2.00	4.00	NA	4.00	1.00	NA	1.00	2.00	2.33
Ē	Comprehensiveness of information											
spai	included in budget documentation	NA	NA	1.00	4.00	NA	3.00	1.00	NA	3.00	4.00	2.67
Ë	Extent of unreported government											
Comprehensiveness and Transparency	operations	NA	NA	1.33	3.00	NA	2.33	2.00	NA	2.33	3.33	2.39
Ë	Transparency of Inter-Governmental											
ess	Fiscal Relations	NA	NA	1.00	3.33	NA	2.00	2.33	NA	1.33	4.00	2.33
en de	Oversight of aggregate fiscal risk from		NIA.		2 22		2.00			4 22		ļ
insi	other public sector entities	NA	NA	1.00	3.33	NA	3.00	2.00	NA	1.55	2.00	2.11
ehe	Public Access to key fiscal information	NA	NA	1.00	3.00	NA	4.00	1.00	NA	2.00	2.00	2.17
훁	Average score for											
3	Comprehensiveness and											
	Transparency Orderliness and participation in the			1.22	<u>3.44</u>		3.06	<u>1.56</u>		1.83	2.89	2.33
_	annual budget process	NA	NA	2 00	3.33	NA	4.00	3.33	NA	2.33	4.00	2 47
ing ing	annual budget process	INA	INA	2.00	3.33	INA	4.00	3.33	INA	2.33	4.00	रुगार
Policy-Based Budgeting	Multi-year perspective in fiscal planning,											
e je	expenditure policy and budgeting	NA	NA	1.33	3.33	NA	2.33	1.33	NA	1.00	3.00	2.0
ž =	Average score for Policy - Based											
	Budgeting			1.67	3.33		3.17	<u>2.33</u>		1.67	3.50	2.61
	Transparency of taxpayer obligations											
<u>.</u>	and liabilities	NA	NA	3.00	3.00	NA	4.00	NA	NA	NA	3.00	3.2
ij	Effectiveness of measures for taxpayer											
3									NIA.	NA	3.00	2 63
Execu	registration and tax assessment	NA	NA	2.00	2.33	NA	3.33	NA	NA	INA		£.V
get Execu	Effectiveness in collection of tax											
tudget Execu	Effectiveness in collection of tax payments	NA NA	NA NA		3.00		3.33		NA	NA		
n Budget Execu	Effectiveness in collection of tax payments Predictability in the availability of funds	NA	NA	1.33	3.00	NA	3.33	NA	NA	NA	1.33	2.2
ol in Budget Execu	Effectiveness in collection of tax payments Predictability in the availability of funds for commitment of expenditures			1.33		NA		NA	NA	NA	1.33	2.2
ontrol in Budget Execu	Effectiveness in collection of tax payments Predictability in the availability of funds for commitment of expenditures Recording and management of cash	NA NA	NA NA	1.33	3.00	NA NA	3.33 2.33	NA 1.33	NA NA	NA 1.33	1.33	2.2
d Control in Budget Execu	Effectiveness in collection of tax payments Predictability in the availability of funds for commitment of expenditures Recording and management of cash balances, debt and guarantees	NA NA	NA NA	1.33 2.33 2.00	3.00 4.00 3.33	NA NA	3.33 2.33 4.00	NA 1.33 2.33	NA NA	NA 1.33 2.00	1.33	2.21
and Control in Budget Execu	Effectiveness in collection of tax payments Predictability in the availability of funds for commitment of expenditures Recording and management of cash balances, debt and guarantees Effectiveness of payroll controls	NA NA	NA NA	1.33 2.33 2.00	3.00	NA NA	3.33 2.33 4.00	NA 1.33	NA NA	NA 1.33	1.33	2.21
ility and Control in Budget Execu	Effectiveness in collection of tax payments Predictability in the availability of funds for commitment of expenditures Recording and management of cash balances, debt and guarantees Effectiveness of payroll controls Competition, value for money and	NA NA NA	NA NA NA	1.33 2.33 2.00 1.33	3.00 4.00 3.33 3.00	NA NA NA	3.33 2.33 4.00 3.33	NA 1.33 2.33 1.33	NA NA NA	NA 1.33 2.00 2.33	1.33 1.33 3.33 1.33	2.2! 2.11 2.8: 2.11
tability and Control in Budget Execu	Effectiveness in collection of tax payments Predictability in the availability of funds for commitment of expenditures Recording and management of cash balances, debt and guarantees Effectiveness of payroll controls Competition, value for money and controls in procurement	NA NA	NA NA	1.33 2.33 2.00 1.33	3.00 4.00 3.33	NA NA NA	3.33 2.33 4.00 3.33	NA 1.33 2.33	NA NA NA	NA 1.33 2.00	1.33	2.2! 2.11 2.8: 2.11
dictability and Control in Budget Execu	Effectiveness in collection of tax payments Predictability in the availability of funds for commitment of expenditures Recording and management of cash balances, debt and guarantees Effectiveness of payroll controls Competition, value for money and controls in procurement Effectiveness of internal controls for non-	NA NA NA NA	NA NA NA NA	1.33 2.33 2.00 1.33 1.33	3.00 4.00 3.33 3.00 3.00	NA NA NA NA	3.33 2.33 4.00 3.33 3.00	NA 1.33 2.33 1.33	NA NA NA NA	NA 1.33 2.00 2.33 NA	1.33 1.33 3.33 1.33	2.2! 2.11 2.8: 2.11
Predictability and Control in Budget Execution	Effectiveness in collection of tax payments Predictability in the availability of funds for commitment of expenditures Recording and management of cash balances, debt and guarantees Effectiveness of payroll controls Competition, value for money and controls in procurement	NA NA NA	NA NA NA	1.33 2.33 2.00 1.33 1.33	3.00 4.00 3.33 3.00 3.00	NA NA NA	3.33 2.33 4.00 3.33 3.00	NA 1.33 2.33 1.33 1.00	NA NA NA NA	NA 1.33 2.00 2.33 NA 1.33	1.33 1.33 3.33 1.33 1.33	2.2! 2.11 2.8: 2.11 1.93
Predictability and Control in Budget Execu	Effectiveness in collection of tax payments Predictability in the availability of funds for commitment of expenditures Recording and management of cash balances, debt and guarantees Effectiveness of payroll controls Competition, value for money and controls in procurement Effectiveness of internal controls for non-salary expenditure	NA NA NA NA	NA NA NA NA	1.33 2.33 2.00 1.33 1.33	3.00 4.00 3.33 3.00 3.00	NA NA NA NA	3.33 2.33 4.00 3.33 3.00	NA 1.33 2.33 1.33	NA NA NA NA	NA 1.33 2.00 2.33 NA	1.33 1.33 3.33 1.33 1.33	2.25 2.11 2.83 2.11

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	14	\$ 8	4	1 8 V	Sepa.	180 a	20 3	Heat Bo	# 4 G	es to	e de	COR
eộ th	Timeliness and regularity of accounts reconciliation				3.33							
Accounting, Recording, & Reporting	Availability of information on resources received by service delivery units	NA	NA	1,00	1.00	NA.	3.00	2.00	NA.	1.00	3.00	1.83
ing, Reco Reporting	Quality and timeliness of in-year budget reports	NA	NA	1.33	2.00	NA	3.33	1.33	NA.	3.00	1.33	2.05
counti	Quality and timeliness of annual financial statements	NA.	NA	1.33	2.00	NA	1.33	2,00	NA.	1.33	2.33	1.72
Ac	Average score for Accounting, Recording, and Reporting			1.50	2.08		2.92	2.08		1.83	2.42	2.14
85	Scope, nature and follow-up of external audit	NA	NA		2.00	NA	1.33	2.33	NA	1,00	3.33	2.00
External Scrutiny & Audit	Legislative scrutiny of the annual budget law	NA	NA	1.00	4.00	NA	3.33	2.33	NA	2.33	2.33	2.55
emal 8	Legislative scrutiny of external audit reports	NA.	NA	1.00	2.00	NA	1.33	1.33	NA	1.00	1.33	1.33
ä	Average score for External Scrutiny and Audit	S 3440		1.00	2.67		2.00	2.00		1.44	2.33	1.91
	Average PEFA score per Country			1.58	2,87		2.87	1.92		_	_	2.22
Standard 4.	0											
Scale:												
	A (highest)											
	A-											
	8•											
	В											
	B-									-		
	C.											
	С											
	C-											
	D•											
	D											
	D- (lowest)											Other

MENA Country Templates and Case Studies on PFM Reform

While the PEFA data provides an important overview, it tells only part of the story. Future PEFA exercises will allow for benchmarking progress, but the exercise is relatively new in the region and currently they provide a one-time snapshot of the quality of PFM practices within a given country. To gain a more comprehensive and dynamic picture, this analysis has been augmented by a series of country chapters, which are provided in Volume 2. These chapters were drafted along a common template and have sought to utilize a modified PEFA framework to provide a more nuanced picture of the PFM reform efforts in the countries of this study. These assessments have also sought to go beyond the "what" of PFM reform and capture some of the "how" and "why" behind the reforms, touching upon both strategies for implementation and broader political economy issues within a given country.

In two cases of particularly interesting and far-reaching reform in MENA, the analysis relies on more detailed case studies. The first is Salam Fayyad's PFM reforms, which were implemented during his first tenure as Minister of Finance in West Bank & Gaza from 2002 to 2005. The second are the reforms in tax policy and administration that have been implemented in Egypt since 2004 under the tenure of Youssef Boutros Ghali. These reforms are singled out both because they were substantial in scope and are widely perceived to be the most successful of their type within the MENA region. They are the subject of more detailed World Bank case studies being developed through a joint case writing program between the Bank and the Dubai School of Government.

Finally, it is worth stating that the PEFA scores do not in themselves provide a guide to the relative priority that should be given to reform activity. They are an important indicator but the assessment of priorities requires a fuller analysis. For example, if a country has sizable expenditure arrears then it may be more important to raise a score from 2 to 3 in this indicator than to improve a score of 1 in another area. Similarly, a low score on the transparency of inter-government relations will have different implications for a country with a highly decentralized system from one that is dominated by the central government.

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¹² The analysis of Salam Fayyad's reforms is captured in Nithya Nagarajan, *Reforms in Public Financial Management: West Bank & Gaza*, and Nithya Nagarajan, *Egypt: Overhaul of Tax Policy and Administration*, (World Bank and Dubai School of Government: *MENA Governance Case Program*, 2010). Egypt's reforms in tax administration are captured in a *Doing Business* case study by Rita Ramalho, *Adding a Million Taxpayers* (World Bank: Doing Business, 2008).

¹³ Since 2005, the World Bank has been working with the Dubai School of Government to identify and draft cases on indigenous examples of governance and public sector reform drawn from throughout the MENA region. These cases will be published in a book, *Governance Reform in the Middle East and North Africa: The Lessons from Experience* (forthcoming).

Chapter 2

The Substance of Public Financial Management Reform: What Reforms are Needed and Which are Working?

In warfare everything is simple. But the simple is often quite difficult.

-- Karl von Clauswitz -

Although Clauswitz's famous dictum focuses on a more elemental field of human endeavour, it could easily apply to the discipline of public financial management. At one level, the goals of PFM are obvious and straightforward. Spend money efficiently within an envelope that is affordable and sustainable, in accordance with established procedures, on activities that will maximize a country's long-term development potential. But while the objectives are simple, their realization is typically anything but.

This section reviews the main PFM reforms being pursued by countries in the region. The aim is to highlight which reforms are making progress (and which are not), as well as to set out some of the technical issues associated with the reforms. The analysis draws from the country case studies in Volume 2 and is structured around some common categories of PFM reform. The selection of categories follows the work of Andrews, ¹⁴ who assesses reforms at six different stages of the budget cycle. However the categories have been adapted to reflect common reform activity in the MENA region. Figure 4 sets out the different stages in the budget cycle and the reform categories considered at each stage.

Strategic Budgeting **Budget Preparation Macro-fiscal capacity Broadening budget** Medium term sector strategies **External Accountability** coverage **Budget integration to improve** Strengthening external audit Improving budget resource allocation transparency and classification **Budget Cycle Resource Management** Accounting and Reporting **Treasury operations** Accounting policy reforms Reforms in tax and customs Introducing a performance **Internal Control and Audit** administration focus to the budget **Developing expenditure Procurement reform** controls, including payroll reform Strengthening internal audit

Figure 4: Reforms at Different Stages of the Budget Cycle

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¹⁴ Andrews, *PFM in Africa: Where Are We, How Did We Get There, and Where Should We Go?* Transparency and Accountability Project, the Brookings Institute and the World Bank. See the following webpage: http://www.resultsfordevelopment.org/sites/default/files/resources/PFM-in-Africa-pdf.pdf.

The choice of reform categories involved a number of compromises and several important reforms that have close links to PFM are not considered. For example, tax and expenditure policy reforms, and civil service reforms are often closely associated with the reform of the PFM system. However, these reform areas are not included in the PEFA framework and including them in the study would have extended the analysis.

Determining whether to create separate categories for some wide-ranging reforms was also an issue. In particular, two common reforms—Medium Term Expenditure Frameworks (MTEFs) and treasury reforms—often cover a number of the above categories. These reforms are considered in their component parts during the discussion. In particular, components of MTEF are considered under both macro fiscal capacity and medium term expenditures, while components of treasury reforms are considered under treasury operations, expenditure controls and accounting policy reforms. A similar situation applies with the reform of the legislative framework for PFM. Rather than consider legislative issues as a separate component, legislative reforms are included where relevant in the different categories. Conversely reforms in budget transparency that occur at a variety of stages in the budget cycle (for example budget documentation, in year financial reporting, and end of year financial statements) are considered in a single category.

For each of the six stages of the budget cycle the relevant PEFA scores are first reported, followed by an assessment of each of the reform areas relevant to this stage. For each reform area, the report sets out briefly the underlying objective of this type of reform before reviewing experience in different MENA countries. It then provides an assessment of what has worked and what has proven to be more challenging.

1. Strategic Budgeting

Multi-year perspective in fiscal planning, expenditure policy and budgeting NA 1.33 3.33 2.33 1.33 1.00 2.33 1.94 NA NA Aggregate expenditure out-turn compared to original approved budget NA NA 1.00 4.00 NA 4.00 2.00 NA 3.00 1.00 2.50 Aggregate revenue out-turn compared to original 4.00 4.00 4.00 3.00 3.00 4.00 3.67 approved budget NA NA NA NA

Table 4: Relevant PEFA Scores for Strategic Budgeting

Macro-Fiscal Capacity

Why is the Reform Important? Having a unit in the Ministry of Finance to provide macroeconomic and fiscal (macro-fiscal) policy advice is important for good aggregate fiscal management. A key task of the unit would be to assist in developing a medium term fiscal framework (MTFF) for the preparation of the budget. The aim of an MTFF is to guide the preparation of the budget so that fiscal policy is consistent with the government's monetary and exchange rate policies and debt levels are kept sustainable. The unit can also monitor progress with budget execution and advise whether a change to the budget stance is warranted during the year.

What is Happening in the Region? The Ministries of Finance in the region have traditionally not had a strong macro-fiscal capacity. To the extent that this capacity existed within government, it was

within the planning ministry. It tended to focus on contributing to planning activities, such as a five year plan, or general economic forecasting.

In recent years Jordan, Egypt, Lebanon and Yemen have started to develop some capacity in the Ministry of Finance to provide macro-fiscal advice. ¹⁵ Initially, many of these units focused on monitoring taxes, and the work was geared towards preparing monthly reports on budget execution. These monthly reports tended to be exercises in data dissemination rather than analysis, but the generation of these reports has proven to be a useful tool to develop capacity in the units. The units have been less active in providing policy advice on fiscal management. This capability can be expected to expand as the capacity of the unit improves and more ministers look for this advice.

As the units increase their capacity, they have become more involved in budget preparation through developing an MTFF. In many countries, the links between the MTFF and the final budget is still not strong, and this will require further development before the reform can be considered successful.

To carry out their role effectively, these units need to recruit staff with good analytical skills. The public sector pay and conditions make it difficult to attract such staff. It is therefore not surprising that in some countries (e.g. Egypt and Lebanon), the officials working on these issues are not serving under standard public sector terms and conditions. Even with these contracts, there will be a challenge to retain staff as they develop experience.

Where it has not been possible to recruit staff on special contracts, it has been necessary to tailor the work of the unit to the capabilities of the staff available. In particular, as discussed above, where staff have limited economic forecasting skills, the units have given priority to fiscal reporting and forecasting. The unit has relied on other institutions (such as the central bank) for the relevant macroeconomic data.

Assessment. The establishment of a macro-fiscal unit has become important, as Ministries of Finance have attempted to develop a MTFF to guide the preparation of the budget. The work is analytically demanding, and attracting suitable staff within standard civil service contracts has proven to be a challenge. By initially focusing on fiscal forecasting, many units have made progress in preparing an MTFF, although the link between this and the preparation of the budget needs to improve.

Medium Term Perspective

Why is the Reform Important? In fiscal management, the cost of a policy in the next year is not always a good indication of its costs over time. For example, capital expenditures on a new school in one year can lead to a need for additional operating expenditure in the future. Similarly, some expenditure is driven by demographic movements that can change substantially over time. While the legal focus is on the annual budget, it is recognized that governments need to understand and make provision for the expenditure implications of policies in the coming years (typically the next three years). To be implemented effectively, this requires a "bottom up" assessment of the medium term cost of existing policy—or "forward estimates"—often as part of a Medium Term Expenditure Framework (MTEF) reform.

¹⁵ Although in Lebanon's case, it was led by consultants outside the Ministry of Finance.

¹⁶ Taking a medium term perspective also helps avoid ad hoc and across the board expenditure cuts when fiscal adjustment is required, as it recognizes the value of targeted savings that take time to bear fruit.

¹⁷ The term MTEF is generally used to refer to a group of budget reforms—including the development of a Medium Term Fiscal Framework (MTFF), which is considered as part of the macro-fiscal section above.

What is Happening in the Region? A number of countries in the MENA region are attempting to develop forward estimates as part of MTEF reforms, but none has a functioning system at present. The work has generally been carried out through pilot projects in various sectors. This is the approach that is being followed in Jordan and Lebanon. The PEFA assessments indicate that the lack of a medium term focus continues to be a major weakness in the region.

The development of sectoral forward estimates as part of an MTEF is a very resource intensive reform. Countries with limited capacity for reform might well decide not to embark on this initiative—an approach taken by Iraq. Even Jordan has faced delay with the reform because senior management has been distracted by the other PFM reforms taking place.

One of the challenges with this reform has been ensuring that it is integrated with the core budget preparation process. In Morocco and Tunisia, which were the first countries in the region to attempt to develop medium term forward estimates, the exercise remains separate from the budget itself and is viewed more positively by sector ministries than the Ministry of Finance. Although the forward estimates beyond the budget year are not legally binding, they do provide sectoral ministries with additional confidence of future resources. Conversely, some Ministries of Finance view the forward estimates with suspicion—taking the view that they restrict the "flexibility" with which the Ministry of Finance can manage budget preparation in the future. This is a concern of the budget directorate in Morocco, which has avoided implementing the reforms fully because it fears being tied by the forward expenditure estimates.

Another challenge with the preparation of forward estimates is ensuring that they focus on both the recurrent and capital budgets. In countries where the two budgets are not well-integrated, this does not always happen. In Jordan, for example, the focus of the estimates is on projects and not sufficiently on recurrent expenditures. Identifying the future recurrent implications of current capital expenditure is one of the more important elements of forward estimates, but it is also important to identify changes in recurrent expenditure needs that are not directly linked to projects.

Assessment. The argument for developing sector based forward estimates to provide a medium term perspective is compelling, but this is a major reform and should only be initiated once more basic improvements to the PFM system have been completed. While there is merit in starting the reform by working with pilot sectors, it is critical that the Ministry of Finance is supportive and committed to using the output in budget preparation. It is also important that the forward estimates include recurrent expenditures as well as projects in order to have a comprehensive picture.

Budget Integration to Improve Resource Allocation

Why is the Reform Important? By integrating the management of operating and capital expenditures in the budget, the quality of government expenditure can be improved. In dual budgeting systems, there are often inconsistencies between the two budgets. For example, insufficient resources may be made available to maintain investments once they are complete. More generally, with a dual approach to budgeting, the link between policy interventions and the budget is weakened. High level allocations for the investment or operating budgets are more important in determining the final budget allocations than an assessment of the right mix of operating and capital expenditures for the sector.¹⁸

What is Happening in the Region? All countries in the region inherited systems of budget management that separated recurrent expenditure from capital expenditure, and many continue to have

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¹⁸ While the term capital budget is used in this report, the non-recurrent budget is variously referred to as the capital, investment, or development budget by countries in the region.

separate ministries managing the two budgets. In addition to the separation of responsibility for budget management at the central institutions, there is generally further fragmentation at the level of line ministries with separate finance and planning departments responsible for the two budgets. Although the dual budgeting system is a legacy from the colonial powers, it is ironic that neither Britain nor France currently operates a dual budget.

In several countries in the region, noticeably the Maghreb countries and more recently Syria, the management of the two budgets is under the Ministry of Finance. However, even with this institutional integration, the Ministry of Finance operates separate processes in preparing the two budgets. Algeria integrated the management of the two budgets within sectoral units in the budget department in 2008, in an attempt to unify the processes.

While it is possible that budget integration could be achieved without consolidating budget management in one ministry, in practice the transaction costs of managing this transition have proven to be an impediment to effective integration. Jordan is one of a number of countries in the region that has received on-going advice from the IMF and the World Bank to consolidate budget management within the Ministry of Finance to assist integration. While the advice appears to be accepted at a technical level, no change has occurred. In Lebanon, some argue that integrating the capital budget within the Ministry of Finance would concentrate too much power under one minister. At present, the capital budget is managed by a separate agency reporting to the Prime Minister. In these circumstances, unless there is a strong political will to overcome institutional resistance, efforts to achieve budget integration are unlikely to be successful.

One of the key challenges when shifting institutional responsibility for the management of the capital budget to the Ministry of Finance is to develop the necessary analytical capacity in the relevant MOF staff. In general, Ministries of Finance have tended to manage the recurrent budget through incremental changes to the prior period budget. Planning ministries have often developed a broader range of project appraisal skills and are more experienced at assessing how projects fit with sectoral strategies. The different capacity of the two institutions has been one reason why some donors have favored maintaining their relationship with the Ministry of Planning for donor financed capital expenditures. The reform in Syria presents an interesting case study. When the management of the investment budget in Syria was transferred from the State Planning Commission to the Ministry of Finance, it was expected that many of the staff would be transferred as well. In practice, many of the staff were reluctant to leave the State Planning Commission, and this left the Ministry of Finance poorly equipped to manage its new responsibilities. In view of this, the Budget Department established a specialist unit to manage the investment budget. So while budget management has been consolidated at the Ministry of Finance, the procedures for the two budgets remain distinct.

While integration of budget management has proven difficult in the region, some of the countries have taken steps to integrate the presentation of the two budgets. For example, Algeria now has a unified budget presentation. The West Bank and Gaza also presented its 2009 budget on an integrated basis. This can be a useful first step towards more substantive budget integration.

The issue of budget integration will become more pressing as countries move to introduce a performance focus to budget management. It is an anathema to performance budgeting to have processes for managing the preparation of the budget based on the nature of the expenditure inputs. The same applies to the separation of management between planning and finance departments within a line ministry. In a performance budgeting environment, it will ultimately be important to reduce restrictions on the use of inputs, which would make the budget split redundant. Moreover, it will be important to have a single process for monitoring the sectoral ministry as part of the accountability framework.

Assessment. All countries in the region continue to have elements of dual budgeting. While some progress has been made to integrate the presentation of the budget, efforts to integrate other elements of budget management have largely been elusive. In countries with a separate planning ministry managing the capital budget, institutional resistance to consolidating the budget management processes has been a particular problem. Where consolidation of budget management within the Ministry of Finance does occur, one of the main challenges is to ensure that the Ministry has the necessary analytical capacity to oversee the capital budget. For this reason, the transition needs to be carefully planned.

2. Budget Preparation

Jordan Algeria Orderliness and participation in the annual budget 2.00 3.33 4.00 3.33 2.33 NA NA 4.00 3.17 NA NA 2.00 1.00 Classification of the budget NA NA 4.00 NA 4.00 1.00 NA 2.00 2.33 Comprehensiveness of information included in budget NA NA 1.00 4.00 NA 3.00 1.00 NA 3.00 4.00 **2.67** NA 1.00 3.33 NA 2.00 2.33 1.33 4.00 Transparency of Inter-Governmental Fiscal Relations NA NA 2.33 NΑ NA 1.00 3.00 NΑ 4.00 1.00 2.00 2.00 2.17 Public Access to key fiscal information NA NA NA 1.33 2.00 NA 3.33 1.33 3.00 1.33 2.05 Quality and timeliness of in-year budget reports 1.33 1.33 2.33 1.72 Quality and timeliness of annual financial statements NA 1.33 2.00 NA 2.00

Table 5: Relevant PEFA Scores for Budget Preparation

Broadening Budget Coverage

Why is the Reform Important? There are two key reasons for ensuring that the scope of the budget is broad. First, the budget is the main mechanism for accountability—of both the executive to parliament as well as within the executive. Because alternative accountability mechanisms are often not put in place, extra-budgetary expenditures are not subject to adequate oversight. In addition, the budget is the main instrument for fiscal management. When expenditure takes place outside the budget, it undermines the budget's effectiveness as a mechanism for fiscal control and a process for allocating resources to the government's highest priority areas.

What is Happening in the Region? Limitations in the scope of the budget are a general problem in the region. In Algeria and Morocco, the budget is fragmented with numerous special treasury accounts outside the general budget—although in the case of Morocco, there is disclosure of the fiscal information relating to these special accounts in the budget documents. In Egypt, significant third party revenues and unused budget allocations have been used for extra-budgetary expenditure, while in Lebanon the coverage of projects financed by foreign donors has not been adequately captured in the budget. Although the PEFA assessments do not address this issue directly, the low scores for unreported government expenditure support the view that this is an area of weakness.

One of the challenges in extending the scope of the budget is that there are strong incentives for those benefiting from the current arrangements to resist the change. In Egypt, the Ministry of Finance attempted to rein in extra-budgetary expenditures as part of its treasury reform. While significant balances were initially brought back to the Central Bank of Egypt, these were kept separate from the government's main bank accounts, and the procedures for the management of the expenditures were not amended. Some of the balances later returned to commercial banks—effectively unwinding the initiative, although the IMF has recently reported that the reform is on track.

In Lebanon, the coverage of foreign financed projects in the budget was considered a delicate political issue, as the current arrangement gives the Prime Minister considerable influence over these expenditures. In 2007, a budget law was drafted allowing for the integration of the largest extrabudgetary entities into the budget—although this was only to the extent of the aggregate flows. However, the law is yet to pass. It failed to address the extra-budgetary expenditure of other large entities, such as those providing health services; family allowances and pensions; and financing to the country's 927 municipalities.

The technical demands of extending budget scope and coverage are not significant, and good progress can be made where there is the political commitment. For example, in Jordan, a number of steps have been taken to extend the coverage of the budget, and the PEFA assessment indicates that only a small proportion of total expenditures are not covered. However, there needs to be a strategic approach taken to these reforms which anticipates the likely resistance from vested interests.

Assessment. Improving budget coverage is important to promote accountability for government expenditure and to support the effective allocation of resources. While the technical demands are not significant, improving the coverage of the budget has proven to be difficult for many countries in the region. There are strong vested interests in the existing arrangements, and this is a reform that requires firm political commitment if it is to be successful.

Improving Budget Transparency and Classification

Why is the Reform Important? The need for better information on budgeted expenditures is one element of a general trend towards improved budget transparency in developed countries. This reflects the view that greater transparency in budget documents can play an important role in building the credibility of the government's fiscal policy with the public, parliament and external financiers. Reforming the budget classification is an important component of this broader objective. Traditional budget classifications have tended to mix expenditures of different economic nature, and it was often difficult to obtain a clear understanding of what was happening with the government's accounts.

What is Happening in the Region? Many countries in the region are reforming the economic classification used in the budget to align with the classification used in the IMF's Government Financial Statistics (GFS) 2001. This change has recently been made in Egypt, Yemen and Iraq, while Tunisia is developing a new classification for use in 2015. Morocco has a budget classification that is broadly consistent with GFS, while Lebanon has had a classification aligned with the earlier GFS 1986 since the late 1990s. Both Algeria and Syria have developed a new economic classification based on the GFS 2001 but have yet to implement it. The improvements in economic classification are reflected in relatively high PEFA scores for the quality of budget classification for a number of countries.

While many of the above countries focused solely on the economic classification, Jordan has taken a more comprehensive approach and developed a new chart of accounts as part of its GFMIS project.

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¹⁹ While the GFS 2001 is an accrual system, these countries are generally using the classification while following cash based accounting.

This includes a revised economic classification in line with GFS 2001, along with new administrative, functional, fund and geographic classifications.

There are reports that the changes to the economic classification have substantially improved the quality of fiscal information in some countries. The benefits of changes to the administrative classification are not as obvious, but are also important as they can improve the accountability for budget allocations. As the administrative classification is also often used to approximate the purpose of expenditure (function), it can be very important in improving the quality of information for policy-makers.

It has been common for those providing technical assistance in the PFM area (particularly the IMF) to help countries prepare a new economic classification. Once the classification is updated, its use tends to become embedded within the PFM system and the reform becomes enduring and self-sustaining. However, a major investment is required to train staff during the transition. In Iraq, the training on the new classification system was viewed by some as inadequate, and this has reduced the quality of information produced.

In addition to reforming the budget classification, many MENA countries have taken steps to improve the transparency of budget reporting. One sign of these improvements is that the *Open Budget Index* recently improved Egypt's ranking from near the bottom (a rating of "provides scant to no information") towards the middle ("provides some information")—a significant improvement from 2006 to 2008. Tunisia prepares well documented and easy to understand budget documents, although only with a one year horizon. Jordan's budget documents meet almost all information benchmarks required by transparent practice, one omission being a list of financial assets. In Morocco and Algeria, the documents are extensive, although there are important gaps and the information is not always user friendly. For example, in Algeria there is a lot of general information but no fiscal balance, no information on public corporations and no information on contingent liabilities. Yemen, Iraq, and West Bank and Gaza have also increased the information content of their budget documents—again with some gaps.

Another important initiative has been to provide monthly reports on budget execution during the year. This is now happening in Morocco, Egypt, Jordan, West Bank and Gaza and Lebanon. These reports are generally posted on the relevant Ministry of Finance website. The PEFA scores for this subcategory reflect some progress in this area, although the overall performance is mixed.

There are some specific features of this reform that have helped to make it successful. First, the preparation of the information is generally carried out by a small number of staff within the Ministry of Finance. As such, it is easier for technical assistance to initiate the work and for these changes to be maintained. Second, as the reports are prepared on a frequent cycle, they become part of the routine of the relevant staff. In West Bank and Gaza, it has become a source of pride for the Ministry of Finance staff that the reports are always prepared by the 15th of the following month—which is reflected in their relatively high PEFA score. Finally, while increased transparency can be a powerful tool, there are likely to be fewer vested interests opposed to the presentation of specific information.

Assessment. There has in general been good progress in improving the quality of budget classification and the transparency of budget documents. After initial technical assistance, the budget classification reforms in particular have been enduring once the change was introduced. Similarly, monthly reporting and improvements to the transparency of budget documents has often been enduring. This is in part because the reforms rely on a small team of staff in the Ministry of Finance for

²⁰ See http://www.openbudgetindex.org/.

implementation, which makes them better placed to succeed in an environment where the civil service has limited capacity. Moreover, because the reforms are considered technical, they have tended to meet less opposition from vested interests than many other PFM reforms.

3. Resource Management

Table 6: Relevant PEFA Scores for Resource Management

Alge	76 (S)	p 18	Soroe	leban	Moroco	3	West by Tunis	Ant & Ge	Al Fene	erage s	core
Predictability in the availability of funds for commitment											
of expenditures	NA	NA	2.33	4.00	NA	2.33	1.33	NA	1.33	1.33	<u>2.11</u>
Recording and management of cash balances, debt											
and guarantees	NA	NA	2.00	3.33	NA	4.00	2.33	NA	2.00	3.33	<u>2.83</u>
Transparency of taxpayer obligations and liabilities	NA	NA	3.00	3.00	NA	4.00	NA	NA	NA	3.00	3.25
Effectiveness of measures for taxpayer registration											
and tax assessment	NA	NA	2.00	2.33	NA	3.33	NA	NA	NA	3.00	<u>2.67</u>
Effectiveness in collection of tax payments	NA	NA	1.33	3.00	NA	3.33	NA	NA	NA	1.33	<u>2.25</u>
Competition, value for money and controls in											
procurement	NA	NA	1.33	3.00	NA	3.00	1.00	NA	NA	1.33	<u>1.93</u>

Treasury Operations

Why is the Reform Important? A well functioning treasury system can reduce the cost and risk of government operations.²¹ In particular, it can improve cash management and minimize thegovernment's net borrowing costs. By consolidating cash holdings, it can also reduce the government's exposure to the risk of bank default.

What is Happening in the Region? A number of the countries in the region have embarked on treasury reforms to improve cash management. While progress has been made, the reforms have not always been implemented as originally envisaged.

In general, the reforms have involved establishing a treasury single account (TSA) at the central bank, with a series of transaction accounts holding "zero balances" at commercial banks. This arrangement allows cash to be consolidated in an account at the central bank while utilizing commercial banks for branch network operations. When fully developed, the reforms involve active cash planning to understand the cash needs of the government so that the consolidated cash balances can be managed on a daily basis. Although the reform should also be associated with steps to improve debt management, few countries in the region have made progress in this area.

Improving cash management by moving towards a TSA has been part of the reform agenda in Iraq since at least 2005. In that year, a joint World Bank/IMF mission recommended, as a medium-term reform (that is, by the end of 2006) that progress towards TSA should be made, subject to

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²¹ Treasury reforms are often used to refer to a range of PFM reforms relating to budget execution. These can include cash management, expenditure control and accounting reforms (often in an improved IT environment). In this section, the focus is on cash management reforms.

improvements in the payments and banking systems.²² Progress has been limited and, in 2008, the IMF reported that the GoI did not yet operate a TSA and continued to hold large idle balances outside the main treasury account.

In Jordan, while many of the bank accounts were initially consolidated at the central bank, a number of accounts were not consolidated and outside the capital Amman, positive cash balances continued to be held at commercial banks. After some delay, it appears that agreement has now been reached to consolidate most of these balances—although in spite of this, a recent IMF/World Bank report noted that government deposits with commercial banks had recently increased. Lebanon also consolidated some balances at the central bank, but a number of important accounts were kept separate and the balances in these accounts were not available to meet cash needs. These limitations were not in general technical but more to do with whether the Ministry of Finance had the authority to consolidate the balances.

As discussed earlier, a similar issue arose in Egypt. The Ministry of Finance attempted to close a large number of accounts at commercial banks in order to consolidate the government's cash balances. However, facing vested interest from the "owner" of the account, the balances were kept separate within the central bank and eventually many returned to commercial bank accounts. The IMF has recently reported a fresh initiative by the Ministry of Finance on this reform.

In Yemen, it was proposed to establish a treasury in the Ministry of Finance to assume many of the budget execution functions at present carried out by the central bank. The reform has not progressed, in part because it was dependent on the implementation of the new information system (AFMIS), which has taken far longer than initially anticipated to make fully operational. More generally, there was limited enthusiasm from the Ministry of Finance for the reform and considerable unease from the central bank, which at present has 80 percent of its staff involved in supporting the budget execution function.

The use of cash plans for active cash management is at an early stage for countries in the region. Good progress has been made with cash planning in Jordan, but this remains a "research exercise" and cash management is still mainly through cash rationing. In Lebanon, cash rationing is still being used on a daily basis by the Ministry of Finance to decide which bills to clear. A start has been made to prepare a cash plan to guide budget execution, but there has been reluctance to involve line ministries in the preparation of the plan, which limits its status and has raised questions about whether the Ministry of Finance is truly interested in making this reform.

Cash constraints are also a significant problem in the West Bank and Gaza. However, there is an interest in moving to a more systematic arrangement and a cash plan was developed for 2009 with input from line ministries. The reform is in its early stages, and the cash plan is not yet being used to assist cash management.

It is worth mentioning that in countries with cash rationing in effect, the Ministry of Finance has considerable influence. It is therefore not uncommon to find the MOF less than enthusiastic about moving to a more systematic cash management system.

With treasury reforms there are a number of technical challenges, and a lot to learn from the experiences of other countries. For this reason, it is valuable to have technical assistance to support the reform. However, a greater need is to have solid commitment from staff within the Ministry of

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²² In fact, the Financial Management Law (CPA Order 93 of 2004) requires that all receipts shall be credited to a Treasury Consolidated Account and paid into the Treasury Single Account, and all payments shall be debited to the Treasury Consolidated Account and withdrawn from the Treasury Single Account.

Finance for the reform. While other PFM reforms can be managed by a small team within the Ministry of Finance, these reforms affect many administrative employees throughout the public sector. Unless there is strong leadership from senior staff at the Ministry of Finance, the changes are difficult to implement successfully.

Assessment. While some progress has been made on treasury reforms in the region, this remains work in progress. Although a TSA has been established in many countries, the coverage is often not complete because the Ministry of Finance has not had the authority to consolidate some balances. A number of countries have set up units to prepare and maintain a cash plan, which can assist in aligning the borrowing and investment activity with the government's cash needs. However, too often the cash plans are not being actively used in cash management. Few countries have taken steps to improve debt management systems as part of treasury reforms.

Reforms in Tax and Customs Administration

Why is the Reform Important? The collection of tax and customs revenues involves a number of challenges. Although the government collects tax by exerting its coercive power, this will meet strong resistance from taxpayers if the system is not perceived to be fair and efficient. ²³ By improving the administration of the tax system, government can increase the revenues it collects consistent with the applicable laws, while enhancing the fairness of the system and reducing the compliance costs for taxpayers. The latter is important, as complying with the tax system can be a high cost of doing business.

What is Happening in the Region? In general, the MENA countries have made much better progress with tax administration reform than they have with expenditure reforms. Historically, countries in the MENA region have had a low tax to GDP ratio and inefficient tax systems that gave considerable discretion to the tax inspectors. Many countries are now interested in increasing the taxes collected—pressed to do so in some cases by the prospect of declining oil revenues. In light of this objective, a number of Ministers of Finance have taken an active interest in reforms to improve tax policy and administration. An additional motivation has been to improve the business environment.

There are some impressive achievements in tax administration reform from the region. Egypt has made considerable progress from a low starting point, and a 2008 IMF report noted a variety of important accomplishments. They include: (1) the successful implementation of self-assessment for income tax; (2) the creation of the Egyptian Tax Authority, as a vehicle for tax administration modernization; and (3) the establishment of a large taxpayer center and a pilot medium-size taxpayer center in Cairo. These reforms are at an early stage but the progress to dates is impressive.

Jordan amalgamated the income and sales tax units into a new tax authority, and more recently it has made a number of changes so that the tax system provides an attractive and stimulating environment for local and international investors. In this regard, they conducted a comprehensive review of tax regimes to simplify and reduce their number to a minimum and consolidated the legislation. Morocco is considered to have a good tax system with a clear legal basis. A single taxpayer identification number is under development, and performance criteria for tax audits have been adopted. The introduction of large and medium taxpayer offices as "one stop shops" for taxpayers has also been adopted in Lebanon and Algeria, while Yemen has also introduced a system of self assessment for large companies.

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²³ This analysis focuses on the administration of general government taxes and duties related to income, trade and consumption etc. Where countries rely on revenues from petroleum or other natural resources, a different set of challenges apply.

It is interesting that more progress seems to be made on revenue administration issues than on expenditure administration. There are a number of possible explanations. One interesting observation is that it has been possible in some countries to provide real incentives to staff of the tax authority as part of the reforms. In particular:

- While in the past, tax administration was often just another department in the Ministry of Finance, many of the reforms have set up a separate tax authority or at least introduced separate administrative arrangements for the tax department. In Lebanon, this approach has allowed otherwise restrictive civil service wage rates to be bypassed. Being a tax official is a sought after job within the administration. Syria is also putting emphasis on this approach as part of its tax reforms.
- A number of countries in the region have also established bonus arrangements to provide tax collectors with an additional incentive. Tunisia attributed part of a recent increase in its tax collections to changes to the bonus structure.

Providing incentives for staff has been more difficult for expenditure reforms because of the wider implications for government administration. These incentives have had a positive effect in helping establish a new culture for tax administration. On the other hand, such arrangements have led some of the better staff to move from expenditure roles within government, exacerbating existing capacity problems in these areas. For this reason, caution should be exercised in deciding whether to adopt the approach.

Assessment. Tax administration reforms have in general been more successful than expenditure reforms in the MENA region. In part, this is because Ministers of Finance have taken an active interest in the reforms. However, tax administration is also a distinct function within government and it has been possible to support reforms by introducing separate administrative arrangements to provide stronger incentives for staff. One unhelpful consequence of this tactic has been that some of the better staff have moved to tax administration from expenditure roles within government, exacerbating existing capacity problems in these areas. For this reason, caution should be exercised in deciding whether to introduce incentives for tax administration in isolation.

Procurement Reform

Why is the Reform Important? The way in which the purchase of goods and services is controlled through the procurement process can help the government to minimize collusion, kick-backs and other corrupt practices. Improvements to procurement procedures can therefore lower the cost of government expenditures.

What is Happening in the Region? As can be seen in the PEFA scores, many MENA countries have weak procurement systems. Yemen provides a good example of the type of problems that exist. The external audit body has commented that the procurement system is rife with fake competition, abuse of contract variations with subsequent project overruns, non transparent tender evaluations, an all too frequent resort to direct procurement methods, and the use of "slicing" to bypass procurement and authorization thresholds.

Procurement reforms are being discussed in a number of countries, usually on the back of a new procurement law. This is the approach being followed in Yemen and West Bank and Gaza. A new law has also been drafted in Lebanon, but is awaiting approval by the Council of Ministers before it can be submitted to parliament. In all cases the new laws include:

• Establishing an independent public procurement agency under the new procurement law;

- Preparing standard bidding documents based on the new law; and
- Preparing a user's manual and guidelines.

Procurement reforms have taken time to implement. Yemen has been working on the reform for over five years and has been actively supported first by the World Bank, and more recently with training by U.S. AID. Syria developed a new law in 2005, but this contained a number of weaknesses and the World Bank is now supporting work to revise the law. The delays stem from a variety of factors, but an important element is the strong opposition to reform from individuals and institutions benefiting from the existing system. In many cases, this is due to significant elements of corruption in the government procurement system.

Assessment. The quality of procurement systems in the region is weak. Reforms have been attempted in a range of countries, but the timescales for these reforms have been extended and the outcomes have been disappointing. The reforms often touch on areas of significant corruption and therefore can pose a threat to particular interests which have strong incentive to delay or divert the process. The failure to make progress in large part reflects an unwillingness to confront these special interests.

4. Internal Control and Audit

Algeria Composition of expenditure out-turn compared to 2.00 2.00 1.67 original approved budget NA NA 1.00 NA 2.00 1.00 NA 2.00 NA NA 1.00 1.00 NA 2.33 NA NA 1.33 Stock and monitoring of expenditure payment arrears 1.42 Effectiveness of payroll controls NA NA 1.33 3.00 NA 3.33 1.33 NA 2.33 1.33 2.11 Effectiveness of internal controls for non-salary 1.33 2.11 expenditure NA NA 1.33 3.00 NA 2.33 3.33 NA 1.33 NA 1.33 2.00 NA 2.33 2.33 NA 2.00 1.33 1.89 Effectiveness of internal audit NA

Table 7: Relevant PEFA Scores for Scope of Budget

Developing Expenditure Controls

Why is the Reform Important? It is an obvious point, but effective expenditure controls are important to ensure that expenditures remain within the budget allocations and support aggregate fiscal control; as well as that the budget's role in allocating resources to sectoral expenditures occurs in a timely manner at the lowest cost, and that any changes in circumstances during the year can be accommodated. In addition to general expenditure controls, there are specific requirements to manage effectively the payroll procurement process. Because of the link to the transaction cycle, the controls are an important element in addressing corruption associated with government expenditure.

What is Happening in the Region? The countries in the region tend to have extensive and time-consuming control systems, but these systems are often not effective. As can be seen in the PEFA scores, controls on payrolls and non-salary expenditures, as well as the management of arrears, are all

areas of weakness. The composition of the outturn also differs greatly from the approved budget in all countries.

In order to improve the quality of expenditure control, reform proposals are being made to:

- Streamline the control processes and clarify accountability;
- Apply controls at the point of commitment; and
- Improve the quality of controls on procurement and payroll.

It is common practice in the region to have multiple signatures associated with the clearance of each transaction. Where there are numerous signatories to a given expenditure, it is often not clear who is ultimately responsible and hence accountable for misuse. This can be problematic within one institution, but in countries like Lebanon, Syria, Jordan and Morocco the problem is exacerbated by having a range of different agencies involved in the ex-ante control process. In addition to weakening accountability, the procedures can become a major impediment to the government's ability to conduct business. In a number of countries (notably Iraq), the delays caused by heavy control procedures are said to explain delays in capital projects. Moreover, in Lebanon, the problem is used as a rationale for managing capital projects outside the government system.

Despite the problems being faced in the region, there have been relatively few attempts to date to streamline the control procedures. Morocco has embarked on a reform of the organization of its exante control system. In 2006, the separate bodies that control payment orders and commitments were merged. In 2007, cumbersome virement rules were revised to provide greater flexibility to ministries. This has already resulted in improvement in the timeliness of budget execution. It is also planned that "ministerial treasuries" will perform a simplified modernized ex-ante control, which will be based on risk assessments and the size of the transactions. However, few of these treasuries have been established. There have been proposals to streamline the ex-ante controls system in Lebanon, but the latest reform action plan makes only a marginal mention of this initiative. The lack of focus on this issue is in part a reflection that the need for reform is not accepted. However, it is also recognition that the reform would be challenging, given it would involve changing the roles of some institutions.²⁴

Cash rationing and the build-up of arrears is a major problem for many of the countries in the region. Lebanon, West Bank and Gaza, Yemen and to a lesser extent Egypt and Jordan have identified problems with expenditure arrears. While many of the problems stem from the poor quality of budget preparation, there are opportunities to better manage the problem if expenditure controls are exercised at the point of expenditure commitment. At present, many countries implement the expenditure controls at the point of payment, by which time the liability has been created and the only question is when payment will be made. In Lebanon, there is an additional complication posed by the violation of the annuality principle in the regular budget.

To address the arrears problem, Morocco has introduced a system of commitment controls, although the draft PEFA assessment suggests that the system is not yet working effectively. West Bank and Gaza is in the early stages of introducing commitment controls in conjunction with the new accounting system. The recent IMF/World Bank mission to Jordan has recommended that

²⁴ This can be particularly problematic where there are known to be side payments for staff associated with the expenditure control process.

²⁵ In Algeria, funds release is not timely and arrears do develop, but the petroleum revenues have been available to finance any arrears that emerge.

commitment controls also be a feature of the financial management system being developed. On the other hand, while a commitment control feature is part of the software specifications in the Yemen financial management information system, this functionality has not yet been designed or activated. Although it is possible to implement commitment controls in the absence of computerization, all the reforms to date are progressing as a component of an IT project.

The PEFA scores suggest that, in relative terms, the management of payrolls is in better shape than other expenditure controls. Both Jordan and Morocco have solid scores in managing the payroll. Progress on a more limited basis has been made in Lebanon. Overall payroll controls in Egypt are fairly effective as payroll audits are carried out, though they are not comprehensive. Lebanon's computerization of payroll and pension management in the 1990s was a major achievement. In 2006, the MOF introduced direct computerized bank payment to public sector employees, which has also allowed a reduction in the number of ghost workers.

Payroll reform is a particular priority in West Bank and Gaza and Yemen—although the problem in each country is different. In Yemen, the problem is one of ghost workers and double dippers, while in West Bank and Gaza, it is the lack of budget discipline in the recruitment process. In West Bank and Gaza, payroll controls have improved substantially in 2007 and 2008. They provide more assurance on the integrity of an item that in the 2009 budget constitutes more than 60 percent of recurrent expenditure. In particular, the payroll system is now connected with the accounting system of the MOF, and a separate financial controllers department reviews the payroll on a monthly basis.

In Yemen, a civil service project started in 1998 which included the establishment of a clean personnel database by 2001. The project was restarted in 2005 with a re-visitation of the clean up exercise (principally of double dippers and ghosts) through a new database that includes biometric control data. However, the clean up exercise currently covers around 70 percent of all Government employees and does not include a significant portion of the ministries of Defense and Internal Affairs. There is a consensus among knowledgeable observers that the former is likely to be particularly problematic in terms of ghost workers and double-dippers. Furthermore, the biometric system is not as of yet closely linked to the payroll, which does not allow it to function as intended.

Assessment. The quality of expenditure controls in all forms is poor for countries in the region. Despite the problems being faced, there have been few attempts to date to streamline and strengthen the expenditure control procedures. Where the reforms involve institutional changes, they have proven particularly challenging. Progress has been made by some countries in payroll management, but this is uneven. The overall impression is that where there is a failure to make progress, it is mainly due to a lack of genuine interest in the reforms.

Strengthening Internal Audit

Why is the Reform Important? Internal audit aims at providing the executive with assurance of the quality of the financial management systems—in particular the implementation of financial controls and the management of risks. ²⁶ Depending on the system of control in place, this could be assurance to the Ministry of Finance or to the senior management of the line ministry.

What is Happening in the Region? The PEFA assessments indicate that the internal audit function is poorly developed in most countries in the region, with Morocco being one of the few countries to have a relatively positive PEFA assessment. Many of the weaknesses are similar to those found with the

²⁶ While internal audit can also provide comment on the value for money of expenditures, this is not generally a core function.

external audit bodies and relate to problems of the scope of work carried out, concerns about conflict of interest, and institutional clarity.

In many countries, the internal audit function has a strong transaction focus, and aims to identify cases of mismanagement or a failure to follow procedures rather than looking at the adequacy of the overall systems. This is often a feature where the function has emerged from a Soviet style inspection service. The internal audit in Syria is an example of this, and the relatively strong PEFA assessment for Syria reflects the extensive control which is applied through this system rather than the adequacy of the scope of its activities. In countries such as Lebanon and Jordan, internal audit is part of the ex- ante control process. This compromises the auditor's independence, as any assessment is a comment on the auditor's own work. Institutional clarity is a particular problem in Tunisia where there are several internal audit bodies, with one reporting to the Prime Minister and another to the Minister of Finance.²⁷ The institutions have similar roles although the latter extends further into value for money issues.

There have been relatively few efforts to reform the internal audit functions in the region—in part reflecting the view that internal audit is an advanced reform. It is certainly more recognized where countries adopt a performance budgeting approach and there is a greater focus on the accountability of line ministries. This creates a demand from managers for assurance on the systems they are managing. However, it is possible that resistance to a change in role is also coming from auditors where involvement in the transaction control process is a source of corruption or influence.

One interesting example of internal audit reform is in West Bank and Gaza. Since 2004 the Ministry of Finance has been building an internal audit functions with support from the European Union. The function has been providing the Minister of Finance with assurance of the financial management systems both within the Ministry and throughout the core public sector. The reform has closely followed international norms for internal audit activity. In view of the Ministry of Finance's objective of devolving responsibility for financial management to the line ministries, the plan is for the internal audit function to also be transferred.

Assessment. Most countries in the region have weak internal audit functions reflecting problems in both the scope of audit activity, and conflicts of interest where the auditor is also part of the control function. Internal audit has in general not been given a high priority for reform in part because it is considered an advanced PFM reform. But resistance to change can also come from existing auditors who are reluctant to be removed from the transaction control process when this is a source of corruption.

²⁷ A third body has a particular focus on public property issues.

5. Accounting and Reporting

Table 8: Relevant PEFA Scores for Accounting and Reporting

Alge	163	in to	Jorda	leban	Moroco	5,0	West & Tunis	3114 & G	Ave Feme	age sco	26
Timeliness and regularity of accounts reconciliation	NA	NA	2.33	3.33	NA	4.00	3.00	NA	2.00	3.00	
Oversight of aggregate fiscal risk from other public sector entities	NA	NA	1.00	3.33	NA	3.00	2.00	NA	1.33	4.00	2.44
Extent of unreported government operations	NA	NA	1.33	3.00	NA	2.33	2.00	NA	2.33	3.33	<u>2.39</u>
Availability of information on resources received by service delivery units	NA	NA	1.00	1.00	NA	3.00	2.00	NA	1.00	3.00	<u>1.83</u>

Accounting Policy Reforms

Why is the Reform Important? Accounting policy reforms canimprove the reliability with which expenditures and cash balances are controlled, monitored and reported.²⁸ Where accounting policies are aligned with international standards, there can be increased confidence in the integrity of the financial information presented.

What is Happening in the Region? Accounting systems in general are not well developed in the region, and there is a mixed record of reform. In Syria, the accounting system still operates on a single entry basis. This makes the system more prone to error, as there is not a ready reconciliation between the flows and stocks. A recent European Union project endeavored to introduce double entry accounting through a new IFMIS system, but this has not been successful.

There are extensive delays in preparing the final accounts in Morocco and Tunisia that reduce the quality of the accounting systems. In both countries, the final accounts are not completed until two years after the end of the financial period.

In Egypt, the accounting system is on a double-entry basis but has a mix of cash and accrual concepts that complicates interpretation of the accounts. The IMF recommended that a pure cash based system be adopted as part of a medium term transition to accrual accounting, but in spite of considerable TA the system has not been reformed. The IMF has recently commented that accrual accounts "of questionable utility" persist, as well as a variety of memorandum accounts. On a more positive note, PEFA scores indicate that account reconciliations are generally conducted on a timely basis. While this indicates adequate processes within the accounting departments, it does not provide assurance on the quality of the accounting framework.

Jordan appears to have made the most progress with accounting reforms. It is now about to adopt the International Public Sector Accounting Standard (IPSAS) as part of the reform project that includes the implementation of a GFMIS.

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²⁸ In this section the focus is on accounting methodology and standards.

As with treasury reforms, there are a number of technical challenges with accounting reforms and there is much to learn from the experience of other countries. For this reason, it is valuable to have technical assistance to support the reform. However, given that the reform affects the work of a large number of civil servants, the main need is to have solid commitment from senior staff within the Ministry of Finance for the reform. This is particularly the case where the existing practices have been in place for an extended time and the accounting staff in the country have considerable human capital attached to knowing these practices.

Assessment. Experience with the reform of accounting systems has been mixed. While most countries operate double entry systems, there has been limited success in reforming accounting methodologies towards a consistent use of cash or accruals, let alone applying international accounting standards. A challenge with accounting reforms is that they affect the work of many employees throughout the public sector, and a strong commitment from the senior staff in the Ministry of Finance is essential if the reform is to be successful.

Introducing a Performance Focus to the Budget

Why is the Reform Important? The traditional input based budget does not provide policy makers with information on what goods, services, or policies are being financed by government expenditure. In the absence of this information, attempting to ensure the efficiency and effectiveness of expenditure is a challenging task. The aim with a performance focused budget is to aggregate inputs that are used to deliver a particular group of activities. Often the reform is associated with some relaxation of input controls and, in the more advanced applications, with the introduction of an accountability framework based on performance.

What is Happening in the Region? The idea of focusing on performance has been around for some time, but in the last twenty years many OECD countries have reformed their budgets to introduce a more explicit performance focus. Such reforms have been given different labels—with program, output, or results oriented budgeting being among the most common.

In view of the broader global trend towards improved effectiveness in public administration, there is considerable interest from countries in the region in introducing a performance focus to the budget. The earliest efforts were made by Jordan, which started its results oriented budgeting reform in 1998. In recent years, a number of other countries have started to work on pilots for program based budgets, including Morocco, Algeria, Tunisia, Lebanon, and Syria.

The Jordanian experience is particularly instructive. The first efforts were supported by the German aid agency GTZ and continued from 1998 to 2004. They were ultimately considered too ambitious and had little impact. Since then, an approach has been piloted in the Ministry of Education and is being extended to other ministries. Initially, there appeared to be little ownership of this initiative by the General Budget Directorate of the MOF, but this is no longer the case. A recent review by the IMF/World Bank noted that progress has been made. However, it also commented that the reform has not yet delivered the benefits that were expected. One reason identified is that the lack of some basic elements of the PFM system (e.g. commitment controls) has tended to negate the progress with this more advanced reform.

Morocco has also been working on performance budgeting reforms for a number of years. The World Bank provided assistance to the government to develop a performance budgeting approach, based on pilots in a number of ministries. However, while some performance budget documents were drafted, government support for this exercise was weak and the initiative has not been pursued after these initial drafts. More recently, the MTEF reform is being used to develop more performance focus. A

methodology was developed in 2006 and work on the MTEFs has continued, but to date the budget is an input based document.

Tunisia has four results based budgeting pilots underway with support of the World Bank, but it is taking a measured approach to the reform. The intention is to include the pilot ministry information as an annex to the 2011 budget. A similar path is being followed by Syria, although it expects to include some material on its two pilots in the 2010 budget. A European Union project financed training and study tours for staff in the Syrian Ministry of Finance over a number of years, but there was no reform to the budget as a result of this initiative. The latest developments are taking place in a low key fashion with the support of the IMF. In Algeria, a pilot program budgeting was carried out in FY07. It was not repeated in 2008 but is expected to resume in 2009. Full adoption of program budgeting and management is planned for the budget in 2012, if the new organic budget framework law is adapted by parliament in time.

In West Bank and Gaza, a pilot approach was rejected and all ministries were asked to develop programs to establish a link between the budget and the government's reform plan.²⁹ The program structure was used for presentation purposes in the 2009 budget, although it will be refined in future years. One of the motivations for this reform has been to demonstrate that budget support from donors is being used as planned.

The slow progress on introducing a performance based approach is in large part because it is necessary to have many of the basic elements of the PFM system in place before it can work effectively. Often these weaknesses are only fully recognized when work on a pilot begins. A number of prominent examples of the challenges facing reforms in this area are:

- In Syria, the work with pilot ministries revealed that—in addition to the standard dual budgeting problem—a large portion of sectoral expenditure (say in education or agriculture) is fragmented between the relevant sector ministry and the Ministry of Local Administration. Unless this institutional fragmentation can be addressed, it will hamper the efforts to make program budgeting effective.
- In West Bank and Gaza, it was recognized that the accounting systems need to be adapted to allow programs to be monitored during the execution of the budget. While chart of accounts changes are manageable, the accounting system will not be able to manage complex cost allocations. This will mean that some of the programs initially defined will need to be simplified to meet the capacity of the accounting system.

Another challenge is to avoid the reform becoming an information collation exercise, which loses sight of the objectives. When fully developed, a program structure can involve a range of subprograms and activities. Combined with associated performance indicators, the information demands can be extensive. This might make sense in a well developed budget system where skilled staff are able to effectively use the information. However, in an environment where there are capacity constraints in both preparing and using the information, the data collation process can become an end in itself, undermining the reform. This was a criticism of initial work on results oriented budgeting in Jordan. Also, the budget documents in Morocco include hundreds of input or output indicators, but little attention is paid to them. The government intends to improve these performance indicators, including reducing their number.

²⁹ Palestinian National Authority, *The Palestinian Reform and Development Plan* (PRDP), 2008.

Finally, it is worth noting that Egypt, Yemen and Iraq have decided not to start work on a performance focused approach to budgeting at this point. In Iraq in particular, this reflects recognition that there are more fundamental reforms deserving priority.

Assessment. There is considerable interest from MENA countries in introducing a performance focused approach to budgeting. However, the successes are limited to date and the timeframe for the reform is proving to be extended. This reform is complicated and difficult—in part because it relies on having many other elements of the PFM system functioning at a reasonable standard. For this reason, even where the reform proceeds, every effort should be made to avoid conceptually sophisticated approaches and to ensure that the approach can be supported by the accounting systems.

6. External Accountability

Table 9: Relevant PEFA Scores External Accountability

Algeria Estra la donda non occo Stria la la Rena score											
Scope, nature and follow-up of external audit	NA	NA	-	2.00	NA	1.33	2.33	NA		3.33	
Legislative scrutiny of the annual budget law	NA	NA	1.00	4.00	NA	3.33	2.33	NA	2.33	2.33	<u>2.55</u>
Legislative scrutiny of external audit reports	NA	NA	1.00	2.00	NA	1.33	1.33	NA	1.00	1.33	<u>1.33</u>

Strengthening External Audit

Why is the Reform Important? External audit provides parliament with assurance on the adherence to financial laws, the reliability of the financial statements, and value for money in government expenditure. As such, it provides an essential discipline on the financial management of the executive.

What is Happening in the Region? The PEFA assessments indicate that the external audit functions of countries in the region have a range of weaknesses. Egypt is an extreme example as the activities of the Central Audit Organization, which is Egypt's Supreme Audit Institution, are shrouded in secrecy. In Algeria, the last published annual report from the National Audit Court was in 1996-97, and its reports are not now publicly available despite an apparent requirement that they be published in full or in part in the Official Gazette.

With some countries, the weaknesses relate to institutional problems, with many external audit bodies reporting to the President or King instead of solely to the parliament. In many countries, the audit function has a strong transaction focus, with the aim of identifying cases of mismanagement or a failure to follow procedures rather than looking at the adequacy of the overall systems. In countries such as Lebanon and Jordan, external audit is involved in ex-ante control, compromising the auditor's independence. In Tunisia, a good quality external audit is carried out by the Court of Accounts and the INTOSAI standards on autonomy, scope and quality are met. However the value of audit work is limited by the fact that it is only partially published, the public accounts may be some two years old by

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³⁰ Whether joint reporting is in practice a problem depends on whether the arrangements compromise the willingness of the auditor to raise concerns or problems.

the time the settlement law is considered by parliament and by the lack of any formal parliamentary hearing on the report by the Court of Accounts on this act. A similar situation applies in Morocco.

In spite of the weaknesses in the external audit bodies, there appear to have been relatively few efforts to reform the external audit functions. Given the relatively limited role played by the parliament in most of the countries in the region, it is not surprising that there is limited demand by the parliament for support in holding the executive to account. This is reflected in the very low PEFA scores for legislative scrutiny of audit reports for all countries in the study.

Although there are proposals for future reform in Jordan and Lebanon, the three countries with the most experience with audit reforms to date are Iraq, West Bank Gaza and Yemen. They have had mixed experiences. In Iraq, the reform involved introducing a new inspector general function based on the U.S. model. A number of PFM experts believe that this reform has not been successful, as the new function is not well understood and is not integrated with the existing oversight institutions. The change has also exacerbated existing capacity problems.

In West Bank and Gaza, a new audit body was established in 2005. However, in light of the prevailing political instability during that period, the capacity building process restarted in 2007. It has received little technical assistance from donors to date, but a major capacity building project is about to start financed by the European Union. Alongside this project, the external audit is being guided by the Auditor General of Norway for the audit of the 2008 financial statements. This would be the first audit of financial statements since 2003. The audit is not complete, but the early indications are that working through a "live" audit will be a very productive capacity building exercise. The presence of the Norwegians has also provided the external audit with needed credibility in its discussions with the Ministry of Finance. The extensive effort made by the Ministry to document and support the 2008 accounts has also confirmed the vital role that an external review can play in ensuring discipline in the financial management function. Without the possibility of external review a range of sloppy—if not unethical—practices can easily develop.

In Yemen, the external audit body has received support from GTZ for a number of years. Since 2007, the body can be seen to be having a real influence, with active consideration of its report by the parliament. Before then little progress was apparent. Although the project has been active since 2005, the reform towards an institution meeting INTOSAI standards is still work in progress. For example, only now has a draft audit bill been completed and forwarded to the President to address (among other things) the independence of the external audit agency.

Assessment. Most countries in the region have weak external audit functions, in part reflecting the relatively minor role played by parliaments in many countries in the region. While the focus of external audit is on providing assurance to parliament, the presence of an effective audit body can also support reforms in budget execution by encouraging more discipline in the accounting practices. However, ultimately the success of efforts to build the capacity of the audit body will depend on whether the parliament is prepared to utilize the auditor's report.

Chapter 3

Implementing Reforms in Public Financial Management: An Emerging Set of Promising Practices in MENA?

One of the lessons of public finance reform is that people do not 'eat' reform, people cannot relate to reform. So what is important is to look for ways to make people actually feel the difference.

-- Salam Fayyad --

At one level, it is an admittedly artificial exercise to separate the content of reforms from their implementation, for the two are inextricably linked. The nature of the reforms being implemented will inevitably influence the pace and timing of change, the size of the effort, and the actors engaged in it. Yet the science (or art) of management has also long-realized that the way in which reforms are implemented can have an important impact upon their realization. This chapter seeks to review the lessons that have been learned from a decade or more of trying to implement PFM reform in MENA to understand if there are obvious pitfalls to be avoided or approaches that will elevate the prospects for success. It also seeks to better understand the various political and bureaucratic dynamics surrounding these changes.

How Important is Implementation to the Success of MENA's PFM Reforms?

Before proceeding, it is important to better understand the role of implementation in contributing to successful PFM reforms. As Table 10 indicates, not all reforms are created equal. This table breaks the MENA experience with PFM reform down along three dimensions. The first category are reforms that have typically been "more successful," in that a number of MENA countries have been able to implement them effectively and achieve concrete, independently verifiable improvements. The third category, "challenging PFM reforms," is comprised of reforms that have shown themselves historically to be more difficult and problematic. It does not mean that they have been impossible to implement, and some MENA countries may have been able to put in place certain elements of these reforms. But this is not common. The "mixed" category represents an area where generalizations across the region are difficult to make and the results are often more specific and unique to a given country.

Table 10: Breakdown of Successful and Challenging PFM Reforms in MENA

Successful PFM Reforms	Mixed	Challenging PFM Reforms
 Improving budget classification Improving budget transparency Reforms in tax and customs 	 Enhance macro-fiscal capacity Budget integration Streamlining ex-ante control processes Commitment control Payroll management Treasury operations Reform of accounting systems Internal and external audit 	 Medium term sector strategies Improving budget scope and coverage Introducing performance into the budget Procurement reforms Large information technology projects

Two types of PFM reforms have been particularly successful in MENA: efforts to improve budget transparency and classification, and revenue related reforms, particularly those involving the reform of tax and customs. Ironically, these represent two very different types of reforms. The first are relatively straightforward and technocratic in nature. An existing body of accepted practice exists to reform economic classification, in the form of the IMF's GFSM 2001, and there are incentives to align accounts along standard international practice to facilitate the production of comparable fiscal and economic data. While there may be some resistance to such reforms stemming from basic bureaucratic inertia, no fundamental interests are challenged or mandates threatened. Once implementation is complete, the reform becomes part of the fabric of the system and endures. It is therefore not surprising that many MENA governments have been able to take this step.

This is not true for revenue consolidation or reforms in tax and customs, where the stakes are much higher. Revenue agencies are often among the entities in government where problems of corruption are most pronounced, since their function places them in a position to extract rents from both firms and the general public in exchange for a variety of favors. Efforts to restructure and reorganize such functions often encounter fierce resistance from both those on the inside (who benefit from informal payments) and some on the outside (who have learned to work around the current system and use it to their advantage). Such reforms are not for the timid or hesitant.

Yet if the challenges are great, the gains are often significant as well. For governments facing significant fiscal deficits, it is often more politically palatable to raise revenues—difficult as that may be—than to engage in painful cuts in expenditure. In Lebanon, for example, reforms in tax policy and administration were initiated since the 1990s because it was the largest single source of revenue for the government. A combination of tax and customs reforms, including moving to a VAT, was able to increase government revenue by \$1.88 billion between 1997 and 2003, or from 11 to 16 percent of GDP. In Egypt, reforms in tax policy and administration implemented in 2005 and beyond brought over 1 million new taxpayers into the system and increased income tax revenue from 7 to 9 percent of GDP. Beyond the promise of new revenue, such reforms are often initiated to remove obstacles to increased private investment. For all of these reasons, such reforms are able to garner the requisite high-level political support to see them through in spite of considerable opposition.

Unfortunately, on the other side of the spectrum are a host of reforms that are neither particularly easy to implement nor which bring the promise of substantial fiscal gains, at least in the short-term. Some, such as improving the scope and comprehensiveness of the budget, are not technically difficult to

implement. Progress has been made in a number of settings, such as Jordan and the West Bank & Gaza. However, the political hurdles are considerable, as many powerful entrenched interests often prefer to remain off-budget. Unless significant political capital is invested in overcoming such resistance, these reforms are unlikely to move forward.

Other reforms, such as the development of MTEFs, introducing large IT projects and integrating more performance information into the budget, are often both technically demanding and run up against powerful vested interests. In many cases, their successful implementation may depend upon underlying systems, procedures and practices being in place that may not exist. It is therefore not surprising that their implementation is frequently delayed or halted. As one assessment of PFM reforms in Yemen noted with refreshing candor, "for the Finance Minister or the National Public Financial Management [Reform] Coordinator, only those set of reforms which can bring instant recognition and resources to the government are of priority...reforms which are painstaking and longterm without immediate benefits take a back seat."³¹

Under such circumstances, it may be tempting to conclude that—in the final calculation—it is the nature of the reforms themselves as much as the way they are implemented that is responsible for their ultimate success or failure. In the words of Egypt's Minister of Finance, Youssef Boutros Ghali, "it is easy to change laws—it is hard to change the attitudes of those who implement them."32 Reforms that are largely technical in nature will be easier to implement; those that are technically demanding and rely upon certain preconditions to be in place will be more difficult. Reforms that do not alienate powerful constituencies will be easier to implement; those that cross fundamental political and bureaucratic interests will be more difficult. Reforms that have a high payoff in terms of tangible. concrete returns in the near term will be easier to implement; those whose benefits are more distant or ephemeral will not be.

While there is certainly truth in this contention, reality is more complex and nuanced. Considerations of political will, leadership talent, the broader authorizing environment, and internal capacity (to name but a few) can shape and modify reform agendas in ways that confound simple predictions. Few would have anticipated that Salam Fayyad, for example, would have enjoyed the success that he has in reforming West Bank & Gaza's PFM practices. His initial focus on consolidating banking arrangements, strengthening expenditure controls and budget reforms—while desperately needed would not have been areas that held great promise for far-reaching improvements on an a priori basis. In a similar fashion, one would have expected that some of the higher income countries with more effective administrations would have been able to make greater progress towards strengthening internal and external audit than has been the case so far. There are a few cases where poorly designed interventions have been made to work through shear dogged determination, albeit often with compromises in timing, cost and functionality. There are far more in which reforms that were generally sound and appropriate floundered through poor implementation.

Box 2 summarizes some of the key lessons from MENA reforms that have emerged from this analysis, including both the individual case studies and the more detailed assessments of reform experience in the WBG and Egypt. Although efforts have been made to make them as rigorous as possible, they are admittedly more qualitative than quantitative. As noted above, these principles are not intended to provide a comprehensive review of all of the lessons from this experience—only to highlight some of the more interesting and relevant ones for future reformers and those who support them. Each will be discussed in greater detail below.

³¹ Arya, *Chapter 10: Yemen*, in Vol. 2, p. 139. ³² Author interview, *H.E. Youssef Boutros Ghali*, 2009.

Box 2: Ten Principles of Implementation for PFM Reforms in MENA

- 1. Know the value—and limitations—of political economy analysis
- 2. PFM reform as means and not ends
- 3. Context matters, so swim with the current
- 4. The wisdom of "muddling through"— grand strategy versus incremental change
- 5. Establish basic systems before contemplating more advanced reforms
- 6. Whenever possible, keep reforms quick, simple and mutually reinforcing
- 7. Be wary of large financial management information systems
- 8. Internal challenges: leadership, coordination, skills and incentives
- 9. External stakeholders—useful, but don't count on them
- 10. On the value of synergy, or all good things go together

Lesson 1: Know the Value—and Limitations—of Political Economy Analysis

In many areas of governance and public administration reform including PFM, there has been a rush to embrace the discipline of political economy analysis (PEA) over the last decade. Definitions as to exactly what PEA is may vary as the field is still evolving, but one in-common usage notes that it is concerned with the interaction of political and economic processes in a society: the distribution of power and wealth between different groups and individuals, and the processes that create, sustain and transform these relationships over time.³³ There are a variety of competing approaches to conducting PEA, including the World Bank's Institutional Governance Reports (IGRs) and Expected Utility Stakeholder Models; DFID's Drivers of Change analysis; as well as other more general types of stakeholder assessment and analysis. At their core, all of these approaches share a common belief that—in the words of the Bank's 2008 IEG study—the performance of both PFM and other reforms would be better if it were informed by deeper institutional and governance analysis.³⁴

At one level, the logic of this position is unassailable. The history of PFM reform is littered with examples where far-reaching reforms were introduced without a careful assessment of the underlying political and institutional environment in which they were being implemented, often in the hope that reforms which had shown themselves to be effective in one country or administrative context could be easily grafted on to another. Few experienced practitioners would argue with the cautionary notes struck by the PEA literature, or the premise that greater upstream analysis of what is politically or administratively feasible will pay downstream dividends when it comes to implementation.

Yet beyond these basic warnings, the PEA literature has relatively little to contribute when it seeks to address the most important questions in any reform initiative: what should be done, when it needs to happen, who should do it and how. The reason is found at the core of the more sophisticated assessments of this discipline. Each reform experience is unique and endogenous to a particular time and country, as well as to an individual set of political, bureaucratic, institutional and personal dynamics. PEA analysis may do an effective job of highlighting constraints or identifying potential supporters. It can help to inform decisions about what is to be done. But it is not going to substitute for solid strategic decision-making, and even less for astute tactical maneuvering in implementation. These will remain highly contextual and contingent upon a host of factors that are fluid, dynamic and idiosyncratic.

³⁴ See IEG, *Public Sector Reform: What Works and Why*, p. 51.

³³ Collinson, cited in the *OECD DAC discussion of political economy analysis*. See http://www.oecd.org/document/8/0,2340,en 2649 34565 37957768 1 1 1 1,00.html

When PEA strays from its descriptive role and seeks to develop more general prescriptive principles for guiding actual reform efforts, the resulting precepts are often rather tepid and generic. Reformers are urged to look for windows of opportunity, pluck "low hanging fruit," worry about incentives, forge coalitions with like-minded groups in government and civil society, know that leadership matters, and to co-opt opponents through negotiation or by disseminating information about the nature and content of the reforms.

Such admonitions are not necessarily foolish or wrong. However, measured against a careful review of how the more far-reaching PFM reforms in MENA were actually accomplished, they often appear detached, debatable and even a bit Pollyannaish. Serious PFM reform involves moving aggressively to overturn a dysfunctional status quo and establish a new institutional order. Those who benefit from the existing system will resist these efforts, at times tenaciously. (At one point during Salam Fayyad's tenure at the Ministry of Finance, rival Palestinian security forces actually confronted each other over efforts to reform the General Personnel Council.) More often than not, traditional interests win, or at least manage to fight the reforms to a draw. Examples of far-reaching PFM reforms in the region are relatively few and far-between.

When such reforms do emerge, the trajectory they follow is typically not what your standard PEA would predict. In light of the high degree of political fragmentation within the PA and the extensive authority centralized under President Arafat, few would have suggested that Salam Fayyad begin his reform agenda with consolidating banking arrangements. The fiscal logic behind such a move was obvious, but it was by no means clear that he would have the mandate and political authority to pull it off. In a similar fashion, Boutros-Ghali noted that political and administrative calculations didn't change his perception of what needed to be done, but they did influence the timing. Beginning his reform agenda with the always thorny issue of tax and customs reform was a risky move politically, yet such institutions had to be reformed to achieve Egypt's broader national goals. As one of his key advisors noted, "on the reform of tax policy, he may have been constantly probing and adjusting his priorities in light of what was politically feasible. But on the administrative side, we knew what needed to be done and we just had to go do it."

Furthermore, the tactics used by all sides—including the reformers—can be ruthless. Some reforms may be the product of extensive coalitions and careful consultations. Others are rammed through quickly with little debate or discussion. (Salam Fayyad argued that a key component of his reform strategy was to move quickly and keep his opposition off balance.) Adversaries are more often than not isolated, cut-out of the action and eventually forced out of government rather than being won over by gentle persuasion. Claims are made about the benefits of reform and accomplishments achieved that, in retrospect, are inflated or exaggerated. Feints and diversions are employed to befuddle adversaries. (Youssef Boutros Ghali once argued that reformers should, "open five fronts, knowing that you will only succeed on two.") Difficult tradeoffs are made, in which reformers settle for half a loaf instead of none or focus their limited political capital on a few important gains with the knowledge that some very dysfunctional policies and practices will continue elsewhere for the indefinite future.

The objective is not to question the ethics or efficacy of these reforms, about which reasonable and well-intentioned observers could differ. It is simply to make the point that the implementation of farreaching PFM reforms in MENA is a complex and difficult task whose success is highly dependent upon a variety of contextual factors, not the least of which is the ability of those championing these reforms to manage the political and bureaucratic process effectively. PEA plays a role in underscoring

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³⁵ Author interview, H.E. Youssef Boutros Ghali, Ashraf Gamal El-Din, Gamil Ezzat and Ayhmed Monkez Shaker, Egyptian Tax Authority, 2009.

the fundamentally political nature of these changes, as well as in identifying the likely sources of support and resistance, and in that it provides a useful service. But more is probably to be gained by investing in greater tactical flexibility, in terms of field-based governance advisors and public sector specialists who can provide real-time advice and assistance in high risk, high engagement settings, than in trying to assume that more rigorous political analysis up-front will answer these questions.

Lesson 2: PFM Reform as Means and Not Ends

PFM reforms arise from a number of different motives. They can be implemented in response to a particular fiscal problem or crisis, typically a growing deficit and the need to raise revenues, curb expenditures or use existing resources more efficiently. They can be implemented as part of a political agenda to ensure better service delivery. They can be pursued at the request of donors or in the hope of improved regional integration. They can also be championed for idiosyncratic reasons, such as ministers or officials seeking to make a career for themselves as reformers. None of these motives are mutually exclusive, and often two or more could come into play.

In the MENA region, the most far-reaching reforms in West Bank & Gaza and Egypt were implemented in response to an acute fiscal crisis—compounded by a severe economic contraction in the case of the West Bank and Gaza. By the spring of 2002, the Government of Israel was withholding clearance revenues, which represented nearly two-thirds of PA revenues. Arab donors had cut their contributions by around half. The international community had expressed serious reservations about President Arafat's stewardship over PA finances and was threatening to withhold desperately needed funds for budget support. In 2004, Egypt confronted a budget deficit of 40 billion pounds (approximately \$7.2 billion), or 8.3 percent of GDP. Around 8.3 million Egyptians were in the informal sector, or 37 percent of the workforce, which provided significant untapped potential for broadening the tax base. Another powerful factor in Egypt was the imperative of enhancing the country's ability to attract much-needed private investment.

Under these circumstances, PFM reforms were effective in large part because they promised to be a solution—or at least part of the solution—to a broader set of fiscal and growth-related problems. As such, senior political leadership was deeply invested in the reforms and was able to push for them strongly, even though the way forward would be difficult and they were likely to encounter entrenched resistance.

Other reforms that were targeted at enhancing performance or modernizing antiquated procedures to make them more in line with emerging best practice have typically not fared as well. Their implementation has been slower at least in part because a general lack of urgency has made it easier to defer difficult choices and avoid tackling entrenched interests. While senior officials often like the notion of pursuing "cutting edge" reforms, such motivations are not enough by themselves to galvanize a serious reform effort. Reforms that rely upon them tend to dissipate once their champion leaves office.

Lesson 3: Context Matters, so Swim with the Current

A corollary of the point that reforms are a means and not an end in themselves is the point that context matters. As noted above, two of the most far-reaching PFM reforms took place against a backdrop of acute financial crisis. Under these circumstances, reformers were able to gain additional support through associating their efforts with desired national ends. They were also allowed considerably more latitude in devising solutions than they would have otherwise enjoyed.

However, like the Almighty, context can both givith and taketh away. Major reform agendas can stretch over years, whereas the political and economic conditions that give rise to them are typically

subject to much shorter time horizons. Pressures towards reform that are felt acutely during times of crisis can dissipate if oil prices rise or other activities take place that distract reformers. The experience of Jordan's *National Agenda* offers a case in point. The government articulated a fairly far-reaching governance reform agenda, including a variety of PFM reforms. However, the hotel bombings in Amman in November 2005 led to a shift in the political center of gravity in which security concerns came to predominate. Although the reform agenda remained, efforts to implement it were slowed down to avoid alienating important traditional constituencies during a period of heightened national tension.

In a similar fashion, as the political contest between Fatah and Hamas intensified in 2005, much of the momentum behind the PA's PFM reform agenda was dissipated. In Algeria, the broader political environment has hindered the reforms. Priorities on the political agenda after the terrorism period, and the general lack of political and technical commitment, explain lack of progress from 2001 to 2005. Lebanon's PFM reform agenda has also been repeatedly suspended by political unrest. A PFM reform program started in 2005 was suspended after the conflict with Israel in 2006, and another PFM reform program presented at the International Donor Conference in Paris in 2007 has been similarly held captive to the ongoing political unrest in that country.

In many parts of the world, the willingness to implement major public sector reforms is often linked to the electoral cycle. It is greatest immediately after an election, particularly if the incoming party is given a mandate for change. It drops considerably in the run-up to an election, partly because senior officials are caught up with the demands of campaigning and have less time for administrative issues, and partly because they are anxious to avoid taking decisions that could alienate powerful constituencies just before going to the polls. Although elections are a factor in a handful of MENA countries such as Morocco, Lebanon, the WBG, Yemen and Kuwait, as a general principle this dynamic is weaker and more muted in MENA for the obvious reason that elections themselves are typically less important.

Of more relevance are cabinet reshufflings. Their impact upon PFM reform agendas can be extraordinarily difficult to predict, but at a minimum such changes are disruptive and can reduce the incentive to support reforms with long gestation periods. This is particularly true in countries where cabinet turnover is more frequent, such as Jordan, where the average life span of a government between 1999 and 2007 was six to eight months. During this period, the Hashemite Kingdom has witnessed no fewer than eight Ministers of Public Sector Development portfolio and five Ministers of Finance. The implications for reform were spelled out in the words of one former civil servant:

It took three months to convince a new minister about our objectives, mandate, and by the time the person understood, he left. So much of our efforts were directed to educating ministers. Ministers knew that their tenure was short lived and that they would not stay for more than one year, and it affected the program greatly. They were interested in short term wins instead of longer term reforms and seeing the process in a holistic manner. ³⁶

Syria provides an interesting study in contrasts. Over the past five years, the two key reformers for PFM (the Deputy Prime Minister and the Minister of Finance) have had continuity in their positions, which has helped to facilitate Syria's reform efforts. However the broader geopolitical developments in the period have exerted tremendous pressure on Syria and diverted some attention of the key political figures.

³⁶ Nagarajan, Cabinet Decision Support Reforms: The Case of Jordan" World Bank and Dubai School of Government Case Study 2009-01 (forthcoming), p. 22.

It is difficult to determine if context is a definitive factor affecting PFM reform in MENA or merely an important one. If reforms are largely technical in nature, have a solid rationale behind them, are supported by well-positioned champions within the relevant ministries, and if they avoid alienating powerful constituencies, then under most circumstances they can probably stay "under the radar screen" and survive the shifting political, economic and administrative sands. Lebanon was able to implement some important reforms in payroll management, for example, even in the midst of a chronic political crisis and the absence of a functioning parliament.

But Lebanon's experience is also instructive, in that when these reforms have needed to move beyond the realm of what could be implemented by a Ministry of Finance decree and required broader cabinet or parliamentary approval, they have stalled. There are no examples of more far-reaching PFM reforms that came to fruition if the broader political context was not supportive. Nor are there examples of where senior officials were able to isolate and protect major PFM reforms from major shifts in the broader political climate. Put succinctly, an ebbing tide grounds all large boats—regardless of how well they are designed or the skill and determination of the captain.

Lesson 4: The Wisdom of "Muddling Through"—Grand Strategy versus Incremental Change

To what extent are MENA PFM reform agendas driven by an overarching strategic framework or integrated plan, versus a more flexible and improvised approach that seeks to take advantage of opportunities when they emerge?

The answer is not entirely straightforward. On the one hand, MENA does not suffer from an absence of strategic plans for upgrading systems and procedures. Algeria drafted a PFM reform strategy in 2007, which has yet to be formally approved, although its Organic Budget Law articulates the directions of reform. In a similar fashion, Egypt has drafted a PFM strategy in 2008 which is currently under consideration by the MOF. Jordan had a Strategy for Financial Reform from 2004-2007 that was also embedded in broader national reform plans, including the *National Agenda*. In Morocco, PFM reforms have been embedded with the Governments Public Administration Reform Program of 2003. In Tunisia, a PFM reform program is being implemented and improving the use of resources as component of the Strategy for the Development of the Public Service 2007-11. The Bank has been assisting the Tunisians in drafting a budget reform master plan in 2008, which has not yet been formally approved but was used by the government in negotiating budget support from the EU. The Palestinians have clarified their intentions for PFM reform in a variety of documents, such as *Building a Palestinian State: Towards Peace and Prosperity*, which was presented to donors in Paris in December 2007. Yemen's PFM reform strategy was approved by Cabinet in 2005 and has also been supported by the donor community.

Furthermore, there have been examples of when countries would have benefited from adopting a more comprehensive approach to PFM reform. Egypt has attempted a wide range of PFM reforms, for example. However, beyond the realm of tax and customs, progress has generally tended to be patchy and of limited duration. Until recently, there has been no overarching strategic framework within which reforms have been planned, prioritized, sequenced, costed, evaluated for feasibility and monitored. In a similar fashion, prior to 2008, Iraq's management of the PFM reform process has suffered from the absence of any overall vision, strategy or prioritized and logically sequenced action plan. For example, the many capacity building workshops that have been run in and outside Iraq have provided participants with new knowledge and skills, but this training has tended to be ad-hoc and provided without the benefit of a more comprehensive framework for staff development, which in turn should be grounded in a careful assessment of the functions that the various ministries should be performing and the skills required to do them well. The lack of a more comprehensive approach can

be particularly problematic in the development of integrated financial management information systems, as will be discussed in greater detail below.

Such reform strategies can be valuable as a statement of intent, or for communicating priorities, securing donor support, or providing political cover for a given set of activities. Yet their role in actually shaping successful reforms can be modest. The development of such plans is no guarantee that they will be implemented expeditiously. In many MENA countries, roll-out has taken much longer than expected, with a number of components being dropped or modified along the way.

Nor are such plans a prerequisite for success. Egypt's far-reaching reforms in tax and customs were initiated in 2004, yet its broader plan for PFM reform is still under review. Senior officials repeatedly emphasized the probing and opportunistic nature of these reforms, while underscoring that the general strategic direction was clear. Salam Fayyad adopted a flexible view to West Bank & Gaza's PFM reforms, recognizing that he could not determine *a priori* the sequencing of reforms or expect to have control over the entire process.

He explains:

The context in which you are operating has to be kept in mind all the time. It's not easy. You are working within a system of deeply entrenched habits—not good ones—so you basically have one of two choices. Either to come in and say, 'this is what I want to do. Either it's done, or I'm out,' which is what everyone was expecting, or maybe even banking on. Or, you could be opportunistic: do what you can, as soon as you can do it, wherever you can do it. I chose the latter way...But, at all times have clarity as to what is important and what is not too important.³⁷

Fayyad describes his approach as being, "patient, deliberate, methodical, and opportunistic, looking for an opening here and there." It was informed by a clear set of priorities. He began by focusing on the major structural problems related to revenue and expenditure management, treasury systems and the budget, which he described as "elements without which you cannot have a well functioning public finance system." But he combined this strategic orientation with tactical flexibility in terms of the sequencing and timing of reforms. His Deputy Finance Minister, Jihad al Wazir, notes that the actual sequencing of the WBG's PFM reform agenda was heavily influenced by political dynamics, and based on doing "what you can get done at the time."

In the final analysis, the optimal approach is likely to be one of "strategic opportunism." Such an approach would combine careful upstream analysis of the major strengths and weaknesses confronting a given PFM system, perhaps drawing upon a variety of analytic tools such as PEFA, PERs, CFAAs, CPARs, Fiscal ROSCs and the like, in forming a clear set of strategic objectives. But it would realize that there is an inherently organic nature to reform that makes it unlikely to proceed in a rational, linear fashion. Within MENA, the most effective reformers are those who have been strategic in recognizing and selecting appropriate windows of opportunity, while being flexible and opportunistic in exploiting them.

Lesson 5: Establish Basic Systems before Contemplating More Advanced Reforms

The temptation is often irresistible for governments and international advisors to strive for quantum improvements in performance by adopting some cutting-edge practices from OECD countries into a developing country context. More often than not, the result has been a litany of dashed expectations and failed reforms. In response, the Bank's *Public Expenditure Management Handbook* (1998)

³⁷ Fayyad, *Transcript*, 2008.

emphasizes the importance of "getting the basics" right before moving on to tackle more advance reforms. Drawing upon earlier work by Alan Schick and others, a number of precepts have been laid for doing so.³⁸ This list includes:

- Foster an environment that supports and demands performance before introducing performance or outcome budgeting;
- Control inputs before seeking to control outputs;
- Account for cash before accounting for accruals;
- Establish external controls before introducing internal control;
- Establish internal control before introducing managerial accountability;
- Operate a reliable accounting system before installing an integrated financial management system;
- Budget for work to be done before budgeting for results to be achieved;
- Enforce formal contracts in the market sector before introducing performance contracts in the public sector;
- Have effective financial auditing before moving to performance auditing; and
- Adopt and implement predictable budgets before insisting that managers efficiently use the resources entrusted to them;

The PFM reform experience within MENA largely bears this out. This has been particularly true with regard to two sets of initiatives that have been among the more technically advanced to be implemented to the region: the move to a Medium Term Expenditure Framework, and the effort to introduce greater performance orientation into the budget process. Both have shown themselves to be complicated and problematic to implement, in part because their realization has relied upon a number of preconditions to be in place before they can be effective, and in part because senior officials have been generally unwilling to allow themselves to be bound by such initiatives.

As the discussion in Chapter 2 indicates, a number of countries in MENA have sought to implement MTEFs, including Algeria, Jordan, Lebanon, Morocco and Tunisia. None have implemented such a system in its entirety. Jordan has probably made the most progress in implementing several components of an effective MTEF, although these reforms are still in their early stages. Other countries have made significantly less progress. Lebanon's MTEF is only a general guidance to sectors communicated in the budget circular in the form of an overall budget ceiling. The MTEF is operational only as a pilot project in the Ministry of Education, and even there it only sets ceilings in terms of overall expenditure. In Morocco, an MTEF methodological guide was developed on preparing sector MTEFs in 2006. This guide has been approved and transmitted officially to line ministries by circular of the Prime Minister in 2007. In 2008, nine sector/ministry MTEFs were prepared, and MTEFs for five additional ministries are now underway. However integration with the budget has yet to be achieved and, at the moment, preparation of the budget remains input based with little explicit discussion of policies and priorities.

³⁸ See *Public Expenditure Management Handbook*, p. 8.

In a similar fashion, reforms to introduce a greater focus on performance into the budget have often taken a long time to implement and been hindered by the lack of underlying conditions, such as a well-functioning accounting system that can yield accurate cost data. Such efforts can be prone to delays and interruptions. With regard to Algeria, for example, the performance budgeting pilots were stopped for one year by the MOF, and real ownership of the MTEF and performance budgeting pilots by the line ministries may be questionable. Jordan has also begun experimenting with some elements of performance budgeting, although the effort is still in its infancy with pilots being carried out in a few ministries. An earlier performance budgeting initiative assisted by GTZ Germany from 1999 to 2004 was regarded as being too ambitious and had little impact.

In some respects, a more interesting question is whether it makes sense to hold out objectives such as MTEFs and performance budgeting as a distant goal in the hope of gaining traction on some important but more pedestrian reforms, such as improving budget classification or upgrading the ability of the accounting system to provide more accurate cost data. A case could be made that embedding these smaller and "less glamorous" reforms in a broader objective will give them greater visibility and cohesiveness than they would otherwise enjoy. While such an approach cannot be ruled out entirely, MENA's experience demonstrates that—while it may help with the initial "marketing" of the reform package—it is not a recipe for long-term success. It is better to set modest, measureable objectives and achieve them than goals that, with the passage of time, appear more and more ambitious and unrealistic.

Lesson 6: When Possible, Keep Reforms Quick, Simple and Mutually Reinforcing

It is an accepted article of faith among many officials and development practitioners that major PFM reforms are difficult, complex undertakings that require years or sometimes decades to fully reach fruition. Laws and regulations must be drafted; longstanding practices restructured; political and administrative cultures changed; institutions built and capacities strengthened. To attempt such undertakings quickly, so the argument goes, is a recipe for poorly thought through implementation and eventual failure.

As with many managerial maxims, there is some truth to these contentions. PFM reforms in a number of MENA countries, such as introducing MTEFs or greater performance orientation into the budget, introducing major IT systems, improving the quality of expenditure controls, or strengthening internal and external audit capacity do take a long time to implement. Algeria's Budget System Modernization Project began in 2001 and was finally closed in 2009 after its objectives had been significantly scaled down. Morocco's PFM reform agenda has been moving forward gradually since 2003. Reforms in West Bank & Gaza have been underway since 2002.

Yet there are also cases where reforms can be implemented quite quickly when the requisite political will exists. Reforms in expanding the scope and comprehensiveness of the budget, for example, can be implemented within weeks or months if the proper political will is in place. Reforms in improving budget transparency can also be implemented within no more than a month or two.

Furthermore, some of the more effective reforms were deliberately implemented with haste. Salam Fayyad wanted to generate confidence in the reform agenda by taking specific, quick steps that made an impression. He explains, "I have learned about the need to move fast, and make an impression. It gets more difficult with time, not easier. You need to use your success as a stepping stone. Success breeds success. If you say 'give me time, I will assess,' that is the wrong approach. You need to immediately begin to make an impression." These sentiments were echoed by Youssef Boutros

³⁹ Nithya Nagarajan interview with Prime Minister Salam Fayyad, 2007.

Ghali, who notes, "the faster you move, the less resistance you will encounter, because it takes time for your opposition to organize and mobilize."

The reality of MENA's experience is that many PFM reform efforts, including those of both Fayyad and Boutros Ghali, tend to follow an uneven trajectory. Periods of reform and progress are offset by intervals of limited activity and little forward movement. Sometimes, these periods of inactivity can be extensive. (Relatively little happened in Algeria's PFM reform effort, for example, for nearly five years.) Admonitions to move with haste can help maintain momentum and push agendas forward. Otherwise, as has happened far too often in MENA, reform can become "business as usual" and lose any sense of priority or urgency.

The Use of Pilots. A related question is whether to pilot reforms or roll them out whole. In MENA, pilot PFM reforms have been implemented in a wide variety of contexts. Algeria piloted some reforms in program budgeting but then discontinued the exercise. Egypt piloted the creation of a medium-size taxpayer unit in Cairo and the introduction of reduced ex-ante controls over virement in three governorates. Jordan piloted a results-based budgeting exercise in the education sector. Lebanon has piloted the introduction of internal audit within the Ministry of Finance. Morocco has also sought to pilot performance budgeting in a number of ministries. In the 2010 budget, Syria piloted the introduction of a program structure that integrated recurrent and investment budgets in two pilot ministries. Tunisia is piloting program budgeting in four ministries. Information systems have been piloted in a number of countries, including Jordan and Yemen.

The jury is still out regarding the effectiveness of pilots. Not surprisingly, the answer to this question is likely to be highly contextual and dependent upon both the nature of the reform and the institutional context in which it is being rolled out. On the positive side, pilots—particularly when combined with rigorous monitoring—provide an opportunity to gain valuable experience in identifying potential problems that could plague a particular set of PFM reforms and rectifying them before too much damage is done. This is particularly important when the roll-out is likely to be time-consuming and expensive, as is the case with large IT systems.

However, in the absence of firm commitment to proceed with a particular set of reforms, pilots can often become an opportunity for delay and inaction. Line departments in many MENA countries are often unenthusiastic about pilots, preferring to adopt a "wait and see" approach rather than invest time and energy implementing new approaches that may ultimately not be implemented. It is interesting to note that, after initially intending to pilot the introduction of the MTEF in specified ministries, Jordan's General Budget Department decided to roll out forward estimates and performance indicators to all ministries rather than starting with a number of pilots. They did so with the understanding that it will take time to build depth in the process and bring about more fundamental changes in budget planning processes, but the effort was worthwhile and needed to proceed regardless. Furthermore, pilots tend to do better in administrations with a history of experimentation and innovation than those with fixed traditions embedded in a strong legal framework. In the Algerian context, for example, it can be easier to implement top down reforms based on laws and regulations rather than those that involve studies and pilots.

The Value of "Virtuous Circles." Finally, certain sets of reforms can foster "virtuous circles" and positive feedback loops, whereas others require constant effort. Budget classification is an example of the former, and it is not surprising that it has been one of the more effective reforms of its type in MENA. While it requires effort in overcoming institutional inertia and capacity building, once these skills have been obtained, it becomes easier each year to prepare and implement the budget with the

⁴⁰ Author interview, H.E. Youssef Boutros Ghali, 2009.

new classification scheme. Other examples are reforms to the payment professes, payroll procedures, and monthly reporting. Once introduced, these procedures have continued. Even when there was a break in monthly reporting in the WBG during the Hamas period, for example, such reforms were reinitiated without too much difficulty.

Lesson 7: Be Wary of Large Financial Management Information Systems

An integrated financial management information system (IFMIS) can offer great benefits for all PFM activities, especially budget execution. Such systems can facilitate timely and accurate reporting of budget execution; allow internal controls to be exercised through the IFMIS, and therefore support more consistent compliance; and allow central agencies to oversee budget execution by line ministries, therefore facilitating the devolution of responsibility to front line managers while retaining information at the center. All countries in the region have made some effort to introduce computerized systems to support PFM. In general, two different strategies have been taken towards this reform. These are to develop either: (1) a "sophisticated" fully integrated IFMIS; or (2) a simple customized IT system to support budget execution. While there are some small successes to date, the "sophisticated" projects have been problematic.

The fully integrated IFMIS approach has been followed by Yemen, Iraq, Egypt, Syria and more recently Jordan. Although the first efforts started in Yemen in 2003, as of 2010 none of the systems are fully operational. The Jordanian GFMIS—which was financed from local resources—appears to be best placed for successful implementation. In contrast to the other projects, the Jordanian GFMIS appears to have followed sound project management procedures and had active involvement from staff in the Ministry of Finance.

At the other end of the spectrum were efforts by U.S AID and a U.S. consulting firm, Bearing Point, to implement a Freebalance system in Iraq. As the discussion in Box 3 indicates, work began in implementing this system in 2003. After spending nearly \$30 million in developing the system, U.S.AID suspended work on the project in June 2007 and eventually signed an MOU with the Ministry of Finance handing over full ownership. While efforts continue to implement the system, recent assessments indicate that it is being used only for a modest number of government transactions.

Box 3: History of the Iraq IFMIS System

In 2003, the Coalition Provisional Authority (CPA) instructed U.S.AID to begin implementation of the Iraq Financial Management Information System (IFMIS) through a contract implemented by the consulting firm BearingPoint. This task was undertaken to modernize Iraq's public financial management systems within a cash accounting framework. It was a key component of Iraq's stand-by agreement with the IMF.

By June 2007, the IFMIS had been rolled out in 132 spending units (SU) nationwide. According to Bearing Point and the MOF, these 132 SUs collectively accounted for over 80 percent of GOI expenditures. Work on the IFMIS was terminated by USAID following the abduction of five Bearing Point consultants in May 2007 at the MOF, as well as due to difficulties in aligning the system to the needs of the Iraqi government.

On January 14, 2008, U.S.AID and the Ministry of Finance (MOF) signed a Memorandum of Understanding (MOU), which gave impetus for USAID to restart the program by outlining an agreement to cooperatively identify and resolve technical issues and transfer full ownership of the IFMIS to the MOF. While USAID may continue to offer limited technical assistance to the MOF to operate, maintain and update the system, the MOF will assume full ownership of the computer hardware and software.

However, questions remain about the extent to which the system is truly being utilized. As of January 2009, eleven pilot SUs have been using IFMIS for less than five months and entered an average of less than 10 percent of total monthly transactions during the period of July to November 2008.⁴¹ A World Bank assessment of this experience noted that it had been plagued by a number of problems, including:

- Unsatisfactory project supervision and contract management arrangements;
- Lack of support for and recognition of Project Management Teams;
- Insufficient or inappropriate incentives to promote the Government's PFM reform agenda;
- Inadequate consultative, coordination and co-financing arrangements to support high levels of ownership, effective
 partnerships and high degrees of commitment from key stakeholders;
- Poor FMIS design and more specifically the planning process to set the FMIS implementation strategy; and
- The absence of a medium-term PFM reform program that informs the prioritization and sequencing of specific PFM reform measures including development and roll-out of an FMIS.

While the Iraq project used an off-the-shelf package, the Yemen project was customized to meet local demands. Neither is considered to be particularly successful, although the Yemen system is likely to meet the basic functionality required by the government. In Syria, the IFMIS was developed as part of an EU project with limited involvement of line staff in the Ministry of Finance. The system was completed in 2008, but there is no indication from the Ministry of Finance that it is ready to be used. In Egypt two separate systems (AGES and IFMIS) were being developed in parallel by different teams. While the IMF recommended that the AGES project be discontinued, for some time the IFMIS was also not promising. However, a number of the problems appear to have been addressed, and recent assessments by the IMF suggest that the development of a new computerized financial management information system, under a project being managed by Booz Allen, is well on track.

The second approach has been to develop simple computerized systems with limited functionality to help support budget execution. The systems are usually customized to fit the specific needs of the budget execution system of the country. This approach was followed by Lebanon in the late 1990s and the system is still in place. More recently in West Bank and Gaza a simple system was developed, which in the space of four months went from concept to managing payments.

The use of a simple system has advantages—especially in cases such as West Bank and Gaza, where a new budget execution system was needed at short order. They tend to have much lower initial

⁴¹ This discussion is adapted from U.S. AID, *Iraq Financial Management Information System Assessment*, (January 2009), http://pdf.usaid.gov/pdf docs/PNADO270.pdf.

development costs and, provided their objectives remain minimal, they may also be an efficient way of exposing officials only familiar with paper based operations to the potential of a future IFMIS. However, there are limitations to the approach. First, because the systems are developed to order, they often do not include standard functionality that has proven to be useful in other systems. Second, the systems tend to be less flexible in dealing with new user requirements than off the shelf systems. This is a problem with the Lebanese system, where changes to the budget procedures can require substantial reprogramming of the IT system. While the initial cost of the system may not have been high, these costs increase over time as the system is reconfigured for new developments. For these reasons, the use of a simple system should be seen as a short term solution, with the eventual aim of moving to a fully integrated system. As with any short term solution, it is important to avoid overinvesting in developments that will eventually be superseded.

In summary, all countries in the region have been undertaking some IT investment to support the PFM system, but the record of the large projects in particular is not successful. There are a number of problems that have undermined these large projects, but two important concerns are: (1) weak project management arrangements; and (2) inadequate commitment and/or engagement of staff of the Ministry of Finance to the reform. The alternative of developing a simple non-integrated system to order has been successful in some countries in the short term. In general this approach makes sense as a step towards eventually developing an IFMIS, but not as a long term solution in its own right.

It should be noted that MENA's experience with FMIS is hardly unique. In both the public and private sectors, the implementation of large IT systems has often been problematic. In one study, fully 75 percent of IT systems implemented in the United States failed to fully deliver in terms of their time, cost or projected functionality. Other studies have cited similar failure rates. The reasons for this lack of success are many. On the design side, they include insufficient analysis of the business case; poor definition of project scope and objectives; insufficient time allotted and over-optimistic planning. Project management issues include insufficient backing from senior executives; a lack of authority or decision-making ability in the team; poor collaboration and communication; and inadequate tracking and reporting. Even under the best of circumstances, large IT systems can be complex and difficult to implement. A World Bank study in 2003, for example, noted that a review of Bank FMIS projects took on average over seven years to complete with an average cost of \$12.3 million. Thus the problems that large IT systems encounter in MENA are more likely to reflect the difficulties inherent in implementing such systems anywhere, particularly in low capacity environments, rather than any special technical or administrative challenges unique to the region.

Lesson 8: Internal Challenges: Leadership, Coordination, Skills and Incentives

MENA's reform experience holds a number of important lessons as to how such reforms should be structured and organized. This section addresses several key themes, including: (1) the stature and status of key reformers; (2) the coordination of PFM reforms within government; (3) how reform units and project management units have been structured; (4) their staffing and skills mix; and (5) the role of the chief executive. Each is discussed in detail below.

Stature and Status of Key Reformers. It is axiomatic in the literature of public management that reforms need to have a champion. It is therefore not surprising that many of the most far reaching PFM reforms within MENA have been driven by powerful ministers of finance, who play a uniquely important role in taking the PFM reform agenda forward. There is, quite simply put, no more important position for advancing this agenda in the region.

In this regard, the experience of Salam Fayyad in the West Bank & Gaza and Youssef Boutros Ghali in Egypt is particularly instructive. Both men brought a combination of impressive expertise and solid

technical understanding of the issues. Their backgrounds are remarkably similar—both have Ph.D.s in economics and spent time in the International Monetary Fund before assuming their duties. Beyond technical knowledge, they brought managerial talent and dynamism, along with a clear vision as to what needed to be done and considerable political savvy. Perhaps most importantly, they brought sheer determination. As Boutros Ghali notes, "you need to be fixated—single minded—and repeat yourself over and over again until it happens."

Egypt's experience is also instructive, in that major reforms cannot be implemented by the Minister alone. Boutros Ghali argued that he could not do a tenth of what was needed. He needed a group of like-minded reformers around him, around 50 in his estimation, to help take the reforms in tax and customs forward. Part of their responsibility was to provide the necessary technical expertise when needed; part of it was to oversee the implementation of various dimensions of the reform agenda; and part was to monitor if actions were being taken as promised. The question of how to best balance external and internal expertise is a thorny one that will be addressed in greater detail below. However, in the view of Minister Boutros Ghali, such a cadre of committed in-house allies was essential, as one should not underestimate the tenacity of resistance to major reforms from the rank and file bureaucracy.

Coordination of PFM Reforms within Government. While national legal and institutional frameworks differ at their core, PFM reforms center upon the Ministry of Finance. The MOF has clear responsibility for the recurrent budget in all of the countries in this study, and MOF staff seconded to line departments play an essential role in authorizing expenditure. The extent to which the MOF dominates the budget and expenditure process may vary. In a few administrative contexts, the MOF is clearly the dominant player in most aspects of public financial management; in others, it has historically played more of an instrumental role in facilitating and monitoring decisions taken elsewhere. Jordan is unique in that responsibility for formulating the recurrent budget has been given to a quasi-independent agency, the General Budget Directorate, with a weak reporting relationship with the Ministry of Finance. Regardless of these arrangements, the MOF occupies a pivotal position in the reform of public finances, and no PFM reforms in MENA have been able to move forward unless the ministry is fully on board and committed.

Most countries also have powerful Ministries of Planning who look after the capital budget. In a number of countries, such as Jordan, WBG and Yemen, the Ministry of Planning is responsible for issues of donor coordination. However, a few (such as Egypt) have given this function to other agencies, such as the Ministry of International Cooperation. Many also have various supreme audit agencies or *cour des comptes* who play a role in ex-post (and occasionally ex-ante) audit and approval. Beyond the immediate core actors, there are a wide array of public sector participants and stakeholders in the budget process, including ministries, agencies, departments, commissions, deconcentrated and sub-national entities, and state owned enterprises.

The quality of coordination between these agencies and the MOF varies both within and between countries, but it is frequently problematic and occasionally dysfunctional. Iraq serves as an example of the latter. One of the most significant challenges facing the GoI is to improve the integration of the capital and recurrent budgeting processes. Bank analysis of the Iraqi PFM system found that reforming these arrangements will be challenging owing to the traditional rivalry between the two ministries, the political allegiances of the respective ministers and the need to ensure no loss of face on the part of either ministry. A 2006 assessment of Algeria's PFM reforms also noted lack of interagency coordination and a failure to adequately engage with line ministries as a reason behind their limited success. Even in countries such as Jordan, the institutional fragmentation of the budget process

⁴² Author interview, H.E. Youssef Boutros Ghali, 2009.

between the MOF, MOP, General Budget Directorate and the Prime Minister's office had been an obstacle to the formation of a unified view of budget reform and has compounded the problems of identifying a champion of the reform process and ensuring effective leadership from the MOF. A joint Bank-Fund team reviewing the reform experience in 2004 suggested that the main constraints on the effective design and implementation of an ambitious budget reform program were weak leadership, institutional fragmentation and weak reform management capacity. ⁴³

To cope with such problems, a number of countries have established inter-agency task forces to facilitate the coordination of PFM reforms. Yemen, for example, has vested overall responsibility for implementation in a Ministerial PFM Reform Committee, which meets annually and is responsible for the implementation of the strategy and achievement of the desired reform outcomes. ⁴⁴ A PFM Reform Task Force headed by the Deputy Minister of Finance in Charge of Budget has been set up which is responsible for overseeing the implementation of the reforms, along with a number of technical committees that have responsibility for specific PFM Reform activities, such as the Committee on Functional Classification.

Unfortunately, while such coordinating bodies can be relatively easy to establish, in a number of cases they end up meeting only infrequently, thus compromising the quality of implementation.

The various MENA country templates underscore that the position of the broader public sector, and particularly line departments, government agencies and state owned enterprises, will vary depending upon the nature of the issue at stake. As a general rule, line departments have been supportive of changes, such as increased virement, that give them greater control over and discretion in the use of resources. They are resistant to changes that create new obligations or could reduce their influence and power, such as eliminating extra budgetary funds. However, the views within such agencies are seldom monolithic. When Salam Fayyad instituted a process of paying the salaries of security services by direct deposit into Bank accounts, many of senior security officers resisted this effort. However, it proved to be quite popular with the rank and file security personnel.

One area where progress could be made throughout MENA is in the expansion of inter-agency coordination mechanisms at the working level. Throughout the region, most decisions tend to flow up to the minister, which can lead to delays and the compartmentalization of information. Within a given ministry, the minister is also typically the focal point for coordination, and interaction across the different departments can be limited. In most reforms, effective internal communication appears to be a problem. The World Bank's 2008 CFAA on Egypt comments that, "information on the MOF initiatives to improve PFM is not adequately communicated to ministries and their staff."

How Reform Units and Project Management Units have been Structured. MENA countries have adopted a variety of approaches to managing PFM reforms on a day-to-day basis and gaining access to the requisite expertise. Some governments have relied heavily upon project implementation units staffed largely by external experts, including Algeria, Lebanon and Yemen. Others have sought to keep these reforms in-house, either by asking existing officials to take them forward as part of their ongoing responsibilities or by setting up dedicated reform units. While each approach has its relative strengths and weaknesses, some general lessons have emerged.

The first is that technically skilled and managerially adept leadership is required at the project management level—and such leaders need to be fully empowered—or the reforms are unlikely to

⁴⁵ World Bank, Egypt: Country Financial Management Accountability Assessment, 2008.

⁴³ World Bank/IMF, Jordan Work Program for Consolidating Budget Management Reforms, 2004.

⁴⁴ The Committee is made up of the Minister and Vice Minister of Finance, the Minister of Planning, the Minister for Civil Service, the Minister for Local Authorities and the Governor of the Central Bank.

succeed. In Algeria, for example, there was no director of the General Budget Directorate for several years, only an acting director. Reforms did not move forward during that period. In Egypt, one of the factors that contributed to the slow progress in GFMIS implementation was the absence of a full-time project manager and support staff; at other times, project managers were appointed without appropriately delegated authority. Iraq has shown that problems can occur during implementation as a result of limited authority and resources being delegated to program managers. Too often, decisions have to be referred up the hierarchy in a way that stifles initiative and provides little incentive to managers, which undermines ownership of and commitment to the reforms.

Second, to some degree, organizational structures and reporting relationships can be flexible and tailored to the unique institutional circumstances and challenges at hand (as well as the available budget). A minimalist approach often involves one or two experts embedded as advisors within a ministry. While their modest capacity limits the reforms they can support, such experts can be valuable in providing real-time advice and assistance and in serving as brokers for bringing in additional expertise as necessary. For more substantial reforms, the typical structure involves a committee at the ministerial or deputy-minister level to provide oversight and political support; a working group at the technical level to coordinate the work, and—depending upon the size of the reform agenda—various sub-groups dealing with particular topics that report up to the technical committee. The technical committee itself is usually staffed by a secretariat consisting of local and international experts.

Numerous variations on these models exist, and a number have been quite effective. Egypt's project management arrangements for tax administration evolved considerably without noticeably impacting the pace of implementation. This may be because the quality of personal relationships among the key players matters greatly. A suboptimal project management structure can be made to work if there is good will and trust among the relevant players, whereas even a well-designed structure will fail if the participants refuse to cooperate.

Staffing and Skills Mix. Capacity constraints at the team level are often not taken seriously enough in designing reforms. Even governments with relatively strong capacity among mid-level managers and at the working level, such as Jordan, have struggled when the PFM reform agendas have become too broad and demanding. The resources required to implement reforms have often been inadequate or not sustained, as other more pressing matters have captured the attention of key officials.

Efforts to work around a lack of capacity by relying heavily upon external experts or local staff recruited specifically for the task are a Faustian bargain. Egypt also demonstrates a particularly interesting approach to the challenge of bringing in talented staff to help with the reform effort. The Minister has surrounded himself with a group of "outsiders," some of whom have been brought in from the private sector while others came from other parts of government. This group provides a specialist cadre that runs parallel to the traditional administration and is much better paid (in this case, by international donors). In a similar fashion, both Lebanon and Yemen have utilized donor funds to recruit external experts at salaries as much as ten times that of local staff to provide badly needed expertise.

Unfortunately, this has created a dichotomy between donor and government financed staff, with the risk that the latter—often very experienced—feel marginalized and lack motivation. It can also lead to a backlash, particularly when such reforms are perceived to be driven by expatriates who do not adequately understand local conditions or may be trying to "impose" a donor-driven agenda. Some ministers, such as Boutros Ghali, have sought to address these concerns by keeping external technical advisors in the background and away from line department staff. While reliance upon imported expertise may be the only way to gain access to the requisite skills and knowledge necessary to

implement certain PFM reforms, it is a short-term approach and should be implemented only with a medium term exit strategy in mind.

Monitoring the PFM Reform Agenda. MENA governments have often chronically under-invested in the careful monitoring of reforms. In Morocco, for example, there is a PFM reform subdivision within the budget directorate of the MEF. The deputy director of budget supervises, among other divisions, this sub-division. However, there does not appear to be any systematic monitoring of the reforms by government. The same is true in Lebanon, where a unit financed by UNDP is in place with a mandate to assist the MOF with the implementation of PFM reforms. However, there is no monitoring system in place to report on progress or delays. Even in cases where formal mechanisms existed, such as in Syria, they are often not utilized.

Office of the Chief Executive. Perhaps one of the more interesting findings to come out of the MENA case studies is the relatively modest role played by leading political authorities, be they sheikhs, presidents or prime ministers, in supporting the PFM reform agenda. While it is difficult to conceive of such reforms going forward without their backing (or at least their implicit support), virtually no head of state sought to proactively advance these reforms. They did not get out in front of the issue by giving speeches, having regular meetings with teams working on various PFM reform agendas, or pushing reluctant or recalcitrant ministries to cooperate. At best, their efforts involved creating enough political space that champions at the ministerial level could advance the reforms and making favorable reference to the agenda in broader speeches before parliament and other venues about the government's overall strategy.

Lesson 9: External Stakeholders—Useful, but Don't Count on Them

As a general rule, the Executive Branch is extraordinarily powerful throughout MENA. Other stakeholders—whether they are the legislative or judicial branches, various civil society organizations, academics, think tanks, private sector groups and the like—operate at a distinct disadvantage when it comes to influencing the process of political and administrative decision-making. This is particularly true with regard to PFM reform, which is often viewed as a narrow, specialized and technocratic field. This analysis focuses upon two sets of stakeholders who (in principle at least) could be able to influence PFM reform: (1) parliamentarians and legislative bodies; (2) civil society and the public. The role of a third group, donors and the international community, is discussed in the following section.

Parliaments and Legislative Bodies. As the tables in the Appendix indicate, MENA averages a bit under the global mean for Lower Middle Income Countries regarding legislative coverage of audit reports, and a bit better for legislative scrutiny of the budget, with its average score being virtually identical. However, these averages mask considerable divergence between countries. Furthermore, MENA's aggregate rankings would fall significantly short of best practice in a broader global comparison. Throughout the region, parliaments operate at a major disadvantage vis-à-vis the executive branch on PFM issues. They typically lack the staff and committee structures that allow them to provide detailed scrutiny to budget proposals, and their follow-up in areas such as audit reports is variable. In a number of countries, their ability to revise or change budgets presented by the executive is limited, and the information they receive can be partial and fragmented.

As a general rule, parliaments have not been a strong force for PFM reform. In fact, at times the opposite has occurred. In Iraq, a major reform of the income tax regime was attempted in mid-2006. During parliamentary consideration, further retrograde changes were proposed with the opposite effect, and accordingly the package became stalled. Elsewhere, parliamentarians have generally been disinterested in PFM issues and reforms or preoccupied with other issues.

However, there are a few bright spots. Until its dissolution in 2006, the Public Accounts Committee of the Palestine Legislative Council played a proactive role in scrutinizing PA finances. In Egypt, there are encouraging signs of parliament becoming more active in its oversight role. Good examples have been provided by recent aggressive debates over the report of the Central Audit Organization and the changes made to the Government's 2007-08 budget proposals. Yemen has enjoyed vibrant parliamentary oversight of the government's budget estimates approval process. The Yemeni parliament appears to have been less engaged in monitoring actual expenditure achievements or of the quality of expenditure management, although again this appears to have changed for the better in recent years.

Civil Society and the General Public. If parliament's influence over the PFM reform process has been modest, that of the public has been virtually nonexistent. A few NGOs and think tanks may have pressed for greater budgetary openness and transparency, but there is no evidence that they have had any real influence over the shape or content of PFM reform programs to date. In general, PFM reforms are too technical and too removed from their day-to-day experience for the public to form strong views about them, either pro or con.

Exceptions to the public's general detachment are PFM reforms that directly touch their livelihood and depend heavily upon citizen compliance. Egypt's tax and customs reforms are an excellent example. These reforms were generally popular, to the extent that they reduced the highest tax rate for corporations from 40 to 20 percent and for individuals from 32 to 20 percent. The Egyptian Government did embark on a fairly substantial consultation effort six months before the reforms were initiated, including both a number of roundtable discussions with various stakeholders and a media campaign. The implementation of these reforms may have been shaped in modest and incremental ways, such as the creation of a Large Taxpayer Center and pilot Medium-sized Taxpayer Center in Cairo. But there are clear limits to public influence. There has been no taxpayers' charter, and the Supreme Council of Taxes (a societal watchdog agency) has yet to be created.

Beyond tax and customs, public opinion may at best play a modest supporting role in two or three countries in the region. Concerns about widespread corruption within the PA, for example, may have generated some goodwill for Salam Fayyad's reforms in 2002. The promise of bringing tangible benefits to the local populace may have also influenced Fayyad's efforts to dismantle the monopolistic pricing structure of the Petroleum Corporation, which was cited in the epigram at the beginning of this chapter.

Unfortunately, even when successful, PFM reforms do not translate readily into political gains. In the January 2006 elections to the Palestine Legislative Council, Salam Fayyad's "Third Way Party" received 2.4 percent of the popular vote and won only two of the Council's 132 seats. There are examples when the public has actively opposed various aspects of the reform agenda, such as when Egyptian pharmacists called a nationwide strike and took to the street in protest against a decision by the Ministry of Finance to alter retroactively a previously agreed arrangement as a part of the tax reforms.

Lesson 10: Lessons for Donors: Be More Strategic, Selective, Modest and Flexible

The donor community has been heavily, although unevenly, engaged in providing support to public financial management reforms throughout the MENA region. Those most involved include the International Monetary Fund, the World Bank, the OECD, UNDP, and the European Union. A number of bilateral donors are also heavily engaged in providing support, including Britain's Department for International Development, the United States Agency for International

Development, the *Agence Française de Développement*, and the Dutch and Norwegian governments, among others.

A detailed assessment of the effectiveness of donor funding is beyond the scope of this exercise, which has focused more generally on the PFM reform challenges confronting the countries of the MENA region; the types of reforms being implemented; and which have shown promise to date and which have not. Nevertheless, a few conclusions emerge that may be valuable to donors active in this area. They are discussed below under three headings: (1) the nature and scope of donor engagement in MENA on PFM issues; (2) the substantive lessons for donors regarding PFM reform; and (3) modalities and processes.

Table 11: Donor Support for PFM Reforms in MENA

PFM - ODA Commitments (Current US\$ million)	2003	2004	2005	2006	2007	(Partial) Total per country	Annual Average
Iraq		0.04		137.61	40.20	177.85	35.57
Morocco			0.00	100.86	0.24	101.10	20.22
Jordan	0.01	2.38	0.04	25.48	58.51	86.42	17.28
Tunisia	0.43	0.48	0.13		41.39	42.43	8.49
West Bank- Gaza	11.54	2.62	4.12	1.35	3.10	22.73	4.55
Syria		9.94	0.39		0.00	10.33	2.07
Egypt		0.02	1.02	3.78	6.23	11.05	2.21
Yemen	0.19	0.04	1.86		3.99	6.08	1.22
Algeria			0.17	0.28	0.26	0.71	0.14
Lebanon					0.20	0.20	0.04
Total for MENA	12.17	15.52	7.73	269.36	154.12	458.90	91.78

Source: OECD DAC. Data are for the most recent years available.

The Nature and Scope of Donor Engagement in MENA on PFM Issues. Table 3.2 provides a breakdown of average donor support for PFM issues by country drawn from the OECD DAC database. Approximately ten MENA countries received donor assistance for PFM reforms during the period from 2003 to 2007, with the lion's share going to Iraq, Morocco and Jordan. Other recipients included Algeria, Egypt, Lebanon, Syria, Tunisia, West Bank and Gaza, and Yemen. According to OECD DAC figures, total funding for PFM was around \$459 million during this five year period. The average was \$92 million, with considerable variation between years.

While the data probably provides a rough proxy for relative levels of donor engagement, care should be taken to not read too much into the findings, since some of these figures may reflect budget support with a PFM focus rather than dedicated resources for PFM reform. The latter is likely to be much more modest, probably averaging in the \$1 to \$5 million dollar range per country annually after adjusting for the odd major IT project, with some countries receiving substantially less. The bottom line is that PFM reform in MENA is not an area where the donor community has over-invested.

It is hard to make judgments regarding the effectiveness of this assistance. An effort to see if there was any statistical relationship between levels of donor aid for PFM and PEFA scores among recipients turned up virtually no correlation whatsoever (the R² coefficient is 0.00). The implications of this finding are unclear. It could mean that donors have not been effective in their support for PFM operations. Far more likely, it means that they allocate their assistance for PFM reform on criteria other than the underlying performance (or lack thereof) of the recipient country, as measured by the PEFA indicators.

In all likelihood, the influence of donors over the PFM reform process is more subtle and nuanced than can be captured by simple correlations. Donors can be a powerful impetus for change and reform, although their "persuasiveness" is closely aligned with a given country's level of aid dependence. In countries such as Algeria and Syria, where donors have relatively little influence on government decision-making, domestic political and internal dynamics predominate. Donors can play a role in proffering advice and disseminating information, but government's enjoy great discretion over whether they choose to accept this advice or not. In settings such as the WBG and Yemen, where governments are heavily aid dependent, donors are able to play a more influential role in pressing for various reforms. A much less powerful but still important factor is the role of the international community. In the Maghreb, proximity to Europe and the pull of the European Union's Neighborhood Policy and *acquis communautaire* have exerted some influence upon the PFM reform agendas in Morocco and Tunisia, as have the French budgetary reforms that have taken place since 2001.

It remains to be seen how the new generation of actionable indicators, such as PEFA, will have an impact upon the willingness of senior MENA officials to improve their PFM performance. On the positive side, it is clear that cross-country comparative indicators such as the World Bank's *Doing Business* have played an important role in motivating senior officials in countries to undertake reforms aimed at strengthening their business environment. In Egypt, such improvements have been the source of considerable pride and have prompted progress towards reform in other areas, such as anticorruption. There is evidence that, in at least one MENA country, PEFA indicators may have played a comparable role. However, in some respects, PFM indicators such as PEFA are qualitatively different. The *Doing Business* indicators cater to a much larger constituency, including foreign and domestic investors and business associations. They are produced annually with an explicit comparative focus. PFM reforms tend to fall in the domain of specialists. PEFA was not explicitly set up with cross-country comparisons in mind, and the analyses are done much less frequently than once a year. For these reasons, they are unlikely to serve as a comparable motivating force for PFM reforms.

The experience of MENA countries indicates that donor engagement on PFM issues is a two-edged sword. On the positive side, the large number of countries with some type of donor supported PFM program bears witness to the considerable demand for donor resources and technical expertise on PFM issues. Beyond these countries, a number of others in the GCC and elsewhere are purchasing technical assistance from institutions such as the World Bank and IMF on a reimbursable basis—a "market test" that provides one of the best indications of country demand available. In addition to advice and assistance, donor engagement can be useful in "locking in" a particular reform program and generating publicity and obligations that domestic reformers can use to their advantage. Donors can also play a vital role in monitoring the implementation of various reform agendas that, as was noted above, is an area of chronic weakness in MENA. For all of these reasons, virtually no major PFM reform in MENA has been exclusively "home grown."

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⁴⁶ Internal World Bank calculations. The authors are indebted to Hala Hanna of MNSED for this analysis. Looking over time, it will be interesting to observe whether repeat PEFA assessments indicate that donor involvement is having a positive effect on overall PFM performance.

But donors can also pursue their own agendas in ways that can occasionally complicate a given nation's PFM reform effort. The most prominent example is West Bank & Gaza, where donors invested considerable effort and energy from 2002 to 2005 in building up the Ministry of Finance as an alternative to the President's Office for managing the PA's finances, only to change course after Hamas was elected in January 2006 and support the President's Office, and then to switch back again in July 2007 after Fatah regained control of the West Bank. Fortunately, PA institutions were durable enough to withstand such pressures. But they did take a toll.

While the situation above is unique, it is far more common to encounter problems in fostering donor coordination in aid dependent environments, which can interfere with efforts to expand budget comprehensiveness or to integrate the recurrent and capital budgets. The PA has struggled with the superficial integration of public investment expenditures into the budget. The Ministries of Planning and Finance are co-signatories to all development projects financed by donors. But in practice, they have had limited engagement in the selection of projects, as donors often elected to engage directly with line ministries, other PA institutions and local governments. As a result, projects were not considered in a framework that accounted for future recurrent costs and debt servicing capacity, and the PA budget did not adequately reflect donor financed public investment.⁴⁷ Different donors also had conflicting expectations, demands and reporting requirements. While they called for PFM reforms since the 1990s, many donors were also under pressure to disburse to the PA and in practice and were willing to allow such reforms to take a back seat to more immediate priorities.⁴⁸

The Substantive Lessons for Donors on PFM Reform. Chapter 2 has addressed the substantive challenges of PFM reform in MENA at length, and its findings are summarized in Table 10. Their messages will not be repeated here. Suffice it to say that many donor-supported reforms have been too ambitious, overstating the amount of political and bureaucratic support for reform; not fully aware of the role of legacy systems and whether the necessary preconditions were in place; and in general trying to do too much within too limited a period of time and without the required capacity. At times, there is even a lack of understanding or consensus as to what reforms such as implementing a "medium term expenditure framework" or "introducing performance into the budget" will actually mean in practice. Donor programs can be far too comprehensive—seeking to solve too many problems at once—and would benefit from greater selectivity and prioritization.

There are two emerging issues that will shape donor approaches on PFM reform in the future. The first is growing use of PEFA exercises, which are likely to play a valuable role in improving the quality of donor assistance. There is considerable appetite within MENA countries for the use of PEFA assessments as a benchmarking tool, and the number of such exercises in the region is progressing steadily at a rate of two or three a year. Some GCC countries such as Kuwait are even willing to pay to have their PFM institutions and systems reviewed through the use of reimbursable technical assistance. This trend is a healthy one, in that the expanded use of PEFA will enlarge the amount of analytic work available to inform PFM reforms; help donors to better understand where the real issues and challenges are; and allow countries to monitor their performance over time, thus creating additional incentives to take PFM reforms forward. However, would be donors should also be wary in using PEFA exercises mechanistically to design reform strategies, lest they find themselves trying to "fill in the gaps." Such motives, while understandable, may well result in developing reforms for areas where a given PEFA score is low but the demand for improving it is also weak and unsustainable. PEFA is not a substitute for careful strategic analysis and decision-making.

⁴⁷ IMF, West Bank and Gaza: Economic Performance in Conflict Situation, op. cit., p.94

⁴⁸ Bank interview, Ghassan Khatib, May, June 2008; Bank interview with Dr. George Giacaman. 2007

The second trend is the increasing use of political economy analysis to illuminate public sector reform options, which is covered in the first lesson of this chapter. Few would dispute that political and bureaucratic dynamics can play a decisive role in the evolution of PFM reforms, and that a careful understanding of the issues involved would be invaluable to donors interested in supporting this work. The problem, put succinctly by a leading reformer in the region, is that donors "are typically not well-equipped to do it." By that, he meant that the process of PFM reform is a dynamic one requiring a great deal of insider knowledge and a lot of tactical real-time adjustments to changes in the prevailing political and bureaucratic winds. To the extent that donors will be able to capture this subtlety and nuance—whether it be through the use of embedded ministry advisors, knowledgeable local experts or some combination of both—their programs will be the better for it. However, if the exercise becomes static and routine, such as bringing in an external expert to draft a political economy report according to a standard template prior to the initiation of a major PFM reform, then much of its usefulness will be lost and the shelf life of the final product may be short.

Modalities and Processes. In a similar fashion, donor modalities need to be developed to better respond to the dynamic nature of the PFM reform process. There is a role for the traditional project management framework when the reforms are large and enduring (and the sums involved substantial), which is designed to successfully manage a broad and diverse agenda and ensure appropriate accountability. But lengthy appraisal, consultant selection and mobilization procedures often result in delays and lost opportunities. As was noted in Lesson 4 above, the more successful PMF reforms tend to involve "strategic opportunism"—seizing upon opportunities rapidly as they emerge within a broader framework of clearly articulated priorities.

To exploit such opportunities as and when they occur, donors need to augment their traditional approaches with small, rapidly disbursing, carefully targeted aid. To do this will require several preconditions: (1) accurate, up to date knowledge of the situation on the ground, including the evolving political and bureaucratic dynamics; (2) talented, advisors who have technical skills, political and managerial savvy, and the trust of senior officials; (3) a well-articulated framework of PFM priorities; and (4) small amounts of discretionary resources that can be utilized quickly and flexibly to help facilitate implementation. Donor support can help create these essential preconditions.

While some donor-financed studies have been technically good, many were overwhelming in the quantity of recommendations provided, and there is often insufficient guidance on the prioritization and time sequencing of reform and on how to deal with institutional and capacity constraints. Furthermore, effective change management processes and skills have often been lacking.

Finally, the legacy of partial and failed reforms in MENA indicates that there are times when the best strategy for donors may very well involve doing nothing. If the preconditions are not in place and there is limited will, capacity or political space for advancing PFM reform, then as indicated earlier, the most promising approach would be to focus on technocratic reforms, such as revising the budget classification. However, in many situations it may be difficult to proceed with even these modest programs. Such an approach runs contrary to the basic incentive systems at work in most donor agencies, where staff are encouraged to "make things happen" and weak PFM practices may be interfering with broader efforts to provide budget support. Yet in most cases, a poorly planned and executed set of PFM reforms is worse than none at all, in that it creates a barrier of resistance and cynicism that future reformers will need to overcome later.

⁴⁹ Author interview, H.E. Youssef Boutros Ghali, 2009.

Appendix

Table A. 1
MENA PEFA Averages Compared With World Averages
For Comparable Countries

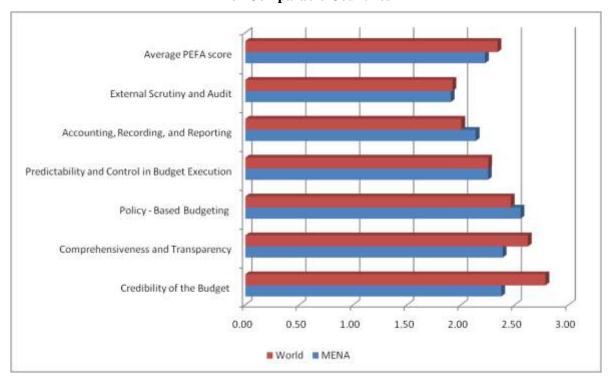
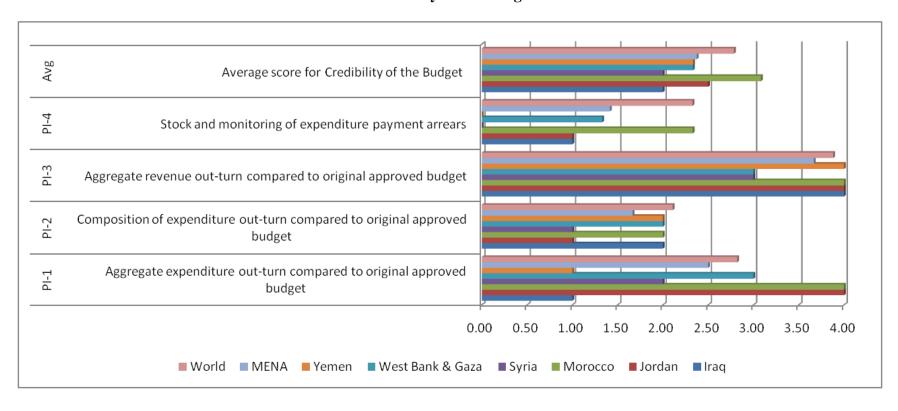
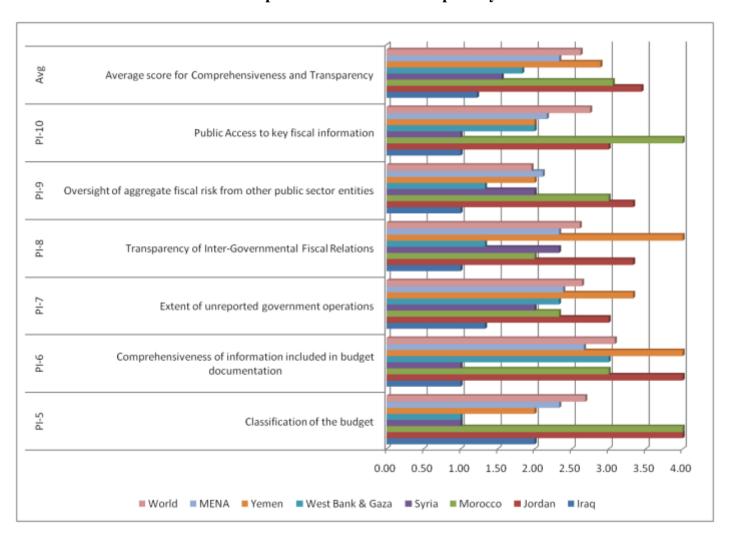


Table A. 2
MENA Country Scores on Individual PEFA Criteria

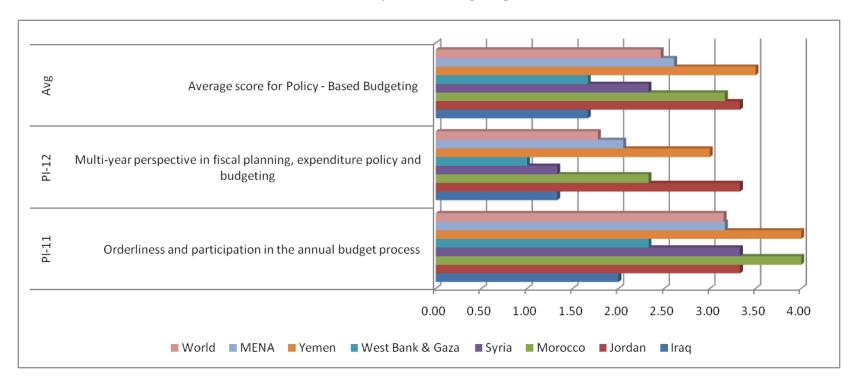
Credibility of the Budget



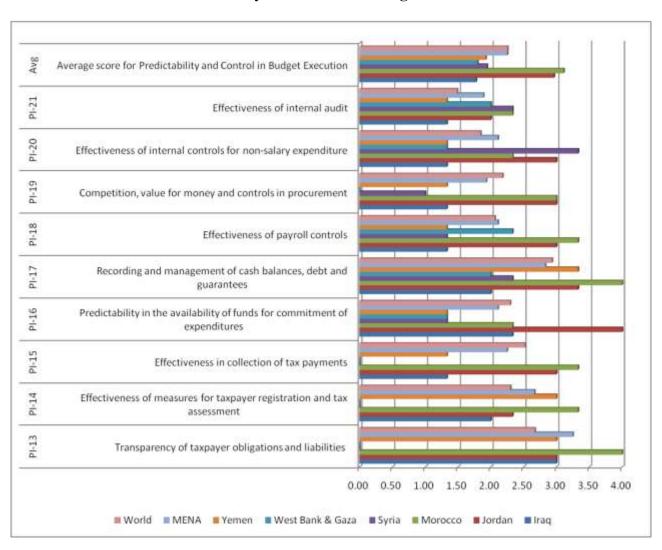
Comprehensiveness and Transparency



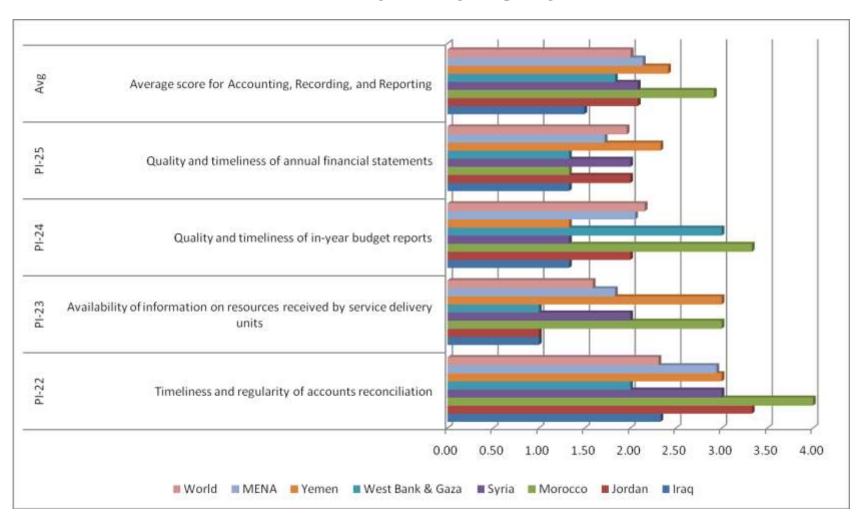
Policy-Based Budgeting



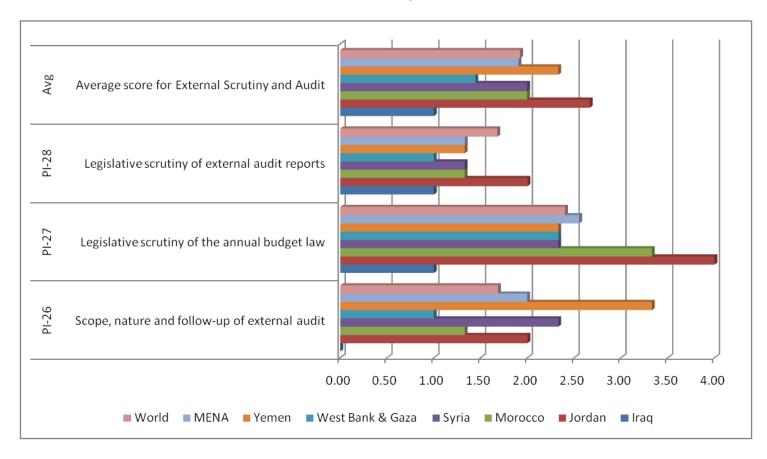
Predictability and Control in Budget Execution



Accounting, Recording & Reporting



External Scrutiny & Audit





Report No: ISR6454

Implementation Status & Results

Iraq

IRAQ: Public Financial Mgmt Reform (P110862)

Operation Name: IRAQ: Public Financial Mgmt Reform (P110862)

Country: Iraq

Project Stage: Implementation Seq.No: 4 Status: ARCHIVED Archive Date: 03-Jan-2012

Approval FY: 2009

Product Line: Recipient Executed Activities Region: MIDDLE EAST AND NORTH AFRICA Lending Instrument: Emergency Recovery Loan

Implementing Agency(ies): Ministry of Finance

Key Dates

Board Approval Date	26-Jun-2009	Original Closing Date	30-Jun-2013	Planned Mid Term Review Date	18-Sep-2011	Last Archived ISR Date 03-Jan-2012
Effectiveness Date	20-Jul-2009	Revised Closing Date	30-Jun-2013	Actual Mid Term Review Date	20-Sep-2011	

Project Development Objectives

Project Development Objective (from Project Appraisal Document)

The Project Development Objective is to support the Government of Iraq's efforts to develop more effective, accountable and transparent public financial management. Support will be provided for strengthening budget management, improving public financial reporting and control, strengthening public procurement, and establishing the tools, systems and institutions required to build capacity for effective public financial management.

Has the Project Development Objective been changed since Board Approval of the Project?

Component(s)

Component Name	Component Cost
Strengthening Budget Formulation and Implementation	3.95
Strengthening Public Procurement	3.20
Strengthening Budget Execution and Implementation	2.33
Capacity Development and Project Management	3.70
Unallocated	2.82
Bank-executed TF (TA to BSA on External Audit and to MOF on Budget Management)	2.00

Overall Ratings

	Previous Rating	Current Rating
Progress towards achievement of PDO	Moderately Unsatisfactory	Moderately Unsatisfactory
Overall Implementation Progress (IP)	Moderately Unsatisfactory	Moderately Unsatisfactory
Overall Risk Rating		

Implementation Status Overview

The Project became effective on July 20, 2009 and is expected to close on June 30, 2013. The project cost is \$16.00 million. At the time of mid-term review, in August - September 2011, the total disbursements under the project were only \$446,000 (less than 3 %) - these have arisen to \$1.687 million (about 11 %) at the end of February 2012. The project has thus made some good progress during the past 4 months - a disbursement of \$1.241 million (7.7 % of the project cost) in just about 4 months. However, the cumulative disbursement rate of only 11 % in 67 % project time is far too low. The uncommitted funds are extremely high (\$8.2 million) - more than 50 % of the project cost; and there are still some major bottlenecks in the project implementation. The government needs to soon decide on the use of uncommitted funds and remove the implementation bottlenecks. The implementation progress is rated Moderately Unsatisfactory.

Lo		

No Location data has been entered

Results

Indicator Name	Core	Unit of Measure		Baseline	Current	End Target	
Component 4: Ministry of Finance training		Yes/No	Value	No	No	Yes	
institute providing training on all operational			Date	01-Jan-2010	30-Mar-2012	30-Jun-2013	
aspects of PFM Project	Percentage		Comments	Limited capacity in the training institute, both human resources, and physical assets/curriculum	While the Consultant Coffey International has done a preliminary Training Needs Assessment and organized a few 'Training of Trainers', the MOF training institute is very far from being capable of providing training in all operational aspects of the PFM project onits own.		
Component 3: Outstanding balances in		Percentage	Value	39.00		9.00	
spending units decline by 30 percentage points, as a share of the budget			Date		30-Mar-2012	30-Jun-2013	
politis, as a share of the budget			Comments		This PDO was to ensure that outstanding balances in Spending Units decline by 30 percentage points, as a share of the budget. In June 2009 when the PFM program commenced, the cash balances at the Rafidain and Rashed (R&R) Banks were estimated at about 27 trillionID (39 % of budget). This was taken as the baseline and objective was to	30% reduction in outstanding balances	

Report No: ISR6454

The World Bank

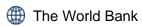
				reduce it by 30 % of budget. However, there was a reclassification of accounts in 2009, due to which, the Cash Balances at 31 December 2009 were reduced to 3.843 trillion ID (5.5 % of the budget). The Cash Balances stand at 5.937trillion ID on June 2011 (6.1 % of the budget) as per new classification. There is thus a problem in comparing the progress with the baselines as the definition of indicator has changed. Thus, the PDO and its baseline needs to be adjusted. The best way forward for the PMT is to estimate the present cash balances as per earlier classification, by includingprovincial accounts, accounts of government trading enterprises, and accounts for the purchase of vehicles. This way, a meaningful comparison of results with the baseline will be done.	
Component 2: At least 50% of contracts above threshold awarded competitively	Percentage	Value	02 May 2010	20 Mar 2042	50.00
		Date Comments	03-May-2010 Baseline not known. PPA states it was 93 %. If that was so, why was the target kept as 50 %	30-Mar-2012 The PDO#2 was to ensure that at least 50 % of the contracts above the threshold level should be awarded competitively. The information provided by the PPA states that even at the baseline in 2009, under the capital budget, the percentage of contracts above the threshold level that were awarded competitively	30-Jun-2013

The World Bank	
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				were 93 %. It appears that the baseline must have been lesser than 50 %, otherwise why else the PDO would have been fixed as 50 %. The PMT is therefore advised to work with the PPA to establish the baseline and update the progress appropriately.	
Component 1: Capital budget execution rate	Percentage	Value	75.00	78.00	85.00
increases by at least 10 percentage points		Date	01-Feb-2010	30-Mar-2012	30-Jun-2013
		Comments	Limited strategic planning; unclear and fragmented project preparation rules/ procedures hindering efficient and cost-effective project implementation	The capital budget execution rate was 75 % in 2008, which has enhanced to 78 % (a 3 % increase) in the first 2 years of the project. While this achievement is below the expected increase of 5 % in 2 years, the progress seems to be on track in the right direction. The PMT is advised to assist the Ministry of Planning in better monitoring and evaluation of the capital budget to identify implementation bottlenecks. (like delay in release of funds, clearances on procurement decisions, land related issues, etc.) and helping to remove those with the help of Ministry of Finance.	Capital budget execution rate increased by 10 %.

Intermediate Results Indicators

Report No: ISR6454



Indicator Name	Core	Unit of Measure		Baseline	Current	End Target
Component 4 - Training program fully in place		Yes/No	Value	No	No	Yes
			Date	30-Jun-2009	30-Mar-2012	30-Jun-2013
			Comments	Limited capacity in MoF training department	The Initial TNA is completed, and the Comprehensive TNA is ongoing, alongside numerous other activities. This indicator is delayedbut on track.	Training program continuing to provide targeted training according to needs; program refined based on feedback from PY3. Long-term business plan for sustainable operations of the MoF trainin department developed and approved
Component 3 - Detailed rules and regulations		Yes/No	Value	No	No	Yes
for new commitment control system developed			Date	30-Jun-2009	30-Mar-2012	30-Jun-2013
			Comments	Commitments are not monitored adequately	Consultancy underway	New system rolled out to at least 4 total sector ministries
Component 3 - First round of training on new cash release system completed with selected pilot ministries		Yes/No	Value	No	No	Yes
			Date	30-Jun-2009	30-Mar-2012	30-Jun-2013
			Comments	Current cash release system inefficient, does not respond to actual needs	Consultancy underway	New system demonstrates 30% improvement in the coherence between cash releases and actual needs - SEE PDO INDICATOR - this will need to be re-classified
Component 2 - Procurement Bulletin Board		Yes/No	Value	No	No	Yes
being fully implemented, and housed within Procurement Regulatory Agency			Date	30-Jun-2009	30-Mar-2012	30-Jun-2013
Frocurement Regulatory Agency			Comments	Limited procurement information available on-line in real-time	Bank will assist in drafting TOR of Web-based portal for publication of bidding opportunities and bidding documents, PMT will revise the TOR in consultation with public contracting directorate of MOP and send the final TOR and EOI with revised cost estimate for publication on UNDB by end of April of 2012	Future options for E- procurement developed (software and hardware requirements specified)
Component 2 - Standard Bidding Documents		Yes/No	Value	No	No	Yes
finalized			Date	30-Jun-2009	30-Mar-2012	30-Jun-2013

			Comments	SBDs not common practice	SBD development ongoing with new consultancy contract, but delays in Gol approval of Inception Report	New SBDs in use in target ministries. Improved procurement efficiency, transparency, and economy, in target ministries, as measuredby data on the method used to award public contracts available	
Component 1 - New Budget Call Circular		Yes/No	Value	No	Yes	Yes	
(BCC) in use			Date	30-Jun-2009	30-Mar-2012	30-Jun-2013	
			Comments	Current BCC difficult to properly complete, as it does not provide sufficient instructional clarity for ministries/agencies	Target met	New BCC with hard budget ceilings issued.	
Component 1 - New Budget Instructions		Yes/No	Value	No	No	Yes	
approved and guidelines ready			Date	30-Jun-2009	30-Mar-2012	30-Jun-2013	
			Comments	Budget instructions have been fragmented and not sufficiently clear, and framework for expenditure 'ceilings' not in use. As a result, budget not adhered to.	Consultancy underway	Budget calendar adhered to. 50% improvement in compliance with ministry/ agency budget requests (based on realism, timeliness and completeness of submission, etc.)	
Component 1 - New procedures in place for		Yes/No	Value	No	No	Yes	
project preparation and appraisal			Date	30-Jun-2009	30-Mar-2012	30-Jun-2013	
			Comments	Unclear and fragmented project preparation rules/ procedures hindering efficient and cost-effective project implementation		10% improvement in capital budget execution performance, as measured by MoPDC and other relevant revies	
Component 1 - Draft Sector Strategies		Yes/No	Value	No	No	Yes	
completed and submitted to all relevant parties			Date	30-Jun-2009	30-Mar-2012	30-Jun-2013	
for comment/revision/etc.			Comments	Limited strategic planning	This task of preparation of sector strategies is being dropped from the TOR as it is being already done by the government with the help of another donor. Now the focus shall be on the assessing the convergence or otherwise of	Selected line ministries employing new strategies for comprehensive sector budget planning	



existing sector strategies with capital budget; and, recommending ways and means of ensuring their convergence.

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Data on Financial Performance (as of 27-Mar-2012)

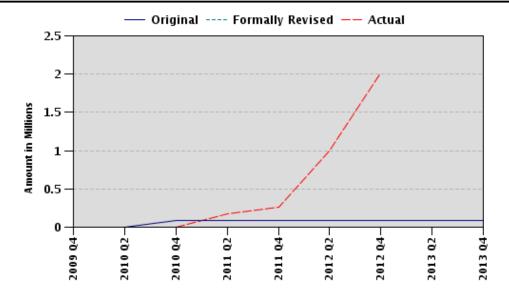
Financial Agreement(s) Key Dates

Project Loan N	No.	Status	Approval Date	Signing Date	Effectiveness Date	Closing Date
1 110002	94552 I	Effective	20-Jul-2009	20-Jul-2009	20-Jul-2009	30-Jun-2013

Disbursements (in Millions)

Project	Loan No.	Status	Currency	Original	Revised	Cancelled	Disbursed	Undisbursed	% Disbursed			
P110862	TF-94552	Effective	USD	16.00	16.00	0.00	2.01	13.99	13.00			

Disbursement Graph



Key Decisions Regarding Implementation

- 1. The PMT has appointed two full time staff a Budget expert and a Treasury expert.
- 2. The Ministry of Finance has finalized and approved the new Chart of Accounts, the exercise for which was going on since 2007.
- 3. The PMT has put on hold all the training activities under Component 4, till the comprehensive training plan is presented by the Consultant Coffey International and is approved by the Ministry of Finance.



4. The PMT has dropped the activity of developing sector strategies under Component 1, as the same is being done by the government with the help of another donor.

5. The PMT has proposed to include following new activities in the project through restructuring: (a) IFMIS, (b) Case Study of Taxation of mobile phone companies, (c) Leadership Training, (d) CPA Training, (e) Completion of IT-based Taxation System started by USAID, and (f) Upgradation of DMFAS

Restructuring History

There has been no restructuring to date.

Related Projects

P124388-Iraq PFM Project - BSA

Report No: ISR6454



Report No: ISR6454

Implementation Status & Results

Iraq

IRAQ: Public Financial Mgmt Reform (P110862)

Operation Name: IRAQ: Public Financial Mgmt Reform (P110862)

Country: Iraq

Project Stage: Implementation Seq.No: 4 Status: ARCHIVED Archive Date: 03-Jan-2012

Approval FY: 2009

Product Line: Recipient Executed Activities Region: MIDDLE EAST AND NORTH AFRICA Lending Instrument: Emergency Recovery Loan

Implementing Agency(ies): Ministry of Finance

Key Dates

Board Approval Date	26-Jun-2009	Original Closing Date	30-Jun-2013	Planned Mid Term Review Date	18-Sep-2011	Last Archived ISR Date 03-Jan-2012
Effectiveness Date	20-Jul-2009	Revised Closing Date	30-Jun-2013	Actual Mid Term Review Date	20-Sep-2011	

Project Development Objectives

Project Development Objective (from Project Appraisal Document)

The Project Development Objective is to support the Government of Iraq's efforts to develop more effective, accountable and transparent public financial management. Support will be provided for strengthening budget management, improving public financial reporting and control, strengthening public procurement, and establishing the tools, systems and institutions required to build capacity for effective public financial management.

Has the Project Development Objective been changed since Board Approval of the Project?

Component(s)

Component Name	Component Cost
Strengthening Budget Formulation and Implementation	3.95
Strengthening Public Procurement	3.20
Strengthening Budget Execution and Implementation	2.33
Capacity Development and Project Management	3.70
Unallocated	2.82
Bank-executed TF (TA to BSA on External Audit and to MOF on Budget Management)	2.00

Overall Ratings

	Previous Rating	Current Rating
Progress towards achievement of PDO	Moderately Unsatisfactory	Moderately Unsatisfactory
Overall Implementation Progress (IP)	Moderately Unsatisfactory	Moderately Unsatisfactory
Overall Risk Rating		

Implementation Status Overview

The Project became effective on July 20, 2009 and is expected to close on June 30, 2013. The project cost is \$16.00 million. At the time of mid-term review, in August - September 2011, the total disbursements under the project were only \$446,000 (less than 3 %) - these have arisen to \$1.687 million (about 11 %) at the end of February 2012. The project has thus made some good progress during the past 4 months - a disbursement of \$1.241 million (7.7 % of the project cost) in just about 4 months. However, the cumulative disbursement rate of only 11 % in 67 % project time is far too low. The uncommitted funds are extremely high (\$8.2 million) - more than 50 % of the project cost; and there are still some major bottlenecks in the project implementation. The government needs to soon decide on the use of uncommitted funds and remove the implementation bottlenecks. The implementation

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No Location data has been entered

progress is rated Moderately Unsatisfactory.

Results

Project Development Objective Indicators								
Indicator Name	Core	Unit of Measure		Baseline	Current	End Target		
Component 4: Ministry of Finance training		Yes/No	Value	No	No	Yes		
institute providing training on all operational			Date	01-Jan-2010	30-Mar-2012	30-Jun-2013		
aspects of PFM Project			Comments	Limited capacity in the training institute, both human resources, and physical assets/curriculum	While the Consultant Coffey International has done a preliminary Training Needs Assessment and organized a few 'Training of Trainers', the MOF training institute is very far from being capable of providing training in all operational aspects of the PFM project onits own.			
Component 3: Outstanding balances in		Percentage	Value	39.00		9.00		
spending units decline by 30 percentage points, as a share of the budget			Date		30-Mar-2012	30-Jun-2013		
points, as a snare of the budget			Comments		This PDO was to ensure that outstanding balances in Spending Units decline by 30 percentage points, as a share of the budget. In June 2009 when the PFM program commenced, the cash balances at the Rafidain and Rashed (R&R) Banks were estimated at about 27 trillionID (39 % of budget). This was taken as the baseline and objective was to	30% reduction in outstanding balances		

Report No: ISR6454

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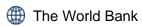
				reduce it by 30 % of budget. However, there was a reclassification of accounts in 2009, due to which, the Cash Balances at 31 December 2009 were reduced to 3.843 trillion ID (5.5 % of the budget). The Cash Balances stand at 5.937trillion ID on June 2011 (6.1 % of the budget) as per new	
				classification. There is thus a problem in comparing the progress with the baselines as the definition of indicator has changed. Thus, the PDO and its baseline needs to be adjusted. The best way forward for the PMT is to estimate the present cash balances as per earlier classification, by includingprovincial accounts, accounts of government trading enterprises, and accounts for the purchase of vehicles. This way, a meaningful comparison of results with the baseline will	
Component 2: At least 50% of contracts above	Percentage	Value		be done.	50.00
threshold awarded competitively		Date	03-May-2010	30-Mar-2012	30-Jun-2013
		Comments	Baseline not known. PPA	The PDO#2 was to ensure that at least 50 % of the contracts above the threshold level should be awarded competitively. The information provided by the PPA states that even at the baseline in 2009, under the capital budget, the percentage of contracts above the threshold level that were awarded competitively	

The World Bank

Report No: ISR6454

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Component 1: Capital budget execution rate	Percentage	Value	75.00	78.00	85.00
increases by at least 10 percentage points		Date	01-Feb-2010	30-Mar-2012	30-Jun-2013
		Comments	Limited strategic planning; unclear and fragmented project preparation rules/ procedures hindering efficient and cost-effective project implementation	has enhanced to 78 % (a 3 %	

Intermediate Results Indicators



Indicator Name	Core	Unit of Measure		Baseline	Current	End Target
Component 4 - Training program fully in place		Yes/No	Value	No	No	Yes
			Date	30-Jun-2009	30-Mar-2012	30-Jun-2013
			Comments	Limited capacity in MoF training department	The Initial TNA is completed, and the Comprehensive TNA is ongoing, alongside numerous other activities. This indicator is delayedbut on track.	Training program continuing to provide targeted training according to needs; program refined based on feedback from PY3. Long-term business plan for sustainable operations of the MoF trainin department developed and approved
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for new commitment control system developed			Date	30-Jun-2009	30-Mar-2012	30-Jun-2013
			Comments	Commitments are not monitored adequately	Consultancy underway	New system rolled out to at least 4 total sector ministries
Component 3 - First round of training on new cash release system completed with selected pilot ministries		Yes/No	Value	No	No	Yes
			Date	30-Jun-2009	30-Mar-2012	30-Jun-2013
pilot ministries			Comments	Current cash release system inefficient, does not respond to actual needs	Consultancy underway	New system demonstrates 30% improvement in the coherence between cash releases and actual needs - SEE PDO INDICATOR - this will need to be re-classified
Component 2 - Procurement Bulletin Board		Yes/No	Value	No	No	Yes
being fully implemented, and housed within Procurement Regulatory Agency			Date	30-Jun-2009	30-Mar-2012	30-Jun-2013
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			Comments	SBDs not common practice	SBD development ongoing with new consultancy contract, but delays in Gol approval of Inception Report	New SBDs in use in target ministries. Improved procurement efficiency, transparency, and economy, in target ministries, as measuredby data on the method used to award public contracts available
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BCC) in use			Date	30-Jun-2009	30-Mar-2012	30-Jun-2013
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Component 1 - New Budget Instructions		Yes/No	Value	No	No	Yes
approved and guidelines ready			Date	30-Jun-2009	30-Mar-2012	30-Jun-2013
			Comments	Budget instructions have been fragmented and not sufficiently clear, and framework for expenditure 'ceilings' not in use. As a result, budget not adhered to.	Consultancy underway	Budget calendar adhered to. 50% improvement in compliance with ministry/ agency budget requests (based on realism, timeliness and completeness of submission, etc.)
Component 1 - New procedures in place for		Yes/No	Value	No	No	Yes
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for comment/revision/etc.			Comments	Limited strategic planning	This task of preparation of sector strategies is being dropped from the TOR as it is being already done by the government with the help of another donor. Now the focus shall be on the assessing the convergence or otherwise of	Selected line ministries employing new strategies for comprehensive sector budget planning



existing sector strategies with capital budget; and, recommending ways and means of ensuring their convergence.

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Data on Financial Performance (as of 27-Mar-2012)

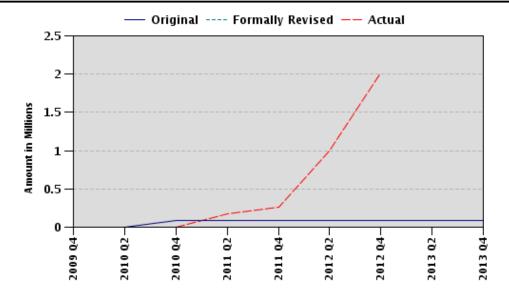
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Disbursements (in Millions)

Project	Loan No.	Status	Currency	Original	Revised	Cancelled	Disbursed	Undisbursed	% Disbursed
P110862	TF-94552	Effective	USD	16.00	16.00	0.00	2.01	13.99	13.00

Disbursement Graph



Key Decisions Regarding Implementation

- 1. The PMT has appointed two full time staff a Budget expert and a Treasury expert.
- 2. The Ministry of Finance has finalized and approved the new Chart of Accounts, the exercise for which was going on since 2007.
- 3. The PMT has put on hold all the training activities under Component 4, till the comprehensive training plan is presented by the Consultant Coffey International and is approved by the Ministry of Finance.



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Restructuring History

There has been no restructuring to date.

Related Projects

P124388-Iraq PFM Project - BSA

Report No: ISR6454

PROJECT INFORMATION DOCUMENT (PID) CONCEPT STAGE

Report No.: AB3737

Project Name	IRAQ: Public Finance Management Project	
Region	MIDDLE EAST AND NORTH AFRICA	
Sector	Sub-national government administration (50%);Central	
	government administration (50%)	
Project ID	P110862	
Borrower(s)	GOVERNMENT OF IRAQ	
Implementing Agency	Ministry of Finance of Iraq	
Environment Category	[] A [] B [X] C [] FI [] TBD (to be determined)	
Date PID Prepared	September 24, 2009	
Estimated Date of	February 11, 2009 (Actual)	
Appraisal Authorization		
Estimated Date of Board	July 20, 2009 (Actual Date of Regional Vice President Approval)	
Approval		

1. Key development issues and rationale for Bank involvement

- 1. Sound public financial management (PFM) is critical to ensuring efficiency and accountability in the management of public resources. Iraq is resource rich and has enjoyed a substantial increase in oil revenues in recent years. However, for the people of Iraq to benefit from its resource wealth, public finance reforms are a priority. Weaknesses in the PFM system not only have high costs in terms of allocative and operational efficiency but also create high levels of fiduciary risk.
- 2. The GoI has made progress in recent years but much remains to be done. Iraq has made progress in reforming public expenditure policy and management since 2003. Key measures include the adoption of a budget classification system that is compliant with Government Finance Statistics (GFS) standards and of a plan to integrate capital and current budgeting processes. However, many challenges remain. Selected examples include:
 - **Budget Preparation**: Budget negotiations between line ministries and central ministries are time-consuming as line ministries are not provided with ceilings within which to prepare budgets. The technical capacity of staff to evaluate and approve capital projects has eroded due to high attrition in recent years.
 - **Budget implementation**: Annual implementation plans for projects presented by line ministries are often revised during the lifetime of the project. Sites for projects are poorly prepared and disputes regarding ownership of the sites lead to further delays. Some line ministries interrupt project execution after projects have been approved and there is no system by which central ministries (finance and planning) can either support the implementation of these projects or find an alternative solution to delays in initiating project implementation by affected line ministries.
 - **Contracting issues**: Few contractors have the capacity to implement large capital projects, often lacking even the capacity to prepare contracts that meet the detailed specification required for the projects. Work orders are frequently changed leading to delays. There is no system to resolve differences between the contractors and spending agencies speedily. Delays lead to increasing project costs that need to go through an approval process leading to further delays.
 - Payments System: The payments system is insufficiently flexible. Currently, Iraq uses a cash-

- based payments system limited to the fiscal year; this precludes the ability to make commitments when necessary and make cash payments according to these commitments. The system also allocates the total cost over the period of execution and requires that these amounts be fully spent within assigned years.
- **Reporting**: The new chart of accounts is not uniformly used at all levels of government, leading to a weak control environment. Independent audits of all Government budget accounts for any recent financial year have either not been undertaken or have not been made available.
- 3. **The main rationale for the Project** is that it will improve PFM in Iraq thereby leading to better use of national resources for the public's welfare. The areas where improvement is needed have been identified in the previous section. In addition, the Project will serve to improve donor coordination. Donor efforts in the PFM area to date are shown in Table 1. However, these efforts have not been adequately coordinated, resulting in duplication of effort.
- 4. The process of Project preparation has already contributed to improved coordination since key donor partners have been involved at all stages. The placement of a senior public sector specialist in the Bank's Baghdad office has also been helpful: meetings are regularly convened to ensure that donor efforts in the PFM area complement one another. Moreover, the Ministry of Finance has developed and passed a PFM Action Plan with support provided by the Bank with inputs from the IMF and DFID during project preparation. This now serves as the blue print for all donor support including the proposed project.
- 5. The GoI has demonstrated its commitment by putting PFM issues at the heart of the socioeconomic pillar of the International Compact for Iraq. The Government recognizes the importance of PFM reform, as indicated in the National Development Strategy and the International Compact for Iraq.
- 6. Finally, GoI is eager to bring to Iraq the Bank's extensive worldwide (and regional) experience in providing guidance on good practices in PFM reform, as demonstrated by their strong commitment throughout project preparation.

2. Proposed project development objective

- 7. The total estimated cost of the Project is US\$18 million, to be funded by: i) US\$16 million from the ITF, to be recipient-executed; and ii) US\$2 million from the ITF, to be Bank-executed, to allow initiation of some subcomponents as well as facilitate opportunities to disseminate results of the reform activities.
- 8. The Project Development Objective is to support the Government of Iraq's efforts to develop more effective, accountable and transparent public financial management. Cross-cutting reforms in PFM will be addressed by the reforms to the national system which will be extended where necessary and appropriate to the subnational system. The aim will be to strengthen budget formulation, execution and control, improve public financial reporting, strengthen public procurement and develop capacity in PFM.

The project is the first stage in a multiyear strategy for budget reform. GOI is putting together a multiyear public financial reform strategy with an action plan which lays out the reforms that will be undertaken in each stage. The project builds on the support that GOI has requested from the donors in the first stage of implementation of their reforms strategy. The primary target group is resource managers and their superiors in the Ministry of Finance (MoF) and Ministry of Planning and Development Cooperation (MoPDC), as well as the line ministries. Effective Project implementation will require international experts to work alongside with these key GoI officials in Iraq on the practical tasks that need to be

3. Project Description

- 9. The Project design reflects the agreements between GOI, the Bank, and the IMF, as expressed in the Public Financial Management Action Plan.
- 10. Component 1. Strengthening budget formulation and implementation (US \$3.95 million). The overall objective of this component of the project is to lay a stronger foundation--building on older procedures and accepted Iraqi norms--for credible annual budgeting framed by a medium-term perspective, and complemented by more rigorous selection and preparation of investment projects within a public investment programming process consistent with national development strategy and detailed sector strategies: execution including procurement. Activities include:
 - Develop detailed sector strategies for two key ministries: Ministry of Education and Ministry of Water Resources
 - Strengthen investment project preparation and appraisal
 - Strengthen the capacity of the Economic Department of MoF
 - Improve the process of annual budget formulation and budget classification and strengthen public financial regulatory framework
 - Improve content of and adherence to budget call circular
- 11. **Component 2. Strengthening Public Sector Procurement (US\$ 3.2 million).** Improvements to the systems of Public Procurement are crucial to ensure successful budget execution. This Component would include:
 - Supporting the public sector procurement system
 - Developing sector specific standard bidding documents
 - Establishing a procurement information and monitoring system
 - Strengthening the capacity of key Iraqi implementing institutions, NGOs, and private sector in public procurement
- 12. **Component 3. Strengthening Budget Execution and Implementation (US \$2.33 million).** This includes the provision of technical support to improve administrative and functional aspects of GoI's budget execution operations. Activities include:
 - Introduce improved cash release system
 - Assess multiple treasury system in KRG
 - Introduce new commitment control system
 - Improve financial reporting
 - Assess the internal financial control system, including the role of the Inspectors General
 - Upgrade content and functionality of MOF website
 - Create internal MoF Network
 - Capacity development of line ministries to enhance their ability to implement investment projects
- 13. Component 4. Capacity Development and Project Management. (US \$3.0 million). This component will ensure coordination of the training and capacity building provided in the first three components of the project. The component also foresees a focused strengthening of the MoF's internal training department, in order develop the department's longer-term capacity to provide comprehensive

'in-house' training The project would finance international and local advisory services (with a small provision for office equipment essential for the effectiveness of the project), as well as training and capacity building directly related to the envisaged reform measures.

Bank-executed part of the Grant. At the request of the Recipient, a portion of the Project has been allocated for Bank-executed technical assistance (TA) to support the implementation of the Grant. In addition to the advisory services to be provided the Bank-executed part of the Grant will allow the Project to support the efforts of the Board of Supreme Audit (BSA) to reinforce their operational capacities. Specifically, support would be provided for advanced training of BSA staff in public finance, legal issues, accounting, auditing, etc. In addition, support could be provided for developing the capacity of the BSA to conduct performance audits.

4. Tentative financing

Source:		(\$m.)
Borrower		0
Iraq Trust Fund		18
	Total	18

5. Contact point

Contact: Yahia Khairi Said Title: Sr. Public Sector Specialist

Tel: +9647 901 927 885

Fax: N/A

Email: ykhairisaid@worldbank.org

PROJECT INFORMATION DOCUMENT (PID) CONCEPT STAGE

Report No.: AB3737

Project Name	IRAQ: Public Finance Management Project	
Region	MIDDLE EAST AND NORTH AFRICA	
Sector	Sub-national government administration (50%);Central	
	government administration (50%)	
Project ID	P110862	
Borrower(s)	GOVERNMENT OF IRAQ	
Implementing Agency	Ministry of Finance of Iraq	
Environment Category	[]A []B [X]C []FI []TBD (to be determined)	
Date PID Prepared	September 24, 2009	
Estimated Date of	February 11, 2009 (Actual)	
Appraisal Authorization		
Estimated Date of Board	July 20, 2009 (Actual Date of Regional Vice President Approval)	
Approval		

1. Key development issues and rationale for Bank involvement

- 1. Sound public financial management (PFM) is critical to ensuring efficiency and accountability in the management of public resources. Iraq is resource rich and has enjoyed a substantial increase in oil revenues in recent years. However, for the people of Iraq to benefit from its resource wealth, public finance reforms are a priority. Weaknesses in the PFM system not only have high costs in terms of allocative and operational efficiency but also create high levels of fiduciary risk.
- 2. The GoI has made progress in recent years but much remains to be done. Iraq has made progress in reforming public expenditure policy and management since 2003. Key measures include the adoption of a budget classification system that is compliant with Government Finance Statistics (GFS) standards and of a plan to integrate capital and current budgeting processes. However, many challenges remain. Selected examples include:
 - **Budget Preparation**: Budget negotiations between line ministries and central ministries are time-consuming as line ministries are not provided with ceilings within which to prepare budgets. The technical capacity of staff to evaluate and approve capital projects has eroded due to high attrition in recent years.
 - **Budget implementation**: Annual implementation plans for projects presented by line ministries are often revised during the lifetime of the project. Sites for projects are poorly prepared and disputes regarding ownership of the sites lead to further delays. Some line ministries interrupt project execution after projects have been approved and there is no system by which central ministries (finance and planning) can either support the implementation of these projects or find an alternative solution to delays in initiating project implementation by affected line ministries.
 - **Contracting issues**: Few contractors have the capacity to implement large capital projects, often lacking even the capacity to prepare contracts that meet the detailed specification required for the projects. Work orders are frequently changed leading to delays. There is no system to resolve differences between the contractors and spending agencies speedily. Delays lead to increasing project costs that need to go through an approval process leading to further delays.
 - Payments System: The payments system is insufficiently flexible. Currently, Iraq uses a cash-

- based payments system limited to the fiscal year; this precludes the ability to make commitments when necessary and make cash payments according to these commitments. The system also allocates the total cost over the period of execution and requires that these amounts be fully spent within assigned years.
- **Reporting**: The new chart of accounts is not uniformly used at all levels of government, leading to a weak control environment. Independent audits of all Government budget accounts for any recent financial year have either not been undertaken or have not been made available.
- 3. **The main rationale for the Project** is that it will improve PFM in Iraq thereby leading to better use of national resources for the public's welfare. The areas where improvement is needed have been identified in the previous section. In addition, the Project will serve to improve donor coordination. Donor efforts in the PFM area to date are shown in Table 1. However, these efforts have not been adequately coordinated, resulting in duplication of effort.
- 4. The process of Project preparation has already contributed to improved coordination since key donor partners have been involved at all stages. The placement of a senior public sector specialist in the Bank's Baghdad office has also been helpful: meetings are regularly convened to ensure that donor efforts in the PFM area complement one another. Moreover, the Ministry of Finance has developed and passed a PFM Action Plan with support provided by the Bank with inputs from the IMF and DFID during project preparation. This now serves as the blue print for all donor support including the proposed project.
- 5. The GoI has demonstrated its commitment by putting PFM issues at the heart of the socioeconomic pillar of the International Compact for Iraq. The Government recognizes the importance of PFM reform, as indicated in the National Development Strategy and the International Compact for Iraq.
- 6. Finally, GoI is eager to bring to Iraq the Bank's extensive worldwide (and regional) experience in providing guidance on good practices in PFM reform, as demonstrated by their strong commitment throughout project preparation.

2. Proposed project development objective

- 7. The total estimated cost of the Project is US\$18 million, to be funded by: i) US\$16 million from the ITF, to be recipient-executed; and ii) US\$2 million from the ITF, to be Bank-executed, to allow initiation of some subcomponents as well as facilitate opportunities to disseminate results of the reform activities.
- 8. The Project Development Objective is to support the Government of Iraq's efforts to develop more effective, accountable and transparent public financial management. Cross-cutting reforms in PFM will be addressed by the reforms to the national system which will be extended where necessary and appropriate to the subnational system. The aim will be to strengthen budget formulation, execution and control, improve public financial reporting, strengthen public procurement and develop capacity in PFM.

The project is the first stage in a multiyear strategy for budget reform. GOI is putting together a multiyear public financial reform strategy with an action plan which lays out the reforms that will be undertaken in each stage. The project builds on the support that GOI has requested from the donors in the first stage of implementation of their reforms strategy. The primary target group is resource managers and their superiors in the Ministry of Finance (MoF) and Ministry of Planning and Development Cooperation (MoPDC), as well as the line ministries. Effective Project implementation will require international experts to work alongside with these key GoI officials in Iraq on the practical tasks that need to be

3. Project Description

- 9. The Project design reflects the agreements between GOI, the Bank, and the IMF, as expressed in the Public Financial Management Action Plan.
- 10. Component 1. Strengthening budget formulation and implementation (US \$3.95 million). The overall objective of this component of the project is to lay a stronger foundation--building on older procedures and accepted Iraqi norms--for credible annual budgeting framed by a medium-term perspective, and complemented by more rigorous selection and preparation of investment projects within a public investment programming process consistent with national development strategy and detailed sector strategies: execution including procurement. Activities include:
 - Develop detailed sector strategies for two key ministries: Ministry of Education and Ministry of Water Resources
 - Strengthen investment project preparation and appraisal
 - Strengthen the capacity of the Economic Department of MoF
 - Improve the process of annual budget formulation and budget classification and strengthen public financial regulatory framework
 - Improve content of and adherence to budget call circular
- 11. **Component 2. Strengthening Public Sector Procurement (US\$ 3.2 million).** Improvements to the systems of Public Procurement are crucial to ensure successful budget execution. This Component would include:
 - Supporting the public sector procurement system
 - Developing sector specific standard bidding documents
 - Establishing a procurement information and monitoring system
 - Strengthening the capacity of key Iraqi implementing institutions, NGOs, and private sector in public procurement
- 12. **Component 3. Strengthening Budget Execution and Implementation (US \$2.33 million).** This includes the provision of technical support to improve administrative and functional aspects of GoI's budget execution operations. Activities include:
 - Introduce improved cash release system
 - Assess multiple treasury system in KRG
 - Introduce new commitment control system
 - Improve financial reporting
 - Assess the internal financial control system, including the role of the Inspectors General
 - Upgrade content and functionality of MOF website
 - Create internal MoF Network
 - Capacity development of line ministries to enhance their ability to implement investment projects
- 13. Component 4. Capacity Development and Project Management. (US \$3.0 million). This component will ensure coordination of the training and capacity building provided in the first three components of the project. The component also foresees a focused strengthening of the MoF's internal training department, in order develop the department's longer-term capacity to provide comprehensive

'in-house' training The project would finance international and local advisory services (with a small provision for office equipment essential for the effectiveness of the project), as well as training and capacity building directly related to the envisaged reform measures.

Bank-executed part of the Grant. At the request of the Recipient, a portion of the Project has been allocated for Bank-executed technical assistance (TA) to support the implementation of the Grant. In addition to the advisory services to be provided the Bank-executed part of the Grant will allow the Project to support the efforts of the Board of Supreme Audit (BSA) to reinforce their operational capacities. Specifically, support would be provided for advanced training of BSA staff in public finance, legal issues, accounting, auditing, etc. In addition, support could be provided for developing the capacity of the BSA to conduct performance audits.

4. Tentative financing

Source:		(\$m.)
Borrower		0
Iraq Trust Fund		18
	Total	18

5. Contact point

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COALITION PROVISIONAL AUTHORITY ORDER NUMBER 95

FINANCIAL MANAGEMENT LAW AND PUBLIC DEBT LAW

Pursuant to my authority as Administrator of the Coalition Provisional Authority (CPA) and under the laws and usages of war, and consistent with relevant U.N. Security Council resolutions, including Resolutions 1483 and 1511(2003),

Having worked closely with the Governing Council to ensure that economic change occurs in a manner acceptable to the people of Iraq,

Acknowledging the Governing Council's desire to bring about significant change to the Iraqi economic system,

Determined to improve the conditions of life, and opportunities for all Iraqis and to fight unemployment with its associated deleterious effect on public security through stable financial markets,

Recognizing that Iraq needs laws concerning the issuance and payment of public debt to assist in financing the Government and to promote confidence in the country's economic system,

Further recognizing the CPA's obligation to provide for the effective administration of Iraq,

Recalling that U.N. Security Council Resolution 1483 (2003) called upon the CPA to promote economic reconstruction and the conditions for sustainable development,

Acting in a manner consistent with the Report of the Secretary General to the Security Council of July 17, 2003, concerning the need for the development of Iraq and the need to enact institutional and legal reforms to give it effect,

I hereby promulgate the following:

Section 1 Purpose

1) This Order promulgates the Financial Management Law, which establishes a comprehensive framework for the conduct of fiscal and budgetary policy in line with international best practices, by setting a structured process for

- the formulation of the federal budget and a number of reporting requirements aimed at increasing the accountability and transparency of the budgeting process.
- 2) This Order promulgates the Public Debt Law, which authorizes the Ministry of Finance to issue and pay debt securities guaranteed by the Government, and establishes certain related authorities and duties, for the purposes of financing Government operations and promoting a stable Iraqi economy.

Section 2 Financial Management Law

The Financial Management Law attached to this Order as Annex A shall have the full force and effect of law.

Section 3 Public Debt Law

The Public Debt Law attached to this Order as Annex B shall have the full force and effect of law.

Section 4 General Provisions

- 1) Prior to the transfer of governance authority to the Iraqi Interim Government in accordance with Article (2)(B)(1) of the Law of the Administration for the State of Iraq for the Transitional Period, the powers and responsibilities assigned to the Prime Minister and Council of Ministers by the Financial Management Law and the Public Debt Law shall be exercised by the Administrator.
- 2) Until such time as the Iraqi Interim Government assumes full governance authority in accordance with Article (2)(B)(1) of the Law of the Administration for the State of Iraq for the Transitional Period, the Ministry of Finance is prohibited from issuing new debt securities if the issuance of such securities would increase the total level of Iraq's public debt, including obligations to the Central Bank, beyond the current level of such debt.

3) Notwithstanding any provision of the Financial Management Law to the contrary, spending units shall submit requests for allocation of funds for the budget for fiscal year 2005 to the Ministry of Finance not later than 15 June 2004.

Section 5 Inconsistent Legislation

Any provision of Iraqi law that was enacted prior to the effective date of this Order, Annex A, or Annex B is hereby suspended to the extent of such inconsistency.

Section 6 Entry into Force

This Order shall enter into force on the date of signature

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L. Paul Bremer, Administrator

Coalition Provisional Authority

IRAQ

FINANCIAL MANAGEMENT LAW OF 2004

Section 1 Purpose

This Law shall regulate the arrangements governing the preparation, adoption, recording, management, execution, and reporting of the federal budget of Iraq and related issues including public borrowing and guarantees, internal control, accounting, and auditing. The principles of transparency, comprehensiveness, and unity shall be of fundamental importance in the preparation and execution of the federal budget of Iraq, and in related issues.

The principle of transparency requires that budget information be classified according to accepted international standards and presented in a way that facilitates policy analysis and promotes accountability.

The principle of comprehensiveness requires that the budget cover all government agencies and institutions undertaking government operations, so that the budget presents a consolidated and complete view of these operations and is voted on, as a whole, by the body vested with national legislative authority.

The principle of *unity* requires that all government resources be directed to a common pool to be allocated and used for public expenditure according to the priorities of the government.

Section 2 Definitions for the Purposes of this Law

- 1) "Budget appropriation" is the legal authorization given to the government to spend public money over the fiscal year for specified purposes.
- 2) "Authorized person" is a person delegated authority in writing by the Minister of Finance to manage public money.
- 3) "Borrowings" are funds received in return for a legally binding agreement to repay.
- 4) "Budget" is a financial program based on annual estimates of government cash receipts and payments, transfers, and transactions in kind.
- 5) "Budget executor" is an authorized person, or person delegated authority by the budget executor, responsible for the execution of the budget.
- 6) "Capital expenditures" are the use of funds to acquire or upgrade capital assets, such as buildings, structures, machinery, and equipment, and financial assets.

- 7) "Cash payments" are any monetary transactions resulting in a reduction in the balance of a bank account or cash balance.
- 8) "Chart of accounts" is a structured list of accounting codes used to classify and record budget revenue and expenditure transactions.
- 9) "Commitment" is an undertaking to make an expenditure following the conclusion of a binding agreement that will result in a payment.
- 10) "Contingency reserves" are funds allocated to the Ministry of Finance in the annual budget law or supplementary budget laws for the purpose of making expenditures that are urgent and unforeseen at the time of passage of the annual budget law.
- 11) "Council of Ministers" is the Council of Ministers described in the Law of Administration for the State of Iraq for the Transitional Period (the "Transitional Administration Law" or "TAL").
- 12) "Current expenditures" are expenditures which are not capital expenditures, such as salaries, supplies, services, and fuel.
- 13) "Economic classification" is a systematic arrangement of budget revenue and expenditure items by type for the purposes of financial statistical reporting and analysis.
- 14) "Financial assets" include foreign or domestic cash, deposits, loans, bonds, financial derivatives, accounts receivable, other types of claims, monetary gold, special drawing rights (SDRs), treasury bills, and shares.
- 15) "Fiscal year" is the general government's accounting period, which begins on January 1st and ends on December 31st.
- 16) "Federal budget" is the estimate of the total annual receipts and payments as approved by the Federal Government.
- 17) "Federal government" is the Iraqi Interim Government, the Iraqi Transitional Government, or the Government to be elected pursuant to a permanent constitution, as set forth in Article 61 of the Law of Administration for the State of Iraq for the Transitional Period (the "Transitional Administration Law" or "TAL").
- 18) "Federal government bank account" is a bank account for the receipt, payment, or transfer of public money belonging to the federal government.
- 19) "Functional classification system" means the array of budget authority, expenditures, and other budget data according to the major purpose served—for example, agriculture, national defense, and transportation.

- 20) "General government" comprises all government units primarily engaged in non-market operations, including the federal government, regional governments, governorates, municipal and local governments.
- 21) "Government debt securities" are debt securities issued by the Ministry of Finance, including debt securities lawfully issued prior to the effective date of the Public Debt Law promulgated in 2004.
- 22) "Governorates' budgets" are the estimates of annual receipts and payments of the governorates.
- 23) "Governorate Councils" are the Governorate Councils described in Section 2 of CPA Order Number 71, Local Governmental Powers (the "Local Governmental Powers Law").
- 24) "Line items" are the payments specifically itemized in the budget law.
- 25) "In kind" means a transfer or exchange in which payment takes the form of tangible property, intangible property, or services rather than cash.
- 26) "Liability" is a present obligation arising from past events, the settlement of which is expected to result in a future payment in cash or in kind.
- 27) "Outlay" means a payment to liquidate an obligation other than borrowing.
- 28) "Payment arrears" arise when a payment is not made by its due-for-payment date.
- 29) "*Petroleum*" means hydrocarbons, including, but not limited to, crude oil, natural gas, and natural gas liquids and refined petroleum products.
- 30) "Petroleum revenue account" means the Development Fund for Iraq (DFI) account as described in United Nations Security Council Resolution 1483 (2003) or any successor account to the DFI.
- 31) "Public money" means cash and bank deposits within the custody and control of the federal government.
- 32) "Public corporations" are -
 - (1) State companies, as defined in Law Number 22 of 1997 on State Companies; and
- (2) any other juridical person or unit that is owned or controlled by the federal government, and produces goods or services for the market and, in the case of a unit which is not a juridical person, functions independently and is capable of maintaining separate accounting.
- 33) "Special budgetary funds" are special funds whose sources, uses, and purposes are established by law.

- 34) "Spending units" are the ministries of the federal government and the administrative bodies of the federal and regional governments, governorates, and municipal and local governments, to which funding is allocated in the annual budget law.
- 35) "Reallocate," in relation to a budget appropriation, means to move budgetary resources from one budget account, unit, or line item to another.
- 36) "Transfers" are the provision of goods and services, assets (including financial assets), or labor that do not require the recipient to provide a good, service, payment, or payment-in-kind in return.
- 37) "Treasury Consolidated Account" is a system managed by the Ministry of Finance for consolidating the balances of the cash accounts of the federal government for the purpose of efficient cash management.
- 38) "Treasury general ledger" is a system, based on double entry principles, of accounting for, executing, and reporting the budget.
- 39) "Treasury Single Account" is a bank account, or a set of linked bank accounts, of the government through which all government receipts and payments are channeled. It is controlled by the Ministry of Finance and is maintained at the Central Bank.
- 40) "Government" is the public authorities and agencies of Iraq, which are entities established through political processes, and that exercise legislative, judicial or executive authority within the territory of Iraq. Government does not include public corporations.
- 41) "Government debt" consists of all liabilities of the government that require payment or payments of interest and/or principal by the borrower to the lender at a date or dates in the future.
- 42) "Petroleum revenue" is petroleum export revenue, non-tax revenue earned from the sale of petroleum to domestic buyers (collectively, petroleum non-tax revenue), and tax revenue levied on petroleum (petroleum tax revenue).
- 43) "Petroleum export revenue" is non-tax revenue earned from the sale of petroleum to foreign buyers.
- 44) "Publicly available" means that information is available for ready access by any member of the public. This includes, but is not limited to, publication in the Official Gazette, on an unrestricted website, or in widely available public newspapers.

Section 3 Exercise and Delegation of Authority

- 1) The Minister of Finance may issue regulations, instructions, guidelines or directions as necessary to give effect to and implement this Law.
- 2) The Minister of Finance may delegate to officials within the Ministry of Finance who are authorized persons those authorities that are conferred upon him under this Order, except the authority to waive the right of the federal government to collect amounts owing, to submit the draft annual federal budget to the Council of Ministers, and to sign borrowing and guarantee contracts of the federal government.

Section 4 General Provisions

- 1) The budget is adopted for the fiscal year and shall be valid during the year for which it is passed. Unspent appropriations will lapse at the end of the fiscal year for which they have been approved, except to the extent that goods and services have been validly ordered and received.
- 2) The draft annual budget law will be determined by the Council of Ministers and will be submitted by the Minister of Finance by October 10th to the body vested with national legislative authority for approval or adjustment pursuant to Article 33(C) of the TAL.
- 3) Pursuant to Article 25 of the TAL, the federal government has exclusive competence in drawing up the federal budget of Iraq. The Governorate Council, pursuant to Section 2 of the Local Governmental Powers Law, possesses the limited amendment authority to amend the budget plan of a ministry with regard to a specific project. Individual governorates' budgets for the fiscal year shall be passed by the Governorate Councils. Individual regions' budgets for the fiscal year shall be passed by the regional governments.
- 4) The annual federal budget shall comprise:
 - a) the receipts and payments in cash or in kind of all government ministries, organizations, and agencies of the federal government; and
 - b) transfers, including to regional governments, governorates, and municipal and local governments, including special budgetary funds.
- 5) The source of all receipts shall be specifically identified in the budget. All payments for the budget year and commitments for future years shall be disclosed in the budget, and the nature and duration of these commitments shall be limited as specified in the annual budget laws.
- 6) The difference between receipts (excluding borrowings) and payments (excluding repayments of debt principal) is the budget surplus (if positive) or the budget deficit (if negative).

7) Receipts consist of:

- a) Tax revenues:
 - 1. Petroleum tax revenues;
 - 2. Non-petroleum tax revenues;
- b) Non-tax revenues:
 - 1. Petroleum non-tax revenues;
 - 2. Non-petroleum non-tax revenues;
 - 1) Social security contributions;
 - 2) External grants;
 - 3) Others;
- c) Domestic and external borrowing;
- d) Repayment of government lending;
- e) Proceeds from asset transfers:
- f) Transfers of surplus profits from the Central Bank of Iraq in accordance with the relevant provisions of the Central Bank Law;
- g) Transfers from public corporations;
- h) Transfers from regional governments, governorates, and municipal and local governments, including special budgetary funds.

8) Payments consist of:

- a) Current expenditures, including for salaries and other allowances, outlays for goods and services, current transfers, including pensions and social security payments, that are paid in cash or have been issued in kind, interest payments and transfers in kind;
- b) Capital expenditures for purchase of fixed assets, inventories, intangible assets, financial assets, capital transfers that are paid in cash or have been issued in kind, and grants;
- c) Gross lending;
- d) Repayment of external and domestic debt;
- e) Other payments in accordance with the laws of the federal government;

- f) Transfers to the Central Bank of Iraq in accordance with the relevant provisions of the Central Bank Law;
- g) Transfers to public corporations;
- h) Transfers to regional governments, governorates, and municipal and local governments, including special budgetary funds.
- 9) A Treasury Consolidated Account shall be established and maintained within the Ministry of Finance. Subject to the transition provisions in Section 15, all receipts shall be credited to the Treasury Consolidated Account and paid into the Treasury Single Account, and all payments shall be debited to the Treasury Consolidated Account and withdrawn from the Treasury Single Account. All federal budget receipts, commitments, expenditures, and other payment transactions shall be entered into the Treasury's General Ledger.
- 10) The Minister of Finance shall issue orders to open bank accounts and such accounts must have a title that includes the words "federal government." An authorized person may dispose of federal government money only in accordance with this law and with regulations properly promulgated by the Minister of Finance. An authorized person must not misapply, improperly dispose of, or improperly use federal government money in contravention of this Law. Violations of this Law are subject to applicable administrative and criminal penalties under the legislation of Iraq, including Article 2(g) of Law Number 7 of 1958, Wastage of Natural Resources and Squandering of Public Assets and Funds, and applicable provisions of Law Number 111 of 1969, as amended, including provisions relating to bribery by public officials, embezzlement by public officials, and officials who overstep the bounds of their duty.
- 11) Subject to the monetary limits established by the Council of Ministers, the Minister of Finance may waive the right of the federal government to collect an amount owing, postpone the time of payment, or allow payment by installment only under the conditions and procedures provided by law.
- 12) The Minister of Finance shall report each and every such written-off sum or postponement to the Council of Ministers with the explanation for the write-off. This report shall be submitted quarterly with a final summary report to be submitted with the annual final accounts of the federal budget. These reports will be made publicly available.
- 13) The annual federal budget shall stipulate the use of the budget surplus or the means of financing the budget deficit.
- 14) The budget deficit shall be financed by cash balances of the federal government, short-term borrowings, domestic and external loans, or by the issuance of government debt securities. Short-term borrowings may be used for the purpose of ensuring liquidity during a period no longer than six months.

15) The annual federal budget shall be accompanied by documents that shall state the objectives and operating rules for fiscal policy, including constraints on borrowing and federal government debt, in accordance with the principles stated in Section 1 and with the provisions in Section 6(1) of this law and following Section 7(1), and will report on progress against these objectives.

Section 5 Management of Petroleum Revenues

- 1) All proceeds from the sale of petroleum or otherwise derived from current and prospective petroleum extraction, including from the federal government's production shares and royalties, and from the amount paid in respect of a right to explore for petroleum resources, and any amount derived from the investment of amounts in the petroleum revenue account, shall accrue to the budget. Except as provided in paragraph 2 of this section, below, or as may otherwise be required by applicable United Nations Security Council Resolutions (UNSCRs), the receipts from the export of petroleum shall be deposited into the Development Fund for Iraq (DFI) account to be held in the name of the Central Bank of Iraq, or a successor account to the DFI, hereafter generically referred to as the petroleum revenue account, and reflected accordingly as receipts and transfers to and from the budget.
- 2) Pursuant to United Nations Security Council Resolution 1483 (2003), and subsequent related UNSCRs, five percent (or such other percentage as may be determined by the United Nations Security Council or jointly by the internationally recognized, representative government of Iraq and the Governing Council of the United Nations Compensation Commission in accordance with UNSCR 1483) of the receipts from the export of petroleum shall be transferred to the Compensation Fund established in accordance with UNSCR 687 (1991) and subsequent relevant UNSCRs and the balance of receipts from the export of petroleum shall be deposited into the petroleum revenue account. These transfers to the Compensation Fund will be shown in the budget.
- 3) Disbursements from the petroleum revenue account shall be restricted to disbursements necessary to finance the budget, which shall include adequate provision for the government's obligations under any relevant UNSCRs or international law.
- 4) In the event that a successor account to the original DFI is established or the original DFI is continued beyond the date of the transfer of governance authority to the Iraqi Interim Government, the following will apply:
 - a) Operational responsibility for the petroleum revenue account will be with the Minister of Finance, reporting to the Council of Ministers, which shall take advice from the Governor of the Central Bank and such other individuals as the Council may deem appropriate. The Council, in its discretion, may delegate responsibility for oversight of the operation of the petroleum revenue account to a committee, which shall be composed of such individuals as the Council may determine, and shall include, as a minimum, the Minister of Finance, the Minister of Oil and the Governor of the Central Bank in an advisory capacity.

- b) Disbursements from the petroleum revenue account require the authorizing signature of at least two authorized persons, one of whom is an official in the offices supporting the Prime Minister or Council of Ministers and reporting to the Prime Minister and the other a permanent employee of the Ministry of Finance, designated by the Prime Minister and the Minister of Finance, respectively. The persons to whom authority has been delegated may not delegate to another person.
- c) Any positive balance in the petroleum revenue account may be invested by the Minister of Finance with the written consent of the Council of Ministers or the committee mentioned in section 5(4)(a) of this law. Any amount so invested shall at all times remain the property of the Government of Iraq. No contract or agreement that purports to encumber the assets of the petroleum revenue account shall be enforceable, and the assets shall continue to enjoy all privileges and immunities to the extent provided by UNSCR 1483, or as otherwise decided by the UN Security Council.
- d) The activities of the petroleum revenue account shall be subject to external audit conducted under the oversight of the Board of Supreme Audit, which shall act in accordance with Law Number 6 of 1990 as amended by CPA Order Number 77 (CPA/ORD/18 April 2004/77), except as otherwise provided by relevant UN Security Council Resolution.
- 5) The Minister of Finance shall make publicly available details of the petroleum revenue account; including opening and closing balance, underlying assets, and summary of movements, within three weeks of the end of each month. The Minister of Finance will authorize a quarterly review of the investment position, and by the end of the month following the end of each quarter submit a report on the results of the review to the Council of Ministers or the committee mentioned in section 5(4)(a) of this law. The final report for each year will detail each investment and enumerate the changes in the portfolio over the year and will be made publicly available.

Section 6 Budget Preparation

1) The preparation of the federal budget shall be based on the projections of economic development, the pursuit of macroeconomic stability, economic policy, and applicable laws and regulations, and shall be prepared with due regard to the desirability of ensuring the sustainability of Iraq's fiscal position, minimizing fluctuations in government spending, and achieving efficient revenue collection. In particular, the preparation of the federal budget will be based upon prudent and conservative forecasts for petroleum prices, petroleum production, and tax and customs revenue. The projections shall be prepared by the Ministry of Finance in consultation with the Central Bank and other Ministries in their respective areas of expertise.

- 2) During the month of May of each year, the Minister of Finance, shall issue a report on the priorities for fiscal policy for the next fiscal year, including the proposed total limit on spending and the limits for each individual spending unit, and submit it to the Council of Ministers for approval, together with the Final Accounts of the Federal Budget as submitted to the Board of Supreme Audit according to section 11(6) of this law, and an update on progress in execution of the budget in the current fiscal year. The Minister of Finance shall consult with the Minister of Planning and Development Cooperation on priorities, estimates of total funding, and procedures for preparing the capital spending plan and current budgetary implications of capital expenditures, including those to be implemented or financed by external sources.
- 3) In the month of June of each year, the Minister of Finance, in consultation with the Minister of Planning and Development Cooperation, and based on the priorities for fiscal policy established by the Council of Ministers, shall issue a circular setting guidelines and objectives of fiscal policy for spending units for the preparation of their budgets. The circular shall include key economic parameters, based on the macroeconomic framework referred to in Section 7(1), the procedures and timetable for budget preparation, as well as total levels of expenditure for each spending unit. This will serve as the basis for the spending unit to prepare its budget request.
- 4) In the month of July of each year, spending units will submit requests, including the information prescribed below, to the Minister of Finance for the allocation of funds. Copies of requests for the capital portion of the budget will also be submitted to the Ministry of Planning and Development Cooperation. Each request shall include:
 - a) The expenditure estimates for the budget year as prescribed in the economic and functional classification systems determined by the Minister of Finance in accordance with international accounting standards, including the value of outstanding commitments for the current or prior year;
 - b) Consistent with the guidelines issued by the Minister of Finance, the expenditure estimates for the year following the budget year (the "upcoming fiscal year") and to the extent permissible given conditions prevailing in Iraq, for the two fiscal years following the upcoming fiscal year as prescribed in the economic and functional classification system determined by the Minister of Finance, in accordance with international accounting standards:
 - c) Estimates of personnel requirements for which budgetary funds are required;
 - d) Estimates of the requirements for other operating costs;
 - e) Multi-year commitments or multi-year payments, along with separately prepared capital expenditures; and
 - f) Estimates of receipts from the core activities of spending units.

- g) Estimates of the proportion of expenditures that would be due in foreign currency.
- 5) The Minister of Finance may determine more specific requirements for the content and format of the request.
- 6) The Minister of Finance, in consultation with the Minister of Planning and Development Cooperation shall, on the basis of the estimates of revenue and submitted budget proposals for the allocation of budget funds, and in the light of discussions with proposing Ministers, determine estimated payments for spending units for the budget, as well as any amounts to be included in the contingency reserve.
- 7) In the event of an irreconcilable disagreement during discussions on the draft annual federal budget between the Minister of Finance and the Ministers responsible for spending units, the Minister of Finance will note the disagreement and explain his proposed solution in his submission of the draft annual federal budget. In determining the proposed solution, the Ministry of Finance may consult with the Ministry of Planning and Development Cooperation regarding the prioritization of capital expenditures. The Council of Ministers may, within the agreed aggregate limit, adjust appropriations in accordance with their collective priorities. Any increase in the aggregate spending limit must be based on a proposal submitted by the Minister of Finance and approved by the Council of Ministers.
- 8) In the month of September of each year, the Minister of Finance shall prepare the draft annual federal budget and submit it to the Council of Ministers for approval. The Minister of Finance shall submit the budget by October 10th to the body vested with the national legislative authority for approval.

Section 7 Budget Law

- 1) In preparing the draft annual budget law the following shall be taken into account, disclosed to the body vested with national legislative authority, and made publicly available in the documents accompanying the budget law:
 - a) A statement of the objectives and operating rules for fiscal policy in accordance with the principles stated in this law, and an explanation of how these objectives relate to provisions in the annual budget law.
 - b) A comprehensive and consistent quantitative macroeconomic framework, and the main assumptions underlying the budget, including the assumptions for oil prices and oil production. To the extent permissible given conditions prevailing in Iraq, the macroeconomic framework shall cover the budget year and the subsequent three years;
 - c) New policies being introduced in the annual budget and their quantified fiscal impact;

d) Major fiscal risks, quantified where possible, including variations in economic assumptions and the uncertain costs of specific expenditure commitments, including financial restructuring;

2) The draft annual budget law shall include:

- a) The estimation of receipts in cash and in kind in accordance with economic classification;
- b) The estimation of payments in cash and in kind in accordance with economic, organizational, and functional classifications;
- c) The use of any surplus, and the financing of any deficit;
- d) The contingency reserve, which shall be no greater than 5% of the non-interest expenditures of the federal budget;
- e) Clear specification of the rules for authorization of expenditure and limits to expenditure. Limits on borrowing, issuance of government debt securities, change in stocks of government debt securities, and guarantees consistent with the Public Debt Law, and the authority granted to the Minister of Finance to buy, redeem, or refund outstanding government debt securities;

and the draft budget law shall be accompanied by a report on the economic and financial situation, including the assumptions, methods, and outcomes of the economic projections on the basis of which the draft annual Federal budget law is established, including actual revenues, expenditures, balance and total debt of the general government for the past two years.

- 3) The body having national legislative authority has the right to reallocate proposed spending and to reduce the total amounts in the federal budget. It also has the right to propose an increase in the overall amount of expenditures to the Council of Ministers if necessary, and provide notice of this proposal to the Minister of Finance. The Minister of Finance will make a nonbinding recommendation to the Council of Ministers with respect to this proposal.
- 4) If the federal budget is not approved by the body vested with national legislative authority by December 31st, the Minister of Finance will, on a monthly basis, approve funds for spending units up to 1/12 (one twelfth) of appropriations of the previous fiscal year until a budget is approved. The funds so provided for can be used only for liquidation of existing commitments, salaries, pensions, social security payments, and debt service.
- 5) The annual federal budget may be amended through a supplementary budget only on the basis of a significant and unexpected change in economic circumstances or national priorities. The supplementary budget must be determined by the Council of Ministers on recommendation

of the Minister of Finance and approved by the body vested with national legislative authority. Should the Minister of Finance conclude that a supplementary budget is required, he shall make appropriate recommendations, including on proposed total receipts and payments, to the Council of Ministers. The Minister of Finance shall, within eight weeks after recommending that the Council of Ministers adopt a supplementary budget, submit details of the draft supplementary budget to the Council of Ministers for approval. The Council of Ministers shall approve such recommendations, with any appropriate modifications, within two weeks of receiving them. The draft supplementary budget, as approved by the Council of Ministers, shall be submitted to the body vested with national legislative authority within one week of such approval. The Minister of Finance shall issue regulations and guidelines for the procedures to be followed in preparing the supplementary budget.

- 6) The revenues and expenditures of special budgetary funds are to be reflected in the annual budget law.
- 7) The approved federal annual and supplementary budgets shall be published in the *Official Gazette* and made publicly available in other media, as appropriate.

Section 8 Public Corporations

- 1) Each public corporation shall prepare its budget proposal, and after approval by its directors and the competent minister, submit it to the Minister of Finance for review and final approval. The budget should, among other things, show budgeted revenues, expenses, profits or loss, capital expenditure, cash flows, borrowings, grants, transfers, contingent liabilities including guarantees, and balance sheet. Any amendments to the budget shall also be submitted to the Minister for Finance for review and approval. The Minister of Finance shall respect the operational independence of public corporations.
- 2) The budgets of public corporations are not incorporated into the federal government budget and are not incorporated into the budgets of any other level of government.
- 3) Public corporations shall submit by August 31st estimates of total loans and short-term borrowings to be raised in the forthcoming fiscal year for approval by the Minister of Finance. Public corporations will report monthly to the Minister of Finance on the amount of loans and short term borrowings raised. Guarantees given by the federal government in respect of public corporations borrowings shall be in accordance with law, and shall be disclosed in the final accounts of the federal government.
- 4) All public corporations shall submit their monthly accounts to the competent ministry 10 days following the end of each month. All public corporations shall submit semi-annual accounts to the Minister of Finance no later than July 15th. Each public company shall submit its audited final accounts to the Minister of Finance no later than March 31st of the year following the fiscal year ended. The final accounts shall include balance sheet, profit and loss statement, cash flow statement, and notes to the final accounts covering, among other things,

accounting policies, revenues and expenses, assets and liabilities including borrowings, commitments, and contingent liabilities. The final accounts shall be prepared in accordance with international standards and shall be audited by an independent auditor.

Section 9 Budget Execution

- 1) The Minister of Finance is responsible for the execution of the federal budget.
- 2) No payments will be made from the Treasury Consolidated Account except under an appropriation made in the annual budget or supplementary budget law, under a standing appropriation of another Law, or to make an investment in terms of Section 5(4)(c) of this Law.
- 3) Spending units will use the funds determined in the federal budget in accordance with a spending plan that has been approved by the Minister of Finance.
- 4) Spending units may not commit to making expenditures that exceed the amounts allocated to them, unless otherwise provided by the budget law.
- 5) Budget executors are responsible for ensuring that allocated funds within their spending units are used for lawful purposes.
- 6) Appropriations for contingency reserve funds may be used for payments that are urgent and that were unforeseen at the time the annual budget law was passed, if approved by the Council of Ministers and the Minister of Finance. The Minister of Finance shall propose the criteria for using reserve funds for approval by the Council of Ministers. All expenditures from the reserve will be reported to the body vested with national legislative authority.
- 7) In accordance with regulations prescribed by the Minister of Finance, the spending units, governorates, and special budgetary funds shall submit reports on realized receipts and executed payments to the Minister of Finance within 30 days following the end of each month. By the 15th of the subsequent month, the Ministry of Finance shall compile a consolidated report on realized receipts and executed payments on the basis of the reports submitted, and make it publicly available in the *Official Gazette* and other media, as appropriate.
- 8) The Ministry of Finance can authorize the responsible Minister or Ministers, subject to the provision below, to reallocate the approved budget appropriations from one spending unit to another up to a limit of five per cent of the amount approved by the annual or supplementary budget law for the spending unit that is to have its appropriation reduced. The following restrictions apply:
 - a) No funds can be reallocated between a current expenditure of one spending unit and the capital expenditures of another or between transfer payments of one spending unit

and other items, including salaries, goods, and services or capital expenditures, of another.

- b) Spending units may, with the approval of the Minister of Finance, reallocate their approved funds between line items by up to 5% of the total amount of funds approved provided that no funds can be reallocated from capital to current expenditures or between transfer payments and other current expenditures, including salaries, goods and services. Virement from salaries or current spending to capital spending of up to 5% may be permitted with the approval of the Minster of Finance.
- c) A report of these transfers shall be prepared by Ministry of Finance and submitted on a quarterly basis to the body vested with national legislative authority. A copy of such report will be forwarded to the Minister of Planning and Development Cooperation.
- 9) Funds approved for spending units may be used only until the December 31st of the fiscal year, except to the extent that goods and services have been validly ordered and received. Receipts received after the end of a fiscal year will be recorded as receipts of the next fiscal year budget.

Section 10 Borrowings and Guarantees

- 1) Federal government debt may be in the form of domestic and foreign loans, short-term borrowings, and securities issues. The issue and redemption of securities shall be managed by the Central Bank of Iraq as the agent for the federal government. The Ministry of Finance and the Central Bank shall share information on government cash and borrowing needs and current monetary conditions in order to ensure effective coordination of monetary and budgetary policy.
- 2) Governorates and regional governments may, upon notification to the Minister of Finance, raise funds through borrowings, and issue loan guarantees subject to the debt limit set in the annual budget law, and to the specific debt limit set for each entity under the apportionment approved by the Council of Ministers on a recommendation of the Minister of Finance. Regional governments and governorates shall submit by August 31st estimates of total outstanding borrowings, and borrowings to be raised in the forthcoming fiscal year for review and for approval by the Minister of Finance. Regional governments and governorates will report to the Minister of Finance monthly on the amount of outstanding borrowings raised and loan guarantees issued.
- 3) The Ministry of Finance shall submit to the Council of Ministers for approval with the draft annual budget law, the financial plan on loans, short-term borrowing, and the issuing of guarantees by the federal government, governorates regional governments. In addition, the Ministry will submit to the Council of Ministers a report any time that the plan must be changed. Such changes must remain within the limits set by the budget. The Ministry of

Finance shall have the right, upon notification to the affected governorate or regional government, to adjust the timing of the issuance of governorate or regional government debt approved in the plan on the basis of macroeconomic and debt policy considerations.

- 4) The annual budget law shall determine the terms, conditions, and the limit on the annual increase in the total existing federal government, regional government and governorate and public corporation debt, and shall establish the total amount of guarantees to be issued by the federal government, regional governments, governorates, and public corporations.
- 5) The federal government shall set limits for guarantees issued by regional governments and governorates, but shall not guarantee them, unless explicitly provided in law.
- 6) The Minister of Finance shall sign the borrowing and guarantee contracts of the federal government, and shall enter into a contract with the Central Bank for services required in implementing all decisions on issues of securities.
- 7) The Minister of Finance shall maintain a record of all federal government debt. The authorized body within the regional governments and governorates shall maintain a record of existing regional government and governorate debt, loans granted, short-term borrowings, and issued guarantees, and shall provide the Ministry of Finance with an updated record of this information within 30 days of the end of each month.
- 8) The Minister of Finance shall prepare a consolidated report on all government debt within 90 days of the end of each fiscal year and shall make this report available to the public.

Section 11 Internal Control and Accounting

- 1) Budget executors shall be responsible for the accounting and internal control of transactions related to receipts, commitments, and payments of spending units and sub-units falling within their jurisdiction.
- 2) The Minister of Finance shall, on behalf of the federal government, have responsibility for the accounting, internal control, borrowing, and debt transactions associated with the budget.
- 3) The Minister of Finance shall prescribe internal control arrangements, accounting procedures and standards, submission of reports on the usage of budget funds, and the manner of recording receipts, payments, and commitments.
- 4) The Minister of Finance may issue special orders to spending units, governorates, municipal and local governments, and other budget entities for their submission of financial reports and shall prescribe the submission of the Final Accounts of spending units, including regional governments, governorates, municipal and local governments, and other budget entities.

- 5) The Minister of Finance shall submit to the body vested with national legislative authority by May 31st and November 30th, quarterly reports on the execution of budget revenue, expenditures, and financing for the quarters ending March 31st and September 30th, respectively. This report will include the execution of budget revenue, expenditures and financing of the federal budget. The Minister of Finance shall also submit to the body vested with national legislative authority by August 31st of each year a mid-year report on execution of budget revenue, expenditures, and financing for the half year ending June 30th. This report will include detailed information on the execution of budget revenue, expenditures and financing of the budget.
- 6) The Minister of Finance shall, by April 15th of the succeeding year, prepare the annual final accounts of the federal budget, including special budgetary funds, and submit it to the Board of Supreme Audit. The Board of Supreme Audit will provide an audit report on the final accounts by June 15th. The Council of Ministers will submit final accounts and the related audit report to the body vested with national legislative authority by June 30th.
- 7) The final accounts of the federal budget must be in accordance with the content and classifications of the budget and international accounting standards, and shall include the following:
 - a) An external audit report from the Board of Supreme Audit in accordance with the Board of Supreme Audit Law, as amended, and its established procedures;
 - b) The initial and final balance of the Treasury Consolidated Account and a summary of movements for the year;
 - c) A report on differences between budgeted and executed receipts and payments and on the financing of any deficit or the use of any surplus;
 - d) A report of all federal government borrowings for the year, and the total debt outstanding, including any payment arrears;
 - e) A report of spending from the budget contingency reserves;
 - f) A report on federal government guarantees issued during the fiscal year;
 - g) The Minister of Finance shall prepare a report of all borrowings by regional governments and governorates;
 - h) Outstanding amounts on capital contracts;
 - i) Retentions due on contracts;
 - j) Letters of credit entered into for which funds have been placed but for which goods have not been received:

- k) The Minister of Finance shall prepare a report on all guarantees by regional governments and governorates.
- 8) Following approval of the final accounts of the annual federal budget by the body vested with national legislative authority, the final account shall be published in the *Official Gazette* and made publicly available.

Section 12 Ministry of Finance Functions

- 1) The Ministry of Finance shall be responsible for, but is not limited to, conducting the following treasury functions:
 - Executing all cash and non-cash payments on the basis of documentation and data supplied manually or electronically by spending units, in accordance with this Law;
 - b) Maintaining the Treasury general ledger and subsidiary accounts;
 - c) Processing budget allocations to spending units;
 - d) Preparing the federal government's final accounts;
 - e) Ensuring that no budget executor can exceed his annual appropriation;
 - f) Developing and managing the federal government's accounting and financial information system;
 - g) Providing regular financial reports as required;
 - h) Supporting analysis and improvements to the federal government's financial systems;
 - i) Making payments from the current and permanent reserves;
 - i) Managing the cash balances of the Treasury Consolidated Account and the investment of the federal government's surplus cash balances;
 - j) Managing the recording of domestic and external debt;
 - k) Managing the recording of international grants, assistance, and loans;
 - l) Preparing government accounting and financial management standards, regulations, and related legislation;

- m) Managing the opening, recording, and reconciliation of government bank accounts; and
- n) Managing the operations of the Regional Treasury Offices.
- 2) The Ministry of Finance shall be responsible for, but is not limited to, the following budget formulation functions:
 - a) Managing the process of budget preparation, planning and development, including the preparation of macroeconomic and other economic advice;
 - b) Proposing guidelines for the preparation, planning, execution, revision, and evaluation of budgets;
 - c) Preparing the annual budget law, any supplementary budget laws, and making them publicly available;
 - d) Monitoring receipts and execution of payments, including petroleum revenues;
 - e) Preparing cash flow forecasts;
 - f) Providing advice to the Council of Ministers on requests by spending units for the reallocation of appropriations and implementing decisions on reallocations;
 - g) Making payments from the current and permanent reserves.
 - h) Providing advisory support on budgetary issues to all spending units; and
 - i) Preparing reports on budget preparation and budget execution for international economic organizations.
 - j) Preparing regulations, instructions, guidelines and directions under this Law and on amendments to this Law.

Section 13 Internal Audit

- 1) The Minister of Finance shall prescribe the manner and procedures by which Ministries, spending units, and public corporations will undertake internal audits, and is responsible for ensuring that the internal audit process is conducted in accordance with these rules and procedures.
- 2) Internal Audit performance consists of the following:

- a) Providing regular assessments of the adequacy and effectiveness of the Ministries' decision-making processes, minimization of risk, and internal control:
- Reporting significant internal control issues and improving the control processes and information system in order to minimize risk in the decisionmaking process;
- c) Reviewing the efficiency and effectiveness of the use of existing services, and proposing more efficient ways of providing these services;
- d) Liaising with the external audit agency; and
- e) Providing periodically information on the status of the execution of the annual audit plan.

Section 14 External Audit

- 1) The federal budget and any supplementary budget shall be subject to annual audits by the Board of Supreme Audit, according to the law.
- 2) In order to facilitate this audit, the Minister of Finance shall make available to the Board of Supreme Audit:
 - a) The approved federal budget and any supplementary budgets, and any accompanying documents;
 - b) The reported results of all internal audits;
 - c) The quarterly and annual reports on loans, borrowings, guarantees, and debt;
 - d) Final accounts of public corporations and the results of all audits;
 - e) Documents discussed by the Council of Ministers its role of oversight of operations for any successor to the DFI, or by any committee delegated with this role according to section 5(4) of this Law, as well as the results of any internal audits; and
 - f) Any other documents, information and explanation requested by the Board of Supreme Audit in connection with the performance of its audit functions.

Section 15 Transitional Arrangements

- 1) To the extent that this Law is inconsistent with existing laws, the provisions of this Law shall prevail.
- 2) Regulations implementing this Law shall be approved within 12 months from the day of enactment of this Law. Until these regulations are approved, existing regulations shall continue to apply, to the extent consistent with this Law.
- 3) In transitioning to the Treasury Single Account, the Minister of Finance is hereby authorized to close the accounts of the federal government Budget Accounts opened at the Central Bank or in any other banks. Resources remaining in Federal Budget user accounts are to be transferred to the Treasury Single Account and reflected in the Treasury Consolidated Account. Until the closure of the existing bank accounts is completed and the Treasury Single Account is fully established, the Minister of Finance is authorized to operate the existing bank accounts on a zero-balance basis under which balances of these accounts will be transferred to the Treasury Single Account on a daily basis. Should circumstances make daily transfers impracticable, the Minister of Finance shall institute transfers as frequently as practicable.
- 4) Law Number 107 of 1985 on Consolidated Government Budget (as amended by Law Number 48 of 1990), and Law Number 20 of 1940 on General Accounting Principles shall not have effect for the fiscal year 2005 and subsequent years.
- 5) The Minister of Finance is authorized to promulgate rules that will facilitate accurate financial reporting during the period in which Iraq is undergoing the transition to international accounting standards ("interim standards"). These interim standards shall apply only for the fiscal year with respect to which they are promulgated. Reports prepared for these periods that are otherwise required to comply with international accounting standards may comply with either the interim standards or international accounting standards.
- 6) Unless otherwise provided by relevant UNSCR and the Transitional Administration Law, including its Annex, prior to the establishment of a national legislature, the Council of Ministers shall serve as the final approval authority for the federal budget, subject to the approval of the Presidency. During such period, if the federal budget is not approved by the Presidency and the Council of Ministers, the Minister of Finance will, on a monthly basis, approve funds for spending units up to 1/12th one twelfth of appropriations of the previous fiscal year until the budget is approved.
- 7) To the extent that the relevant UNSCR and the Transitional Administration Law, including its Annex, attributes executive power to a body or person different than the Council of Ministers, powers and responsibilities delegated to the Council of Ministers by this Law shall be delegated instead to the executive body or person so identified in the relevant UNSCR or the Transitional Administration Law.

8) Upon the transfer of governmental authority to the Iraqi Interim Government, the Program Review Board established pursuant to Coalition Provisional Authority Regulation Number 3 (CPA/REG/18 June 2003/3) shall cease to perform budgetary functions for Iraq and shall dissolve.

Section 16 Entry into Force

This Law shall enter into force on the same date that the Order authorizing this law enters into force. It shall apply to the budget of the fiscal year 2005 and subsequent years, and additionally, following the transfer of governance authority to the Iraqi Interim Government, shall apply to any supplementary budgets for fiscal year 2004.

IRAQ

PUBLIC DEBT LAW

Section I Definitions

For the purposes of this law, the terms below are defined as follows:

"Bank" means a bank as defined under the Banking Law.

"Government" means the entity exercising temporary governmental authority in Iraq on the date this law enters into force and then the transitional Iraqi administration upon the transfer to it of full governmental authority and the recognition of the sovereignty of that administration by the CPA, and then the internationally recognized representative government of Iraq once it assumes the responsibilities of such authority.

"Government Debt Security" means a debt security issued by the Ministry of Finance, including debt securities lawfully issued prior to the effective date of this Law. The term "debt security" shall have the same meaning assigned to it in the Banking Law.

"Minister" means the Minister of Finance acting in an official capacity.

"Official Publication" means the Official Gazette or such other general publication of wide circulation as specified by the Council of Ministers or its delegee.

"Owner" means the person registered as the owner of a Government Debt Security on the books of the government securities registrar.

Section II Authorities and Duties Pertaining to the Issuance of Government Debt Securities

- 1. The Minister shall have authority to issue Government Debt Securities as an obligation guaranteed by the Government only in amounts reasonably necessary for expenditures authorized by law and in amounts necessary to buy, redeem, or refund outstanding Government Debt Securities.
- 2. The issue and redemption of Government Debt Securities shall be managed by the Central Bank of Iraq as the agent for the Government.

- 3. The Minister shall have authority to set the terms and conditions for Government Debt Securities before they are issued, such as:
 - (a) the date of maturity;
 - (b) the offering price and interest rate;
 - (c) the method of computing the interest rate;
 - (d) the dates for paying principal and interest;
- (e) whether a debt security is to be issued on an interest-bearing basis, a discount basis, or an interest-bearing and discount basis;
 - (f) the form of the security;
 - (g) the currency in which the debt is issued; and
 - (h) any other condition not prohibited by law.
- 4. The Minister shall have authority to determine how it will offer Government Debt Securities for sale, such as by competitive auction and by subscription.
- 5. The Minister shall have authority to offer Government Debt Securities for sale to any person.
- 6. The Minister shall deposit without delay all proceeds from the sale of Government Debt Securities into the public treasury or an authorized depositary.

Section III Authorities and Duties Pertaining to Outstanding Debt Securities

- 1. The Minister shall have authority to buy, redeem, or refund Government Debt Securities in accordance with their terms and conditions using public funds.
- 2. The Minister shall have authority to give relief to owners of lost, defaced, or destroyed Government Debt Securities in accordance with regulations issued by the Minister.

- 3. The Minister shall pay principal and interest in legal tender when due, or earlier in his discretion, in accordance with the terms and conditions of the Government Debt Security.
- 4. The Minister shall have a permanent and indefinite appropriation of public funds for the purpose of buying, redeeming, or refunding Government Debt Securities and for the purpose of paying interest on those securities.

Section IV Authorities Pertaining to Fiscal Agents and Depositaries

- 1. The Minister shall have authority to engage the Central Bank of Iraq, and any other Bank, as a fiscal agent for the purpose of carrying out any function authorized by this Law.
- 2. The Minister shall have authority to designate Banks that are eligible to act as depositaries for any part of the proceeds from the issuance of Government Debt Securities. The Minister shall have authority to prescribe conditions for the deposit of public money, including the interest rate on amounts deposited.
- 3. The Minister shall have authority to transfer public money in a depositary's possession to the public treasury, and to transfer public money between depositaries.
- 4. The Minister shall have the authority to require his fiscal agent and depositaries to provide him with any information about their activities under this Law.

Section V Administrative Authorities and Duties

- 1. The Minister shall have authority to issue regulations, prescribe policies, and issue announcements for the purpose of implementing this Law and carrying out the Minister's functions under this Law.
- 2. The Minister shall have authority to delegate his duties and functions under this Law, except the power to delegate, to any person within the Ministry of Finance.
- 3. The Minister shall publish all regulations issued under this Law in the Official Publication.
- 4. Prior to any sale, the Minister shall list the terms and conditions applying to a Government Debt Security in a regulation or an offering announcement. An offering announcement shall be publicized in a manner that ensures wide circulation among potential buyers.

- 5. If the Minister proposes to issue a regulation pursuant to this Law, he shall publish a draft of the proposed regulation in the Official Publication. Along with the proposed regulation, the Minister shall publish an explanation of the regulation and provide at least thirty days after publication for the public to submit comments. The Minister shall consider all comments received. If the Minister determines that a final regulation is appropriate, the Minister shall issue the regulation accompanied by a general description of the comments and his response to those comments. The Minister may issue a final regulation without publishing a draft or considering public comment if the Minister determines that the delay involved would be a serious threat to the interests of the financial system or hinder the effective conduct of monetary policy. In such an event, the Minister shall publish an explanation of his decision to depart from the procedures in this paragraph in the Official Publication.
- 6. The Minister shall maintain a system of books and records
 - (a) describing all issued Government Debt Securities;
 - (b) identifying the dates when outstanding obligations come due; and
- (c) stating all amounts of principal and interest paid on Government debt securities.
- 7. The Minister shall make all its books and records pertaining to Government Debt Securities available for inspection upon request by the Prime Minister and Council of Ministers or its delegee.
- 8. On or before the end of the fiscal year, the Minister shall submit a report to the Prime Minister and Council of Ministers on the public debt activities of the Ministry of Finance. The report shall include, at a minimum:
- (a) A table showing the public debt from all outstanding Government Debt Securities as of the date of the report, the interest cost for that debt in the current year, and the projected interest cost for government debt over the next five fiscal years, taking into account projections for the budget.
- (b) A table showing the maturity distribution of the public debt from all Government Debt Securities outstanding as of the date of the report.
- (c) An explanation of the overall financing strategy used in determining the distribution of maturities and interest rates for Government Debt Securities issued during the current fiscal year.

Section VI Final Provisions

- 1. Any provision of Iraqi law that was enacted prior to the effective date of this Law and that is inconsistent with this Law is hereby superseded.
- 2. This Law shall enter into force on the same date that the Order authorizing this Law enters into force.

Doc Name	Document Date	Report Number	Document Type	Author	Collection Title	Country	Credit No	Disclosure Date	Disclosure Type ISBN	Language	Loan No	Major Sector	Rel. Proj ID	Region	Rep Title	Sector	Source Citation	SubTopics	Topics	Theme	TF No/Name	Unit Owning	UN Registration No Volume No
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													IQ-Iraq: Public					Procurement, Access to Finance, Public Sector Corruption &				Social & Economic	
Trust Fund Grant Agreement TF094552 Conformed (English)	JUL 20, 2009		Grant or Trust Fund Agreement	Soubbotin,Nikolai						English			Financial Mgmt Reform P110862 IQ-Iraq: Public					Anticorruption Measures	Trade, Public Sector Development		TF094552	Development Gp (MNSED)	LICUN
													Financial Mgmt Reform P110862,IC Public Finance	۵.				Post Conflict Reconstruction,E-	Finance and Financial				
													Management Project Bank-Executed Trust Fund,IQ: Public					Business,Banks & Banking Reform,Access to	Sector Development,Private Sector				
Trust Fund Grant Agreement TF094654. Conformed (English)			Grant or Trust Fund										Financial Management Project - Bank- executed TA	nt				Finance,Public Secto Corruption & Anticorruption	Development, Public Sector Development, Conflict			Social & Economic Development Gp	
Conformed (English)	JUL 20, 2009		Agreement	Soubbotin,Nikolai				1		English			component					Measures Public Sector Corruption &	and Development		TF094654	(MNSED)	LICUN
																		Anticorruption Measures,Public Sector Expenditure	Communities and	Public expenditure,			
													IQ-Iraq: Public	Middle East and Nor	rth Iraq - Public Financia	Sub-national government I administration,Centra	4	Analysis & Management, Housin & Human	Human Settlements, Finance and Financial Sector	financial management and procurement, Decentral		Social & Economic	
Irag - Public Financial Management Reform Project (English)	DEC 09, 2008	46833	Integrated Safeguards Data Sheet			Iraq				English		Public Administration, Law, and Justice	Financial Mgmt Reform P110862	Africa, Middle East a North Africa	nd Management Reform Project	government administration		Habitats,Debt Markets,m m,Public Sector	Development,Public Sector Development	ization,Administrative and civil service reform		Development Gp (MNSED)	1 of 1
																		Expenditure Policy,Debt Markets,Housing &	Communities and	Public expenditure,			
													IQ-Iraq: Public	Middle East and Nor	rth Iraq - Public Financia	Sub-national government I administration,Centra		Corruption &	Human Settlements, Finance and Financial Sector			Social & Economic	
Iraq - Public Financial Management Reform Project (English)	AUG 27, 2008	AC3514	Integrated Safeguards Data Sheet			Iraq		AUG 27, 2008		English		Public Administration, Law, and Justice	Financial Mgmt Reform P110862	Africa, Middle East a North Africa	nd Management Reform Project	government administration		Anticorruption Measures	Development, Public Sector Development	ization,Administrative and civil service reform		Development Gp (MNSED)	1 of 1

Doc Name	Document Date	Report Number	Document Type	Author	Collection Title	Country	Credit No	Disclosure Date	Disclosure Type ISBN	Language	Loan No	Major Sector	Rel. Proj ID	Region	Rep Title	Sector	Source Citation	SubTopics	Topics	Theme	TF No/Name	Unit Owning	UN Registration No Volume No
																				Public expenditure,	TF093400-IRAQ PFM PROJECT APR/SPN,TF094552- Public Finance		
Irag - IRAQ: Public Financial Mgmt Reform:													IQ-Iraq: Public	Middle East and Nor	ash.	Sub-natl govt admin,Central				financial management and procurement,Decentral	Management Project,TF094654-Iraq	Poverty Reduct &	
P110862 - Implementation Status Results Report : Sequence 04 (English)	APR 15, 2012	ISR6454	Implementation Status and Results Report	Arya,Arun		Iraq		APR 15, 2012		English			Financial Mgmt Reform - P110862	Africa, Middle East a North Africa	nd	government administration				ization,Administrative and civil service reform	Management Project - Bank Executed	Econ. Mgmt Dept (MNSPR)	
																					TF093400-IRAQ PFM PROJECT APR/SPN,TF094552-		
																Sub-natl govt				financial management and	Project,TF094654-Iraq		
Iraq - IRAQ: Public Financial Mgmt Reform: P110862 - Implementation Status Results Report: Sequence 03 (English)	JAN 03, 2012	ISR5663	Implementation Status and Results Report	Arya,Arun		Iraq		JAN 03, 2012		English			IQ-Iraq: Public Financial Mgmt Reform P110862	Middle East and Nor Africa, Middle East a North Africa		admin,Central government administration				procurement, Decentral ization, Administrative and civil service reform	Management Project -	Poverty Reduct & Econ. Mgmt Dept (MNSPR)	
																				Public expenditure, financial management			
Iraq - IRAQ: Public Financial Mgmt Reform: P110862 - Implementation Status Results	_		Implementation Status										IQ-Iraq: Public Financial Mgmt	Middle East and Nor Africa, Middle East a	nth nd	Sub-natl govt admin,Central government				and procurement, Decentral ization, Administrative			
Report : Sequence 02 (English)	APR 30, 2011	ISR3016	and Results Report	Khairi Said, Yahia		Iraq				English			Reform P110862	North Africa		administration				and civil service reform	TF093400-IRAQ PFM PROJECT	(MNSED)	
																		E- Business,Community Development and			APR/SPN,TF093376- IRAQ PUBLIC FINANCE		
																Sub-national		Empowerment, Debt Markets, Public Secto Corruption &	Development, Social		MANAGEMENT PROJECT COMPANION BANK-		
Iraq - Public Finance Management Project :	_											Public Administration,		Africa, Middle East a	rth Iraq - Public Finance nd Management Project	: government	d	Anticorruption Measures,Bankruptcj and Resolution of	Development, Private		EXECUTED TF,TF094552-Public Finance Management	Development Gp	
procurement plan (English)	OCT 01, 2010	57686	Procurement Plan			Iraq		NOV 07, 2010		English		Law, and Justice	Reform P110862	North Africa	procurement plan	administration		Financial Distress Public Sector Expenditure	Sector Development		Project	(MNSED)	1 of 1
																Sub-national		Policy,Debt Markets,Housing & Human	Communities and Human	Public expenditure, financial management			
Iraq - Public Financial Management Reform Project (English)	SEP 24, 2009	AR3737	Project Information Document									Public Administration, Law, and Justice	IQ-Iraq: Public Financial Mgmt Reform P110862	Middle East and Nor Africa, Middle East a North Africa	rth Iraq - Public Financia nd Management Reform Project	government I administration, Centra government administration	d .	Corruption & Anticorruption	r Settlements, Finance and Financial Sector Development, Public	ization,Administrative		Poverty Reduct & Econ. Mgmt Dept (MNSPR)	1 of 1
Project (Endish)	SEP 24, 2009	AB3737	Document			Iraq		SEP 24, 2009		English		Law, and Justice	Reform - P110862	North Ainca	Project	administration		Measures Banks & Banking Reform, Debt Markets, Government		and civil service reform		(MNSPR)	1011
													IQ-Iraq: Public					Procurement, Access to Finance, Public Sector Corruption &				Social & Economic	
Trust Fund Grant Agreement TF094552 Conformed (English)	JUL 20, 2009		Grant or Trust Fund Agreement	Soubbotin,Nikolai						English			Financial Mgmt Reform P110862 IQ-Iraq: Public					Anticorruption Measures	Trade, Public Sector Development		TF094552	Development Gp (MNSED)	LICUN
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																		Expenditure Policy,Debt Markets,Housing &	Communities and	Public expenditure,			
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Integrating of accrual cost information with performance information

Peter Gibson – Assistant Secretary, Accounting Policy, Dept of Finance & Administration, Australia

What is performance?

- Accountability for expenditure
- Accountability for managing
- Accountability for managing what ?
- The Australian experience responsible for managing all resources at the agency level

Performance Information

- Once the government moves to make managers accountability for managing, more than just cash accounting is necessary
- The approach in Australia requires full accrual accounting to provide the necessary information about costs and assets/liabilities
- Will also require some additional information not included in an accounting system

What does accrual accounting provide?

- Improved resource allocation
- Strengthened accountability
- Enhanced transparency of total resource costs
- A more comprehensive view of the impact of government on the economy
- Ability to judge the sustainability of government policies in the longer term

How does Australia budget and report?

- Full accrual budget (both GFS and IFRS)
- Full accrual reporting (both GFS and IFRS)
- IFRS reports are subject to audit
- IFRS fully implemented for 2005-06
- Looking to harmonise GFS and IFRS
- Constitutional requirement based on cash

Integrating cost with performance measurement – use in Australia

- Costing of outputs
- Financial management of agencies and for whole of government
- Financial performance of government business enterprises
- Decisions about the future social security, infrastructure

Preconditions

- Systems and skills to be able to make it work
- Specification of performance requirements
- Match responsibility and accountability
- Incentives and sanctions to encourage agency heads
- A clear performance assessment process
- Agreed arrangements to collect the necessary information

Australian implementation

- Accrual accounting part of a package of reforms
- Accrual reporting introduced first "big bang"
- Followed by accrual budgeting "big bang"
- Commentary on financial statements

PROJECT INFORMATION DOCUMENT (PID) CONCEPT STAGE

Report No.: AB3737

	Report No.: Ab5/5/
Project Name	IRAQ: Public Finance Management Project
Region	MIDDLE EAST AND NORTH AFRICA
Sector	Sub-national government administration (50%);Central
	government administration (50%)
Project ID	P110862
Borrower(s)	GOVERNMENT OF IRAQ
Implementing Agency	Ministry of Finance of Iraq
Environment Category	[] A [] B [X] C [] FI [] TBD (to be determined)
Date PID Prepared	September 24, 2009
Estimated Date of	February 11, 2009 (Actual)
Appraisal Authorization	
Estimated Date of Board	July 20, 2009 (Actual Date of Regional Vice President Approval)
Approval	

Comment [OPCS1]: The report number is automatically generated by the Internal Documents Unit (IDU) and should not be changed.

1. Key development issues and rationale for Bank involvement

- 1. Sound public financial management (PFM) is critical to ensuring efficiency and accountability in the management of public resources. Iraq is resource rich and has enjoyed a substantial increase in oil revenues in recent years. However, for the people of Iraq to benefit from its resource wealth, public finance reforms are a priority. Weaknesses in the PFM system not only have high costs in terms of allocative and operational efficiency but also create high levels of fiduciary risk.
- 2. The GoI has made progress in recent years but much remains to be done. Iraq has made progress in reforming public expenditure policy and management since 2003. Key measures include the adoption of a budget classification system that is compliant with Government Finance Statistics (GFS) standards and of a plan to integrate capital and current budgeting processes. However, many challenges remain. Selected examples include:
 - Budget Preparation: Budget negotiations between line ministries and central ministries are timeconsuming as line ministries are not provided with ceilings within which to prepare budgets. The
 technical capacity of staff to evaluate and approve capital projects has eroded due to high attrition
 in recent years.
 - Budget implementation: Annual implementation plans for projects presented by line ministries
 are often revised during the lifetime of the project. Sites for projects are poorly prepared and
 disputes regarding ownership of the sites lead to further delays. Some line ministries interrupt
 project execution after projects have been approved and there is no system by which central
 ministries (finance and planning) can either support the implementation of these projects or find
 an alternative solution to delays in initiating project implementation by affected line ministries.
 - Contracting issues: Few contractors have the capacity to implement large capital projects, often
 lacking even the capacity to prepare contracts that meet the detailed specification required for the
 projects. Work orders are frequently changed leading to delays. There is no system to resolve
 differences between the contractors and spending agencies speedily. Delays lead to increasing
 project costs that need to go through an approval process leading to further delays.
 - Payments System: The payments system is insufficiently flexible. Currently, Iraq uses a cash-

based payments system limited to the fiscal year; this precludes the ability to make commitments when necessary and make cash payments according to these commitments. The system also allocates the total cost over the period of execution and requires that these amounts be fully spent within assigned years.

- **Reporting**: The new chart of accounts is not uniformly used at all levels of government, leading to a weak control environment. Independent audits of all Government budget accounts for any recent financial year have either not been undertaken or have not been made available.
- 3. **The main rationale for the Project** is that it will improve PFM in Iraq thereby leading to better use of national resources for the public's welfare. The areas where improvement is needed have been identified in the previous section. In addition, the Project will serve to improve donor coordination. Donor efforts in the PFM area to date are shown in Table 1. However, these efforts have not been adequately coordinated, resulting in duplication of effort.
- 4. The process of Project preparation has already contributed to improved coordination since key donor partners have been involved at all stages. The placement of a senior public sector specialist in the Bank's Baghdad office has also been helpful: meetings are regularly convened to ensure that donor efforts in the PFM area complement one another. Moreover, the Ministry of Finance has developed and passed a PFM Action Plan with support provided by the Bank with inputs from the IMF and DFID during project preparation. This now serves as the blue print for all donor support including the proposed project.
- 5. The GoI has demonstrated its commitment by putting PFM issues at the heart of the socioeconomic pillar of the International Compact for Iraq. The Government recognizes the importance of PFM reform, as indicated in the National Development Strategy and the International Compact for Iraq.
- 6. Finally, GoI is eager to bring to Iraq the Bank's extensive worldwide (and regional) experience in providing guidance on good practices in PFM reform, as demonstrated by their strong commitment throughout project preparation.

2. Proposed project development objective

- 7. The total estimated cost of the Project is US\$18 million, to be funded by: i) US\$16 million from the ITF, to be recipient-executed; and ii) US\$2 million from the ITF, to be Bank-executed, to allow initiation of some subcomponents as well as facilitate opportunities to disseminate results of the reform activities.
- 8. The Project Development Objective is to support the Government of Iraq's efforts to develop more effective, accountable and transparent public financial management. Cross-cutting reforms in PFM will be addressed by the reforms to the national system which will be extended where necessary and appropriate to the subnational system. The aim will be to strengthen budget formulation, execution and control, improve public financial reporting, strengthen public procurement and develop capacity in PFM.

The project is the first stage in a multiyear strategy for budget reform. GOI is putting together a multiyear public financial reform strategy with an action plan which lays out the reforms that will be undertaken in each stage. The project builds on the support that GOI has requested from the donors in the first stage of implementation of their reforms strategy. The primary target group is resource managers and their superiors in the Ministry of Finance (MoF) and Ministry of Planning and Development Cooperation (MoPDC), as well as the line ministries. Effective Project implementation will require international experts to work alongside with these key GoI officials in Iraq on the practical tasks that need to be supported and strengthened.

3. Project Description

- 9. The Project design reflects the agreements between GOI, the Bank, and the IMF, as expressed in the Public Financial Management Action Plan.
- 10. Component 1. Strengthening budget formulation and implementation (US \$3.95 million). The overall objective of this component of the project is to lay a stronger foundation--building on older procedures and accepted Iraqi norms--for credible annual budgeting framed by a medium-term perspective, and complemented by more rigorous selection and preparation of investment projects within a public investment programming process consistent with national development strategy and detailed sector strategies: execution including procurement. Activities include:
 - Develop detailed sector strategies for two key ministries: Ministry of Education and Ministry of Water Resources
 - Strengthen investment project preparation and appraisal
 - Strengthen the capacity of the Economic Department of MoF
 - Improve the process of annual budget formulation and budget classification and strengthen public financial regulatory framework
 - Improve content of and adherence to budget call circular
- 11. **Component 2. Strengthening Public Sector Procurement (US\$ 3.2 million).** Improvements to the systems of Public Procurement are crucial to ensure successful budget execution. This Component would include:
 - Supporting the public sector procurement system
 - Developing sector specific standard bidding documents
 - Establishing a procurement information and monitoring system
 - Strengthening the capacity of key Iraqi implementing institutions, NGOs, and private sector in public procurement
- 12. Component 3. Strengthening Budget Execution and Implementation (US \$2.33 million). This includes the provision of technical support to improve administrative and functional aspects of GoI's budget execution operations. Activities include:
 - Introduce improved cash release system
 - Assess multiple treasury system in KRG
 - Introduce new commitment control system
 - Improve financial reporting
 - Assess the internal financial control system, including the role of the Inspectors General
 - Upgrade content and functionality of MOF website
 - Create internal MoF Network
 - Capacity development of line ministries to enhance their ability to implement investment projects
- 13. Component 4. Capacity Development and Project Management. (US \$3.0 million). This component will ensure coordination of the training and capacity building provided in the first three components of the project. The component also foresees a focused strengthening of the MoF's internal training department, in order develop the department's longer-term capacity to provide comprehensive

'in-house' training The project would finance international and local advisory services (with a small provision for office equipment essential for the effectiveness of the project), as well as training and capacity building directly related to the envisaged reform measures.

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4. Tentative financing

Source:		(\$m.)
Borrower		0
Iraq Trust Fund		18
•	Total	18

5. Contact point

Contact: Yahia Khairi Said Title: Sr. Public Sector Specialist

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Email: ykhairisaid@worldbank.org

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