

## **Yemen Policy Note 2:**

# **Economic, Fiscal and Social Challenges in the early phase of a Post Conflict Yemen**





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# Acronyms

## Acknowledgements

AFMIS	Automated Financial Management Information System
CBY	Central Bank of Yemen
COCA	Central Organization of Control and Audit
IMA	Independent Monitoring Agents
IMF	International Monetary Fund
IT	Information Technology
LGMIS	Loans and Grants Management Information System
NPL	Non-performing Loan
MAF	Mutual Accountability Framework
MOPIC	Ministry of Planning and International Cooperation
MTFF	Medium-Term Fiscal Framework
PEFA	Public Expenditure and Financial Accountability
PFM	Public Financial Management
PIP	Public Investment

Plan PIU Project Implemen- tation Unit	
RPBA Recovery and Peacebuilding Needs Assessment	
SOE State-owned en- terprise	
TPSD Transitional Pro- gram for Security and Development	
TSA Treasury Single Account	

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## Summary – key messages

***Stabilizing the macro economy is key for gaining the peace and realizing the peace dividend.*** For the short term, though, the prime challenges are: (1) rebuilding key economic stocks and central national economic institutions, foremost the foreign reserves and the Central Bank, the anchor for Yemen's financial system, (2) restoring the fiscal revenues, (3) restoring the hydrocarbon sector as the financial backbone of the economy without which economic stability will be difficult to conceive over the medium terms, and (4) establishing the legitimacy of the central institutions, especially through restoring the fiscal management system and its accountability mechanism while delivering on reconstruction and restoring public services.

***Restoring a minimum stock of foreign reserves is a priority for allowing the private sector to recover and initiate economic recovery.*** The minimal stock of initially available foreign reserves commensurate with restoring macro stability should amount to roughly 3 months of imports<sup>1</sup>, estimated at \$4.5 billion under pre-conflict conditions.<sup>2</sup> The availability of foreign reserves will allow to fund recovery imports and are indispensable to engage the private sector for recovery.

***Restoring the operations of the Central Bank immediately is a sine qua non conditions for economic recovery and regaining macro stability.*** The Central Bank of Yemen would need to be able to assume again its normal financial anchor functions which are (1) servicing as a lender of last resort to the Yemeni financial system, (2) balancing the national private and public debt market, (3) facilitating international trade, and (4) ensuring the viability and credibility of the Yemeni financial system.

***Resuming trade to its full potential and reviving the hydrocarbon sector requires a regularization of the external debt situation to allow investors to have access to currency flows.*** Accumulated arrears on external debt obligation will be an obstacle to resuming normal trade activities, reviving the private sector in general, and for entering in complex financial transaction for restoring the hydrocarbon sector, as creditors would insist on meeting their claims before new investors could make a claim on external currency flows. External debt obligations would need to be restructured; similarly, external debt arrears would need to be rescheduled.

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1 Three months of import coverage is considered a minimum level for countries to meet macroeconomic stability criteria.

2 Which would be equivalent to about 10 percent of the conflict depressed GDP total by the end of 2016.

**Yemen needs to restore its fiscal revenue base from day one.** Yemen's reconstruction, stabilization, and development path from the immediate over the medium to the longer term hinges critically on the ability of its future government to raise domestic revenues to fund its public expenditure program. External resource availability has an important role to play for early stabilization, restoring of livelihood as well as the social and institutional fabric. However, sustainable recovery, restoring its own systems and its institutional fabric, requires generating own resources.

**Trade and consumption taxes have an important role to play in the short term to restore fiscal revenues.** Yemen's given tax regime does not *a priori* represent an obstacle to efforts aimed at strengthening revenue collection. However, a post-conflict situation requires some initial short term "emergency responses" to finance and support reconstruction efforts. In this context, it is critically important to (1) sequence the re-establishment of the tax and customs administration appropriately; and (2) minimize administrative complexities so as to permit the government to re-assume its core functions without asphyxiating first signs of private-sector recovery. *Trade taxes* and *consumption taxes* should receive attention on a priority basis.

**The pace of the recovery of fiscal receipts and export earnings over the medium term (after 6-12 months) depends on the speed and depth to which the oil and gas sector can be restored.** Pre-conflict, the hydrocarbon industry in Yemen generated 50-60 % of the fiscal revenues and up to 85 % of export revenues, and nearly 50% of foreign reserves. The sector's share of the GDP amounted to 8-9%, and its importance for direct employment is negligible. Yet, despite of the massive decline of international hydrocarbon prices since 2014, the recovery of the hydrocarbon sector continues to constitute a

central imperative for economic recovery and sustainable economic stabilization in Yemen.

**How quickly the past production revenue capacity can be restored depends on (1) the speed of investor re-engagement, (2) better utilization of given investments, and (3) the future investment conditions available to the sector, ultimately aided by a conflict resolution agreement.** The future international oil price is assumed to rally around \$50 a barrel, about half of past prices. Achieving the pre-2014 hydrocarbon rent level for Yemen's fiscal and external balance going forward, would require a substantial increase in the annual production. The decline in production - as observed since 2002 - could be reversed, if the investment climate in the sector would allow for a more sustainable prospection, exploration, and production path.

**Legitimacy, trust building, and effectiveness of any expenditure program all require the restoration of normal budget operations.** Normal budget operations will have to be restored in order to support the state administrative structure and to provide some degree of service delivery. This will include establishing the authorizing arrangements, as well as restarting treasury operations. As a starting point, an "emergency budget" for the post-conflict fiscal year would need to be prepared.<sup>3</sup>

**There is no legitimacy without restoring budget integrity.** In order to build confidence among the relevant stakeholders and to make efficient use of limited resources, it will be important to ensure that fundamental controls are in place to prevent fiscal leakages. Under the presumption that expenditure priority will initially be placed on payments of civil servant salaries, securing the integrity of payroll data and controls will be imperative.

<sup>3</sup> Emergency budgets may be required even beyond the first post-conflict fiscal year.

**Commitment to and delivery on fiscal transparency will be an important trust and confidence-building measure.** Producing timely and reliable information about the budget and its execution (to start with) will help to open doors for public debate. It will also facilitate accountability over the use of public resources to citizens and development partners alike. It will be particularly important for the government to quickly show that spending is going to support reconstruction and service restoration in the various areas of the country.

**The first post-emergency budget formulation exercise will be constrained by the presumed limited available capacity.** A simple mechanism for selection and allocation of funds to reconstruction capital investment projects would need to be established and further developed over time. While these investments would initially be supported largely by development partners on the basis of a Recovery and Peacebuilding Needs Assessment (RPBA), the foundations for an institutional project “gate-keeping” process could be set early on.

## Toward a Shared Recovery

This note lays out the key economic challenges, risks and policy options that Yemen faces during a first phase of socio-economic stabilization post conflict, supporting restoration of public and social services, recovery of economic activities, creating income opportunities, overcoming economic legacies and managing key risk factors. The suggested range of policy options aim for a ‘shared recovery’, acknowledging that unsustainable pre-conflict policies, mixed with bad governance, led to economic distortions and economic capture by a few undermining investment and employment oppor-

tunities, and sustainable development in Yemen. Resulting capture, economic distortions and underperformance are equally symptoms of the conflict context in Yemen as they are also drivers of such conflict. While it will take time to address this *dead-end development path*, there is no alternative to beginning to address the root causes of this path, starting with setting the conditions for a *shared recovery*. The risk of failure is high: Walter (2004) estimates that countries have a 40 % chance of reverting to violence within the first decade after peace. But identifying and addressing key risks, among others through realistic, well sequenced and balanced policies, can break the cycle of violence in Yemen and allow the country to enter a shared recovery and to outgrow deeply seated legacies.

## *Salient economic and social features in Yemen*

**Yemen’s development path has been mixed and state dependent.** In the two decades that followed Yemen’s unification in May 1990, the country enjoyed its most stable period, politically as well as economically, since the modern Yemen emerged from its colonial period (South Yemen) or the Imamate governed period (North Yemen) in the 1960s. Post-unification the economic growth in Yemen from 1994-2010 was driven primarily by demographic change, exporting labor to the GCC countries, shifting out of agriculture, and since the early 1990s by the development of an oil sector. The Yemeni oil sector was considered small by regional standards, reaching about 350,000 barrel a day at its peak (2000) but delivering on average about 60 % of fiscal revenues and 85 % of export revenues. A large state determined private sector<sup>4</sup>, inherited both, from the former Northern Yemen as

<sup>4</sup> Capturing more than 50% of the economy, depending on the measurement applied.

well as from the socialist former South Yemen, augmented by the oil sector, gave the central state a broad leverage about many economic assets, and state determined employment was encompassing in the modern economy. The emerging state dominated economic structure gave rise to a rent-seeking economy, where formal employment opportunities and use of economic assets were continuously negotiated along political consideration and shifting loyalties, on the local level as much as on the national level. A competitive and productive private sector could not develop on a scale under these conditions. Large family based conglomerates formed the nucleus of a private sector but they, too, were dependent on state granted privileges, which could be withdrawn or renegotiated. The business climate in Yemen was not helpful for developing a thriving and competitive private sector. Employment and income sources beyond the government and a small modern sector, were largely determined by services (about 37 % of the GDP), mostly at low productivity, and agriculture (10 % of the GDP).

***Growth has been reliant on hydrocarbon investment.*** Growth per capita averaged 1.3 % annually in the two decades preceding 2011, the year which set transition in Yemen into motion but ended up in the on-going open conflict. The marginal returns on fixed capital investments were fairly high<sup>5</sup>, but reflected, to a great extent, investments in the hydrocarbon sector. Overall, investment has been on a declining path since 1997, reaching 14.8 % during 2006-2010, while the private investment sank to 8.8 % of the GDP in 2005-2010, reflecting also the lack of profitability outside the few areas offering access to rents (hydrocarbon sector). High operating costs, many formal or informal restrictions, and overall low profitability hampered expansion of production for small and medium enterprises, limiting employment and income opportunities.

<sup>5</sup> Yemen- Country Economic Memorandum, October 2015, World Bank, Report no. 102151-YE; Figure 6.

Exports - except of hydrocarbon product - contributed close to nothing to growth while domestic demand has been an overriding factor explaining growth.<sup>6</sup>

***Non-sustainable use of resources in combination with exclusion of a large part of Yemenis is hindering improvements and limiting options in the future.*** Yemen is one of the most water-deficient Arab countries, with declining freshwater resources due to over-pumping of aquifers and the rapid growth of the population and the development of commercial agriculture. In 2010, annual demand for water was estimated at 3.9 billion cubic meters (bcm) (90 % for agriculture – of which 40 % is reserved for Qat production), 8 % for municipal uses, and 2 % for industry) against an estimated renewable supply of 2.5 bcm. The shortfall (1.4 bcm) has been met by depleting Yemen's stock of non-renewable groundwater, which became accessible in the 1970s because of modern diesel powered tubewell technology. The largest user of water is agriculture. However, ownership of land is favoring a few with large land assets, running cultivation for fruits, vegetables and Qat (30 % of the total agricultural production)<sup>7</sup>. Operations of these farms were helped by (1) misguided policies involving subsidies (diesel and cheap pricing) for water extraction, leading to the over-extraction of water, especially for the cultivation of Qat, (2) a lack of legal enforcement to regulate water use; and (3) public investment that encouraged the use of water in surface or spate irrigation. Most of Yemenis live from small scale agricultural production that is rain fed.

***Poverty and dismal social outcomes are a direct result of a rent seeking and non-competitive, managed or negotiated economy.*** Lagging productivity of the Yemen economy

<sup>6</sup> Yemen- Country Economic Memorandum, October 2015, World Bank, Report no. 102151-YE, page16.

<sup>7</sup> Qat is a Yemeni flowering plant typically chewed as a stimulant and to induce euphoria (amphetamines).



underpinned overall stagnation of livelihood conditions in the country prior to the conflict, combined with a lack of opportunity. The World Bank's 2015 Country Economic Memorandum (CEM) identified such a result as a major obstacle to sustaining high growth. The mutual dependence of rent seeking, a non-competitive economy, bad governance, and non-sustainable use of resources compounded sub-optimal economic outcomes and the event of poverty. Since long, Yemen had the highest poverty incidence in the Middle East, with about 35 % of the population living below the poverty line of US\$2 (2005 PPP) a day per person. Poverty is more widespread and persistent in rural areas, where 70% of the population lives. A preliminary analysis of the 2014 Household Budget Survey data shows that poverty has been increasing between 2005 and 2014. Initial simulations of the impact of the ongoing conflict indicate that the poverty incidence may have almost [doubled] nationally, from 34.1 % in 2014 to 78 % in 2016.<sup>8</sup> In 2012, Yemen had one of the highest malnutrition rates in the world, with almost 60 % of children under the age of five (about 470,000) suffering from chronic malnutrition, 13 % acutely) and 35 % underweight.

***Demographic pressures keep rising, especially young Yemenis have to deal with a weak economy, and a dramatically weakened access to education is going forward.*** Population growth is estimated to be around 2.5-3% per annum. A third of the population of 28 million is at school age (5-19 years). Currently, about 400,000 young Yemenis enter each year the labor market. If gender balance is assumed for the labor market entry, the pressure would be even higher. The required investment in schooling has, however, been lagging earlier, and the lack of investment is compounded by the conflict.

<sup>8</sup> The poverty headcount is based on a national poverty line of YER 10,913 (or about US\$50) per capita per month in 2014 prices. In terms of 2011 PPP terms, it is about US\$3.52 per person per day, or about US\$105.6 per person per month.

A third of the student population is assessed to not attending school since the outbreak of the conflict. The school program of those attending is in many ways adversely effected, undermining the quality of their learning program, which was considered low already prior to the conflict. The adverse long-term effects on the economy, on the labor market, and ultimately on society as a whole of a generation growing up without proper schooling, formal qualifications, and limited economic options will be tremendous.

### *Overview of economic, fiscal, financial, and social challenges*

***The economy has contracted sharply since the open conflict erupted in early 2015 and vital social and institutional functions have been impaired.*** Official reporting suggests that Yemen's GDP has contracted by approximately 40 % in the two years since 2015. The conflict had a devastating overall effect on the economy, damaging the production chain and markets in the real sectors. The conflict-related losses, damages, and disruptions to industry, agriculture, livestock and fisheries are estimated at the end of 2015 to be in the order of \$18 billion, or higher.<sup>9</sup> Due to the overall breakdown of access to inputs markets (energy, labor, intermediate goods, and services) while demand is also depressed, a quarter of all firms suspended operations (estimations point to 35 % of the services sector, 29 % of the industrial enterprises, and 20 % of the trading companies).<sup>10</sup> Supply of centrally generated electricity has diminished since late 2014, and with the onset of the conflict it has come to complete stop in 2015. Oil production has come to a virtual halt. However, extraction continued for producing liquefied gas used for the domestic market. Businesses face high operative costs, lack of input markets, and are vulnerable to the risk of violence (see also the Policy Note no. 3). Formal private sector

<sup>9</sup> Yemen: Preliminary Damage and Needs Assessment, June 15th, unpublished.

<sup>10</sup> UNDP SMES Rapid Business Survey, April 2016.

employment is estimated to have declined by about 50 %. This has exacerbated the pre-war premium on high-rents sector, and further emphasized the lopsided structure of the Yemeni economy.

**90 % reduction in Yemen's hydrocarbon production and export income since 2014 deprived the country from its main foreign exchange earning source and the state from 50-60 % of its fiscal income.** Yemen's hydrocarbon sector drives the fiscal and the external balance of the country. Hydrocarbon production exports (oil and gas) generated about 60 % of fiscal revenues (11.2 % of the GDP in 2014; about \$5 billion) since the early 2000s. They generated up to 85 % of export revenues, in 2014 roughly \$7 billion. Oil and gas production declined from an average equivalent to 326,000 barrels a day to no more than 30,000 barrels in 2016. Other sources of exports declined by around 60 % in 2015 compared to their level in 2014. In total, exports in 2016 are estimated to have declined to below 10 % of their pre-conflict level.

**Yemen's foreign reserves flows depend currently largely on a dwindling flow of remittances.** The lack of exports, lack of foreign assistance flows of about \$2 billion annually, left only remittances as the source for foreign exchange earnings. Remittances maintained initially their level up to early 2015 but have since then declined, estimated to amount currently to not more than \$1.4 billion.<sup>11</sup> The uncertainty in general, and in the financial market in particular, with the Central Bank system currently being dysfunctional, led to the fall in transfers to Yemen. If not in cash, a large part of these remittances is estimated to come to the country through private money trader and payment houses, adding to the financial resilience of families but depriving the financial

<sup>11</sup> The assessed decline is related to the dwindling trust in the Yemen financial system; the dwindling capacity to absorb in the absence of the Central Bank of Yemen services.

system of these flows.

**Access to foreign exchange is market driven and subjected to the political, institutional, and economic uncertainties prevailing in Yemen.** With the Central of Bank of Yemen being largely absent, currency exchanges are undertaken at a market exchange rate, which varies currently (March 2017) from about 320 Yemeni Riyal per dollar to 360, depending on the size and type of transaction and whether it is a cash or paper transaction. Incoming cash transactions enjoy the most favorable exchange rate. Banks are constrained by the fact that the interbank market has largely collapsed, given the high degree of uncertainty or risks and the absence of the Central Bank as a market actor. Banks have some credit and exchange relations with national money traders. But there are high transaction costs involved and the market is not very liquid. A transaction in the fall of 2016 aiming to raise the equivalent of about \$80 million for financing food imports caused an immediate fall of the free market exchange rate to 400 Yemeni Riyal per dollar. The situation is further compounded by the absence of a formal access to the international financial markets, either because of the absence of the Central Bank or because of the *de-risking* problem which tends to work against small financial operators like those established in Yemen.

**The official import regime has ceased to operate in 2016 in the absence of the Central Bank and the gradual decline of the foreign reserve level.** Imports have contracted since 2014 by about 50%. Since September 2016, imports are not being affected anymore via official channels, or supported by the Central Bank of Yemen (CBY), due to the lack of appropriate institutional arrangements and the institutional uncertainties created in the context of moving the CBY to Aden. Supplies, including food, are deemed

to be procured informally, and by traders with allegiances to conflict parties, or through humanitarian assistance. The inefficiencies of such an outcome results in higher prices and rationing of goods and locations, yielding limited choices over quality. The United Nations launched therefore a humanitarian appeal in early 2017, with the objective to bridge the gap in food supplies.

***The financial sector suffers from the economic decline and from the in-operation of the Yemen Central Bank system.***<sup>12</sup> The financial sector has lost effectively its lender of last resort since the CBY HQ has been moved to Aden. As a result, the payment system among banks has virtually been brought to a standstill. The economy is largely being deprived of its financial sector, rendering also humanitarian assistance costlier to implement.<sup>13</sup>

**Central state institutions are undergoing their deepest crises as public finances are under severe stress:**

- The assessed fiscal deficit reached 14 % of the GDP in 2016 and is projected to be much higher in 2017 without turning to peace soon. Until August 2016, fiscal resources available covered mainly public sector salaries and wages only (in 2014: 10 % of the GDP). Public finances, which are under severe stress, have been unable to maintain a large part of their functions since August 2016. Since then, salaries have not been paid anymore for most civil service officials. In addition to rising salary arrears, arrears to suppliers are also building up. While non-hydrocarbon tax collection remained in 2015 broadly at their pre-conflict level of about 10 % of GDP, they declined dramatically during 2016. Going forward, the risk of a higher

level of inflation could materialize as one way to allow the state to discount the real value of accumulated arrears, which adds to the uncertainties.

- The quantitative fiscal outturn does not reveal easily the forced fiscal adjustment that the Central Government had to implement since 2015. While the GDP has shrunk by about 40 % since early 2015, the fiscal resource envelope available, including deficit financing, shrunk to less than half in percent of Gross Domestic Product (GDP), from 23.6 % in 2014 to 11 % of the GDP at the end of 2016 (see also annex 5). As a result, institutions and services reduced their functions, range, and depth progressively during this period, if they did not stop to function altogether.

The legitimacy of any public expenditure program in 2015 and 2016 was based – broadly - on the 2014 budget, the last one approved by Parliament, which formally served as the reference for the 2015 and 2016 budgets, in accordance with the budget law. The tensions between maintaining a framework resembling legality and the demands of the day for payment and services under the condition of a conflict, when revenues were dwindling, were increasingly resolved in favor of short term consideration and the imperatives of the conflict, with a devastating impact on service delivery, credibility (arrears), and effectiveness of the central government, undermining altogether the credibility of an already deemed weak budget and public financial management system. Since August 2016, public service salaries could only be paid partially, indicating the financial stress but also the incremental fragmentation of the central state's capacity and waning legitimacy.

- The Central Bank of Yemen first helped the economy to weather the difficult con-

<sup>12</sup> See also the separate Policy Note no. 3 on this topic.

<sup>13</sup> See also note no. 3 on the Private Sector in Yemen, including the financial sector.

text of Yemen's fragile transition process since 2011 and continued to do so when the conflict situation deepened in early 2015. It did so by managing relative exchange rate stability for the Yemeni Riyal, in line with its longstanding conservative economic monetary policy paths. Yet, exchange rate stability could ultimately only be maintained at the expense of running down its foreign reserves. This policy came largely to an end in March 2016 with the foreign reserves had fallen below the level of one month of imports. The official exchange rate was consequently adjusted to YR250 per dollar (from YR215), with a market exchange rate running currently at around YR330 to 360 per dollar, depending on the transaction (cash or non-cash, see above). Transactions at the official rate have not been affected since September by the market exchange rate.

***The financial counter-side of this conflict caused a massive build-up of public debt and arrears, domestically as well as externally, and weakened the financial sector.*** Total public debt was relatively low prior to 2015 but the rising fiscal deficit financed through the CBY overdrafts has increased the domestic debt by almost 30 % to 65 % of GDP by end-2016. Statutory limitations of local banks buying state debt are exhausted. Additional domestic debt has been created by accumulating payment arrears at currently unknown levels; non-payment of civil service salaries is just one source of arrears accumulation. Going forward, the weakened financial sector is not in position to be a significant source for public domestic financing, constraining domestic financing options for the future government and for recovery. Yet, not addressing the build-up of domestic payment arrears will hinder the financial sector and the remaining private sector to contribute to recovery. Financing space during an initial

post conflict phase depends currently largely on external sources.<sup>14</sup>

***Infrastructure, institutional capacity and delivery systems are impacted adversely by the conflict and hinder effective humanitarian assistance delivery.*** Servicing the many suffering Yemenis quickly in a post-conflict situation will be ineffective without restoring the social and economic core systems, private (e.g., financial market; payment system, delivery chains, etc.) as well as public ones (budget and public financial management systems). Yet, these have suffered either physical (infrastructure), conflict induced political damages, or suffer from the general decline in institutional capacity (administrative capacity, enforcement, etc.). The restoration of this economic and institutional fabric as well as delivery systems is expected to take time. The destruction having so far occurred will therefore have a *legacy effect* on the speed of future recovery.

***Poverty and misery is pervasive in today's Yemen and a challenge for building a more inclusive society post-conflict.*** Initial estimates of the poverty dynamics suggest an increase of about 14 %age points to 78 %, from 48 % in 2014, of Yemenis living below the national poverty line.<sup>15/16</sup> It is estimated that approximately 19.4 million Yemenis lack access to clean drinking water and sanitation, with about 8 million facing acute shortages and 14.1 million cannot access adequate health care. Children and adults are facing significant psychological stress; severe food insecurity affects 8.1 million people, and an estimated **3.3 million are acutely malnourished**, of which

14 Yemen's Precarious External Financing Situation: What Could Donors do? IMF, unpublished, May 23, 2016.

15 The poverty headcount is based on a national poverty line of YER 10,913 per capita per month in 2014 prices. In terms of 2011 purchasing power parity, the national poverty line is equivalent to about US\$3.52 per person per day based on 2014 prices.

16 Poorer households appear to be more affected by insecurity than better off household – see the Household Budget Survey result of 2014.



2.1 million are children. An estimated 2 million children are out of school because of fighting and insecurity. The total number of IDPs has risen to over 3 million, while 2 million of IDPs remained internally displaced for longer than 6 months. The prospects for women-headed households, which represent 52 % of the displaced community, are particularly challenging.<sup>17</sup> These conflict related results pose serious risks to the future of human development in Yemen.

**Recovery, regaining growth, and employment all require having confidence in the eventual arrangements for peace.** Whether rapid external and sizeable support as well as early restoration of livelihoods, infrastructure, and the hydrocarbon economy can translate into generating a *recovery growth shock*, reversing the economic decline since 2014 depends on: (1) whether the expected eventual political agreement about ending this conflict and resuming the political transition in Yemen is shared by the major political stakeholders in the country and, therefore, enjoys credibility, and (2) whether the external resources possibly made available by Yemen's partners can lead to reconstruction and investment in Yemen, leading eventually to development. This second condition requires continuous participation of Yemen's stakeholders, willingness and demonstration of a reversal in traditional approaches (see above), including governance, which in turn requires a decisive degree of transparency and communication about plans, sequencing of action, and finally also early tangible results in recovery. Financial assistance has been massively available for Yemen in the past but the post conflict financial assistance will not deliver the expected restoration (and repair of the break with past cycles) unless a peace process can be set into motion in Yemen that aims to include all Yemenis at their different levels, reaches

17 IOM (International Organization for Migration). 2015. Task Force on Population Movement in Yemen: 6<sup>th</sup> Dashboard.

out to the different regions, brokers the undoubtedly diverse expectations, helps to identify a national purpose, and allows for a broad and continuous dialogue within Yemen as well as with its regional and international partners.

## 1. Recommendations for immediate actions post-conflict

**Stabilizing the macro economy is a key to gaining the peace and realizing the peace dividend.** Peace cannot win, if the economy continues to struggle, particularly if the war economy prevails. Anchoring the economy and providing a credible perspective for recovery and reconstruction will be extremely important. Balancing the macro economy, essentially the external and the domestic economic aggregates, would be a first step. Stabilizing the macro economy would initially – beyond policies – require restoring the essential stocks of the macro economy, with a minimum stock of foreign reserves to allow for imports and recovery, including recovery of the private sector, and a minimum of fiscal resources to begin rebuilding public services and respective institutions, and ultimately the central state. It would also require to endow the state, specifically the future new Yemeni Government with initial resources, to allow for salary payments, servicing accumulated arrears, and beginning with service delivery.<sup>18</sup> The latter will be particularly important to restore credibility among the Yemeni population. **Restoring a minimum stock of foreign reserves is a priority for allowing the private sector to recover and initiate economic recovery.** The minimal stock of initially available foreign reserves which commensurate with restoring macro stability should amount to roughly 3 months of imports<sup>19</sup>, estimated

18 The modality for support could have many forms but the external and initial support should focus on supporting and restoring the functioning of the national budget system.

19 Three months of import coverage is considered a minimum level for countries to meet macroeconomic stability

at \$4.5 billion under pre-conflict conditions.<sup>20</sup> Restoring the reserves to this level would be a first priority. The known reserves (January 2017) amount to less than one month of imports<sup>21</sup>. It is further estimated (see below) that the potential for hydrocarbon export receipts would amount during the first 2 years to maximum 50 % of pre-conflict export receipts because it will take time to reach the pre-conflict production volume and export prices have since been cut by half.<sup>22</sup> It is estimated that such exports could result in around \$3 billion of hydrocarbon export receipts per year, beginning with 2018 at the earliest, if peace should become possible by mid-2017. It is likely that this post-conflict export potential will require at least 6 months to emerge, so it will not be available in the short term (see also the section 2.2.1, below, on the hydrocarbon sector recovery). Remittances – prior to 2015 running at about \$3 billion a year - would initially be the more significant source and more reliable source for restoring the stock of foreign reserves than the hydrocarbon sector. While remittances continue to flow to Yemen (via private channels), attracting these flows back to the Central Bank through rebuilding confidence in this institution and its policies, would be the immediate task. If the CBY can attract post-conflict a third to half of the current remittance flows, it could amount to maximum \$750 million. It is therefore highly

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criteria.

20 Which would be equivalent to about 10 percent of the conflict depressed GDP total by the end of 2016.

21 Actual statistics on reserves are not available. An assessment made by the end of 2016 suggests that reserves have fallen below a critical level. The then assessed level reflects, however, the economic dimension of the dividing conflict lines in Yemen, which translates in a lack of trust by economic agents toward such an institution and its ability to attract reserves. A look at the balance sheet of the Central Bank only would underestimate the actual level of available reserves in the economy.

22 The complexity of restoring the hydrocarbon sector will not only be determined by restoring the physical infrastructure and contracts, including contracts with national and foreign operators. Accommodating and balancing the political economy of the sector, which also has a local and regional dimension, will be time consuming and costly.

important to endow the Central Bank early on with an adequate foreign reserves level for rebuilding confidence in this institution. Such an initial foreign reserve endowment could help the CBY in the short-term to return to known policies, including policies of the exchange rate management, which would instill confidence and positively influence its ability to attract currency flows from the economy. The estimated foreign reserve gap for the initial 6 months would oscillate between \$2 and \$3 billion, taking also into account recovery import needs.

***Restoring the operations of the Central Bank immediately is a sine qua non conditions for economic recovery and regaining macro stability.*** While the current discussion on the Central Bank of Yemen focuses much on its ability to service public salary payment, its actual financial function to serve as a lender of last resort to the Yemeni financial system, to balance the national private as much as public debt market, to facilitate international trade, and to ensure the viability and credibility of the Yemeni financial system<sup>23</sup> are not yet the subject of this discussion. The Yemeni bank's balance sheets are currently frozen in time. The non-performing loan rate for banks is reaching alarming levels (see also the Policy Note no. 3 on the private sector). The \$2 to \$3 billion for meeting the foreign reserve gap - argued for above as a first and quick assistance to stabilize the economy - would also help indirectly, in a first step, to revive the financial sector services as the import activity could be resurrected, a business area, which traditionally has been important to Yemeni banks. The availability of a critical

23 The Yemeni financial system suffers deeply from the impact of what is called "de-risking", which describes a trend that banks and financial institutions located at larger financial and capital markets which are well supervised tend to "de-link" from small banks or small or marginal financial markets for fear of taking risks to be exposed to money laundering transactions and possible terrorists financing. The counter side of this trend is that Yemeni banks are deprived of their correspondence banks in these larger financial markets, and any transaction in foreign currency becomes costlier, if not feasible or accessible at all.

amount of foreign exchange would help the Central Bank to support policies, which revive the economy while managing inflationary pressures through sterilization, a policy stance pursued with some success in 2015 (and earlier). Certainly, more resources and policy measures will be required over time (after 6 months, or earlier) to go this route and address more structural issues with regard to the banking sector's portfolio of assets (see also the Policy Note no. 3 on the Private Sector Recovery). It is unclear how quickly and broadly the economy would respond to such assistance. Judged by past experience (2012 to 2013) the impact could be significant<sup>24</sup> in a first instance.

**Resuming trade to its full potential and reviving the hydrocarbon sector requires a regularization of the external debt situation to allow investors to have access to currency flows.** Accumulated arrears on external debt obligations will be an obstacle to resuming normal trade activities, reviving the private sector in general, and for entering in complex financial transactions for restoring the hydrocarbon sector, as creditors would insist on meeting their claims before new investors could make a claim on external currency flows. External debt obligations would need to be regularized, specifically external debt arrears and possibly debt falling due (going forward) would need to be rescheduled. The level of the total external debt outstanding amounted to about 21 % of the GDP by the end of 2016, and accumulated arrears on external debt obligation amount to about 2 % of GDP. Both the parameters, the total outstanding debt stock and the accumulated arrears are still relatively low by international comparison and normally bearable for Yemen<sup>25</sup>, or re-

24 Roughly 1 % of the GDP in form of external support (\$1 billion) would buy 3 % of growth in a first round, if the past serves as a guide. Whether the multiplier effect can be maintained depends on the credibility of the peace arrangements and whether the hydrocarbon sector can be revived with speed (after 6 months of a peace agreement) which would serve for stabilizing expectation for economic growth.

25 Under normal economic circumstances, the external

regarding the external arrears, could be worked out. However, if left unresolved, accumulated arrears will adversely tax recovery efforts. So, it would be critical to regularize the debt situation with Yemen's external creditors.<sup>26</sup>

**Similar to the external debt status, containing domestic debt, addressing arrears (e.g., suppliers, salaries) and possibly restructuring domestic debt would be important to (1) build the foundation for macro-economic stability, (2) create fiscal space for recovery expenditures, and (3) build confidence for the economic management of the central state** (reinforcing the above mentioned recommendation). Domestic debt as a share of the GDP almost doubled within the two years (end 2014 to end 2016, from 34 % of the GDP to 65 %). Much of this domestic debt is, either with the Central Bank (overdraft to fund the fiscal needs), with unpaid suppliers, or unpaid public civil servants. Almost half of the public expenditures in 2016 were for salaries, and a third has been for interest rate payments. The expenditure and debt path is not sustainable and would put recovery into jeopardy, as it would also crowd out private credit needs (see also above - the need to restructure the financial sector; or the Policy Note no. 3 on the Private Sector Recovery). The accumulated domestic arrears are estimated to amount to 3.5 to 4 % of the GDP (equivalent to about \$1.3 billion) by the end of 2016. The 2017 fiscal deficit is likely to be in the order of the one of 2016, roughly 13 % of the GDP, with a primary deficit of an estimated 8 % of the GDP, broadly equal to the level of domestic debt interest obligations, respectively a third of total expenditures (see also the macro-indicator table of annex 5). Although the relative weight of the domestic debt reflects the precarious fiscal situation caused – among others - by the on-going conflict and the consequently depressed state of

debt situation would be bearable, as has been the case prior to 2015.

26 The Paris Club would normally serve as the indicated international institution to help to find a solution.

the economy, the sheer share of the domestic debt service – a third of total expenditures (at the minimum) – is an indication that the central state, fiscally speaking, is reaching its financial boundaries. Not addressing this problem would undermine peace building and feed into drivers of conflict, and most certainly heighten the risk of inflation. Addressing this problem is not only a question of resources, or a one-time pay-off of the debt (unpaid contracts, salaries etc.), but also addressing the lacking fiscal legitimacy of the state, which is hindering raising the required fiscal resources in the short term. Injecting fiscal resources, short-term, joined by measures in support of fiscal legitimacy would inject some initial confidence in favor of peace building and institutional capacity, and thereby facilitate medium term recovery. All these parameters together would help to turn around this adverse debt path. In this regard, priority would be given in the immediate term to cover first back payments (contracts, salaries), because of their (1) economic (multiplier) effect, and (2) because of the reassertion of the state's authority. Second, arrears clearance with the private sector needs to be tackled in parallel (see also page 32 on modes for addressing arrears). Such step would obviously help the liquidity of the private sector, but would also positively feed-back on the financial sector; this would send a signal for recovery. Third, an inflation neutral foreign refinancing of domestic interest rates payments at least for 6 initial months (about 4 % of the GDP), would impact positively early macroeconomic stabilization, and help the banking sector in two ways: (1) gaining much needed liquidity, and (2) easing the shortage of foreign exchange, which would support imports. Both are fundamental features for Yemen's economic recovery, as well as for the recovery of Yemen's financial sector (see also the Policy Note no. 3 on Private Sector Recovery).

**Setting the steps toward inclusive recovery.** Recovery of the Yemen economy and

social fabric is likely to take some time as will peace building. Both dimensions (recovery and peace building) are, however, mutually supportive. In this sense, economic recovery is also a part of winning the peace. Yet, the central state, its institutions, and the emerging future Yemeni government will find it difficult to meet expectations about restoring public services, exert an inclusive policy coverage, integrating all regions, and regaining credibility. The actual task appears to be daunting. Nonetheless, early stabilization efforts need to show at the minimum the ability to (1) stop economic deterioration, (2) create an environment for recovery, which combines security with taking visible steps toward restoring the Yemeni productive, trade, and financial system, and (3) show how citizens across Yemen benefit from peace and recovery. While the above and before-mentioned recommendations for the immediate post-conflict period would initiate economic recovery benefiting, at different pace, citizens, enterprises, and institutions, the many more impoverished Yemenis, estimated now to have doubled to a level of 78 % of the population as compared to 2005<sup>27</sup>, would also need to receive support and relief aids. While humanitarian assistance will continue to be necessary after a peace agreement and will have to be augmented to cover areas difficult to access, it will be critical that social safety net support to the most vulnerable Yemeni is resumed.<sup>28</sup> Therefore, the Social Welfare Fund (SWF) and other institutions<sup>29</sup> supporting the livelihoods of many Ye-

27 The year of the last household budget survey preceding the one of 2014, which is not the most recent available.

28 For an overview of social protection institutions and policies in Yemen, please see the *Joint Social Economic Assessment (JSEA) for the Republic of Yemen*, 2012, and the forthcoming *Poverty Assessment on Yemen: Free Falling – Living Standards during Times of Conflict in Yemen* (chapter 4).

29 The Social Welfare Fund has suffered institutionally since end 2015. Its targeting system has been improving but could not yet meet all expectations prior to 2015. However, given its central role in reaching out to the most vulnerable Yemenis, partners have been working with the SWF and other stakeholders since late 2016 to design, update and



menis should also be a priority for early economic and social stabilization. Cash grants for the poor could usefully be combined with nutrition/food vouchers for children's education to create more socially desirable incentives or demand for restoring education services and combat malnutrition among children (see also Policy Note no. 4). A full year of SWF funding is estimated at about \$40 million, without counting for newly qualifying households and additional vouchers. External funding of such support would equally help the Central Bank to restore its stocks in foreign reserves and thereby restoring the import capacity.

**Massive external financial assistance is required for the first 6 months to support peace building** (see above). Aside from the willingness among Yemeni political leadership to build peace and design policies supporting the above-mentioned stabilization efforts, massive external financial assistance is required for the first 6 months, at the minimum, in support of restoring the social and economic national systems. Given the inter-linkages between peace building, service delivery, institutional capacity, employment, and recovery in general, including for the private sector, the payment or regularization of arrears and bringing the level of external reserves to 3 months of imports<sup>30</sup> would be the first priority. In addition, initial fiscal support is required to compensate for lacking fiscal revenues, estimated to be scarce for at least 6 months after peace agreement (see also the section on recovery of oil revenues below). To accelerate recovery and make up for the initial lack of fiscal resources, external funding, provided in phases (installments) and against transparent agreements (see also Policy Note Paper no. 5 on Aid Coordination), of up to an estimated \$5 billion dollars<sup>31</sup>, would be critical in a first phase. Such a level of external support would

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improve the targeting system, using also the most recent data on conflict impact and displacement.

30 Three-month coverage of imports is considered a minimum level for countries.

31 Judged by today's given knowledge – February 2017.

be a strong signal of support, and would help to rebalance economic incentives from conflict toward peace, to provide perspectives for citizens, and to facilitate initial trust building across diverse segments of Yemeni institutions and society.

## 2. Priorities to be tackled to win the peace momentum - the medium term (6-24 months)

Over the medium-term, making progress on the country's overarching reconstruction and development objectives cannot be achieved without ensuring a stable macroeconomic and fiscal path and using the country's resources in a sustainable and inclusive way. Rebuilding the country's institutional foundation, funding as well as providing for public services that help to give rise to a more inclusive society, and help the private sector to restart and/or expand private-sector activities would require work on rebuilding the domestically available fiscal resources. The focus on domestic fiscal resources and the management is thus a necessity but not a sufficient criterion for Yemen's economic transformation and the initiation of an ultimately virtuous cycle of development.

### 2.1 Establishing the public revenue base with a view toward a revised social contract

**Yemen needs to restore its fiscal revenue base from day one.** Yemen's reconstruction, stabilization, and development path from the immediate over the medium to the longer term hinges critically on the ability of its future government to raise domestic revenues to fund its public expenditure program. External resource availability has an important role to play for early stabilization, restoring of livelihood as well as the social and insti-

tutional fabric. However, sustainable recovery requires generating own resources. External aid offers, if well designed, at best accelerate the country's recovery investment and its eventual development program. Yet, sustainability of the country's ability to generate inclusive recovery and growth with the help of such investments depends ultimately on whether Yemen can restore its own systems, its institutional fabric, and whether it will be able to claim and steer ownership. A key prerequisite for such an objective will be a critical level of own funding.<sup>32</sup>

**Raising fiscal revenues and reshaping the social contract in Yemen are mutually interdependent.** The ability to raise resources is not only critical for financing public expenditures but also a legitimacy test of the eventual post conflict peace arrangements; and the transitional governance arrangements, based on which public institutions, central or local, are to be restored to deliver the services in need. Delivery of such services will constitute a central element and test for the future (transitional) government's ability to reshape the social contract between citizens and the state.<sup>33</sup>

### **The tax system design is more important**

32 See also the *Addis Ababa Action Agenda* and, specifically, the *Addis Tax Initiative* (ATI). Domestic public resources are a more stable and sustainable source of income, they also strengthen a legitimate relationship between citizens and the state and foster good governance" (Addis Tax Initiative Declaration, [https://www.addistaxinitiative.net/documents/Addis-Tax-Initiative\\_Declaration\\_EN.pdf](https://www.addistaxinitiative.net/documents/Addis-Tax-Initiative_Declaration_EN.pdf)). The July 2015 ATI is the foundation of the evolving global tax agenda aimed at strengthening countries' abilities to collect budgetary resources in a manner that is consistent with overarching objectives of fostering socio-economic development and improving the business climate. At this point, the ATI—through which the doubling of international and multilateral support for technical cooperation is foreseen over the next few years—seeks to support governments' corresponding efforts with diagnostic work, global expertise, and the active connection to the global tax debate. This development focus represents an important anchor to efforts aimed at reaching relevant *Sustainable Development Goals*.

33 World Bank, IDA 18, Special Theme: Governance and Institutions, IDA, Washington D.C., (2016), unpublished.

**than the tax rate.** Raising tax revenues is not so much a question of raising tax rates – especially for a country like Yemen that is coming out of conflict - but it is a question of designing a tax system that minimizes distortions to economic activity, contributes to reducing income disparities and incorporates an element of sharing or social solidarity. As such, building a domestic revenue base and the underlying tax system is part of the components that strengthen mutual accountability between citizens and the state.<sup>34</sup>

**Attaining a tax to GDP ratio of 15 % (excluding the hydrocarbon rents) for Yemen over the medium term is deemed critical, judged by international experience.** Prior to the conflict, the non-hydrocarbon tax-to-GDP ratio has been around 8 to 10 %. A tax-to-GDP ratio of 15 % is judged to be a threshold below which it has proven difficult to provide the state with both the resources and legitimacy to build functioning public institutions (and crowd in private-sector activities), and deliver the services required to sustain the social contract between citizens and the state.<sup>35</sup> The aim should be to achieve such a level without the benefits from the hydrocarbon sector, which in the future is projected to achieve a maximum revenue level of 6 % of the GDP at the currently prevailing price level and at the pre-2015 production level.

34 Research by academics and international organizations has focused on mechanisms between (effective and non-discriminatory) taxation and efficient, accountable, responsive, and inclusive governments. The OECD (2008) argued that, historically, the formation of accountable and effective states has been closely related with the emergence of taxation systems, whether in Europe, North America, Eastern Asia or among the pioneers of good governance in Latin America and Africa (such as Costa Rica and Mauritius): "The concept of a 'fiscal social contract' is central to the explanations of how representative government and democracy emerged in Western Europe and the United States. Citizens accepted obligations to pay tax in return for rights to be represented in the process of decision-making about how public money was raised and spent" (OECD 2008:7).

35 Governance and Institutions, World Bank, IDA Resource Mobilization Department May, 2016, unpublished.

**Trade and consumption taxes have an important role in the short term to restore fiscal revenues.** Yemen's tax regime is relatively simple (see annex 1) and does not *a priori* represent an obstacle to efforts aimed at strengthening revenue collection. However, a post-conflict situation requires some initial short term “*emergency responses*” to finance and support reconstruction efforts. In this context, it is critically important to (1) sequence the re-establishment of the tax and customs administration appropriately; and (2) minimize administrative complexities so as to permit the government to re-assume its core functions without asphyxiating first signs of private-sector recovery. The following taxes should receive attention on a priority basis:

- **Trade taxes.** Yemen's import reliance will increase, not least in the context of national reconstruction efforts. There are limited points of entry (harbors, airports, and main border crossings) through which the majority of imported commodities enter the country. For these reasons, Yemen would be able to ensure a relatively sizeable and reliable stream of revenues, which administratively are manageable. Tax and revenue raising efforts should therefore begin with the customs and the trade flows.

The country could take advantage of using time-bound management contracts with specialized private companies for the design and implementation of most urgently needed physical and ICT investments, while ensuring that customs duties fall on all traders in a uniform and non-discriminatory manner. The objectives would be to (1) provide government with a secure revenue stream; (2) improve governance (reduce smuggling) and, in so doing, establish credibility vis-à-vis the

private sector; and (3) allow for proper infrastructure and training that permits the gradual transition of responsibilities back to Yemeni authorities. The experience could serve as a base for further reforms after an initial phase of restoration.

In a number of (post-conflict) countries, contracting out parts of the custom management task has proven cost-effective and provided for a major advance in raising revenues. Through a transparent scheme and accountability obligations, such tools added to the country's overarching reform agenda, and the re-establishment of essential trust between the private sector and the government.

- **Consumption taxes.** The second policy priorities would cover indirect taxes, both for reasons of tax policy (Yemen's general sales tax has particularly low rates) and tax administration. In light of the need to make important institutional investments in tax administration, Yemen might want to take advantage of the situation and consider replacing its general sales tax (GST) with a modern value-added tax (VAT),<sup>36</sup> possibly paired with select excise taxes for commodities currently taxed at rates (considerably) above the general rate of 5%. In most countries, including those in a post-conflict situation, a modern, administratively not excessively complex VAT has proven effective in providing the authorities with a stable revenue base, while avoiding growth-inhibiting distortions and negative effects on

36 More than three-quarters of countries worldwide have currently adopted a VAT, generally with good success. In May 2015, Ministers of Finance of member countries of the Gulf Cooperation Council (GCC) agreed, in principle, on the introduction of a VAT in its member countries. Related tax policy reform priorities which will be actively supported by international development partners; see, e.g., IMF (2015).

foreign direct investments (FDI) and external trade. The case for replacing Yemen's GST—described by very low standard rate (5 %), high thresholds, and a narrow base—is even stronger in light of substantial compliance challenges.<sup>37</sup> This tax, in particular, could allow for some increases, especially if revenues were to be shared, eventually, between the central and regional governments.

GCC countries have recently embarked on VAT reform or introduction of VAT system in response to lower revenues derived from hydrocarbon exports. There exists a variety of VAT implementation approaches in the GCC member countries, learning from which would be at Yemen's benefit.

- *Income taxes.* Contrary to neighboring GCC member countries, Yemen has levied a personal income tax, differentiating residents from non-residents. Even if effective as an instrument of (implicit) tax progressivity, the inherent cost/benefit balance of related administrative enforcement requirements by the revenue authorities—especially related to the resources and capacities required to assess residents' *global* income—is unlikely to warrant this complexity. In the first phase of Yemen's post-conflict reconstruction, the authorities might want to consider to (i) restrict the tax base to domestic income; and (ii) apply a uniform tax rate. For similar reasons, the

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37 Such a reform would be considerably more far-reaching and ambitious than the measures agreed between the Government of the Republic of Yemen and the IMF in 2014. In paragraph 25 of the Memorandum of Economic and Financial Policies (MEFP), dated July 1, 2014, Yemen announced its intention of increasing the GST rate “from 5 percent to 10 percent” and unifying 90 percent all tobacco products, while expanding the GST coverage “to include all imported used vehicles and spare parts” (IMF, 2014).

differentiation in the application of the corporate income tax by sectors (apart from extractive industries) adds unnecessary administrative complexity and should be reconsidered.

***Using tax reform as a driver for reshaping the social contract and accelerating development*** (see annex 2). Yemen has already developed important pillars for driving tax reform as an outcome of the National Dialogue Conference. If reconfirmed in a post-conflict reconciliation agreement, Yemen has major elements in place to commence a tax reform agenda, not least a draft constitution, with very specific stipulations for initiating the process of administrative and fiscal decentralization<sup>38</sup>. In this process, it is imperative that explicit rules are defined, by law or in the constitution, to accompany and guide the process toward decentralization. The sequencing of assigned fiscal responsibilities as well as the distribution thereof on the expenditure and revenue sides as well as the mechanisms or formulas for “shared resources”, like the hydrocarbon revenues. If done properly, governments on different levels of jurisdictions are equipped to deliver public goods more directly and effectively, earn legitimacy and credibility, and, in so doing, contribute to the gradual increase in tax compliance. A successful tax reform would aim at (i) increasing collection efficiency; (ii) facilitating, accelerating, and professionalizing the private sector's required interaction with tax authorities; and (iii) establish-

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38 Fiscal decentralization constitutes a more structural and longer term reform program when it comes to implementation. Given the topic's significance at the onset of the current conflict in Yemen, and given the limited capacity in Yemen as well its fragmented politics post-conflict, fiscal devolution would be a first step toward forms of decentralization.



ing taxes gradually as a “fair” price for socio-economic development.

## 2.2 Stabilization and peace building requires restoring the non-hydrocarbon sector

**The pace of the recovery of fiscal receipts and export earnings over the medium term (after 6-12 months) depends on the speed and depth the oil and gas sector can be restored to.** Although crude oil production has been on a gradual declining path since 2000, oil production reached an average of 175,000 and 156,000 barrels per day in 2013 and 2014, respectively. Gas production which came on stream in 2009, reached

been in the past to fund the government and imports. Recovery of the hydrocarbon sector constitutes therefore a central imperative for economic recovery and sustainable economic stabilization in Yemen.

**The hydrocarbon production capacity has been affected by the conflict on the level of infrastructure, investment, and sector logistics.** The ongoing conflict has led to numerous destructions of the hydrocarbon sector infrastructure, resulting either directly from the destruction of production or transmission infrastructure, such as pipeline connecting Marib’s oil fields to the export terminal at the Red Sea and the refinery facilities

Table 1: Oil and Gas Future Price Forecasts

	2014	2015	2016	2017	2018	2019	2020
Net Oil Output (million b/y)	57	22	0	30	66	67	68
Net LNG Output (million b/y)*	61	24	0	0	61	61	61
WEO future \$/bbl	96	51	43	55	56	56	56
Yemen price \$/bbl (WEO - \$3)	95	49	41	53	54	54	54
Yemen LNG \$/MT (Contract Price)	513	650	431	503	499	497	496
<b>Memo:</b>							
Qatar LNG Price \$/MT	493	498	509	530	554	578	585
Henry Hub Price \$ per metric ton	436	291	193	226	224	223	223
WEO LNG Index	160	107	71	83	82	82	82
* In barrels of oil equivalent.							

Source: IMF and staff calculations - January 2017.

an equivalent of around 190,000 and 167,000 barrels of oil per day in 2013 and 2014, respectively. Pre-conflict, the hydrocarbon industry in Yemen generated 50-60 % of the fiscal revenues and up to 85 % of export revenues, and nearly 50% of foreign reserves. The sector’s share of GDP amounted to 8-9%, and its importance for direct employment is negligible. The hydrocarbon sector economic role has

in Aden, or indirectly by the halted production and the exodus of foreign and private operators, including the service companies, as well as interruption of maintenance. The current production is limited to an estimated 10 % of capacity relying on production from Block 18 in Marib, whose crude oil is mainly transformed into (bottled) cooking gas for domestic sale. The operations are run by the state

owned Safer Company<sup>39</sup>, running currently at a level of about \$200 million in turnover.

**How quickly the past production revenue capacity can be restored depends on (1) the speed of investor re-engagement (2) better utilization of given investments, and (3) the future investment conditions available to the sector, ultimately aided by a conflict resolution agreement.** Although oil production has been on a declining path since early in the last decade, oil revenues were enhanced, over-compensating the loss in production through the high international average price level for hydrocarbon products from 2010 up to mid-2014. The future prices are assumed to rally around \$50 a barrel, about half of past prices. Achieving the pre-2014 hydrocarbon rent level for Yemen's fiscal and external balance going forward, would require a substantial increase in the annual production. The decline in production - as has been observed since 2002- could be reversed, if the investment climate in the sector would allow for a more sustainable prospection, exploration, and production path. Also, only 12 blocks are currently active whereas another 86 onshore and 29 offshore blocks have bare-

ly been explored.<sup>40</sup>

## 2.2.1 Outlook for Yemen's Hydrocarbon Production Recovery

### Oil sector recovery

**Initial post-conflict restoration of production needs to rely on state-owned oil production blocks.** As of 2014, the state operated two of the 12 active blocks, represented around 42 % of the country's total output for 2014 (Block 18 by Safer, Block 14 by PetroMasila). However, following the Production Sharing Agreement (PSA) expiry in 2015 of TOTAL's Block 10 in Hadramout and consequent handover by TOTAL to the state-owned company PetroMasila the share of state owned companies in national production increased to potentially around 65 % of currently total possible production (156,000 barrels a day in 2014).

**The government share in revenues derived from oil production will be lower going forward compared to prior to the conflict.** The share of the Yemen Government in oil output averaged at around 60 % during the 2000-2014 period. The ratio of the govern-

Table 2: Yemen: Estimated Yemen's output share in oil production, 2017 and 2018 (in 1000 barrels)

Block	Operated by	2017	2018	2019
<b>National Operators</b>				
Marib 18	SAFER	1,826	2,233	2,177
MASILA 14	PetroMasilah	2,948	5,225	4,256
(E. SHABWA (Block 10	(PetroMasilah (formerly TOTAL	3,753	8,278	9,435
<b>Total</b>		<b>8,527</b>	<b>15,735</b>	<b>15,868</b>
<b>Foreign Operators</b>				
JANNAH 5	Jannah-Hunt	4,279	9,535	10,798
(Ulquah (Block S-2	OMV	1,368	5,031	2,868
<b>Total</b>		<b>5,647</b>	<b>14,566</b>	<b>13,666</b>
<b>Grand Total</b>		<b>14,174</b>	<b>30,301</b>	<b>29,534</b>

Source: Staff calculations - January 2017.

<sup>39</sup> Safer Company is a state-owned company operating block 18 in the Marib governorate.

<sup>40</sup> Yemen Ministry of Oils and Minerals.

ment's share in oil output improved up to 2011 but has been declining since then, taking into account the difficult operating environment since 2011, which led to increasing operation costs and in turn, are part of costs recovery arrangements between the operating companies, including the state owned ones, and the government. Between 2000-2014, cost recovery averaged 17.6 % of the net output. In post-conflict phase, this share is to increase because of compensation needs, damage repairs, backlog in maintenance, and a continuous high cost operating environment due to continuous presumed conditions of insecurity. Therefore, the net earnings for the state from the post conflict oil production will decrease relatively to the pre-conflict situation for the initial years. Eventually, if conditions improve, especially the overall investment conditions, the ratio could improve again in favor of the government share.

***Oil production by the nine privately operated blocks, could take more time to restore.***

Nine out of the country's 13 oil production sites are operated by foreign and private companies, only 2 sites (Block 5 – Jannah hunt & Block S2 – OMV) yield larger production potential, and thus would pose greater economic incentives for a quick restoration. The others are small blocks and were operated by small and medium sized private companies. Most are not expected to return and resume operations in the first year of post-conflict due to weak economic incentives (i.e. low global oil prices vs. security), revoked/expired contracts that require renegotiations, damaged infrastructure, etc. On the other hand, the success of national or large operators in restoring the sector and its operating logistics would provide significant incentives (synergy effect) for smaller operators to restore production of smaller sites.

***Restoring oil production: three scenarios for the post-conflict (2017-2018).*** If a peace settlement is reached, and the pipeline infra-

structure could be restored/maintained, the country's post-conflict oil production (2017-19) could be gradually restored to around 130 thousand barrel per day during 2017/18 compared to the pre conflict level of 156 and 59 thousand barrel per day in 2014 and 2015, respectively. The restoration scenario is based on (1) the full engagement of state owned national operators (Blocks 18, 10, 14), which would secure 65 % of the estimated daily production, (2) status-quo of the oil infrastructure as known at end 2016 remains valid (no further damage or deterioration), and (3) a quick return of the large foreign operators and restoration of their production capacity. The state's export revenues from the so restored output could exceed \$1 billion in 2017.<sup>41</sup>

• ***Full recovery of oil production:***

the full recovery is dependent on the speed of foreign operators returning, representing around 35 % of the total production. If production of the two state companies and of all foreign operators can be fully restored in the 2<sup>nd</sup> half of 2017, the estimated total oil output in this scenario would be around 30 million barrels in 2017, and 65 million barrels in 2018, resulting in a net share for the state of about 17 million in 2017 and 37.5 million barrels in 2018, which generate nearly \$0.9 billion of revenues for the state in 2017 and \$2 billion in 2018, based on the current oil price forecast.

• ***Partial Recovery of oil production: 2 state companies and the 2 largest foreign operators resume operations (no return of most foreign oil operators).***

Given the vested interest and potential commercial viability concerning the 5 largest production blocks (18, 10, 14, 5 and S2) in Yemen, it is likely that the 2 largest private investors (Jannah Hunt & OMV) join the two

<sup>41</sup> Based on the estimated state output share for 2017 times the future oil price for 2017.

state companies in restoring production. In this scenario, the state's output share could reach 14 million barrels in 2017 and 30 million barrels in 2018. This would imply state net revenues of \$0.7 billion in 2017, and \$1.6 billion in 2018.

- **Slow Recovery of oil production (no return of foreign operators):** If production capacity by foreign operators could not be restored in the initial post-conflict period (2017-2018), the expected output for the state by its two operators (block 10, 18, 14) would be around 25 million barrel for period total, which would imply around \$1 billion of state revenues.

#### *Gas production recovery*

**Yemen's gas sector has played a vital economic role since it came on stream in 2009.** The Republic of Yemen has 430 billion cubic meters of proven gas reserves, mainly in the Marib basin. Two-thirds of these reserves (288 billion cubic meters) were allocated in 2007 to the Yemen Liquefied Natural Gas Consortium (YLNG) under an agreement, by which 90 % of this amount would be exported and the remaining 10 % would be used for power generation and household consumption in Yemen. The remaining one-third of the reserves (142 billion cubic meters) has not yet been certified. Of this remaining volume, around 40 % is so called near-term gas that could be mobilized. So far, gas production has been limited to Marib's block 18, but a large part of the country has not yet been explored because of a lack of resources, leading to the uncertain political outlook and investment conditions, which hinders investor's interest. Data are not available on the potential size of probable and pos-

sible reserves or on the likely cost of development. Indications are that sizeable gas reserves might still exist in the east of the country. However, proactive measures to encourage discovery and development may be needed.

**Gas production and export infrastructure are managed jointly by the state and the private sector.** The country's gas upstream/production is managed by the state-owned company SAFER, which extracts the gas from its Block 18 in Marib. Safer delivers the gas to the Yemen Liquefied Natural Gas Company (YLNG), which is a private consortium with 21.7 % state ownership<sup>42</sup>. TOTAL company operates YLNG. Although gas export infrastructure is managed by YLNG, SAFER is managing the transport of gas via a pipeline from Block 18 to YLNG's liquefaction built-facility (at a capacity 6.7 MBTU per year) and export terminals at the port of Balhaf in Shabwah governorate.

**The state's revenues derived from the gas sector has 2 components and are roughly equal to 25% of the gas export revenues.** The government revenues from the LNG project are derived from two main sources: (i) direct taxes, bounces and royalty, and (ii) indirectly, from the profit sharing agreement of the consortium signed with the two state owned enterprises, the Yemen Gas Company (YGC), and the General Authority for Social Security Pensions (GASSP), both of which are shareholders of YLNG (about 25% in total). The gas off-take price was renegotiated in 2013 in favor of augmenting the net revenues flow to the state. As a result, the state's net share from LNG exports in 2014 almost doubled to around \$0.7 billion, from \$353 million in the previous years.

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<sup>42</sup> Yemen LNG Co. which is a private consortium featuring Total, Canadian Nexon, Kogas, Hyundai as the private shareholders in addition to the state, which owns 21.7 % of the company through the Yemen Gas Corporation and the General Authority for Social Security Pensions.



**Conditions determining recovery of gas production in Yemen are less dependent on physical infrastructure factors but more on legal or contractual considerations.**

While restoring infrastructure for the gas export sector would not pose a significant constraint<sup>43</sup>, the biggest challenge facing the sector recovery would be the restoration of the revoked long-term sale contracts for Yemen LNG export. As the conflict escalated early 2015, Yemen LNG Company announced on April 7<sup>th</sup>, 2015, its decision to halt all production and export operations, and evacuate the site personnel. In addition, TOTAL, which operated Yemen LNG, has declared *force majeure*<sup>44</sup> in relation to its various stakeholders and contracts in Yemen. Until now, it is not clear how the halted operations and the contractual status of having declared *force majeure* would impact the contractual legal agreements with the company's three principal (gas) buyers, and the feasibility for reinstating of these three long term sale contracts. There is also a shift in the international gas market conditions through shale gas production and traditional producers planning to reenter the international gas market.<sup>45</sup> As a result, Yemen, as a small producer<sup>46</sup>, is likely to have a reduced relative competitive position for future re-engagement scenarios, if the prospect for building more scale cannot be established. How these factors of relative size, complex investment environment, legal legacy, and rise of other investment opportunities (supplies) can be balanced with Yemen's gas sector restoration needs is difficult to assess. Yet, financial incentives to overcome compensation claims

43 As per a mid-2016 assessment which concludes that little infrastructure damage has been documented/reported for the LNG facilities and gas transmission pipeline from Marib to Bahaf.

44 Force majeure is a legal clause meaning circumstances which make it impossible to meet contractual obligations.

45 Iran, a very large potential producer, announced to expand heavily its gas production over the next years.

46 Yemen's share in global gas production amounted in 2014 to 2.2 %.

of operators are likely to play a role, and will dampen the outlook for revenues from the gas sector for the first 12 to 18 months.

**Two tentative scenarios for illustrating the possible recovery path of gas sector.** It is assumed to be unlikely that the legal and contractual issues of the sector allow for a quick resumption of production, although the technical readiness would be relatively easy to restore. As a result, gas production would resume only at the end of 2018, if peace should emerge in mid-2017:

• **Restoring full LNG export capacity from 2018:** assuming that full "contractual" export capacity of 6.7 million BTU tons a year could be restored, and the contract related compensation claims due to conflict related losses and damages are settled rather quickly, and assuming, too, that the export price setting mechanism as renegotiated in 2012-2013 can be applied, the expected resumption of LNG export could generate around \$3 to \$3.3 billion in annual export revenues for the first post-conflict year (2018) and thereafter. Consequently, the estimated total net share for the central government from of LNG export could reach around \$1.07 billion for the first year (2018) with an increase to \$1.1 billion in the second year in 2019.

• **Restoring at 75 % export capacity in the first post-conflict year in 2018:** In this scenario, full maintenance of the transmission pipeline to the YLNG liquidation facilities in Belhaf, could not be achieved by the end of 2017. Other technical reconstruction work and repairs took also more time as in the first scenario, so that production and exports set only in after the first quar-

ter of 2018. The total gas export revenues could then equal around \$2.5 billion in 2018 and \$3.3 billion for 2019. Consequently, the total for the central government net share of LNG export would then be around \$0.8 billion for 2018, and increasing to USD 1.1 billion in 2019.

However, the calculations of compensation for economic losses and actual repair costs did not enter in the above made revenue projection. It is very likely that a substantial share of the estimated revenue amount will not be available to the government during the first two years after conflict as sector operators will claim compensation from the government to resume services; and the government will have to finance the restoration and compensation claims. The presumed large claims by companies will also determine their strategic approach toward restoring the legal framework for their operations. In short, it will be difficult to settle sector restoration issues and considerations in isolation.

### *2.0.2. Yemen's key policy and institutional challenges for the hydrocarbon sector*

***Yemen's Production-Sharing Agreements (PSAs) are mostly outdated and require renegotiations to incentivize for a more efficient hydrocarbon resource exploitation.*** Gas has not been exploited for production in the country's active blocks (except in the state-owned block 18) because of the lack of contractual provisions in the Oil Production-Sharing Agreements (PSAs) permitting gas sales. So far, Yemen has issued four generations of PSAs three of which did not include provisions regarding associated gas sale whereas the deficiency was partly remedied in the newest PSAs (4th generation)<sup>47</sup>, which

<sup>47</sup> The updated PSA continued to set 20-year production schedules with an option to extend production by 5 years while carrying an interest rate of 5–10 % granted to the

Yemen issued during the fourth bidding round in mid 2000s, which contained provisions that define gas sales and provide PSA holders the right to negotiate the development of non-associated gas fields. Using gas resources would require (i) renegotiating PSAs pre-dating the 4<sup>th</sup> generation PSAs, or (ii) waiting until they lapse.

***The sectors incentives and governance provisions would need to be rebalanced to provide a premium for the long term investment view.*** Although the new generation of PSA contracts (4<sup>th</sup> generation) allow for profit-sharing in the development of gas, so far little success has been achieved to attract investment into the sector. The pre-2015 record has been poor with regard to this type of exploration activity. Perceived weak government capacity to commit to attractive terms, and deep insecurity in Yemen with related uncertainty about investments, have left the current 4<sup>th</sup> generation of PSA ineffective, judged by market observers. Furthermore, the government's decision to take over the Masila and Marib concessions, in 2011 and 2005, respectively, have led investors to question the value of investing in Yemen. Oil firms also pointed to a lack of assurances that future governments will not try to renegotiate deals (as the government has done with the off take agreements negotiated in 2005 for its LNG project) and push for even less attractive or simply altered terms. As a result, investors are risk adverse and prefer the short-term view, favoring a quick recovery of investment. It would be important for a more efficient, economic, and more sustainable use of Yemen hydrocarbon resources to change the investor's incentive structure, and create an investment climate, which favors the longer term view, which pro-

Ministry of Oil. Under the new deals, a joint management committee would oversee exploration and, if a discovery were to be made, it would negotiate the terms of a joint venture company to manage the asset, for which the state would hold a 50 % stake. With the addition of the carried share, the government would, in effect, have a 55–60 % share in the asset.

vides for a more secure “give & take”, influenced and supported by the overall governance of the sector.

***Establishing performance based instruments for operators, especially also for the large state owned operators, Safer and PetroMasila, would help to improve the efficiency and investment path of these companies.***<sup>48</sup> Competing institutional arrangements have prevented the creation of performance-based incentives supporting investment, i.e. by allowing public operators to own/access a share of their revenue or to commercialize part of the hydrocarbon output, favoring also short term financial profits and output gains over medium or longer term financial viability and production capacity. In addition, capital expenditure cuts for the state-run oil operators ordered in the recent past by the Ministry of Finance further distorted the incentives of state owned operators to improve revenues performance and efficiency of their operations, favoring instead short term profit considerations. Creating more publicity or public debate on such choices and their trade-offs would help to change these adverse policies.

***Enhancing the governance and competitiveness of the domestic gas distribution market in Liquefied Petroleum Gas (LPG/cooking gas) would cut rents and help meeting demand with fewer subsidies.*** As of now, there is no clear governance framework to regulate the private sector role in the distribution and completion in the upstream or downstream stages. Since 2015, the LPG sector has seen considerable expansion activities and rising interests from local private sector when domestic demand for LPG sales began to increase substantially, due to additional

<sup>48</sup> Since 2010, reportedly, Safer did not receive capital budget from the Ministry of Finance to fund its operations, which were kept alive, thanks to the gas production payments made “directly” to Safer by the Yemen Liquefied Natural Gas consortium.

consumption uses such as being alternative source for car fueling or to generate electricity when regular fuel supplies in 2015 became very scarce and expensive. Non-competitive arrangements help also to maintain implicit subsidies for the used gas cylinders.

***Establishing a stronger link between hydrocarbon revenues and development expenditures.*** The opaqueness of the institutional set-up of the hydrocarbon sector in Yemen and the capture of its operation by way of the universe of state owned companies would need to be addressed if the notion of sharing the natural resources with all Yemeni should be meaningful. A start could be made by setting up a council composed of the Ministries of Oil and Minerals, Finance, and International Cooperation and Planning, as well as Yemen’s Central Bank. This council would then be tasked to report to the Yemeni public the state of the production, sales and prices obtained, as well as revenues collected from operation. It would build on the Extractive Industry Transparency Initiative (EITI) to which Yemen had subscribed to in 2011.

***Setting up a fundamentally revamped governance for the sector over the medium term is unavoidable for creating scale investment opportunity, and enhancing transparency.*** A review of the sector’s organizational set-up is recommended, which would help to re-define the delineation of the sector’s political oversight and operations across an array of existing institutions, entities, and state owned companies. Considerations should be given to inviting public entities (e.g., Ministries) into the collective oversight responsibilities in order to broaden the demand for transparency and align interests in favor of transparency. The future organizational and governance set-up would have to serve the sus-

tainable development of the sector, to provide for more investor reassurances, domestic or foreign investor, and to balance out the Yemeni region's share or regional shares with regard to the financial benefits the explorations of this national resource offer. One way forward could be to form a national hydrocarbon holding company, which is tasked to deal along commercial criteria with the national resource, as an investor and operator, jointly with other investors or alone. The holding company could allow for foreign strategic or portfolio investors to participate in providing for private sector incentives for improved overall sector governance and management.<sup>49</sup> As an additional visionary point, the sectors' assets could also, along the above-mentioned path, eventually form a nucleus of private assets traded at a stock exchange in Yemen or elsewhere, adding to the incentives for private sector based governance while also using the sector as an entry point for revamping the large state owned enterprise sector in Yemen.

### *2.3. Fiscal policies for peace building, recovery and fomenting growth*

***Rebuilding the country after agreeing to peace building will not be possible with the fiscal expenditure program executed in Yemen in the past and the financial envelope likely to be available for the next 2 years (see also above).*** Pre-conflict expenditure fiscal programs reached about 28 to 34 % of the GDP. Roughly a third (around 10% of GDP) was reserved by the civil service, another third (nearly) was spent over the last decade on transfers and subsidies, predominately gasoline and diesel. Capital spending reached only in 2005 8% of the GDP but since

then oscillated around 4-5% of GDP, half of it foreign financed. Of the roughly 6-7 % of the GDP was spent on social expenditure about 2/3 were spent on education. About 80 % of the total social spending was due to wages and salaries. The structure of the expenditure program since 2015 has been further compressed to comprise only (1) salaries, (2) interest rate payments due to the build-up of public debt, and (3) some consumption of gasoline/diesel/energy/some goods. With recovery growth reaching an assumed 5 to 10% annually over the first 2 years of an initial post conflict period, the resource envelope available will not be much more than half of the costs for a minimal expenditure program, implying that a fiscal deficit of about 10 to 12 % of the GDP should be counted with. The domestically raised revenues are likely to cover at best salaries and allow for some down payments on regularizing accumulated domestic, and some re-initiation of social services. Employment and recovery programs are unlikely to be possible to be financed from own resources, particularly savings, during the first two years post conflict. The limited expenditure options risk in such a scenario to put the peace under stress, as the future government will not be able to deliver on expectations.

***Foreign financial assistance is required for Yemen to recover and restore, and to build peace.*** With an estimated deficit going forward of 10 to 12% of the GDP, additional resources of about 5 to 6% of the GDP are required to settle with an effective deficit of about 5-6 % of the GDP, which is in the order experienced on average since 2000. Such deficit would require more external assistance than in the past, but it would also require a higher absorption capacity, which has been already an obstacle in the past. In the decade 2000-2010 Yemen absorbed annually on average not more than 1.5 % of the GDP in external aid. Even if foreign aid becomes available on the required level of up to 6 % of the GDP the country's capacity after the conflict is likely not

<sup>49</sup> See also the reform of ARAMCO in the Kingdom of Saudi Arabia.



up to delivering the needed higher absorption rate of aid. To facilitate such aid flows under the given constraints, more budget directed assistance would need to be considered, as happened in 2012, and bolstering of foreign reserves as a partial alternative could be considered. Bolstering the reserves have the advantage to benefit the private sector via imports they can pay for; and the bolstered reserves could help to stabilize the exchange rate as well as expectation early on. Particularly, stabilizing expectations, as a measurement of trust building, would be an important positive by-product (externality) of bolstering the foreign reserve stock.

**Fiscal policies are key for supporting recovery and growth.** Past effectiveness of the public expenditure program has been limited in terms of its impact on growth. In fact, public investment has been low and the vast share of expenditures went for consumption or current expenditures (see also above) since the turn of the millennium. The Joint Social Economic Assessment (JSEA) of 2012<sup>50</sup> laid out that supporting industry and service development through public spending has the highest growth impact, if such spending is invested in electricity and water, public works, housing and roads.<sup>51</sup> The productivity growth in Yemen has been notoriously low over the past 2 decades<sup>52</sup>, which translates – among others - into a low per capita growth rate, low income per capita, and is in general an indicator for the relative stagnant state of Yemen's economy up to 2012. Future fiscal policies in Yemen will therefore have to look at how

50 The JSEA was a joint assessment undertaken by the World Bank, the United Nations, the European Union and the Islamic Development Bank to assess broadly Yemen's priority needs in support of the Yemen's Transition Agreement which was signed in November 23<sup>rd</sup>, 2011.

51 See JSEA, page 19, table 5; "Public Spending and Elasticities". See also Table 7 "Projected Growth Rates by Sector".

52 See The Republic of Yemen: Unlocking the Potential for Economic Growth; a Country Economic Memorandum, World Bank, Washington D.C., 2015.

they can contribute to stirring up productivity. Apart from the above referred redirection of public investment program, the regulatory framework and market conditions would be an important area to look at, and to incentivize much needed private investment.<sup>53</sup> The state owned enterprise sector and its social and economic performance would be another important area for gaining productivity through interventions and reform. The aim would not be simply privatizing but first to use any possible mean to make the state owned sector economically more performing, be less of a fiscal burden to the public, and be more enterprising, ultimately more productive. Only then it can fulfill its employment objective in a sustainable and credible way.

**Fiscal policies should free space for investment expenditures and should stop supporting private consumption (foremost subsidies) regardless of income brackets.** Going forward, subsidies for energy consumption should be all but abolished. In the past, up to 8% of the GDP, up to a third of the fiscal envelope, were used for subsidies, foremost energy subsidies. This represented much more than was spent on education or health. While subsidies were reduced in mid-2014, and the remaining one supports only a subsidy for diesel for electricity generation, the country would be better off when all energy subsidies could be clearly abolished, in line with a general regional policy shift away from energy subsidies. Apart of distorting economic outcomes at the expense of the public, or education for that matter, energy subsidies were also a lucrative area for extracting rents. None of these outcomes would be acceptable going forward. Eliminating all energy subsidies would therefore equally reinforce better governance as a large source for rent distribution would be dried up, another prerequisite for supporting sustainable growth. The Social Welfare Fund's cash transfer program for poor households should instead be used

53 See also Annex 6.

to compensate the poor for loss of income, or supporting income, while also helping to leave poverty through productivity enhancing programs, which could be linked to the cash transfer program. In general, the future public expenditure program should focus more on investment, including human capital investment, rather than on consumption.

None of these fiscal policy priorities will be successful or effective without rebuilding the public financial management system.

## *2.4 Re-establishing the Public Financial Management System*

**Effective Public Financial Management (PFM) forms a critical prerequisite for economic governance and supporting sustainable recovery.** PFM is a basic but also a central instrument to create trust in the state and its public purpose through applying rigorously its standards, regulations, and processes in a transparent and accountable way. It is at the center of state rebuilding efforts, as it matches publicly available resources with public service delivery, Yemenis are hoping for and counting with. Mastering the PFM system is therefore a sine-qua-non condition for restoring the central state. If mastered in a transparent and accountable way it will help to contribute to rebuilding legitimacy. It is not an end in itself. It is meant to deliver on policies and public services, to which all Yemenis have access. If the system helps to deliver such services based on agreed policies (e.g., budget), it will also help to refocus the political discussion in Yemen about resources and services, which has been fragmented before 2015 but is certainly heavily fragmented in the immediate post conflict period.<sup>54</sup>

### ***Experience in post-conflict situations has shown that rebuilding the government's***

<sup>54</sup> Letter dated 27 January 2017 from the Panel of Experts on Yemen addressed to the President of the Security Council; United Nations Security Council, January 31st, 2017; document no.: S/2017/81

**own PFM capacity is highly important for achieving recovery, stability, and ultimately peace.** There are essentially three reasons why the focus on the national PFM system is important: (1) the orderly flow of revenues and expenditures to allow the provision of public sector services, (2) using national systems is a cost effective and sustainable way to absorb external assistance, and (3) rebuilding the national PFM system in an accountable and inclusive manner offers the opportunity to rebuild trust between citizens and the state (see also above). The state-building impact of the PFM system and its reform can be significant, if it is taken as a building bloc towards forming an environment for domestic accountability, joined by the development of sustainable capacity and a clear focus on supporting and delivering services (Gill 2015).

**A recent World Bank review of PFM reforms in post-conflict countries underpins the supporting role of the PFM system in generating recovery, trust, and stability.** Despite many legacies, including very low capacity, continuous insecurity, and acute cases of failed development, building more effective PFM systems has been a key driver for overcoming these constraints. At the same time, there are also tremendous risks: progress has been uneven across the dimensions of the budget cycle, and the sustainability of PFM reforms frequently remains uncertain due to capacity challenges, political and security reasons (World Bank 2012).

**While it is important for the PFM systems to support immediate needs such as restoring basic services, this should be done without compromising longer-term institution-building objectives.** One of the main challenges in post-conflict situations is finding the right balance between the urgencies of the day and addressing medium- to longer-term governance challenges (World Bank 2016).

### 2.4.1 Policy challenges for the Public Financial Management System

**A number of contextual and structural problems will shape the post-conflict PFM policy priorities:** the mismatch between the available fiscal revenues and the pressure on expenditures, the absence of an approved budget for some time, the need to reconcile actions taken during the conflict by the conflicting parties in Sana'a and in Aden, and maybe also by local actors in other locations in Yemen, the significant cash flow shortages disrupting service delivery, limited or interrupted chain of information about budget implementation, compounded by the erosion of PFM capacity on all levels.

**Already prior to the current crisis, the country has been unable to establish a sustainable fiscal position and depended on foreign support.** As a result of the dramatic deterioration of the fiscal situation in Yemen, and starting in May 2015, the Ministry of Finance implemented expenditure containment measures, such as: (i) suspending investment projects (budget chapters 4 and 5); (ii) reducing some recurrent expenditures (budget chapters 1 & 2); and (iii) limiting budgets of the economic units to salary and wages only — except for medicines and some operating costs for hospitals. Notwithstanding these measures, a large increase in the budget deficit and public debt occurred.<sup>55</sup> Salary and wages have exceeded revenues, leading to direct financing from the central bank, and lately arrears.

**The fiscal challenges have been exacerbated by the political crisis, leading to two separate authorities (in Sana'a and in Aden) issuing instructions that created uncertainty for the PFM systems.** In

<sup>55</sup> The public budget's financing gap is estimated at US\$5.8 billion in 2016, without even considering reconstruction needs (Government of Yemen 2016).

the absence of an approved budget in 2015 and 2016, an expenditure plan using the 2014 budget ceilings was applied, even though the 2014 fiscal context was largely outdated in 2015 and thereafter. In 2016, expenditures have been limited to parts of Chapters 1 (payroll) and 4 (debt service), with the process controlled and largely financially serviced by the CBY. However, with the CBY running out of tradable assets, domestic as well as external assets (foreign reserves), its supporting service function stopped.<sup>56</sup> The Hadi-administration has prepared its own budget, but it has not become operational.

**The quality of fiscal information cannot be ascertained and the integrity of government accounting records is uncertain.** The use of the Automated Financial Management Information System (AFMIS) by the spending units has apparently continued in some ministries, but has been stopped in others due to the ongoing conflict. The Central Organization of Control and Audit (COCA) institutional structure seems to have remained intact and staff continue to operate. However, no audited financial statements have been produced. In addition, the PFM capacity, which has been limited before the conflict, seems to have been significantly deteriorated. For example, few staff continue working at the Ministry of Finance premises under authorities who are not recognized by the administration in exile.

**Tackling PFM policy options and actions is critical for the post-conflict to be sure**

<sup>56</sup> In September 2016, President Hadi issued decrees to move the CBY from Sanaa to Aden, replace the Bank's Governor and reshuffle the Board of Directors. This change coincided with the depletion of national bank notes and foreign reserves. Since then, the CBY in Sanaa stopped paying salaries. Servicing external debt stopped already earlier, in April 2016. Since March 2016, CBY rationed access to foreign reserves in favor of critical food imports, a policy which was discontinued in the wake of the decisions taken in September 2016 by the political leadership, and due to the lack of foreign reserves.

**that policy measures meet envisaged results.** The government and its development partners are advised to place immediate post-conflict focus on downstream budget implementation, where funding and expenditures produce results and accountability. Fragile states are particularly weak in *de facto* (versus *de jure*) PFM measures that track implementation of budget transparency and execution, including crucial downstream processes such as cash management, procurement, payroll control and internal control (Porter et al 2010). Therefore, a focus on budget execution and on the ability to verify and report on where the government is spending its money across the main stages of the budget cycle is more critical in the immediate term than upstream processes, such as multi-year budgeting frameworks or program-based budgeting. The former are also more likely to bear fruit in improving results and accountability in government spending.

**PFM policies will evolve with the political compromise found for the post conflict in Yemen and will need to be revisited and adapted regularly.** Adaptation and precise requirements will also depend on the terms of the political settlement that, at present, is still unknown. In any case, selectivity is needed to avoid placing excessive demands on the weak administrative capacity, which in the short term will require re-assembling a core group of local budget management experienced practitioners, supported by international expertise. Evidently, the degree of political commitment will be a critical factor for the success of PFM measures and their sustainability in the longer run. Experience with PFM reforms in post-conflict environments shows that the greatest progress has been achieved when two factors are aligned: (i) the development of a close relationship between the national authorities and the international community; and (ii) a domestic commitment to state building (World Bank 2012).

**The short-term demands from the PFM system is to support fiscal stability, restoration of service delivery, reconstruction, and building of trust.** Such demands would require restoring budget operations quickly, ensuring the integrity of budget control processes as soon as possible, providing information on where the funds are flowing in a transparent fashion, and launching a new budget.

**In parallel, the government is advised to start deliberations for the Medium-Term Strategy which should include further strategically minded PFM reform.** These reforms would have to strengthen the core foundations of the PFM institutions and systems in Yemen and adapt them, as needed, to the emerging public sector administrative setup, which will likely include a wider sharing of power across regions.

## 2.5. Policy recommendations for the Public Financial Management System

### 2.5.1 Restoring budget operations

**Legitimacy, trust building, and effectiveness of any expenditure program requires the restoration of normal budget operations.** Normal budget operations will have to be restored in order to support the state administrative structure and to provide some degree of service delivery. This will include establishing the authorizing arrangements, as well as restarting treasury operations.

i. As a starting point, an “emergency budget” for the post-conflict fiscal year would need to be prepared.<sup>57</sup> Its initial approval and subsequent adjustments may be subject to temporary authorizing procedures as possibly articulated in

<sup>57</sup> Emergency budgets may be required even beyond the first post-conflict fiscal year.



the post-conflict political settlement, for instance by a “Fiscal Policy Committee” with representation from the Ministries of Finance, Planning, and Oil, the CBY, and the Prime Minister’s Office. This authorizing body would then set the revenue and expenditure policy and procedures.<sup>58</sup>

ii. In order to build cash balances for budget execution, the Ministry of Finance and the CBY would need to implement as possible treasury consolidation, i.e. control of central government revenue inflows (from hydrocarbon, taxes, untied donor aid, and so on) through the Treasury Single Account (TSA).<sup>59</sup> Possession of “own revenues” by central government entities should be discouraged. Similarly, creation of extra-budgetary funds should be restricted.

iii. While the principle of treasury consolidation should be vigorously pursued, it is likely that in the aftermath of conflict, development partners will require special flow-of-fund mechanisms to mitigate fiduciary risks. These may include the use of financial intermediary agencies (including United Nations agencies) for investment projects, the establishment of a recurrent cost operation to provide for immediate stabilization and reconstruction needs,<sup>60</sup> and the recruitment of Independent Monitoring Agents (IMAs) to provide an additional level of fiduciary controls. These mechanisms can prove valuable in the short-term, provided they are not detrimental to the formal national

58 As a part of the preparation of the emergency budget, there will be a need to review the impact of the major decisions and actions taken by both administrations during the conflict.

59 This note does not address fiscal decentralization policy, including revenue-sharing arrangements.

60 Examples supported by the World Bank include the Afghanistan Reconstruction Trust Fund and the Somalia Recurrent Cost and Reform Financing Project.

PFM systems. In particular, these funding mechanisms should not be fully off-budget, i.e. they should be considered in the emergency budget planning, cash flow programming, and budget execution reports. In addition, they should be subject to sunset provisions aligned with the PFM Strategy and Action Plan (see section (e) below).

iv. An inventory of liabilities and expenditure arrears (salaries, entitlements, domestic debt, suppliers, etc.) would need to be conducted, verified, and categorized to help to inform expenditure prioritization decisions, including the identification of financing sources and a timetable for liquidation (IMF 2014b). These decisions should be communicated by the authorizing body in a transparent manner.

v. Based on the revenue projections and prioritized expenditures, a simple cash flow program would need to be prepared and operationalized. The arrangements for central treasury payments between the Ministry of Finance and the CBY, in existence prior to the conflict, would need to be reinstated.

### 2.5.2. Ensuring the integrity of budget controls

***There is no legitimacy without restoring budget integrity.*** In order to build confidence among the relevant stakeholders and to make efficient use of limited resources, it will be important to ensure that fundamental controls are in place to prevent leakages.

i. Under the presumption that expenditure priority will initially be placed on payments of civil servant salaries, securing the integrity of payroll data and controls will be imperative. The post-conflict environment might actually bring with it the opportunity to

consolidate a uniform payroll directly linked to a personnel database (to be computerized in due course), providing the list of all staff whose salaries would be financed by the budget. The list should be verified against the approved establishment and personnel records.<sup>61</sup> The system used for payroll calculations needs to be verified as well. Subsequent amendments to the payroll and personnel databases should be processed in an authorized and timely manner, and documented through a monthly reconciliation report. An audit trail of all payroll transactions and authorizations should be kept.

ii. The Ministry of Finance would also need to resume the operationalization of other basic budget execution controls for incurring commitments (which will be important to prevent a new build-up of arrears), verification of receipt of goods and services, preparation of payment orders, and issuance of payments.

iii. In addition, the Ministry of Finance would need to exercise strict enforcement of budget appropriation ceilings. A centralized payroll system, as suggested above, should help in this regard. As a general hard budget constraint, no budget overruns should be allowed before a transfer between or within appropriations (“virements”), including the use of the contingency reserve, is approved by the authorizing body. In the absence of an operational AFMIS, the previously used sub-account structure of the TSA, mirroring the chapter and sub-chapter ceilings, can facilitate effective virement control.

<sup>61</sup> In the case of Central African Republic, for instance, the post-conflict census of civil servants was completed in around two months.

### 2.5.3. Providing information about where government funds are going

**Commitment to and delivery on fiscal transparency will be an important trust and confidence-building measure.** Producing timely and reliable information about the budget and its execution (to start with) will help open doors for public debate. It will also facilitate accountability over the use of public resources to citizens and development partners alike. It will be particularly important for the government to quickly show that spending is going to support reconstruction and service restoration in the various areas of the country.

i. The government would need to resume public access to budget information, i.e., availability without restriction, within a reasonable time, with no requirement to register, and free of charge, to a basic set of budget documents, starting with:

- Enacted budget and supporting documentation, within two weeks of passage.
- Monthly budget execution reports, in a format consistent with that of the approved budget, within one month of their issuance.
- Annual budget execution reports, within six months of the fiscal year end.
- Audited annual financial statements, incorporating or accompanied by the COCA auditor’s report, within twelve months of the fiscal year end.<sup>62</sup>

<sup>62</sup> In addition to the identified priority documents, other elements would need to be added in due course, specifically: (i) executive budget proposal documentation to be made available to the public within one week of the executive’s submission to the legislature; (ii) macroeconomic forecasts, within one week of their endorsement; (iii) a Pre-budget Statement, including the broad parameters for the executive budget proposal regarding expenditure, planned revenue, and debt, at least four months before the start of the fiscal year; (iv) other external, non-confidential, audit reports

ii. The preparation, issuance and dissemination of audits by COCA would constitute an important element of early commitment to financial accountability. With this objective in mind, COCA would need to develop a basic financial audit program allowing it to issue an opinion on the annual financial statements (or at least the budget execution report) soon after the end of the fiscal year. Further, it would need to develop a program of compliance audits focused on budget execution that can provide a minimum degree of external assurance — even before the annual accounts are closed. In conducting these activities, COCA will benefit from collaborating with other oversight bodies such as the Supreme National Authority for Combating Corruption and the Higher Council for Procurement.

#### 2.5.4. Launching preparations of the new budget

**The first post-emergency budget formulation exercise will be constrained by the presumed limited available capacity.** If anything positive can arise from the absence of effective public investment planning and budgeting processes during the conflict, it is the opportunity to achieve the long-sought integration of the capital and recurrent budgets under a fiscally sustainable outlook.

i. The new budget formulation process would need to consider the preparation of a basic fiscal outlook to inform budget ceilings. These ceilings, together with the arrears liquidation and the expenditure prioritization program, would set hard budget constraints for nego-

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on central government entities, within six months of submission; and (v) a Citizen's Budget within two weeks of the executive budget proposal's submission to the legislature and within one month of the budget's approval (the first Citizen's Budget for Yemen was prepared in 2013). (Adapted from PEFA Framework 2016).

tiation with spending entities.

ii. The budget would need to be unified. While an inter-agency “gatekeeping process” for approval of capital projects can be instituted (*see next point*), the Ministry of Finance would lead the single formulation of the capital investment and recurrent expenditure budgets.<sup>63</sup> Moreover, to main budget integrity, donor-financed investments would be incorporated into the national budget, even if special implementation mechanisms are required by the donors.<sup>64</sup>

iii. A simple mechanism for selection and allocation of funds to reconstruction capital investment projects would need to be established and further developed over time. While these investments would be supported largely by development partners on the basis of a Recovery and Peacebuilding Needs Assessment (RPBA), the foundations for an institutional project “gatekeeping” process can be set early on, using basic appraisal techniques<sup>65</sup> and

63 As one of the reform pillars under the 2012 Mutual Accountability Framework (MAF), the Ministry of Finance and MOPIC made the first joint attempt at budget integration through “The Executive Plan for the Harmonization of Investment Programs and State Public Budget.” (Government of Yemen 2012). The plan intended to solve problems resulting from dual budgeting and the misalignment of the budget with the government's economic priorities, specifically the priorities and objectives reflected in the government's Transitional Program for Security and Development (TPSD) 2012-14, as well as with the future development plans and programs in general.

64 While allowing for special implementation mechanisms, the government and its development partners should prevent the emergence of enclave-type arrangements whereby a donor agrees with a ministry on investments in the sector without reference to the overall reconstruction program, development and fiscal sustainability objectives reflected in the budget (UN and World Bank, forthcoming).

65 Investment priorities in post-conflict settings

involving the Ministry of Finance, MOPIIC, and eventually the Cabinet. A “clean” public investment project database would be built from scratch for planning and monitoring purposes, with the underlying information system platform evolving over time.

iv. The budget approval procedures, and the phasing out of the post-conflict ad hoc authorizing body would need to be established as soon as the new legislative body could be reconstituted.<sup>66</sup> The new budget approval process could also serve as a means to encourage more public debate around the public policies reflected in the budget, including the public investment program.

#### *2.5.5. Establishing the core foundations for rebuilding PFM institutions and systems*

***While the preceding proposed policy measures would take place in the immediate post-conflict context, a parallel dedicated effort will be necessary to shape the PFM institutions and systems for the medium and longer term.***

i. During the immediate term, priority should be placed on addressing concrete PFM problems. Yet, as soon as the conditions on the ground are conducive, a broad evidence-based assessment of the PFM system performance and associated resources will normally require making distinctions between projects that should be identified and executed under special modalities suitable to their political/social objectives; other projects tailored to humanitarian or damage-control goals; and projects that should meet the standard rules of economic appraisal. (UN and World Bank, forthcoming).

<sup>66</sup> Prior to the conflict, Yemen was characterized by a well-structured and vibrant parliamentary oversight of the government’s budget estimates approval process that addressed both fiscal policy and details of the revenue and expenditure estimates (Arya 2010).

need to be conducted. To this effect, two instruments are recommended: (i) the indicator-based, globally-recognized Public Expenditure and Accountability Framework (PEFA) PFM Performance Assessment (PEFA 2016), and (ii) a Capacity Needs Assessment to identify and measure capacity constraints to PFM reform, such as scarce resources, low staff skills, mandate limitations, and underdeveloped systems, among others.

ii. Using both, PFM performance and capacity assessments, a PFM Strategy and Action Plan would need to be prepared. The plan would cover revenue administration, the budget cycle, internal control, public investment management, management information systems, and fiscal transparency. A similar undertaking will be needed to strengthen accountability functions, such as COCA’s external audit and Parliamentary budget oversight. It would need to be carefully sequenced—but not prescriptive in nature. Instead, it should seek to define the trajectory of reform while allowing for learning and adaptation (Williamson 2015). The plan should be developed in an inclusive manner by the government (and, as noted below, development partners should coordinate their initiatives around the plan), with due attention to empowering groups of leaders working in coalitions around the key PFM problems (Porter et al 2010). As PFM reform encompasses the whole of the public sector, Cabinet discussion and approval of the PFM Strategy and Action Plan is suggested.

iii. The PFM Strategy and Action Plan would need to be supported by a large capacity-building program, us-



ing a combination of approaches. For most staff in charge of routine PFM functions, including in central finance agencies and spending line ministries, mechanisms for capacity building through skills development will be appropriate. However, gains will be slow and incremental, given the limited absorption capacity that has been further exacerbated by the conflict. For some specialized PFM functions, capacity supplementation or substitution supported by development partners can be incorporated as a short-to-medium-term measure, with built-in mechanisms for transitioning over time. For coordination of PFM capacity building, a centralized unit to manage the activities and associated donor funding, and to liaise with line ministries, could be set up at the Ministry of Finance (e.g., Liberia PFM Unit).

iv. One particular aspect that would need to be tackled early in the post-conflict reform period involves the budgetary classification of public sector entities. In particular, the state budget financing of economic units should be done more transparently,<sup>67</sup> differentiating between non-market entities that should form part of the central government budget and procedures, and actual public corporations (market producers) that fit the definition according to international standards.<sup>68</sup>

v. Any PFM strategy would need to be adapted to the fiscal decentralization and intergovernmental relationship

67 Inter-enterprise credit and commercial loans might represent a hidden source of fiscal risk, with a number of SOEs amassing a substantial amount of payment arrears and incurring debts that the general budget may have to absorb at a later stage (Lepain, 2014).

68 See Chapter 2 of the International Monetary Fund's *Government Finance Statistics Manual* (IMF, 2014a).

framework that is expected to emerge after the conflict — including the powers, roles and responsibilities for each level of the sub-national structure, the fiscal risk monitoring mechanisms, and the coherence and linkages between the central and sub-national PFM systems. For instance, the public sector chart of accounts and budget classification across central and sub-national government administrations should remain unified. In addition, the transfer system could include financial incentives (e.g., performance grants) for compliance with PFM procedures and development of PFM skills in local administrations. Mechanisms for local participation in budget planning and oversight could also be fostered.

vi. The PFM legal framework would need to be updated as needed to consolidate reforms. However, comprehensive legal reform would be irrelevant if the capacity for implementation is not available. Therefore, revisions to the PFM legal framework should be well targeted and fit to context.<sup>69</sup>

vii. Early on, the development partners would need to establish effective donor coordination mechanisms for analytical and implementation support for the preceding elements. Resources to support PFM diagnostics, reform, and capacity building should be provided in a coherent manner, avoiding duplicated and/or fragmented interventions.

### 3. Final Remarks

The many conflict, social, and economic challenges Yemen is facing the post-conflict

69 Regarding the independent audit function of COCA, prior to the conflict the World Bank had discussed with COCA a set of recommendations to bring the legal provisions closer to international standards (World Bank, 2013).

phase will require time to heal and time to be addressed. Although the observer to the Yemen case will easily point to the risks ahead for peace building, there is no alternative to overcoming these challenges, in phases, well communicated, and by practicing the open participatory approach, which Yemeni political traditions would suggest. While external political and financial support to peace building in Yemen is critical to overcome the conflict mode, the national political leadership's commitment to peace building is more important. In fact, willingness to build peace will generate external support, and not the other way around.

The post-conflict period, following examples in Europe, in Africa, and in Asia, can easily take up one or two decades, depending on the factors at work and depending on the willingness of neighbouring countries or the region's ability to help and integrate the country, politically and economically. Yemen is unlikely to be an exception.

The reality of major conflict work-out across the globe has shown that tremendous post-conflict support is needed to build peace. Such support cannot content itself by just supporting a reconstruction fund, although such a fund is certainly helpful. Regional leaders should think about providing Yemen with a perspective for integration in regional institutions and schemes, thereby sharing more horizontally economic and political opportunities for Yemen. There should be a shared interest among regional stakeholders to build peace in such a forward looking way, which could over time benefit all, either in terms of stability, welfare, or simply by enhancing future economic opportunities. Europe and its post-World War II architecture could serve as a positive example.

For the short term, though, the prime challenges are: (1) rebuilding central national economic institutions, foremost the fiscal system with its budget and the anchor for the financial system, the Central Bank, (2) restoring the hy-

drocarbon sector as the financial backbone of the economy without which economic stability will be difficult to conceive, and (3) establishing the legitimacy of the central institutions and their leadership, which is ultimately the Yemeni government. Such legitimacy can be built by delivering on reconstruction and restoring public services. Only when Yemenis are able to agree individually that the public purpose of the central government makes a difference in terms of security, economic well-being, and service delivery (health, education, etc.), legitimacy of the central state and its government can be re-established. Trust – as argued above – is an important building block for legitimacy and can best be practiced where and when it matters most: during the initial peace building period, when scarce public resources, domestic or external ones, are used for restoring and rebuilding legitimacy and overcoming conflict. The question of how political process is facilitated and choices are best made, centrally or on the sub-central level, can be worked out over time, and, if well-conceived and credible, can surely add to building legitimacy.

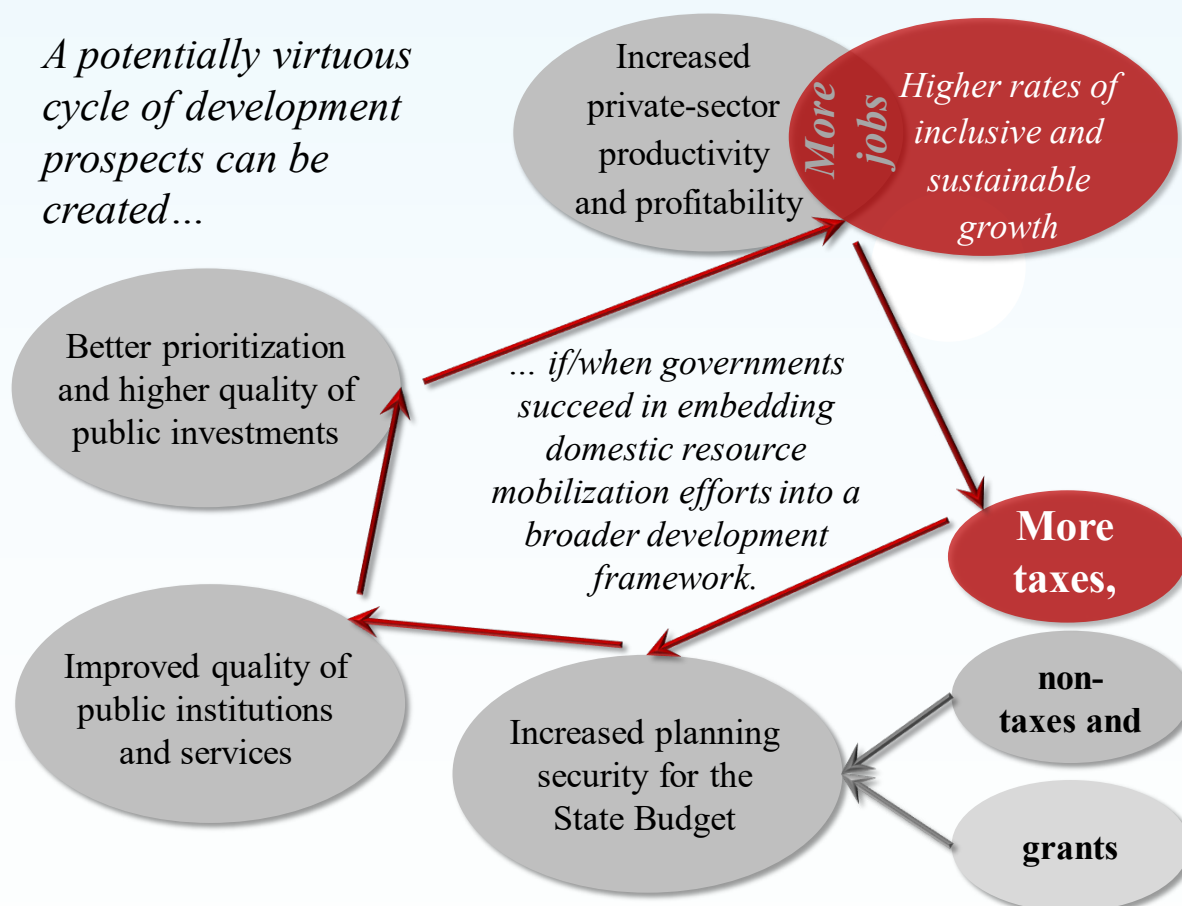
Lacking inclusiveness was seen as a driver of conflict in Yemen, for long. The problem has only been compounded by now, with an increasing number of households falling below the poverty line in Yemen. If the poverty rate has been 48% in 2014, it is per end 2016 estimated at around 70% of the population. Addressing inclusiveness in Yemen could have many entry points but given this massive scale and increase in poverty, for the immediate, successful recovery would be a base for facilitating more inclusiveness.

## Annex 1: Summary of Yemen's Current Tax Regime

	Tax base	Tax rates	Exemptions
<i>Direct taxes</i>			
Personal income tax <i>(Income Tax Law No. 17 of 2010)</i>	Worldwide income (residents)	10–15%	
	Domestic income (non-residents)	20%	
	Net wealth tax	2.50%	
Corporate income tax <i>(Income Tax Law No. 17 of 2010)</i>	Taxable income, incl. capital gains, excl. dividends from public company	20% (standard); 50% (mobile phone); 35% (int'l telecom, oil and gas, cigarettes, importers); 10–20% (SMEs); special rates for oil/gas, mining, and investments; 15% (investment projects).	Micro entities; 2010 income tax law abolished all incentives and exemptions; accelerated appreciation of 40% in first year of use.
Withholding tax	On payments made to non-residents (commissions, patents, trademarks, copyright royalties) and on fees for transfer/use of technology/licences.	10%	Dividends paid to residents; interest paid to foreign banks (if approved by Yemeni CB)
	Fees paid to resident technical and professional service providers.	3%	
<i>Indirect taxes</i>			
Property tax <i>(Income Tax Law No. 17 of 2010)</i>	Based on rental value of property.	One month's rent	
	Sale of land, constructed property.	1%	
General sales tax <i>(General Sales Tax Law No. 19 of 2001)</i>	Export, int'l transport, baby milk	5% (general rate) 0%	Services (financial, insurance, health, education, non-profit, land transport, renting, water, clean-up, historical, religious).
	Gold (half-manufactured)	2%	
	Jewellery and gold	3%	
	Telecommunication	10%	
	Qat	20%	
	Cigarettes, cigars, arms, ammunition	90%	
<i>Social security</i>	By companies	9% of salary	
	By employees	6% of salary	
<i>Customs (Law 37/1997)</i>	Assessed value of imports, applying CB exchange rate	Ad valorem duties of 5, 10, 15, and 25%	More than half the scheduled items are taxed at ≤ 10%.

## Annex 2: Tax Reforms as Initiator of Virtuous Cycles of Development

*A potentially virtuous cycle of development prospects can be created...*



### Tax Reform and Reconstruction Efforts

There have been a considerable number of countries<sup>70</sup> over the last decades that managed to translate a popular “never again” mood when coming out-of-conflict into root-and-branch reforms to address entrenched problems in society and unresolved issues from the past, including those related to tax revenue reconstruction. A number of common lessons can be drawn from

successful experiences in re-creating modern, efficient, transparent, and pro-

<sup>70</sup> See, e.g., Müller-Armack (1956) for (post-World War II) West Germany, Hacıbeyoğlu (2009) for (post-Soviet) Azerbaijan, or Land (2004) for (post-genocide) Rwanda.

fessional revenue authorities:

- **Ownership and political leadership.** There is no substitute to a government’s commitment to a (complete) break with the past and a process of economic transformation, institutional reform, and public accountability. By redefining the role of the State, altering the balance between promises of service delivery and means of financing, allows the authorities to have residents be included in shaping the public policies and accept their civic duties. Whether it was West Germany’s post-World War II decision to build the institutional framework for a *social mar-*

ket economy<sup>71</sup> or Rwanda's commitment to anchoring its tax reform agenda in the *2002 Poverty Reduction Strategy*, these highly inclusive and comprehensively communicated policies managed to link tax-related efforts to the country's (in this case, Rwanda's) overarching attempts "in galvanizing a societal drive to pick itself up and to work towards becoming a prosperous, secure and confident society" (Land, 2004). In 2000, Azerbaijan went as far as to establish a *Ministry of Taxes*, with clear mandates, specific objectives, and a committed minister who wanted no less than to revolutionize his country's tax administration by creating a state-of-the-art online system (Hacıbeyoğlu, 2009) that transformed the revenue authority into an efficient, transparent, service-providing public institution. In these endeavors, development partners and international financial institutions can provide technical and/or financial support, but the definition of—and political commitment to—the agenda and objectives has to emanate from the country itself as the political leadership that frames, guides, supports, and has to co-finance these efforts.

71 The concept of a *social market economy* originated in the Federal Republic of Germany after World War II—that is, during a period of time, in which the country needed to look for a new start. Anchored on the conviction that a strong state, functioning institutions, and a well-defined legal framework supports, constrains, and directs a market economy (called *Ordnungspolitik* in German). The efficiency of the market system was to be balanced with explicit social objectives alien to a *laissez faire*-type economic model. At the time, it took eight years after statehood in 1949 before a core consensus on development priorities started to emerge. The then Minister of Economy Ludwig Erhard (1957) published *Wohlstand für alle* (prosperity for everyone), popularizing the core principles of a social market economy and succeeding in securing its gradual acceptance as the country's economic anchor. Originally coined by the "Freiburg School" around Walter Eucken and Alfred Müller-Armack (1956), the concept of a social market economy, in which competition and free initiative were to be channeled by a rules-defining, rules-enforcing, and rules-adhering state toward the overarching goal of increased social equity, aimed at combining the efficiency of a free-market economy with an explicitly stated social objective of constraining market outcomes at either end of the income distribution.

- **Political mandate and clear objectives.** The comprehension of the urgency for reforms has to translate into clearly defined political mandates given by the highest political authority (President, Prime Minister, and/or Parliament) to the lead implementing agency (typically the Ministry of Finance), joint with clear (monitorable) objectives, sufficient financial resources, and the necessary political and managerial independence to implement a corresponding reform agenda.

- **Reliance on information and communication technologies (ICT).** Increasingly, successful tax reforms worldwide have tended to rely on the inclusion of comprehensive ICT components to a tax policy/administration reform agenda aimed at (i) ensuring an efficient, transparent, and non-discriminatory interaction with (large) taxpayers; (ii) facilitating revenue authorities' administrative tasks, inspections, and audits; (iii) effecting a culture change with revenue authorities to impede corruption and institutional arbitrariness. No country was more innovative than Estonia in building a modern public administration by implementing a comprehensive ICT agenda, where more than 95 % of residents are now filing their tax returns through the internet (Estonia, 2014), thereby providing the revenue authority an efficient instrument for collection, communication, and auditing purposes. For households and companies this implies that (i) all required information and forms can be found online; (ii) there is no personal interaction with tax officials (except on hotlines), minimizing the risk of corruption; (iii) the time and effort required to file a proper tax return is reduced to the absolute minimum. Of course, rebuilding (rather than reforming) a revenue authority makes these types of fundamental reforms easier to implement and accept.

- **International collaboration.** Following

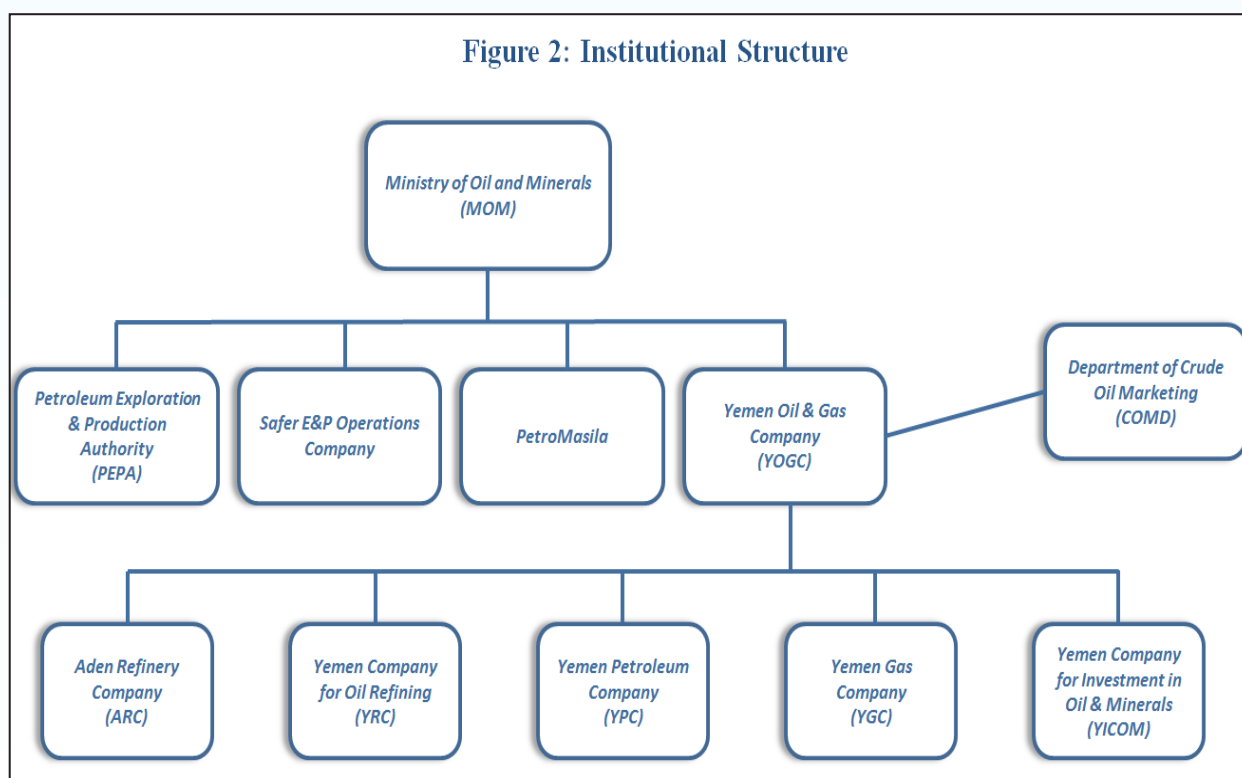


the strong international commitment to supporting demobilization and reconstruction efforts, especially in the ATI context, governments have access to comprehensive technical and/or financial support to strengthen the “hard” and “soft” components of their respective tax regimes. Lead agencies should not hesitate to collaborate closely with the World Bank, the IMF, the OECD, and other relevant institutions in their efforts to build efficient and modern

tax administrations.

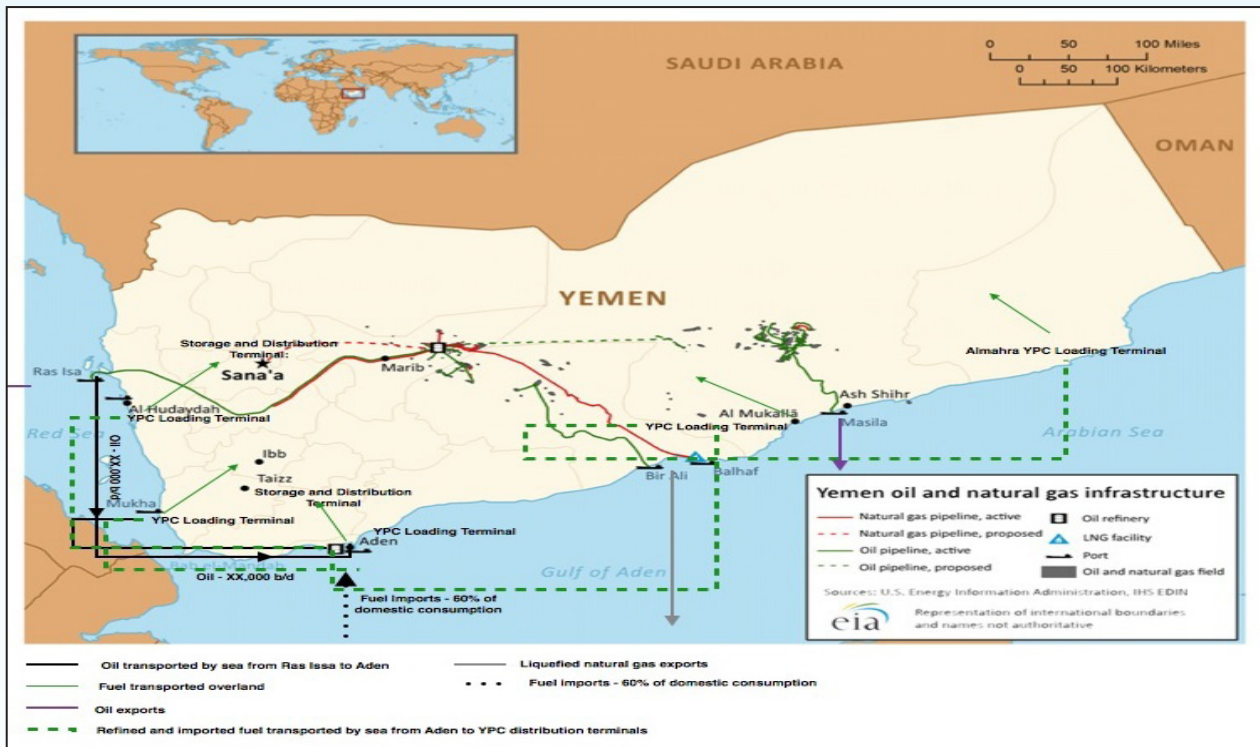
- **Communication.** Especially in a context, in which citizens (and resident enterprises) resisted tax compliance on the account of sub-standard public goods received in return, it is paramount that tax reform agendas are consulted with, and explained and communicated to, the public, ideally in the context of the broader socio-economic development agenda.

### Annex 3: Oil and Gas Sector: Institutional Structure



Source: Government of Yemen.

## Annex 4: Oil and Natural Gas Infrastructure



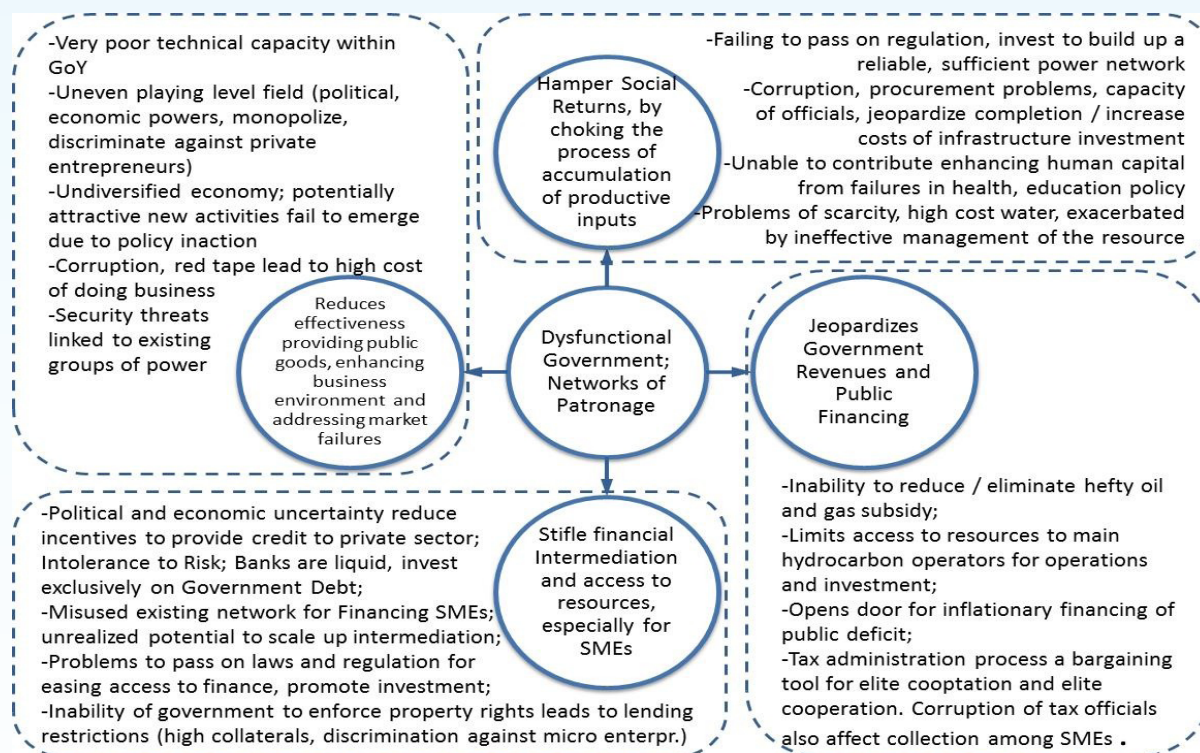
Source: Energy Information Agency (EIA).

## Annex 5: Republic of Yemen: Selected Economic Indicators, 2010–17

	2010	2011	2012	2013	2014	2015	2016	2017
						Prel.	Prel.	Proj.
<b>National Income and Prices</b>								
(Change in percent, unless otherwise indicated)								
Nominal GDP, market prices (billions of YR)	6,219.3	6,480.5	6,785.8	8,462.7	9,289.3	8,108.6	7,648.9	9,812.0
Real GDP growth	7.7	-12.7	2.4	4.8	-0.2	-28.1	-9.8	5.0
Hydrocarbon sector growth	46.9	-14.5	-11.5	13.2	-11.3	-61.0	-87.0	447.4
Nonhydrocarbon sector growth	4.4	-12.5	4.0	4.0	1.0	-25.0	-6.0	2.0
CPI (period average)	11.2	19.5	9.9	11.0	8.2	39.4	5.0	20.0
Hydrocarbon production (in thousand barrels per day)	426	364	322	365	324	126	16	90
Crude Oil	264	197	155	175	156	59	16	90
LNG (oil equivalent)	162	167	167	190	167	67	0	0
<b>Central Government Finances</b>								
(In percent of GDP)								
Revenue and Grants	26.1	25.3	29.9	23.9	23.6	12.9	10.8	18.6
of which hydrocarbon revenue	16.5	16.5	14.1	12.8	10.6	2.9	2.3	6.2
of which grants	1.2	1.2	6.1	0.9	2.7	0.5	0.0	3.7
Expenditure and net lending	30.2	29.8	36.2	30.8	27.8	23.5	24.4	24.6
Current, of which:	25.5	27.8	32.5	28.4	26.9	23.5	23.8	22.8
wages and salaries	8.7	10.0	11.1	10.2	10.0	11.3	11.4	10.2
subsidies	8.7	8.1	9.3	7.2	5.6	0.7	0.9	1.4
Capital	4.7	2.0	3.7	2.4	1.8	0.8	0.5	1.9
Overall fiscal balance (excl. grants)	-5.3	-5.7	-12.4	-7.8	-6.9	-11.1	-13.6	-9.7
Primary non-oil fiscal balance (cash)	-19.4	-17.9	-21.1	-15.2	-12.3	-6.5	-7.6	-8.7
Nonhydrocarbon primary fiscal balance (cash) excluding grants								
Gross Public Sector Debt	42.9	45.7	47.3	48.2	48.7	66.7	83.8	75.8
Domestic debt	23.0	27.1	29.9	33.0	34.5	51.2	63.6	56.2
External debt	19.9	18.6	17.4	15.2	14.3	15.5	20.3	19.6
<b>Monetary data</b>								
(end-of-period annual growth rate)								
Broad money	9.2	0.0	21.5	12.5	0.2	3.1	13.0	18.2
Reserve money	7.7	15.8	12.9	1.9	1.4	27.4	23.8	10.7
Credit to private sector	8.2	-16.9	-0.6	38.9	2.6	-22.3	1.3	15.7
Benchmark deposit interest rate (percent)	20.0	20.0	18.0	15.0	15.0	15.0	15.0	15.0
Velocity (non-oil GDP/M2)	2.4	2.3	2.4	2.4	2.4	2.4	2.4	2.4
<b>External Sector</b>								
(In millions of U.S. dollars, unless otherwise indicated)								
Exports (goods & services)	9,271	9,929	8,802	9,037	9,287	3,864	898	2,749
of which hydrocarbon (oil and gas)	6,279	7,731	6,332	6,537	6,774	2,440	248	1,755
of which nonhydrocarbon	1,369	931	1,017	1,102	1,132	501	125	219
of which services	1,622	1,267	1,453	1,398	1,390	923	524	775
Imports (goods & services)	10,629	10,708	12,921	12,186	12,257	8,485	6,855	8,420
of which hydrocarbon	2,073	2,578	3,840	3,265	3,094	1,278	1,373	1,711
of which for food	2,476	2,725	2,692	2,701	2,645	1,859	1,450	1,740
of which services	2,156	2,165	2,680	2,294	2,525	1,896	1,339	1,738
Current account balance (in percent of GDP)	-3.4	-3.0	-1.7	-3.1	-1.7	-5.5	-6.1	-4.2
<b>Reserves</b>								
Central Bank own gross reserves (billions US\$ end-period)	5.1	4.0	5.6	4.8	4.1	1.5	0.6	1.1
Central Bank own gross reserves (in months of imports)	5.7	3.7	5.5	4.7	5.7	2.6	0.9	1.2
<b>Exchange Rate</b>								
Exchange rate (per US\$, official rate)	219.6	213.8	214.3	214.9	214.9	214.9	250.0	...
<b>Memo Items</b>								
Nominal GDP in billion US\$	30.9	32.7	35.4	40.4	43.2	37.7	27.3	27.2
Population (in millions)	23.6	24.2	24.9	25.5	26.2	26.8	27.5	28.2
Nominal per capita GDP (US\$)	1,310	1,350	1,423	1,583	1,651	1,406	993	964

Source: Yemeni authorities; and staff estimates.

## Annex 6: The Republic of Yemen: Growth Diagnostics Tree



## Annex 7: A brief background information to the PFM system in Yemen

**Yemen's executive power comprises the President and the Council of Ministers, with executive authority established in the Office of the President.** The Prime Minister is responsible for the day-to-day running of government affairs. The Ministry of Finance is responsible for the management of public finances, with the Ministry of Planning and International Cooperation (MOPIC) in charge of preparing the investment budget. The Minister of Finance appoints Financial Officers to each ministry and department with responsibility for safeguarding the application of funds as intended by Parliament in the approved budget. The Ministry of Finance is also responsible for maintaining financial records and internal con-

trols in accordance with the financial law and regulations, as well as submitting the financial and accounting records to the Central Organization of Control and Audit (COCA), the supreme audit institution. The Central Bank of Yemen (CBY) operates the Treasury Single Account (TSA).

**The multiparty Parliament votes on the budget, but has no authority to directly amend budget lines.** COCA is responsible for conducting external audit and special investigations for the Cabinet, the Minister of Finance, and the parliamentary Public Accounts Committee. Line ministries, for their part, are responsible for drafting, negotiating, and implementing their respective budgets.

There are two main tiers of sub-national government in Yemen. The first is at the Governorate level (22), each of which has an executive office headed by a Governor. There is a local council whose members are elected by the districts. The second tier is comprised of the district councils (303) and headed by council chairmen. Both tiers have the authority to raise revenues (Arya 2010).

**The state budget in Yemen is characterized by its limited credibility, a problem compounded by its fragmentation into four largely independent components: the operational budget, the subsidy budget, the investment budget, and the economic entities' budget.** The investment budget is based on multi-year Public Investment Plans (PIPs), including on-going projects which are neither properly documented nor monitored. In this context, the PIPs are prepared without consideration of the Ministry of Finance's Medium-Term Fiscal Framework (MTFF). The economic entities budget is a supposedly auto-financed budget, which is not the case in practice. The concept of economic entities tends to group State-Owned Enterprises (SOEs) with a number of non-market budget entities that nevertheless have a significant volume of own-source revenue. (Lepain 2014). Some budgets are not disaggregated (for example, the Ministry of Justice, Interior and Defense), and some off-budget funds and special accounts remain. Financial reports are cash-based, but are not aligned with the pertinent international standards.

**The 2008 PEFA assessment revealed that previous PFM reform plans did little to address fiscal sustainability and budget credibility.** The poor matching of expenditure out-turn figures to the budget estimates reflected a lack of strict fiscal discipline exercised in budget execution. Many factors contributed to the undermining of Yemen's PFM capacity in terms of improving the credibility of the budget and achieving fiscal discipline. These include: (i) the lack of predictability in budget releases;

(ii) the weak cash management system — in spite of the existence of many requisite elements for sound cash management (including a TSA and centralized payments); (iii) the non-uniformly implemented commitment controls; (iv) the less than fully effective salary expenditure controls; (v) the non-achievement of value-for-money in procurement; (vi) the practice of ex-post approval of the supplementary budget by Parliament; (vii) the accumulation of arrears without proper and complete tracking; and (viii) the incomplete information on donor-funded projects. (World Bank 2008).

**Following the PEFA, the government implemented a World Bank-financed PFM Modernization Project since 2009.** The project included the improvement of the Ministry of Finance's functional organization, implementation of an Automated Financial Management Information System (AFMIS), capacity building of procurement institutions and of the Central Organization for Controls and Audits (COCA). In 2012, donor and government stakeholders decided to pursue a new, two-year PFM Intermediary Action Plan to provide strategic direction and reduce donor fragmentation. The new Action Plan, to be implemented from 2014–2015, was meant to define the government's priorities and allow donors to align their assistance based on these priorities, including: (i) general budget reform; (ii) reinforcing revenue management; (iii) enhancing control and accountability; (iv) enhancing capacities of a financial institute to become a regional institute specialized in public finance; (v) public debt management; and (vi) the institutional restructuring of the Ministry of Finance.<sup>72</sup>

**PFM modernization activities were suspended since early 2015 due to the political and security crisis.** While the AFMIS system facilitated a strengthening of budget execution reporting and follow-up, the system has still not sufficiently enhanced budget ex-

<sup>72</sup> PFM Reform Initiative Team, *Draft Action Plan of Yemen Public Finance Management Reform Program 2014 – 2015*.



ecution control mechanisms. In particular, the critical functions of expenditure commitment controls<sup>73</sup> and cash management were still underdeveloped, and a comprehensive stock-taking of all state budget payment arrears was considered necessary. The AFMIS was deployed in 35 ministries and central agencies, but not in the governorates or the security sector (Defense and Interior Ministries and related agencies). In turn, the Loans and Grants Management Information System (LGMIS) for financial management of external aid

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73 A commitment control trial manual system was placed in 15 spending units, but only six units used it.

was rolled out to 38 Project Implementation Units (PIUs).<sup>74</sup> A strategic development plan for COCA was prepared and a training center established.<sup>75</sup>

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74 The External Aid and Grants Directorate of the Ministry of Finance is responsible for the review and approval of disbursement requests to donors and of payment orders to the CBY for payments to suppliers and beneficiaries. This internal control process was facilitated by the LGMIS, which improved the processing times, among other benefits.

75 COCA staff were trained on themes such as information technology (IT)-based audits, procurement laws and procedures, and budget classification, preparation and execution, among others.

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