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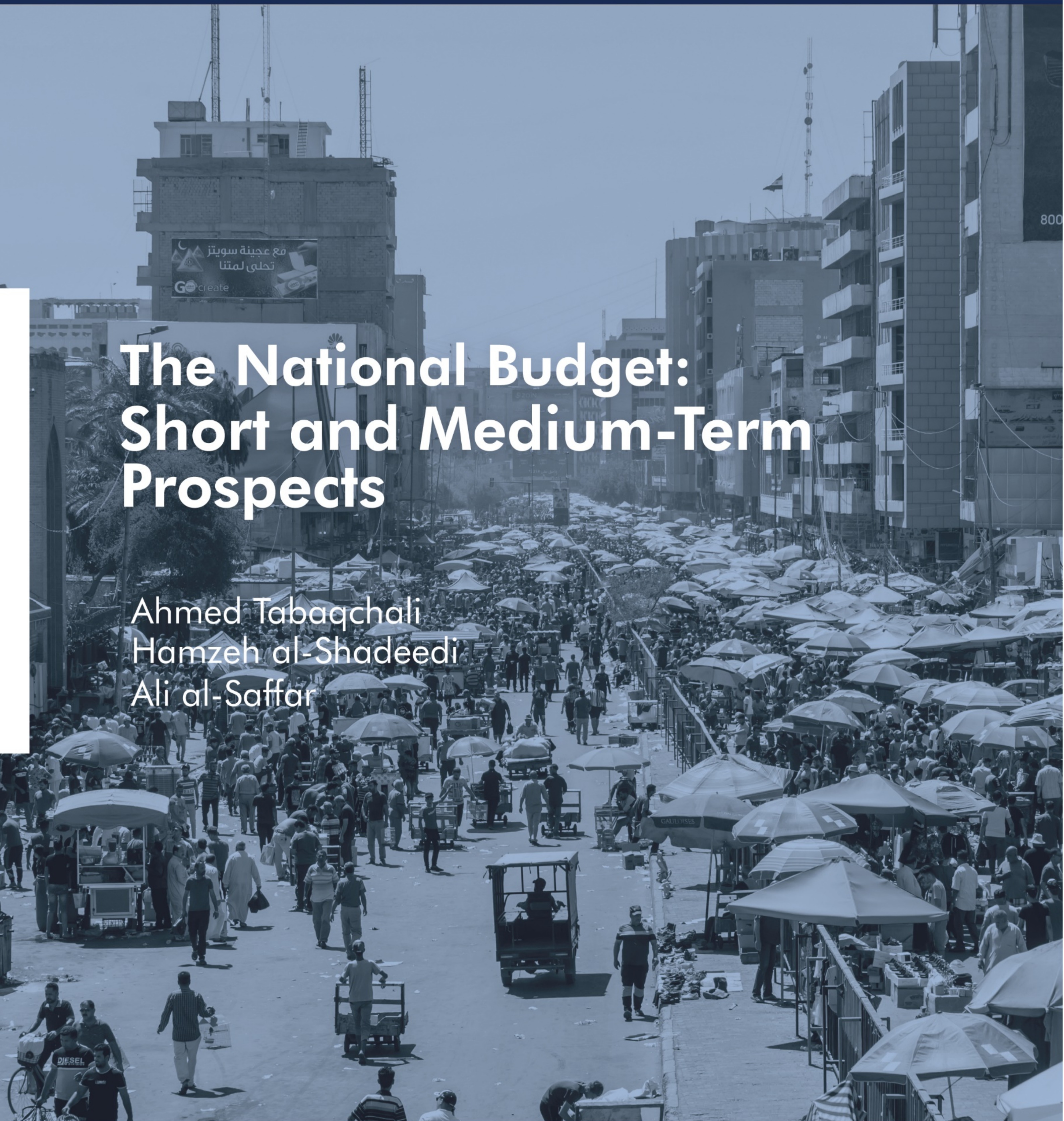

The National Budget: Short and Medium-Term Prospects

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Iraq Economic Review
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The policy discourse on economic development in Iraq has often rested on the assumption that the non-oil private sector must expand, thereby granting economic agency and autonomy to members of the population at large. But what this expansion would entail for Iraq, a country under cyclical waves of conflict and instability, remains almost entirely undefined. Now that Iraq and the Middle East region as a whole face the prospect of a long-term decrease in demand for oil, the need for understanding Iraq's economic dynamics and challenges have never been greater. Funded by the National Endowment for Democracy (NED), the Iraq Economic Review (IER) aims to direct the national policy conversation toward a sustainable economic vision and provide loc al civil society actors with the necessary knowledge and tools to press for changes in the governmental approach to the economy. Published by the Institute of Regional and International Studies (IRIS) at the American University of Iraq-Sulaimani, the IER is a one-stop-shop for understanding major economic trends. The Review couples analysis of the economy's main potential growth areas with a close examination of the legal frameworks, public infrastructures, and financial systems needed to ensure that growth transpires in an inclusive fashion.

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Introduction

There is a growing sense among the Iraqi populace that the economy is irreparably broken. Over the past five years, mass protests have cyclically broken out over unemployment and pervasive corruption. The government and dominant political parties have, in turn, tried to quell dissent by further extending salaries and pensions. In 2005, the percentage of state oil revenues directed towards public sector salaries and pensions stood at 26%. In 2016, at the peak of a period of severe economic duress, salaries and pensions consumed 88% of state oil revenue. In the 2020 economic crisis, these obligations alone exceeded the state's total oil income, rising to almost 120% of oil revenue. The budget projections suggest that the same will be true for 2021.[1] Currently, more than 6 million people receive wages from public sector employment.[2]

Public sector employment in Iraq is shaped by political interests and patron-client relationships. Many Iraqis obtain their public sector posts through the backing of one political party or another. But this patronage strategy has nearly run its course, with its structural vulnerability coming to the fore during periods of financial and economic crisis. The most recent economic crisis – arising from the COVID-19 pandemic and the drop in global oil prices – has put the government on the brink of insolvency. In October 2020, the government could no longer pay public sector employees without borrowing.[3] Consequently, resource-rich Iraq, which has long been considered a middle-income country, would ultimately succumb to a financial and liquidity crisis that would push millions of people below the poverty line. Meanwhile, most Iraqis continue to experience a chronic absence of basic needs such as water, electricity, healthcare, etc. In short, Iraq is not an oil-backed welfare state. Rather, it is an oil-backed rentier state that extends wages without providing meaningful services — and now even its capacity to provide salaries is in question.

Over the past several months, the government has been under pressure to deliver a budget that will address these challenges. Part I of this edition of the Iraq Economic Review (IER) unpacks the progression of the budgetary process, which to date remains incomplete. The Review focuses on three stages: (1) The formation of the government's overall economic philosophy through the publication of a policy White Paper (WP) on the economy; (2) the role of the Ministry of Finance in interpreting the WP and forwarding an initial budget; (3) the recent modifications made to the budget by the Council of Ministers (CoM). The Review also makes speculations about further modifications likely to be made by the Iraqi Parliament. After the discussion on the budget, Part II of the Review engages in an analysis of the oil sector, as its development over the short- and medium-term is essential to understanding budgetary challenges.[4] Part III addresses conclusions and policy implications.

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[1] Emergency Cell for Financial Reform, 'The White Paper for Economic Reform: Vision and Key Objectives,' *Government of Iraq*, October 22, 2020, https://gds.gov.iq/ar/iraqs-white-paper-for-economic-reforms-vision-and-key-objectives/ , English: https://gds.gov.iq/iraqs-white-paper-for-economic-reforms-vision-and-key-objectives/. Updated estimates based on latest data from the MoF at http://www.mof.gov.iq/obs/ar/Pages/obsDocuments.aspx, and SOMO https://somooil.gov.iq/exports. The percentage in 2021 has declined due to the different exchange rate and would be at 124% of oil revenues under the prior exchange rate. The amounts for salaries and pensions do not include the estimated 600,000 + employees of the State-Owned Enterprises (SOE's) given the lack of reliable data.

[2] Finance Minister: Public sector employees, including pensioners, exceeded 6.5 million, (Arabic). *Al-Mada Paper*. May 29, 2019, https://almadapaper.net/view.php?cat=218954

[3] Al-Kadhimi orders the release of public sector employees' salaries for October and November after the Parliament passed the deficit financing law, *Rudaw (Arabic),* November 12, 2020, https://www.rudaw.net/arabic/middleeast/iraq/1211202011

[4] The next issue of the Iraq Economic Review will include a discussion of the budgetary crisis between Erbil and Baghdad and the position of the Kurdistan region within the federal budget in terms of the Region's commitments and allocations.

Part I: Addressing the Budget Crisis

One of the challenges in understanding the 2021 federal budget is that the 2020 budget never existed. Because of the youth-led demonstrations erupting across the country in the fall of 2019, the budget proposal for 2020 was not submitted to Parliament at its scheduled time in early October 2019. Following the resignation of former Prime Minister Adel Abdul-Mahdi under pressure from demonstrators, the caretaker government no longer possessed the authority to propose bills to Parliament, including the budget. The current Prime Minister Mustafa Al-Kadhimi inherited this situation of paralysis and his government continued to spend throughout 2020 according to the “1/12th Rule.” This rule essentially means that the government can spend up to a twelfth of the appropriations made in 2019 on a monthly basis.[5] The problem with this approach from a policy standpoint is that the declining revenues and increasing expenses of 2020 were not consistent with 2019’s levels.

Table (1): 2019 and 2020 Budget Spending.[6]

Year	Total Spending (IQD bn)	Current Spending (IQD bn)	Salaries (IQD bn)	Pensions (IQD bn)	Investment Spending (IQD bn)	Non-oil Investment Spending (IQD bn)	Oil Investment Spending (IQD bn)	Total Revenues (IQD bn)	Non-oil Revenues (IQD bn)	Oil Revenues (IQD bn)	Avg Iraqi oil price ($/bbl)	Avg Brent (price $/bbl)	Oil Exports (mbbl)	Surplus/ Deficit (IQD bn)
2019 Actual (MoF)	111,724	87,301	40,634	10,544	24,423	5,437	18,986	107,567	8,076	99,491	61.01	64.36	1,287	-4,157
2020 Jan-Oct Actual (MoF)	57,865	56,368	33,435	11,268	1,498	1,328	169	43,094	4,316	38,778	37.37	39.84	927	-14,771
2020 Nov-Dec Estimates	22,500	21,901	7,200	2,254	599	531	68	10,710	1,500	9,210	43.70	46.18	178	-11,790
2020 Estimate	80,365	78,269	40,635	13,522	2,097	1,860	237	53,804	5,816	47,988	38.39	40.90	1,105	-26,562

The fall in oil revenues forced the government to hold back on almost all spending apart from the most rigid components of the budget – in particular salaries, pensions, and social security. Nevertheless, these reduced expenditures still exceeded revenues by 26.6 trillion Iraqi dinar (IQD), or approximately $22.4 billion USD.[7] This gap needed financing, which could only be done by borrowing, but without a budget law in place, the Ministry of Finance (MoF) approached the Parliament to authorize borrowing. The Parliament passed two deficit financing laws in June and October 2020, allowing the government to borrow 27.0 trillion IQD ($22.7 billion USD). This was only made possible by indirect monetary financing by the Central Bank of Iraq (CBI) through the issuance of Treasury Bills (T-Bills) that are bought by state-owned banks which subsequently sell these to the CBI. Yet, this amount was significantly less than what the government needed to meet its increasing obligations which exceeded those under the “1/12th Rule.” Al-Kadhimi’s administration also struggled to meet the commitments made by past administrations to martyrs and victims of political persecution, in addition to payroll extensions that were made in order to appease the October 2019

[5] Ahmed Tabaqchali, ‘Gone with the Muhasasa: Iraq’s static budget process, and the loss of financial control,’ *the Atlantic Council*, January 6, 2021, https://www.atlanticcouncil.org/in-depth-research-reports/report/gone-with-the-muhasasa-iraqs-static-budget-process-and-the-loss-of-financial-control/

[6] Actual data for 2019 and January-October 2020 obtained from the Ministry of Finance (http://www.mof.gov.iq/obs/ar/Pages/obsDocuments.aspx), *the Ministry of Oil* (https://oil.gov.iq) and *Statista* (https://www.statista.com/statistics/262861/uk-brent-crude-oil-monthly-price-development/). November-December estimations are based on the government’s proposals for deficit financing and the CoR’s subsequent deficit financing legislations.

[7] Numerical values are rounded up to a single decimal for simplification. Please bear in mind the impact this round up has on USD values. Dollar values spent/budgeted before December 2020 are based on the pervious exchange rate (1 USD = 1,190 IQD). Thereafter, values are based on the new rate (1 USD = 1,460).

demonstrators.[8] Much of the state obligations that could not be met in 2020 will come due in 2021.

1. The Government's White Paper

By the time that Al-Kadhimi's government was formed in May, oil revenues had collapsed by over 50% from the average in the first two months of 2020. Analysts projected continued low oil revenues given the oil demand collapse associated with worldwide lockdowns. Facing the genuine prospect of insolvency, the Prime Minister swiftly announced the creation of an Emergency Task Force for Financial Reform.[9] Composed of a team of expert advisors, the Task Force was charged with crafting a white paper to outline a future economic plan that would confront the immediate crisis and address the broader weaknesses in the economy.[10] The White Paper (WP) was finally published to great fanfare on October 22, 2020,[11] making the bold claim that it would "redefine the role of the state in the economy and society." The WP states:

> *"The imbalance in the economic structure is the sum of the accumulated public and economic policies since the 1970s - employing the growing oil revenues as a tool to amplify the role of the state in the economy and society through expanding: (i) the public sector; (ii) direct and indirect control of the economy by the state; and (iii) the rentier role of the state in public service delivery to society. Opportunities have existed to change this course after 2003. However, the new political regime wasted and misused those opportunities, as it was unable to create a free and diversified economy in accordance with the principles approved by the constitution, and continued to apply the previous philosophy, with the emergence of new power centers and the trend towards using sectarian quotas as its tool. The result of these policies was a fragile economy, which contributed to the development of the conditions that led to the current economic crisis."*[12]

The WP forwards four main policy ideas. First, the WP argues that the over-reliance on oil-based income combined with an over-extension of budgetary obligations to payroll expenditures lies at the heart of the current fiscal crisis. The unpredictability of oil revenues and the continuous increase in payroll obligations together create an extremely precarious

[8] In order to appease demonstrators, the prior government lowered the retirement age to 60, freeing 200,000 jobs, and added 300,000 new jobs for a total of 500,000 jobs. Karam Saadi, 'the new retirement law sparks controversy in Iraq,' *the New* Arab (Arabic), February 22, 2020, https://www.alaraby.co.uk/قانون-التقاعد-الجديد-يثير-الجدال-في-العراق.
Farah al-Khafaf. 'Prime Minister's Advisor: Insuring payemnts for public sector employees,' *al-Sabah* (Arabic), February 17, 2020. https://alsabaah.iq/22006/

[9] Samir al-Naseeri, 'Emergency Cell for Financial Reform,' *al-Sabah* (Arabic), May 16, 2020, https://alsabaah.iq/25528/خلية-الطوارئ-للإصلاح-المالي

[10] "A white paper is a report or guide that informs readers concisely about a complex issue and presents the issuing body's philosophy on the matter. It is meant to help readers understand an issue, solve a problem, or make a decision. The initial British term, concerning a type of government-issued document, has proliferated, taking a somewhat new meaning in business. In business, a white paper is closer to a form of marketing presentation, a tool meant to persuade customers and partners and promote a product or viewpoint." Source: https://en.wikipedia.org/wiki/White_paper

[11] Emergency Cell for Financial Reform, 'The White Paper for Economic Reform: Vision and Key Objectives,' *Government of Iraq*, October 22, 2020, https://gds.gov.iq/ar/iraqs-white-paper-for-economic-reforms-vision-and-key-objectives/ , English: https://gds.gov.iq/iraqs-white-paper-for-economic-reforms-vision-and-key-objectives/

[12] Unofficial English translation of the White Paper, *Iraqi Economists Network*, October 19, 2020, http://iraqieconomists.net/en/2020/10/19/iraq-white-paper-complete-english-translation/

dynamic. The state has no control over the direction or magnitude of oil revenues, and non-oil revenues will take years to increase significantly even under the best-case scenarios. Accordingly, the WP contends that an initial feasible option would be to align payroll expenditures with the likely variations in oil revenues. Specifically, the WP advocates for a significant reduction over a three-year timeframe of the largest of the state's expenditures. This particularly applies to public sector wages, which would be cut from 25% of Gross Domestic Product (GDP) to 12.5% of GDP, and the system of subsidies, which would be cut from 13% of GDP to 5% of GDP.

Second, the WP indicates that the reduction of public expenditures towards salaries, pensions and subsidies should be coupled with increased investment in infrastructure and platforms benefiting private sector development – electricity, communications, transportation, industrial cities, and duty-free zones – much neglected since 2003.[13] Third, the paper argues that the legal and bureaucratic obstacles to business should be significantly reduced. Finally, the WP maintains that economic reforms should be made while ensuring the provision of effective basic services and social benefits towards the most vulnerable members of society.

If implemented, the WP's proposed program would have to contend with several tough realities simultaneously. As Iraq's economy feeds off the public sector payroll, with a relatively miniscule private sector, the overall level of activity in the market in the short-term would decrease as employees would have far less to spend on consumer goods. While the overall payroll is extremely large, individual wages and family incomes are, on average, very modest. Therefore, at the level of individuals and families, a reduction of the public sector payroll would strain pocketbooks and generate financial hardships. Finally, the country's conflict-damaged institutional infrastructure requires significant investment, meaning that aligning state expenditures with revenues will be difficult even under the best-case scenarios. Thus, by necessity the transformations suggested by the WP would have to be gradual and carefully calibrated.

Perhaps the most significant shortcoming of the White Paper lies in its very nature in being a blueprint for economic reform while Iraq's core problems stem from structural distortions in the country's political economy. Since 2003, the national budget has become the primary mechanism through which political parties extended patronage and shored up support. Thus, without a parallel political reform agenda that tackles the core of this clientelism, any effort to introduce a broad shift in economic policy will face significant roadblocks.[14]

Therefore, it was predictable that the WP's core ideas would be diluted over the course of the 2021 budgetary process as the proposed budget law passed from the Ministry of Finance to the Council of Ministers (CoM), and finally to the Parliament. The political class is particularly resistant to backing unpopular cuts as national elections approach in the fall of 2021. The progression of the budgetary process will be explained and analyzed in the following sections.

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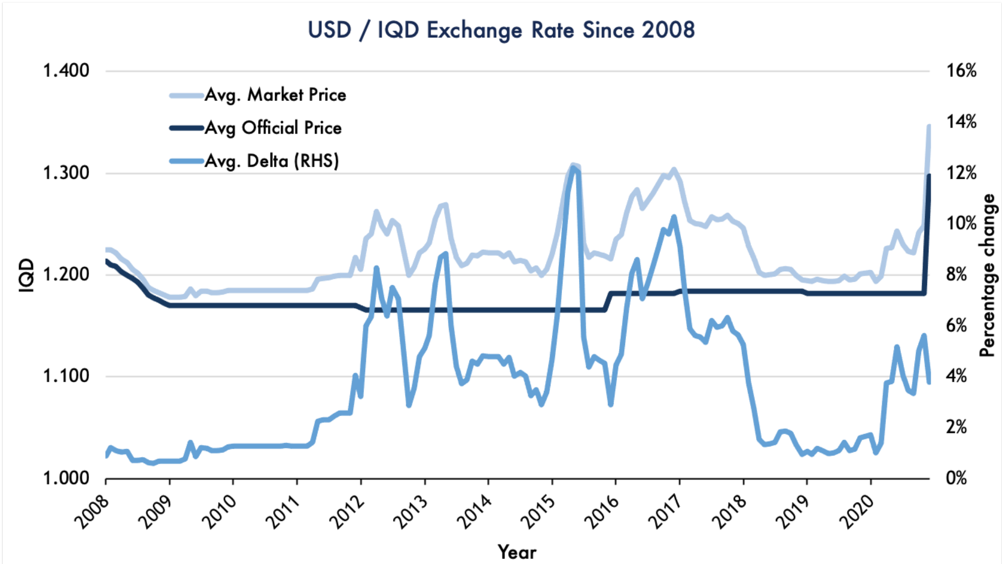
[13] Ahmed Tabaqchali, 'Iraq's investment Spending Deficit: An Analysis of Chronic Failures,' *Institute of Regional and International Studies (IRIS)*, December, 2018, https://auis.edu.krd/iris/latest-iris-publications/iraqs-investment-spending-deficit-analysis-chronic-failures

[14] Ahmed Tabaqchali, 'Will COVID-19 Mark the End Game of Iraq's Muhasasa Ta'ifia,' *Arab Reform Initiative*, April 24, 2020, https://www.arab-reform.net/publication/will-covid-19-mark-the-endgame-for-iraqs-muhasasa-taifia/

2. The Ministry of Finance 2021 Budget Proposal

The most controversial and far-reaching aspect of the MoF's 2021 budget is a recommendation to devalue the Iraqi Dinar by about 23%. The WP discussed the negative effects of an overvalued exchange rate on the competitiveness of Iraq's agricultural and industrial products.[15] But the WP argued that a devaluation, while seemingly positive for the government's ability to make payments for salaries and pensions, would raise the cost of living and thus lower the living standards of the majority of the population given the country's high dependence on imports to satisfy consumption.[16] Moreover, the authors of the WP were concerned that devaluing the currency as a main solution to ensure the payments of salaries and pensions would enable the political class to sidestep the necessity of embarking on structural reforms. Without the reforms, a second devaluation would ultimately be forced on the country.

The need to protect foreign reserves likely weighted heavily on the MoF's decision to recommend a devaluation. (At the end of 2020, foreign reserves stood at $54.0 billion USD as compared to $67.5 billion USD at the end of 2019.) On December 19, 2020, the CBI modified the Iraqi Dinar's exchange rate from the prior 1,190 IQD per $1 USD to 1,460 IQD per $1 USD.[17]



Source: see footnote.[18]

[15] A case of the "Dutch Disease," which is defined as: "Dutch disease is an economic term for the negative consequences that can arise from a spike in the value of a nation's currency. It is primarily associated with the new discovery or exploitation of a valuable natural resource and the unexpected repercussions that such a discovery can have on the overall economy of a nation." James Chen, *Investopedia*, November 22, 2020, https://www.investopedia.com/terms/d/dutchdisease.asp

[16] As the state revenues mostly come from oil sales in USD, devaluating the IQD would enable the state to make its domestic obligations in IQD without running the risk of further depletion of the country's foreign currency reserves.

[17] The Central Bank of Iraq statement on the exchange rate adjustment, December 21, 2020, https://cbi.iq/news/view/1624

[18] CBI Monthly averages of the official exchange rate (navy), parallel market rate (sky blue), the premium of parallel market rate versus the official rate (blue, right hand side scale). Note: The devaluation took place on December 19th, and thus the chart for the month has an average of the old and the new rates. Moreover, the IQD parallel market rate was between 3-12% above the official price for much of 2012-2013, and the low premium was a recent feature that ended with the return to fears of conflict in early 2020 and the disruptions brought by the coronavirus.

A by-product of this change is a stimulus to the country's traded goods and services sectors – in particular the country's agricultural sectors, which account for about 20% of all jobs in the economy, in a country in which nearly a third of the population live in rural areas.[19] While a positive development, this will take time to bear fruit.

Other elements from the WP were introduced in the MoF budget proposal. For instance, the MoF focused on increasing non-oil revenue sources.[20] The budget proposes an additional 9.3 trillion IQD ($6.4 billion USD) in non-oil revenues, on top of the existing ones, and 1.2 trillion IQD ($822.0 million USD) in oil-related revenues.[21] The 9.3 trillion IQD comes from introducing increased consumption taxes (malls, restaurants, cosmetics, alcohol, tobacco, and car purchases), services (hotels, hairdressers, air travel, beauty, and massage centers), and increased fees and accelerated asset sales. Crucially, 9.3 trillion IQD includes 1.9 trillion IQD ($1.3 billion USD) from increased consumption taxes on refined petroleum products. The 1.2 trillion IQD in oil-related revenues comes from increasing prices of crude oil sales to local refineries, thereby removing some price subsidies as well as capturing all sales revenues – which have thus far been used by the state-owned oil companies to pay their employees' incentives.

Secondly, the proposal increases current taxes on total salary amounts by 1.5 trillion IQD ($1.0 billion USD), and imposes caps on allowances and benefits (e.g., additional compensation for dependents and spouses, university degrees, etc.). For most public sector employees, however, the base salary is relatively small, and the extras represent the bulk of the total income. The MoF estimates that cuts to these benefits would generate 12 trillion IQD ($8.2 billion USD) in savings annually, for a combined net savings of 13.5 trillion IQD ($9.2 billion USD). To put these figures in perspective, the pre-tax, pre-cap payment for salaries and pensions would have been 74.3 trillion IQD ($50.9 billion USD) for 2021, up 43% from 2019's 52.0 trillion IQD ($43.7 billion USD).[22]

Finally, the MoF's proposal sets a budget of about 9.6 trillion IQD ($6.6 billion USD) to help the most vulnerable members of society. This includes increasing social security spending from 1.8 trillion IQD ($1.2 billion USD) to 5.0 trillion IQD ($3.4 billion USD) and spending 648 billion IQD ($443.8 million USD) to improve the effectiveness of the Public Distribution System (PDS) to target those earning less than 1.5 million IQD ($1,027.4) per month.[23]

Despite these measures, the gap between revenues and expenditure in the MoF budget remains on par or higher than previous years due the dramatic drop in state oil revenue, and

[19] For a review of the importance of the agricultural sector to the economy see chapter four of the World Bank's report 'Breaking out of Fragility: A country economic memorandum for diversification and growth in Iraq", *the World Bank*, September 30th, 2020, https://www.worldbank.org/en/country/iraq/publication/breaking-out-of-fragility-a-country-economic-memorandum-for-diversification-and-growth-in-iraq

[20] See a complete draft of the Ministry of Finance 2021 budget proposal, *al-Rasheed Media* (Arabic), December 17, 2020, https://www.alrasheedmedia.com/wp-content/uploads/2020/12/مشروع-قانون-الموازنة-العامة-الاتحادية-للسنة-المالية-2021.pdf

[21] All subsequent USD values relating to the 2021 budget are based on the new exchange rate of 1 USD = 1460 IQD

[22] The increase in spending stems from adding more public sector posts – a decision taken by the prior government. These additions include 312,237 more hires thus taking the total public sector employees number to 3,250,838.

[23] Other social security measures include budgeting 0.6 trillion IQD to support youth-led small and medium enterprises (SME's) and 0.8 trillion IQD towards health measures to combat the effects of COVID-19. Additionally, the proposal allocates 4.2 trillion IQD for the increase in pension payments in 2021 and 1.5 trillion IQD towards rectifying past shortages in commitments to survivors of martyrs and victims of political persecution and their survivors.

sharply increased expenditures. The projected deficit of 58.3 trillion IQD ($39.9 billion USD) represents 39% of total spending, compared to 21% in 2019. As the budget moved from the Ministry of Finance for approval and through amendments by the Council of Ministers (CoM), the projected deficit would grow even larger.

3. The Council of Ministers Amendments on the 2021 Budget Proposal

The MoF submitted its budget proposal to the Council of Ministers (CoM) for review in mid-December 2020.[24] While the CoM maintained portions of the MoF budget proposal related to societal support, enhancing some, and made no modifications to the dinar devaluation scheme,[25] but it fundamentally transformed the mechanisms of reducing overall state expenditures.

Departing from the MoF budget, the first change in the CoM budget was to cut some of the increased consumption taxes – crucially the CoM removed the 1.9 trillion IQD ($1.3 billion) in consumption taxes on refined petroleum products. The CoM, however, raised the crude prices charged to refineries, leading to an additional 0.9 trillion IQD ($616.4 million) in oil related revenues.

Second, instead of cutting benefits and allowances significantly, the CoM advanced the progressive income tax on the total salary (i.e., the base salary as well as benefits). Effectively, taxes start at around 1% for income above 500,000 IQD ($342.5 USD) per month and increases proportionally to 27% for incomes above 10 million IQD ($6,849.3 USD) per month.[26] Again, because benefits represent such a large portion of many public sector salaries, the move from imposing hard caps on such allowances to progressive taxation of the total salary preserved more of the gross income for most middle class people on the government payroll.[27] These measures would have increased non-oil revenues by about 4.1 trillion IQD ($2.8 billion USD). The new taxation scheme generates far fewer savings, in effect replacing a net savings of 13.5 trillion IQD ($9.2 billion USD) trillion with a net savings of 4.1 trillion IQD ($2.8 billion USD).

The two main changes of the MoF's budget proposal by the CoM reflect political considerations during an election year, in which politicians will be highly sensitive to public opinion. These same considerations will weigh heavily on Parliament too – all of which give a scale of the political obstacles of implementing fiscal and economic reform.

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[24] A complete draft of the Council of Ministers 2021 budget proposal: https://drive.google.com/file/d/1ezNiFZVEJtG6MP5TYZONxzhqR3HOrzgM/view

[25] The CoM budget reserves 9.6 trillion IQD towards supporting the society and the economy through the COVID-19 crisis and 5.7 trillion IQD set for accommodating the increase in pension payments (4.2 trillion IQD) and for meeting the government past commitments to political persecution, martyrs, and their survivors (1.5 trillion IQD).

[26] The scale, for all public sector employees except the top positions, starts at 10% for income above IQD 500,000, 20% for income above IQD 1,000,000, and 30% for income above IQD 1,500,000. Effectively this translates to around 1% for income above 500,000 IQD ($342.5) per month and increases proportionally to 27% for incomes above 10 million IQD ($6,849.3) per month.

[27] In a confidence building measure intended to stave off public dissent, the CoM introduced a 40% flat tax on the total pay of the President, Prime Minister, Parliament Speaker, the heads of the Supreme Federal Court and the High Judicial Council, and the deputies of all these posts. A similar 30% tax was imposed upon the incomes of ministers, Parliament members, and directors-general.

4. Financing the budget deficit

Table (2): 2021 budget proposal and the most likely scenario.[28]

Year	Total Spending (IQD bn)	Current Spending (IQD bn)	Salaries (IQD bn)	Pensions (IQD bn)	Investment Spending (IQD bn)	Non-oil Investment Spending (IQD bn)	Oil Investment Spending (IQD bn)	Total Revenues (IQD bn)	Non-oil Revenues (IQD bn)	Oil Revenues (IQD bn)	Avg Iraqi oil price ($/bbl)	Avg Brent (price $/bbl)	Oil Exports (mbbl)	Surplus/ Deficit (IQD bn)
2021 Budget Proposal ex-KRI	150,302	125,538	47,479	18,455	24,764	11,142	13,622	86,878	19,424	67,454	42.00		1,095	-63,425
2021 Budget Proposal --- KRI	13,903	10,912	6,360	2,000	2,991	2,991		6,282	725	5,557	42.00		91	-7,621
2021 Budget Proposal	164,205	136,450	53,839	20,455	27,755	14,133	13,622	93,160	20,149	73,011	42.00		1,186	-71,045
2021 Estimate	148,571	129,378	51,319	18,455	19,193	5,571	13,622	90,743	16,119	74,624	47.00	50.00	1,095	-57,828

As a result of the CoM's modifications, the total projected spending in the CoM draft budget increased to 164.2 trillion IQD ($112.5 billion USD) while the projected deficit increased to 71.0 trillion IQD ($48.6 billion USD), as compared to 150.0 trillion IQD and 58.3 trillion IQD ($102.7 and $39.9 billion USD) in the MoF budget, respectively.

The projected deficit of 71.0 trillion IQD would be partially funded by 23.2 trillion IQD ($15.9 billion USD) in a combination of domestic debt servicing (i.e. interest and repayments) restructuring (i.e. debt owed to state banks that the government can easily restructure, and T-Bills, which can be rolled over), and planned foreign debt servicing restructurings (most all of which is bilateral debt provided to Iraq on friendly terms during the 2014-2017 crisis, and thus very likely to be granted). Additionally, the state could potentially produce some savings through the postponement of payments for gas, electricity, and to contractors. Finally, the government would raise 5.6 trillion IQD ($3.8 billion USD) in investment spending from existing funding agreements (most of which are foreign). After accounting for the 23.2 trillion IQD ($15.9 billion) in funding sources, the deficit would amount to 47.8 trillion IQD ($33.0 billion USD). This would be mostly financed by indirect monetary financing from the CBI, which ultimately would lead to the erosion of the country's foreign reserves.[29]

The government reports that it is in talks with the International Monetary Fund (IMF) for a $6 billion USD loan package.[30] The IMF reported that "the Iraqi authorities have requested emergency assistance from the IMF under the Rapid Financing Instrument (RFI), and indicated their intention to also request a longer-term arrangement with the Fund in support of planned economic reforms." However, this emergency assistance covers two very different scenarios. The RFI essentially is a quick financial assistance provided to the IMF's member countries that need an urgent balance of payments without the conditions or monitoring that come with a full-fledged IMF program.[31] Furthermore the amounts provided under an RFI are much less than the figures assumed in the budget proposal (see footnote 29). A full-fledged

[28] Data based on the 2021 budget proposal as amended by the CoM, the initial MoF proposal which was leaked on social media. KRI figures are derived from the budget proposal, estimates of KRG's independent oil sales on top the 250,000 bbl/d that are required to be sold through SOMO. The estimates are based on expectations that the KRG-GoI deal will likely not materialize, and thus the GoI would pay part of the KRI salaries in line with what was paid in 2019 and most of 2020.
[29] Interestingly the MoF proposes to reduce the call on the CBI by 17.1 trillion IQD ($11.7 billion), i.e. the call on the CBI goes down to 30.1 trillion IQD ($20.6 billion). While details are not provided, the 17.1 trillion IQD is mostly composed of 8.5 trillion IQD ($5.8 billion) from national bonds, even though the sales of such bonds in the past have rarely crossed 0.5 trillion IQD ($342.5 million); and loans of 1.8 trillion IQD ($1.2 billion) and 5.9 trillion IQD ($40.4) from the World Bank and the IMF respectively.
[30] 'IMF says Iraq seeking emergency loans after oil price plunge,' *Al-Jazeera*, January 25, 2021, https://www.aljazeera.com/economy/2021/1/25/imf-says-iraq-seeking-emergency-loans-after-oil-price-plunge
[31] 'The IMF's Rapid Financing Instrument,' International Monetary Fund Factsheet, April 9, 2020, https://www.imf.org/en/About/Factsheets/Sheets/2016/08/02/19/55/Rapid-Financing-Instrument

IMF program such a Stand-By Arrangement (SBA),[32] or an Extended Fund Facility (EFF),[33] would come with conditions to undertake economic reform to address economic and structural problems that led the country to require IMF assistance in the first place. While the IMF made a positive statement in support of the CoM's approval of the budget, this was before details of the CoM's amendments were released.[34] Also, the IMF has been clear that Iraq needs to implement substantial structural reforms, [35] but Iraq has a poor track record in this arena.

5. Looking ahead: What to Expect in the Budgetary Process

As the Council of Representatives (CoR) – i.e. Parliament – now debates the CoM's proposed budget, it is expected that they will further dilute expenditure reduction measures. While MPs are not authorized to increase total expenditures, they can reallocate budget spending items before ratifying the bill into law. Notably, with the prospects of federal elections in the short-term, it is improbable that the current Parliament would impose taxes on public sector employees, as they make a large electoral base for the dominant political parties. As such, parliament will probably reverse most of the 4.1 trillion IQD ($2.8 billion USD) in additional income taxes leaving only the politically expedient income taxes on the top positions. It would also likely further reduce consumption taxes.

In a nod to fiscal sobriety, parliament would likely aim to reduce the deficit through a combination of cost reductions and revenue increases. However, given the political considerations of an election year, a great deal of these would create a lesser deficit in paper only. For instance, it is reported that Parliament is considering increasing revenues to over 98.0 trillion IQD ($67.1 billion USD) from 93.2 trillion IQD ($63.8 USD), and lowering expenditures to under 130.0 trillion IQD ($89.0 billion USD) from 164.2 trillion IQD ($112.5 billion USD), thereby lowering the deficit by about 57% to about 30.5 trillion IQD ($20.9 billion USD) from 71.0 trillion IQD ($48.6 billion USD).[36]

Lowering expenditures to 130 trillion IQD better aligns with budgetary constraints; however, the reductions in the budget are likely to be accomplished almost entirely through cuts in the provision of goods and services as well as delays in paying off debt for gas, electricity and contractors – thereby creating future liabilities that need to be paid for in subsequent budgets. Payroll obligations would still account for a disproportionate amount of total spending.[37]

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[32] 'IMF Stand-By Agreement,' *International Monetary Fund Factsheet*, March 27, 2020, https://www.imf.org/en/About/Factsheets/Sheets/2016/08/01/20/33/Stand-By-Arrangement
[33] 'IMF Extended Fund Facility,' *International Monetary Fund Factsheet*, June 5, 2020, https://www.imf.org/en/About/Factsheets/Sheets/2016/08/01/20/56/Extended-Fund-Facility
[34] Deena Kamel, 'IMF calls for structural reforms in Iraq as economy set to contract,' *The National News – Business*, December 14, 2020, https://www.thenationalnews.com/business/economy/imf-calls-for-structural-reforms-in-iraq-as-economy-set-to-contract-1.1127637
[35] 'IMF Staff Completes 2020 Article IV Mission with Iraq.' *International Monetary Fund Press Release.* December 20, 2020, https://www.imf.org/en/News/Articles/2020/12/13/pr20372-imf-staff-completes-2020-article-iv-mission-with-iraq?cid=em-COM-123-42420
[36] For more on the Parliament discussions on the budget, see: Firas Adnan, 'The Financial Committee: Discussions have reduced the 2021 budget deficit by 57%,' (Arabic), *al-Mada Paper*, January 27, 2021, https://almadapaper.net/view.php?cat=233284, and Mohammed Sabah, 'Discussion on the 2021 budget reach advanced stages: Two options on salary reduction,' (Arabic), *al-Mada Paper*, January 30, 2021, https://almadapaper.net/view.php?cat=233331
[37] In a surprising development, though, the CoR's finance committee is planning to reverse the former government's policy of adding 321,944 public sector post to appease the demonstrations. This would lower the public salary component of the budget by about 11.0 trillion IQD ($7.5 billion USD) from 53.8 trillion IQD ($36.8 billion USD) to 42.8 trillion IQD ($29.3 billion USD)

Increasing projected revenues to over 98.0 trillion IQD would be made through higher assumptions of oil and non-oil revenues. The CoR's proposed budget raises oil price assumptions from $42 USD per barrel (/bbl) to $45 USD/bbl, which is a reasonable assumption given the changed oil demand outlook as a result of the availability of vaccines for COVID-19 – also the WP assumed an oil price of $47 USD/bbl for 2021. However, this will only increase revenues by 5.1 trillion IQD ($3.5 billion USD). Thus, most of the hoped for increased revenue projections – especially given the reduced income tax amounts – would need to come from non-oil export revenues on top of the increases in the proposed budget, which is highly unlikely given the country's poor track record in generating non-oil revenues.

However, one element will not change in the short-term: the decision to devalue the currency is already in effect. The question is whether or not Parliament will exert political pressure on the CBI and call for adjustments to the devalued exchange rate. As MPs are primarily concerned with ensuring public support, especially during an election year, they will be closely reading opinion on the ground. Reports from the southern Iraqi regions of Basra and Thi Qar pointed to an increase in food prices even before the CBI official announcement of devaluation. Interviews with middle class residents of Baghdad, central Najaf, and northwestern Sulaymaniyah pointed to sharp increases in the price of imported goods such as rice, grains, milk formula, sugar, cooking oil, flour, diapers, and dairy products. MPs are likely to continue criticizing the devaluations and may make it into an election issue. In sum, the final version of the budget approved by Parliament will likely look very different from the current proposed budget.

As the budget is debated and reviewed within Parliament, it is important to keep the bigger picture in mind: The budget as it currently stands does not depart significantly from those of previous years. The most crucial shortcoming is the dominance of current expenditures at the expense of non-oil investment spending.[38] The historic shortfall of non-oil investment spending, particularly for infrastructure projects, is particularly concerning given that it has only been three years since Iraq emerged from the war against ISIS Iraq has yet to rebuild destroyed areas.[39] Moreover the sectors that most economists believe would stimulate long-term growth (e.g., agriculture, industry, communications, healthcare) receive very little investment spending.

The other major structural issue is that the payments for salaries and pensions constitute the bulk of the current spending. Within that, the security sector stands out. The sector receives significantly more in the proposed 2021 budget than the 2019 budget. Budgeted salary payments for the Popular Mobilization Forces (PMF), for example, have increased consistently over the years from 1.3 trillion IQD ($1.1 billion USD) in 2018, 2.1 trillion IQD ($1.8 billion USD) in 2019, 3.1 trillion IQD ($2.6 billion USD) in 2020, and 3.5 trillion IQD ($2.4 billion USD) in 2021. Several recent studies have analyzed how Iraq's political parties draw upon the security sector as a source of jobs as well as coercive power, and it would appear that this priority continues despite the economic crisis.[40]

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[38] Ahmed Tabaqchali, 'Iraq's investment Spending Deficit: An Analysis of Chronic Failures,' *Institute of Regional and International Studies (IRIS)*, December, 2018, https://auis.edu.krd/iris/latest-iris-publications/iraqs-investment-spending-deficit-analysis-chronic-failures

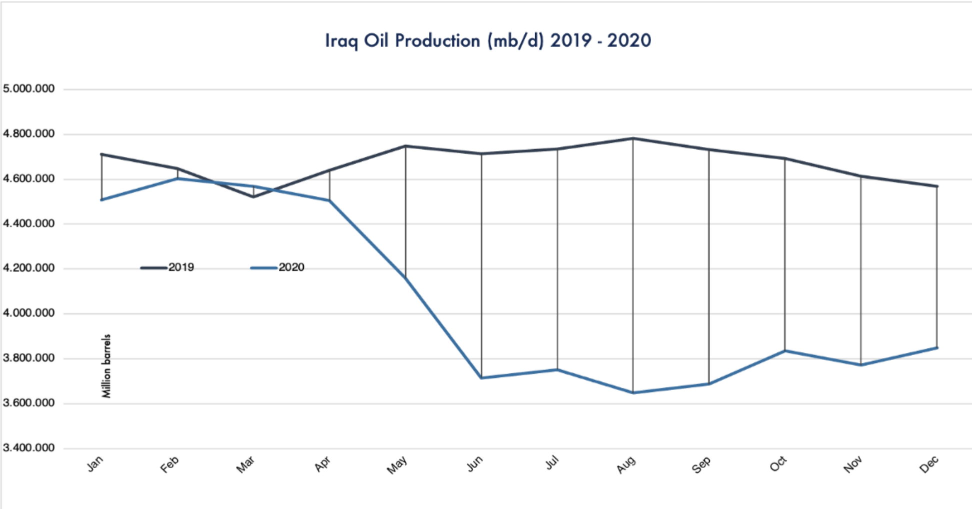
[39] Zmkan Ali Saleem and Mac Skelton, 'The Failures of Reconstruction in Mosul: Root Causes from 2003 to the Post-ISIS period,' *Institute of Regional and International Studies (IRIS),* October, 2019, https://auis.edu.krd/iris/frontpage-slider-publications/failure-reconstruction-mosul-root-causes-2003-post-isis-period

[40] Renad Mansour, 'More than militias: Iraq's popular mobilization forces are here to stay,' *War on the Rocks*, April 3, 2018, https://warontherocks.com/2018/04/more-than-militias-iraqs-popular-mobilization-forces-are-here-to-stay/ and Mac

Part II: The Oil Sector

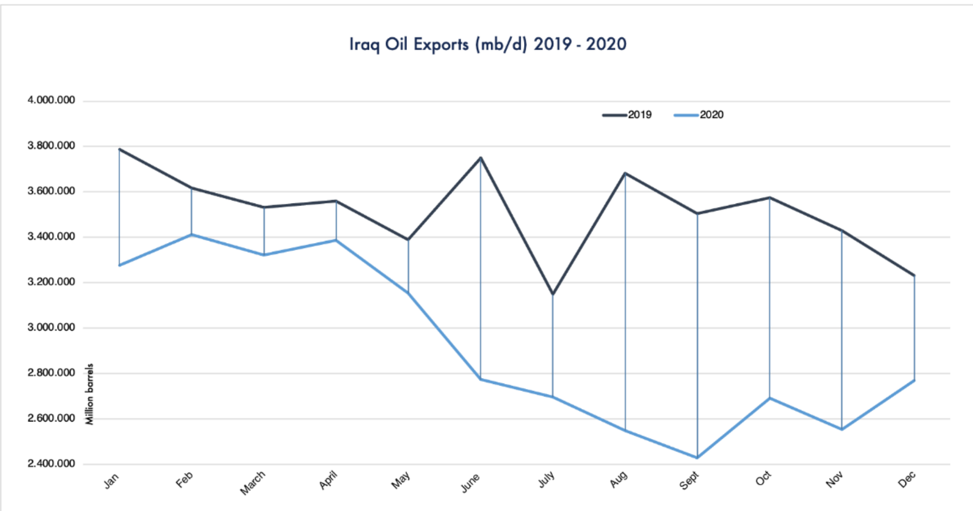
1. A Closer Look on Oil Production and Exports

Iraq oil production and exports declined sharply in 2020 compared to 2019 (see charts below). In April, Iraq agreed to comply with the OPEC+ production cut agreement. The country had to reduce production by 1.06 million barrels per day (mb/d) in May-June and by 0.85 mb/d in July-December. The result is an annual decrease of about 17%. While Iraq did not fully comply with the agreement initially, monthly data show increasing compliance. As of December, data for average daily production show that Iraq production in 2020 was 13% below the same period in 2019. Full OPEC+ compliance is complicated by the fact that the federal government has effectively no control over production and export levels in the Kurdistan Region.



Source: https://www.ceicdata.com/en/indicator/iraq/crude-oil-production

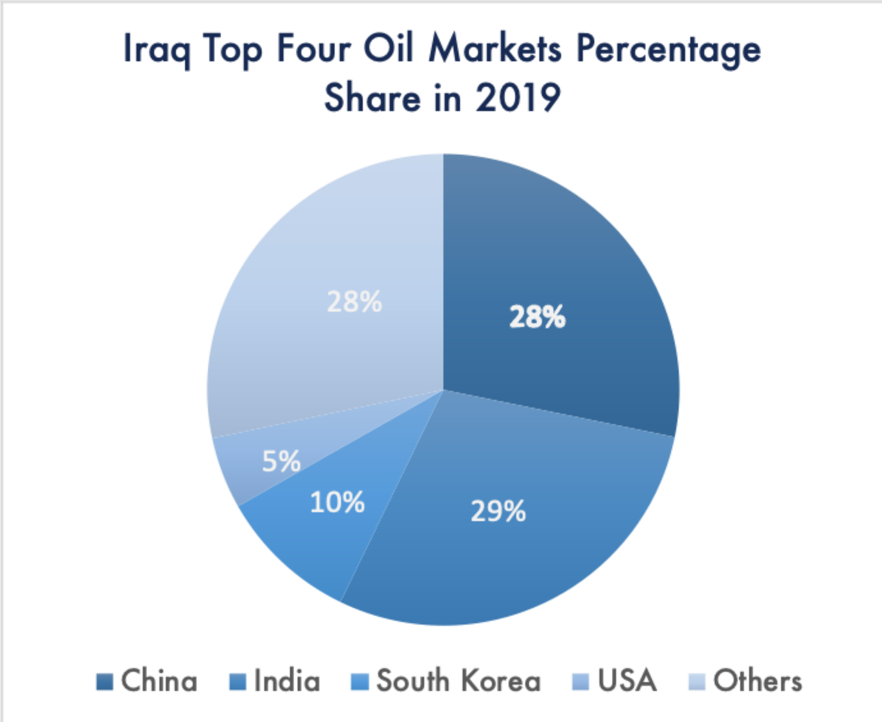
Federal oil exports (excluding the Kurdistan region) declined significantly in 2020. The daily average rate of exports for the year was 17.3% less than exports made in 2019.

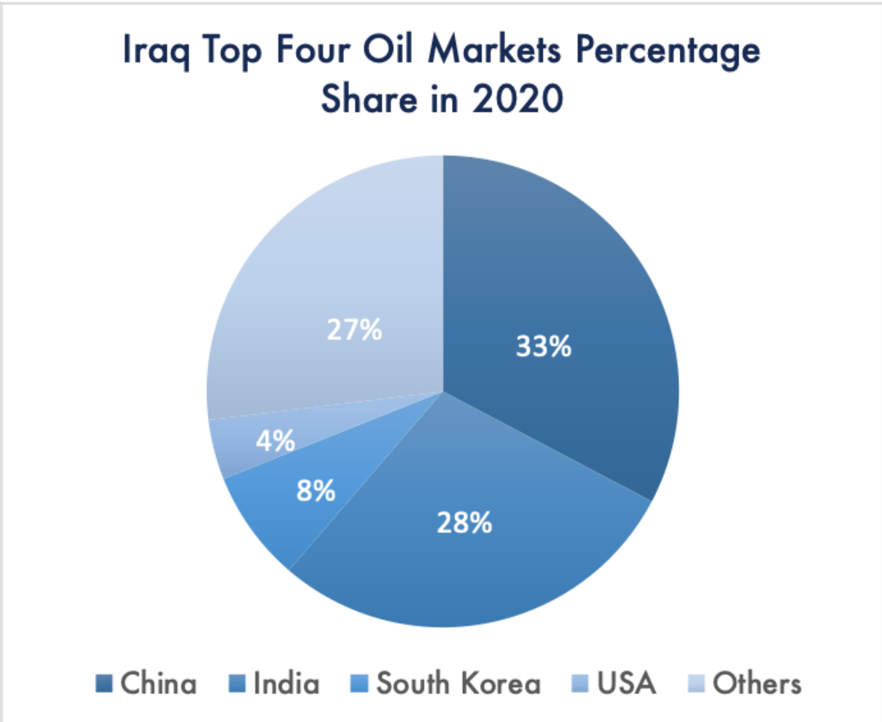


Source: Tanker Trackers, https://tankertrackers.com

Skelton and Zmkan Ali Saleem, 'Iraq's political marketplace at the subnational level: The struggle for power in three provinces, *LSE Conflict Research Programme and IRIS,* June 2020, https://auis.edu.krd/iris/frontpage-slider-publications/iraq's-political-marketplace-subnational-level-struggle-power-three

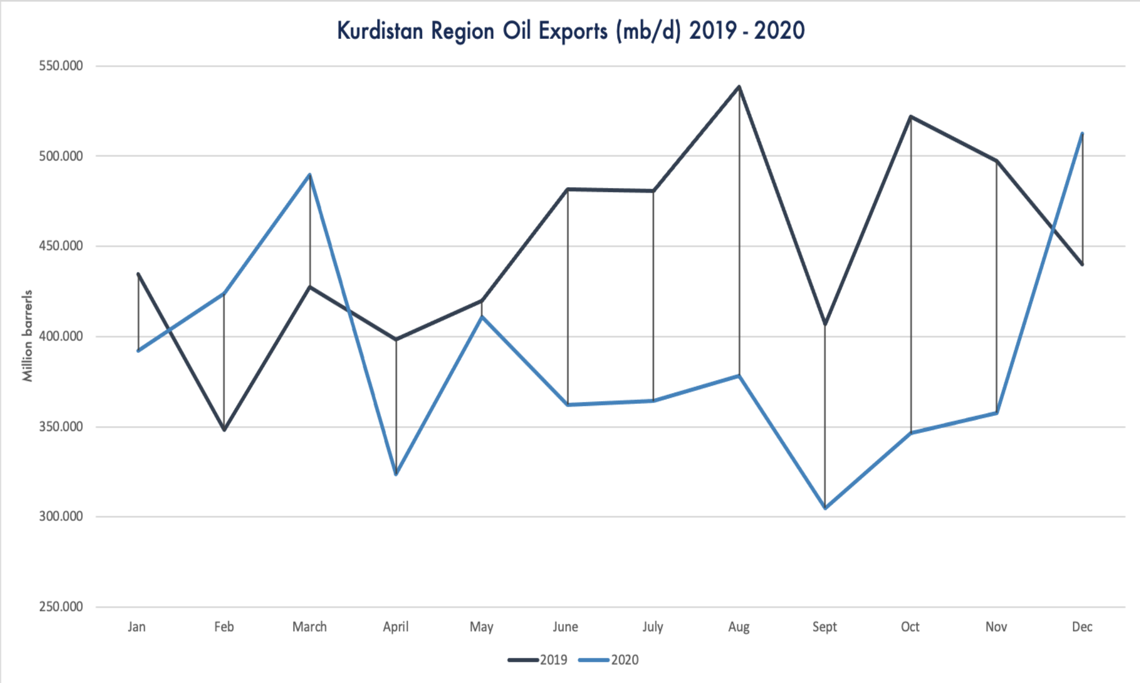
The top four purchasers of oil from federal Iraq – China, India, South Korea, and the USA – have remained consistent over the past two years. However, it is notable that China and India's share increased significantly during that period, highlighting the importance of these markets for Iraq.





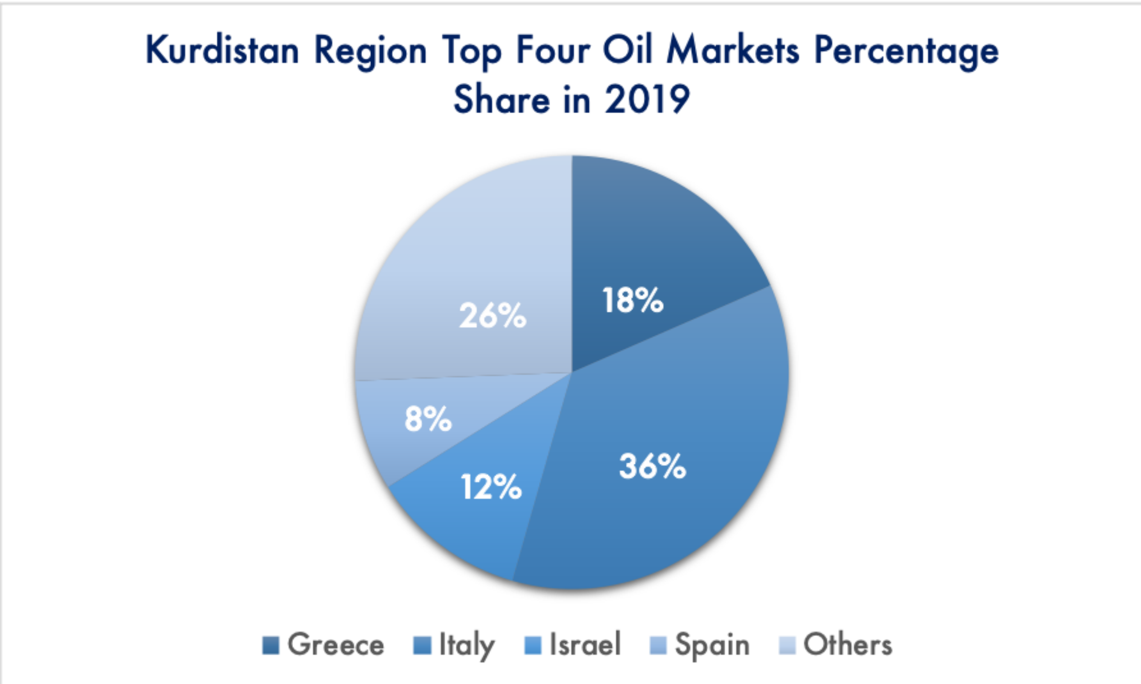
Data based on monthly average, source: Tanker Trackers, https://tankertrackers.com

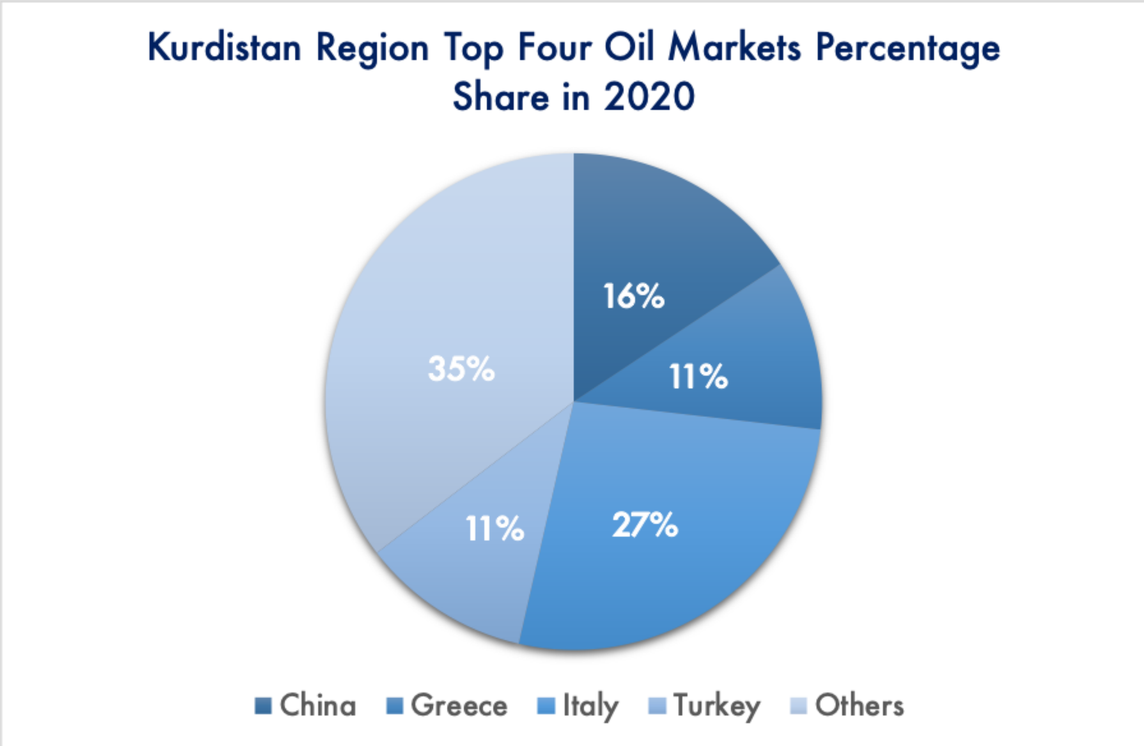
The Kurdistan Region of Iraq's (KRI) oil exports declined in 2020, with the daily average being 16.2% lower than 2019.



Source: Tanker Trackers, https://tankertrackers.com

The KRI's top four export destinations changed a great deal in 2020. China and Turkey emerged as particularly important buyers of KRI oil, purchasing 731,127 and 513,969 barrels of KRI oil in 2020.





Data based on monthly averages, source: Tanker Trackers, https://tankertrackers.com

2. Expert Commentary: Iraq and the Oil Markets Prospects in the Medium Term

By Ali al-Saffar

The onset of the COVID-19 pandemic brought with it unparalleled ruptures in the energy market. The decrease in total energy demand this year is seven times larger than the decline in 2009 when the global economic recession was at its nadir. The various measures ranging from travel restrictions to lockdowns taken to limit the spread of the virus have significantly impacted oil demand. In April, when up to 4.5 billion people worldwide were under some form of confinement, oil demand was almost 22 million barrels per day (mb/d) lower than in the same month of the previous year. Although there has been some recovery since that point, demand in 2020 was around 8.8 mb/d lower than it was in 2019. As a result, the pandemic has wiped out almost a whole decade of growth. The decline in production has been coupled with a dramatic drop in oil prices. In turn, this has affected state revenues for countries heavily reliant on oil exports, shining a light once more on the vulnerability of undiversified oil-based economies. Iraq is on the extreme end of this spectrum with oil income constituting about 90% of total state revenues. What comes next in the energy market is therefore crucial to Iraq's immediate economic and financial fortunes.

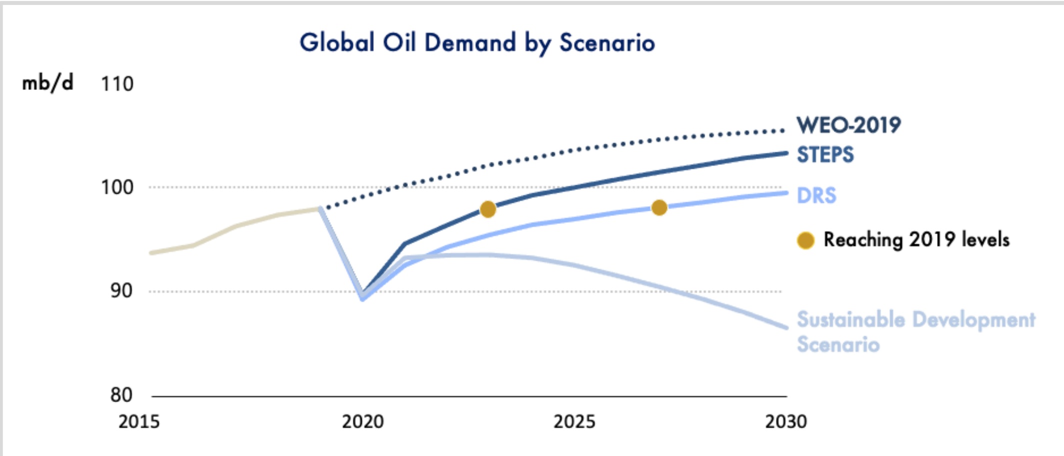
The Short-Term Outlook for Supply, Demand and Balances

Taking a global view, the trajectory for oil demand recovery going forward depends largely on the degree to which economic activity is restored in the wake of the pandemic. Assuming that there is a gradual improvement over the next year, the International Energy Agency (IEA) anticipates that global demand will increase by 5.7 mb/d in 2021, recovering nearly two-thirds of the losses in 2020. Demand will still be 3.1 mb/d lower in 2021 than 2019, largely due to weak demand in aviation fuels.

The impact of weaker demand on prices will be contingent on future developments on the supply side, particularly whether or not OPEC+ countries extend their current production caps agreement. But ascertaining how long it will take for global crude oil stocks to return to pre-pandemic levels is the key factor in evaluating the potential for future price fluctuations. According to the IEA, global crude market balances showed an incremental increase of nearly 840 million barrels between December 2019 and May 2020. For 2020 as a whole, the implied stock increase amounts to 1.7 mb/d. The trend is expected to reverse in 2021, with a stock draw of 1.8 mb/d. This reversal would bring the overall levels close to pre-pandemic levels by December 2021. In other words, barring an event that would reduce supply in the meantime, current market fundamentals make it very unlikely that oil prices will jump before the end of the year.

The Longer Term: When Will Demand Recover?

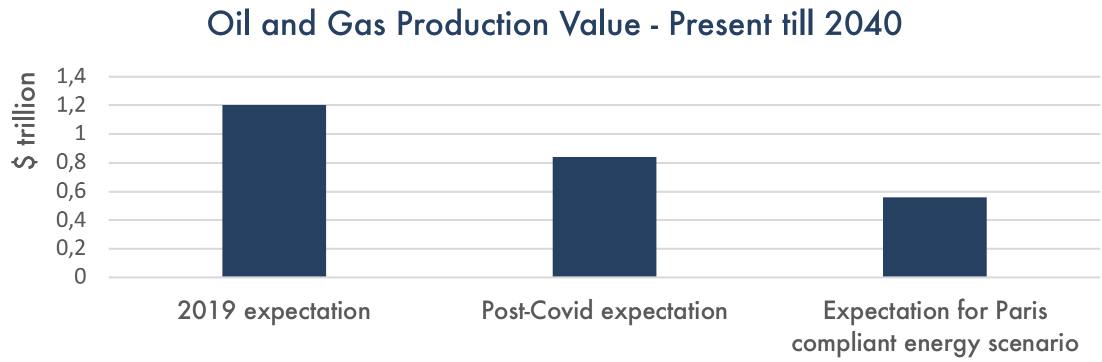
Under the assumption that the pandemic will be brought under control in 2021, full recovery in oil demand (to reach and surpass levels of 2019) would likely occur in 2023. However, the disruption during that period will generate a lasting legacy. By 2030, oil demand is expected to be two mb/d lower than it would have been if the pandemic had not transpired at all. This estimate, however, is a relatively optimistic outlook, and it is important to pose the question: What happens if the recovery from COVID-19, and therefore the global economic outlook, is significantly delayed? Under such a scenario, the IEA believes that it could take up until 2027 to reach pre-pandemic levels.



Source: IEA World Energy Outlook, 2020

Impact on Prices and Revenues: Lessons for the Future?

Consumers spent $1 trillion less on oil products in 2020 as compared to 2019, causing tremendous strain on producer economies that rely on revenues from the export of oil and gas. However, the impact of the unprecedented shock to oil markets in 2020 is not static and cannot be confined to this year alone. The pandemic has fundamentally changed the outlook for demand, and therefore future prices. The value of anticipated cumulative oil and gas production worldwide until 2040 has fallen by almost a quarter due to the pandemic-related shock. For Iraq, the impact is greater still, declining by 30% compared to 2019, from $1.2 trillion by 2040 to less than $850 billion during the same period.



Source: International Energy Agency

The global imperative to advance energy transitions towards renewables will only accelerate in the coming years, raising the prospect that the lower demand/lower price environment we are experiencing today will endure. This would imply significantly reduced revenue streams for producer economies such as Iraq. Those pressures will certainly accumulate in the absence of a substantial reorientation of the economic structure and a meaningful diversification of government revenue streams. The severity of Iraq’s financial crisis is particularly troubling considering that the country had several years of high oil prices to build a financial buffer, but failed to do so. An energy outlook that assumes a consistently weaker oil demand would result in perpetually lower revenues, removing the potential for stable prices to return in the future.

What the Shift in Demand Means for Iraq

The seismic impact of the COVID-19 pandemic on the energy market severely strained Iraq's economy. The effects will be long-lasting, diminishing the value of the country's oil exports well into the future. The potential for a shift in global energy demand towards renewables adds another element of uncertainty. These medium and the long-term vulnerabilities in the energy market indicate that Iraq has no time to lose in the quest for economic reform. If the current political paralysis in Iraq remains unchanged, the shifts in the global energy market will almost certainly outpace Iraq’s capacity for instituting economic reform. This would further exacerbate the country’s financial and economic strain, and would put even larger segments of Iraqi society at risk of poverty. The road to reform is arduous and lengthy but is a far more attractive route than the alternative.

Part III: Conclusions and Policy Implications

The evolution of the 2021 budget from the original version proposed by the MoF to the current version under debate by the CoR reflects the realities and challenges of Iraq’s political economy. The budget has undergone and will undergo significant dilutions of the reform program’s initial vision. This dilution does not reflect different approaches to implementing reform as much as it reflects political calculations in an election year. Politicians will be highly sensitive to public opinion and are in fierce competition to secure seats in the parliamentary elections – the proportion of which determines the relative control of state resources that characterize Iraq's post-2003 political order. These dilutions will not alter the underlying problems that necessitated reform in the first place, and as such will merely defer the need to implement reform as well as create liabilities for the state in subsequent years. These will have implications for future budgets, and ultimately for the country.

The plan for imposing caps on public sector benefits and allowances, and increasing overall income tax, was not intended to be accomplished in a single calendar year. Rather, it was the first step in a multi-year plan to restructure the major fault-lines in the budget and the economy. That plan involved developing progressive income taxation that increasingly over three years would align the public sector payroll with the variability of oil revenues. Thus, the removal of the caps by the CoM, and the likely removal or dilution of the progressive taxation scheme, significantly weakens this plan. In the end, it would most likely turn the economic reform package into a cosmetic exercise.

While the political class is focusing on measures that are aimed at securing public support, these considerations overlook the significant erosion of trust in the political class. This erosion, many years in the making, evolved over a series of increasing nationwide demonstrations in 2011, 2015, 2018, and 2019. By the summer of 2018, the demonstrations put on display a significant divide between the bulk of the population and the political class.[41] That divide culminated in the October 2019 movement in such a way that "rendered this same political elite ideologically bankrupt in the eyes of the public."[42] This erosion of trust would diminish the possibility of public buy-in of the measures in the 2021 budget, and the overall WP reform program.

Finally, there are major structural problems facing the Iraqi economy that the budget, as part of an economic reform program, cannot resolve. The most crucial of these is the state's lack of a monopoly over violence, and furthermore its weakness in enforcing the rule of law. The long-term approach to economic reform in Iraq as a country under conflict will not resemble that of other countries. As such, it must be merged with broader changes in the political, security, and legal orders.

[41] Renad Mansour, 'Protests Reveal Iraq's New Fault Line: The People vs. the Ruling Class,' *World Politics Review*, July 20, 2018, https://www.worldpoliticsreview.com/articles/25161/protests-reveal-iraq-s-new-fault-line-the-people-vs-the-ruling-class

[42] Renad Mansour, 'Running Out of Options: Why Iraq's Elite Fails to Address Protests Demands,' *Institute of Regional and International Studies (IRIS)*, October, 2020 https://auis.edu.krd/iris/sites/default/files/Running%20Out%20of%20Options%20-%20RM%20-%2022%20Oct%2020.pdf

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