IRIS

American University of Iraq, Sulaimani
Institute of Regional & International Studies

Breaking the Impasse: The Baghdad-Erbil Budget Divide

Ahmed Tabaqchali
Hamzeh al-Shadeedi
Sarwar Abdullah

Iraq Economic Review
May 2021

About IRIS

The Institute of Regional and International Studies (IRIS) is an Iraq-based research center committed to producing independent and empirically rigorous political analysis of Iraq and the broader Middle East region. Housed at the American University of Iraq, Sulaimani (AUIS), the Institute partners with academic institutions and funding agencies from across the world that share IRIS' mission of grounding the policy conversation on Iraq in rigorous research and local expertise. IRIS convenes events throughout the year, including the annual Sulaimani Forum, in order to disseminate research findings and to promote dialogue among a broad range of stakeholders on the most complex policy challenges facing Iraq and the region. Finally, IRIS builds the skills and capacity of young researchers, policymakers, and leaders towards the aim of leveraging policy research into political and social change.

About the Iraq Economic Review

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.

Institute of Regional and International Studies (IRIS)
American University of Iraq, Sulaimani
Kirkuk Main Road, Raparin Sulaimani, Iraq

www.auis.edu.krd/iris
iris@auis.edu.krd
@IRISmideast
/IRISmideast

Iraq Economic Review

May 2021

Authors & Contributors

Ahmed Tabaqchali, Lead Researcher

Ahmed Tabaqchali, an experienced capital markets professional with over 25 years' experience in United States and MENA markets, is the Chief Investment Officer (CIO) of AFC Iraq Fund. He is also an Adjunct Assistant Professor at the American University of Iraq-Sulaimani (AUIS), and a Senior Fellow at the Institute of Regional and International Studies (IRIS) at AUIS. He is Non-resident Senior Fellow with the Atlantic Council - Iraq Initiative of the Rafik Hariri Center and Middle East Programs. Tabaqchali is also a board member of the Credit Bank of Iraq, and of Capital Investments, the investment banking arm of the Capital Bank of Jordan. He is a former Executive Director of NBK Capital, the investment banking arm of the National Bank of Kuwait, Managing Director and Head of International Institutional Sales at WR Hambrecht + Co., Managing Director at KeyBanc in London and Director and Head of Capital Markets and Institutional Sales at Jefferies International in London. He started his career at Dean Witter International in London. Ahmed holds an Master's degree in mathematics from the University of Oxford in the United Kingdom, a Bachelor's degree (Honors, 1st class) in Mathematics from Victoria University of Wellington in New Zealand and a Bachelor's degree in Mathematics from the University of Canterbury in New Zealand.

Hamzeh al-Shadeedi, Researcher

Hamzeh Al-Shadeedi is a Policy Researcher at the Institute of Regional and International Studies (IRIS). In this capacity, he focuses on issues of economics, security and the rule of law in Iraq. Before joining IRIS, Hamzeh worked for the Conflict Research Unit of the Clingendael Institute, where he researched issues of local governance and security sector reform in Libya. He holds a Bachelor's degree in Business Administration from the American University of Iraq, Sulaimani and a Master's degree in Modern Middle East Studies from Leiden University.

Sarwar Abdullah, Guest Contributor

Dr. Sarwar Abduallah teaches at the College of Political Science at the University of Sulaimani. He holds a PhD in Politics and International Studies from the University of Newcastle in the UK. His doctoral research entitled "Clientelism, rent-seeking and protection: a study of corruption in Iraq after 2003", examined Corruption in Iraqi rentier state after 2003. He has several academic publications on corruption in Iraq, he also has published several policy articles on the Washington Institute for Near East Fikra Forum, where he focuses on the issue of sectarianism and corruption in Iraq.

Introduction

The annual debate over the Kurdistan Regional Government (KRG)'s share of the federal budget in return for its contribution in oil exports has been a source of continued conflict and strife between the KRG and the Government of Iraq (GoI), poisoning the relationship between the two sides to the detriment of both.

The 2021 Iraqi federal budget backed by Prime Minister Mustafa al-Kadhimi's government was submitted for parliamentary consideration in late 2020. The proposal incorporated an agreement -- reached earlier between the al-Kadhimi administration and KRG counterparts -- on the KRG's share of the federal budget and expected contributions to oil exports. The agreement stipulated that the KRG would receive its share of the federal budget in exchange for its contribution of 250,000 barrels per day (bpd) in oil exports, including an allowance for the KRG to receive the salary and pension portion of its share of the budget even in the event of its failure to supply the required contribution in oil exports, and importantly the agreement aimed to address the contentious issue of compensating the KRG for oil production and export costs. The agreement had aimed to re-set the relationship between the two sides and resolve past conflicts.

However, the Prime Minister's budget proposal was met with strong opposition from a majority in parliament, particularly from MPs from the non-Kurdish blocs. They cited the KRG's failures over the last two years to fulfil its obligations as mandated by prior budget laws while continuing to receive salaries and pension payments from the federal budget. The MPs' uncompromising stance was effectively the diametric opposite of the Prime Minister's, and was first articulated in the November 2020 deficit financing law, which was passed by a majority in parliament with opposition from the Prime Minister Mustafa al-Kadhimi and Kurdish party leaders.[1, 2, 3] The deficit financing law stipulated that the KRG would receive its share of the federal budget only after paying its contributions to oil exports – a conditional payment departing significantly from the flexible implementation schedule implied in the original agreement between al-Kadhimi's government and the KRG.

Eventually, after three months of negotiations,[4] a compromise was reached that addressed the demands of the MPs while preserving the thrust of the original agreement. The compromise was incorporated into the 2021 budget that Parliament passed into law at the end of March 2021. The promising potential of this compromise could – depending on the level of goodwill between the KRG and the GoI – settle long-standing contentious issues between the two sides over the development of the country's oil and gas sector, which are rooted in divergent visions of the nature of the Iraqi federation. However, this resultant pact, its potential promising aspects not-withstanding, was struck for political expediency and as such it sacrificed clarity for compromise. The compromise sidestepped the crucial task of

1 Baraa al-Shamary. "Iraq: passing the deficit-financing law causes a new crisis between Baghdad and Erbil" [Arabic]. The New Arab. November 12, 2020. Available at https://www.alaraby.co.uk/politics/العراق-تشريع-قانون-يتسبب-بأزمة-جديدة-بين-بغداد-وأربيل

2 "Al-Kadhimi promises to send the Kurdistan Region employees' salaries within two weeks and the PUK holds the KRG delegation responsible [for failing to include the KRI employees' salaries in the deficit-financial law]" [Arabic]. Mawazin News. November 17, 2020. Available at https://www.mawazin.net/Details.aspx?jimare=130825

3 "Al-Kadhimi's government accused of breaching the deficit-financing law and paying the Kurdistan Region employees: MPs threaten to block any agreement that does not include the KRG handing oil revenues first" [Arabic]. Al-Sharq al-Awsat. December 14, 2020. Available at https://aawsat.com/home/article/2681451/اتهامات-لحكومة-الكاظمي-بخرق-«الاقتراض»-لتسديد-رواتب-كردستان

4 Mouayad al-Tarafi. "Conflicts among Iraqi political parties threaten the approval of the federal budget after three months of negotiation: Opinions differ on the portion of the Kurdistan Region as well as revenue sharing from oil exports and border-crossings" [Arabic]. Independent Arabia. March 11, 2021. Available at https://www.independentarabia.com/node/201181/الأخبار/العالم-العربي/خلافات-الكتل-العراقية-تهدد-إقرار-الموازنة-بعد-3-أشهر-من-المناقشة

addressing core constitutional considerations, and thus ultimately risks a repeat of past failures.

Accordingly, Part I outlines the core issues behind the GoI-KRG reoccurring conflict over the budget and natural resources. It examines Iraq's constitutional language relating to oil and gas, which contributed to the divergent paths taken to develop natural resources based on differing views of federalism; the evolution of the KRI's oil production and exports since 2003; and the KRG's budgets. These sections form the backdrop for a discussion of the current 2021 GoI-KRG budget deal. Part I ends with implications on the prospects of success and the effects on stability inside the Kurdistan region. Part II of the Review offers a closer look at the potential routes for economic diversification in the Kurdistan region.

Part I: Understanding the Baghdad-Erbil Economic Divide

1. The Constitution and the Development of Oil and Gas Resources

Both the GoI and the KRG maintain that they are seeking to resolve the dispute over the KRG's share of the federal budget and its contribution to oil exports according to the country's 2005 constitution.[5] However, the parties fundamentally disagree over the nature of the state's federal structure as enshrined in the constitution[6] – a disagreement that is brought into focus in their divergent interpretations of constitutional articles 111 and 112, which address the development of oil and gas (hydrocarbon) resources. The core of the fundamental disagreement is over the balance of power between the center and subnational entities (e.g., governorates, regions). On the one hand, Kurdish parties interpret the Iraqi constitution as prescribing a loose federal system in which power and decision-making authority rest at the subnational level. On the other hand, non-Kurdish parties interpret the constitution as placing federal power and decision-making in the hands of the central government.

These opposing understandings of the state's structure have manifested themselves in the interpretation and implementation of the said articles,[7] particularly Article 112. The issue of contention is the ambiguity of the word "*with*" appearing in Articles 112-1 and 112-2. The articles state: "The federal government, *with* the producing provinces and regional governments, shall undertake the management of oil and gas extracted from current fields…" and "The federal government, *with* the producing regional and governorate governments, shall together formulate the necessary strategic policies to develop the oil and gas wealth …". What are the roles of each party implied through the usage of the word "*with*"? The federal government interprets the *with* as acknowledging a role for the subnational entities – but a subordinate one; while the KRG's interpretation is the opposite, in that the *with* acknowledges a role for the federal government – but one that is supportive of (rather than in control of) hydrocarbon development driven by subnational authorities. Thus, the interpretation of Article 112 has become a major sticking point.

---

5 Conflict between the GoI and the KRG is much broader than a conflict between two official entities. It is a conflict between Kurdish politicians (KRG officials, members of the Kurdistan parliament, Kurdish members of the federal parliament, Kurdish officials of the federal government) and their counterparts in the GoI and the federal parliament. For simplicity, the terms "Kurdish parties" and "non-Kurdish parties" are used to describe these political entities in this paper.

6 For details on constitutional ambiguity and differing views on Iraq's federation, see Raad Alkadiri, "Federalism and Iraq's constitutional stalemate," Chatham House. November, 2020. Available at: www.chathamhouse.org/sites/default/files/2020-11/2020-11-27-iraq-federalism-alkadiri.pdf.

7 A link to the original, official Arabic text of the constitution, alongside an unofficial English translation by Zaid al-Ali, are available on al-Ali's website at: https://zaidalali.com/resources/constitution-of-iraq/. Zaid al-Ali is a specialist in international commercial arbitration and comparative constitutional law and has worked as a legal adviser to the UN focusing on constitutional, parliamentary, and judicial reforms in Iraq. Al-Ali's English version has added interpretive aides such as sub-headings to better understand the contents of each constitutional article.

Moreover, the requirement in Article 112-2 to "develop the oil and gas wealth in a way that achieves the highest benefit to the Iraqi people using the most advanced techniques of the market principles and encouraging investment" is subject to various interpretations. Each side has interpreted this clause to justify pursuing oil developments strategies with International Oil Companies (IOCs) that are best suited to the geological characteristics and export challenges of their respective oilfields.

As for the issue of the right to export oil produced by these IOCs, there are no constitutional articles addressing oil and gas exports and whether they fall under the authority of the oil producing governorates/regions or the centre. However, some have argued that Article 110 addresses this issue indirectly in describing the federal government's exclusive powers, including: "Formulating foreign policy and diplomatic representation; negotiating, signing, and ratifying international treaties and agreements; negotiating, signing, and ratifying debt policies and formulating foreign sovereign economic and trade policy."[8]

Due to the above ambiguities in the constitutional articles, when it came time for lawmakers to translate them into a federal oil and gas legislation, further conflicts and disagreements arose. After nearly two years of agonizing negotiations involving the federal government, KRG, and international stakeholders, a compromise over the legislation nearly emerged in early 2007. But it eventually failed to become law due to irreconcilable views on key issues.[9, 10] Ultimately, the two sides adopted their own interpretations of the said constitutional articles,[11] and signed divergent oil production contracts with IOCs. The KRG adopted production sharing contracts (PSCs) after passing its own oil and gas law, while the GoI implemented technical service agreements (TSAs).[12]

The GoI and non-Kurdish politicians never accepted the legitimacy of the KRG's PSCs. And consequently, they did not accept the notion of obliging the GoI to renumerate IOCs operating in the KRI according to these contracts. This refusal to accept the PSCs would lead to sharp disagreements over the KRG's share of the federal budget in return for the region's contributions in oil exports[13].

2. KRG Budgets

Subsequently, successive federal budget laws omitted compensation to the KRG for the costs of the region's oil production, which effectively obliged the regional government to pay the IOCs operating in the KRI from its standard annual budgetary allocation[14]. These omissions exacerbated the tensions between the two sides, which eventually led to a rupture

8 Several senior U.S. officials have cited Article 110 in voicing skepticism over the legality of the KRG's independent oil exports to Turkey in 2013
Ben van Heuvelen, "Turkey planning to control Iraqi oil revenue," Iraq Oil Report. April 2, 2013. Available at: www.iraqoilreport.com/?p=10526.

9 For a review of the conflict over the oil and gas law, see Lionel Beehner and Greg Bruno, "Why Iraqis Cannot Agree on an Oil Law," Council on Foreign Relations. February 22, 2008. Available at: www.cfr.org/backgrounder/why-iraqis-cannot-agree-oil-law.

10 For more on the failure of the 2007 negotiations, see James Glanz, "Compromise on Oil Law in Iraq Seems to be Collapsing," New York Times. September 13, 2007. Available at: www.nytimes.com/2007/09/13/world/middleeast/13baghdad.html.

11 The differences over articles 112, and the federal oil and gas law, were part of much bigger differences and actions taken by both sides over the years. For a concise review of these see Scott R. Anderson, 'The constitutional context for Iraq's latest crisis,' Brookings. November 2017. https://www.brookings.edu/blog/markaz/2017/11/07/the-constitutional-context-for-iraqs-latest-crisis/

12 Also known as Technical Service Contracts (TSCs) or Service Level Agreements (SLAs).

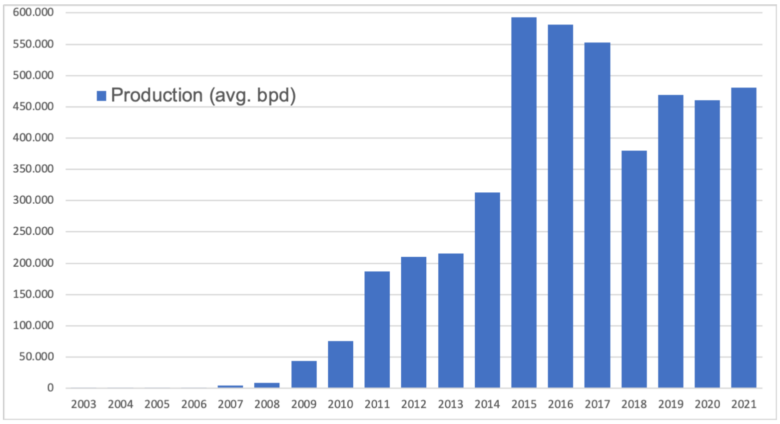
13 For a detailed review of the issues in the conflict over the KRG's share of the federal budget in return for its oil exports see Ahmed Tabaqchali, 'The debate over Iraqi Kurdistan's share of the federal budget,' al-Bayan Center for Planning and Studies. June 2020. https: English version: https://www.bayancenter.org/en/2019/06/1940/, Arabic version: https://www.bayancenter.org/2019/07/5383/

14 Budget laws recognize federal oil revenues, as net of the cost of production, i.e. after paying the renumeration of the IOCs operating in federal oil fields. However, these budget laws, recognize the KRG's oil revenues as gross revenues, i.e. without acknowledging the renumeration of IOCs operating in the KRI oil fields. These laws thus imply that the KRI should pay those costs separately from its share of the overall budget.

in the relationship cumulating in the GoI's withholding the KRG's share from the federal budget in 2014. The KRG responded by taking the bold step to pursue its own oil exports in order to raise independent revenues.

Over the course of the last several years, the IOC's operating the KRI expanded production capacity significantly in their fields. By 2020, the KRI's oil production reached an average of 460,000 barrels per day (bpd) from an average of 1,100 bpd in 2003, which is estimated to increase to 480,000-500,000 bpd in 2021.[15] (See Chart 1).

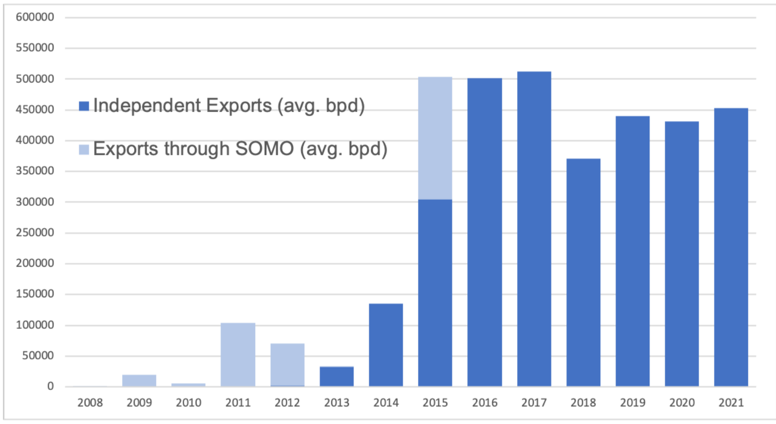
Chart 1: KRG Oil Production 2003-2021



Sources.[16]

Mirroring the growth in production, the KRG's exports reached an average of 430,000 barrels per day (bpd) in 2020 from an average of 900 bpd in 2008, which is estimated to increase to 450,000 bpd in 2021.

Chart 2: KRG Oil Exports 2008-2021



Sources.[17]

15 See "Weekly Energy, Economic and Geopolitical Outlook" Middle East Economic Survey, Volume 64, Issue 3. January 22, 2021. Available at: www.mees.com/vol/64/issue/3.
Nikloas Stefanous initation of research coverage on the Oil Exploration and Production companies (E&P) operating in the KRI on February 18, 2021 Available at: www.rencap.com.
16 Data for 2003-2009 : KRG Ministry of Natural Resources (MNR), available at: http://mnr.krg.org/index.php/en/oil/monthly-export-production-data.
Data for 2010-2020: based on estimates by Renaissance Capital, which in turn are based on MNR figures available at: https://gov.krd/mnr-en/publications/oil/, Deloitte audit reports of the KRG's oil production and exports, and Wood Machenzie.
2021 Estimates: Renaissance Capital.
Note: Data for the average daily production is based on the year's total production divided by 365 days
17 Data for 2008-2016: KRG Ministry of Natural Resources monthly oil exports and production data. Available at: http://mnr.krg.org/index.php/en/oil/monthly-export-production-data.
Data for 2017- 2020/01-09: Deloitte Reports on oil and gas review in the Iraqi Kurdistan Region available at:

However, the region's revenues from its independent oil exports were not sufficient to cover the full expenditures of the KRG, compelling Kurdish leaders to seek renewed negotiations over the budget in subsequent years. In a sign of rapprochement, in early 2018 the GoI started transferring to the KRG the salary and pensions portion of its share of the federal budget, even though the KRG had not met its commitments in oil exports set at 250,000 bpd in the 2018 budget. These payments continued in 2019. The federal budget for that year mandated that the GoI maintain transfers of the salary and pensions portion of the KRG's share of the federal budget even in the event of the failure of the KRG to meet its commitments in oil exports of at least 250,000 bpd,[18] with the caveat being that the *full* share of the budget would only be paid if the required 250,000 bpd was transferred to the GoI State Organization for the Marketing of Oil (SOMO).

The KRG's revenues are derived from independent oil exports, non-oil revenues in the form of taxes and customs tariffs, and recently salary and pension transfers from the GoI. These have been augmented further by borrowing in the form of forward oil sales.[19]

In the absence of the GoI transfers between 2014 and 2017, the KRG's revenues were not enough to cover expenditures, especially salaries and pension payments to the KRG's enormous public sector. And thus, the regional government often resorted to cuts and delays in paying its obligations as short term means for bridging the gap between revenues and expenditures[20]. This situation continued in 2018-2020, but far less severely following the rapprochement in 2018 as can be seen from the table below.

As displayed in the table below, estimated total oil revenues for 2020 were 2.46 billion USD. Estimates of non-oil revenues (taxes and customs tariffs), and other revenues (e.g., from US government support for peshmerga, federal government salaries) were 3.5 bill USD. This amounts to a combined total of 5.97 billion USD. Given that estimated expenditures were 8.28 billion USD, this left a deficit of an estimated 2.3 billion USD. Similar but less severe deficits had previously been estimated for 2018-2019.

The economic disruptions and movement restrictions in the wake of the COVID-19 global pandemic in 2020 led to severe declines in both the KRG and the GoI oil and non-oil revenues. Revenue shortfall at the federal level, and anger over the failure of the KRG to supply the requisite 250,000 bpd to SOMO in 2019 and 2020, led non-Kurdish politicians to demand an end to the salary allocations to the KRG that were included in the 2019 federal budget. [21, 22]

2017 Reports: https://gov.krd/english/information-and-services/open-data/deloitte-reports/deloitte-report-2017/, 2018 Reports: https://gov.krd/english/information-and-services/open-data/deloitte-reports/deloitte-report-2018/,
2019 Reports: https://gov.krd/english/information-and-services/open-data/deloitte-reports/deloitte-report-2019/, 2020 Reports: https://gov.krd/english/information-and-services/open-data/deloitte-reports/deloitte-report-2020/.
Oct-Dec 2020, and 2021 are IER estimates.
Note: Data for the average daily exports is based on the year's total exports divided by 365 days.

18 These are discussed in fuller detail in Ahmed Tabaqchali, 'The debate over Iraqi Kurdistan's share of the federal budget,' al-Bayan Center for Planning and Studies. June 2020. https: English version: https://www.bayancenter.org/en/2019/06/1940/, Arabic version: https://www.bayancenter.org/2019/07/5383/

19 Forward oil sales are loans that will be repaid from future oil sales. These sales are discussed in the sections entitled, "Oil: Assets, Liabilities, Production, and Exports" (p. 4) and "Debt: Arrears and Borrowings" (p. 25) of Tabaqchali, "Statehood in the Kurdistan Region," IRIS.
The total outstanding stock of forward oil sales was $4.3 billion by end of September 2020. Source: https://gov.krd/english/information-and-services/open-data/deloitte-reports/deloitte-report-2020/.

20 These are discussed in the section entitled, "Revenues and Expenses" (p. 30) of Tabaqchali, "Statehood in the Kurdistan Region," IRIS.

21 25 federal MPs demanded a judicial investigation against the former Finance Minister, Fouad Hussein from the Kurdish Democratic Party, for wasting public funds and transferring USD 5 billion to the KRG even though the latter did not meet its obligations towards Baghdad. Speda. April 23, 2020. Available at: http://www.speda.net/index.php/ar/news/iraq/53470

22 This was still valid in 2020 according the 1/12th rule. The rule essentially means that the government can spend up to a twelfth of the appropriations made in 2019 on a monthly basis and it was applicable given the failure of the GoI to submit a budget proposal for 2020 in late 2019.

Table 1: The KRG's Oil Exports and Budget Dynamics

		2018	2019	1Q20	2Q20	3Q20	4Q20E	2020E
	Dated Brent, $bbl	71.1	64.4	50.1	29.56	42.94	44.16	42
	Kurdish discount, $bbl	*12.66*	*11.8*	*18.5*	*13.8*	*11.3*	*11.8*	*13.9*
	Average realisation, $bbl	**58.44**	**52.6**	**31.6**	**15.8**	**31.7**	**32.36**	**28.1**
	Total KRI production, kbopd	**379.8**	**468.4**					**460.2**
	Production exported, kbopd	371.0	439.6	463.8	410.0	430.3	**440.0**	**434.5**
	Production exported, mmbbl	**135.4**	**160.4**	**42.3**	**37.4**	**39.3**	**39.6**	**158.6**
A	**Oil sales revenue**	**7,914.7**	**8,438.6**	**1,342.3**	**590.3**	**1,243.5**	**1,281.5**	**4,457.6**
	IOC cost/profit oil and other payments	-2,407.1	-2,537.1	-427.5	-500.6	-421.5	-448.5	-1,798.1
	% of total revenue	*30%*	*30%*	*32%*	*85%*	*34%*	***35%***	*40%*
	Turkish Energy Company tariffs	-436.2	-494.2	-136.7	-70.0	-47.7	-39.6	-294.1
	% of total revenue	*6%*	*6%*	*10%*	*12%*	*4%*	*3%*	*7%*
	in $/bbl	*3.2*	*3.1*	*3.2*	*1.9*	*1.2*	**1.0**	*1.9*
	Kurdistan Pipeline Company tariffs		-644.4	-179.1	-84.9	-191.3	-158.4	-613.7
	% of total revenue	*0%*	*8%*	*13%*	*14%*	*15%*	*12%*	*14%*
	in $/bbl	*0.0*	*4.0*	*4.2*	*2.3*	*4.9*	**4.0**	*3.9*
	Forward oil sales charges	-19.7	-15.0					
	Legal fees	-24.6	-3.5	-9.8				-9.8
B	**Oil operating expenses**	**-2,887.6**	**-3,694.1**	**-753.2**	**-655.5**	**-660.5**	**-646.5**	**-2,715.6**
A-B	**Oil netbacks**	**5,027.1**	**4,744.5**	**589.1**	**-65.1**	**583.0**	**634.9**	**1,742.0**
	% of total revenue	*64%*	*56%*	*44%*	*-11%*	*47%*	*50%*	*39%*
	in $/bbl	*37.1*	*29.6*	*13.9*	*-1.7*	*14.8*	*16.0*	*11.0*
	Electricity payments	-411.4	-398.5	-24.1				-24.1
	Other payments	-112.5	-379.6	-36.0	-11.1			-47.1
C	**Other KRG costs**	**-523.9**	**-778.0**	**-60.1**	**-11.1**	**0.0**	**0.0**	**-71.3**
	Debt repayment to TEC and TPIC	-690.0	-610.0	-60.0				-60.0
	Forward oil sale repayments (incl interest)	-337.7	-706.0	-6.6	-21.4	-29.6		-57.6
D	**Financing expenses**	**-1,027.7**	**-1,316.0**	**-66.6**	**-21.4**	**-29.6**	**0.0**	**-117.6**
E	**Additional net proceeds from PSC/other**	**868.3**	**292.2**					
F	**New forward sales**	**190.6**	**1,572.7**	**498.7**	**415.0**	**0.0**		**913.7**
G=A+E+F-B-C-D	**Net proceeds relating to oil activities***	**4,534.3**	**4,515.4**	**961.0**	**317.3**	**553.5**	**634.9**	**2,466.7**
	Non-oil revenue	914.9	1919.6	240.0	240.0	240.0	240.0	959.8
	US government payments for the Peshmerga	262.2	290.0	51.0	51.0	51.0	51.0	204.0
	FG salary payments	2,397.5	4,578.2	583.0	583.0	583.0	583.0	2,331.9
H	**Other revenues**	**3574.5**	**6787.8**	**873.9**	**873.9**	**873.9**	**873.9**	**3,495.7**
I=G+H	**Total KRG revenues**	**8,108.8**	**1,1303.2**	**1,834.9**	**1,191.2**	**1,427.4**	**1,508.9**	**5,962.4**
	KRG public sector payroll	-6,668.4	-9,025.21	-1,805.0	-1,579.4	-1,579.4	-1,579.4	-6,543.3
	KRG debt repayments	-500.0	-690	-86.25	-86.25	-86.25	-86.25	-345.0
	KRG goods, services, maintenance	-1,339.6	-2,500.84	-312.5	-312.5	-312.5	-312.5	-1,250.0
	KRG investments	-268.1	-473.949	-35.5	-35.5	-35.5	-35.5	-142.0
J	**Total KRG expenditure**	**-8,776.0**	**-12,690.0**	**-2,239.3**	**-2,013.7**	**-2,013.7**	**-2,013.7**	**-8,280.3**
I-J	**Surplus/(deficit)**	**-667.2**	**-1,386.8**	**-404.4**	**-822.4**	**-586.3**	**-504.8**	**-2,317.9**

Note: As disclosed by Deloitte.

Source: Deloitte, Ahmed Tabaqchali, Company data, Renaissance

Source and terms[23]

23 Nikloas Stefanous, of Renaissance Capital, initiation of research coverage on the Oil Exploration and Production (E&P) companies operating in the KRI on February 18, 2021 Available at: www.rencap.com.
Terms: /bbl = price per barrel, kbpod = 1,000 barrel oil per day, TEC. = Turkish Energy Company, TPIC = Turkish Petroleum International Company, FG = Federal Government of Iraq.

3. The 2021 GoI-KRG Deal

The current GoI-KRG deal, as in prior years, specifies that in return for its share of the federal budget, the KRG is required to submit 250,000 bpd in oil exports to SOMO. But in a significant departure from the past, the deal allows for the renumeration of the IOCs operating in the Kurdish region by acknowledging that KRG exports in excess of 250,000 bpd can be used to meet the costs of oil production and exports. It also allows for the KRG to continue to receive from the federal budget the salaries and pensions portions of its share, but not the full share, even if it fails to supply the required 250,000 bpd to SOMO. Moreover, the deal called for a review and a settlement of the KRG's debts following the withholding of its share of the budget by the GoI in 2014.

This deal first took shape during the second half of 2019, which saw a renewed effort by fresh leadership on both sides to resolve past conflicts and develop a deal that both parties could support to be included in the 2020 budget proposal.[24, 25] Just as an agreement was taking shape, the youth-led demonstrations erupting across the country in the fall of 2019 forced the resignation of former Prime Minister Adel Abdul-Mahdi, and as such the resultant caretaker government no longer possessed the authority to propose bills to Parliament, including the budget. The current Prime Minister Mustafa al-Kadhimi inherited his predecessor's precarious political balance of power in Parliament. Needing the same support of Kurdish parties as his predecessor did, the budget deal previously developed in the fall of 2019 was soon revived and found its way into the 2021 budget with most of the original terms intact.[26] But the agreement soon faced significant resistance in parliament stemming from MPs who cited the KRG's failure to meet its obligations in 2019 and 2020 in the form of oil exports of 250,000 bpd.

The compromise that was eventually reached in the budget's passage preserves the essential thrust of the original agreement while satisfying most of the demands of the deal's opponents. In essence, the compromise changes the language and the sequencing of the terms that required the KRG to supply at least 250,000 bpd in oil in return for its share of the budget. The updated language and sequencing now require the KRG to produce at least 460,000 bpd of oil, from which it can cover the costs of oil production, operation, and exports, and subsequently submit the revenues of at least 250,000 bpd to the GoI at SOMO's prices. Thereafter, the GoI is to pay the KRG its share of the budget. The compromise also removed the items dealing with the KRG's debts.[27]

Importantly, the compromise still allows for the renumeration of the KRI's IOCs from the KRG's independent oil exports above 250,000 bpd – a situation vastly different from past budget laws which implied that the KRG should pay this renumeration from its own share of the federal budget and expected the KRG to hand over to the GoI the full proceeds of its independent oil exports above 250,000 bpd. Moreover, the compromise implicitly accepts the KRG's full control of its oil export infrastructure in requiring it to submit the proceeds of exports

24 Mohammed Hussein, Rawaz Tahir, Ben van Heuvelen, "New leadership revives Baghdad-Erbil oil talks," Iraq Oil Report. August 5, 2019. Available at: www.iraqoilreport.com/news/new-leadership-revives-baghdad-erbil-oil-talks-41985/.

25 Rawza Tahir, Mohammed Hussein, Ben van Heuvelen, "'Ahead of oil talks with Baghdad, KRG proposes new budget framework,'" Iraq Oil Report. August 22, 2019. Available at: www.iraqoilreport.com/news/ahead-of-oil-talks-with-baghdad-krg-proposes-new-budget-framework-42052/.

26 This assumption is inferred from: a) the footnote above' b) the terms of the 2020 national budget proposal submitted to Parliament in September 2020, later withdrawn; and c) the terms of the initial 2021 budget proposal proposed by the federal Ministry of Finance.

27 The Compromise, like the deal, includes other items that have appeared in prior budget laws, such for the GoI and the KRG to settle and audit all outstanding issues from 2004-2020, and for the KRG to effectively hand over to the GoI half its its non-oil revenues.

of at least 250,000 bpd at SOMO's prices and not to supply the 250,000 bpd for SOMO to export.

These positives, however, are somewhat offset by two primary negatives. The first is that the proceeds of the KRG's independent oil exports above 250,000 bpd, while easily covering the renumeration of the Kurdish region's IOCs, fall far short of covering the additional costs of the KRG's oil export infrastructure and the obligations arising from forward oil sales (see table 1). The second is that the requirement to submit the proceeds of exports of at least 250,000 bpd at SOMO's prices implies that the KRG would need to pay the GoI – from its share of the budget – the difference between its selling prices and SOMO's higher selling prices.[28] These two negatives are compounded by Parliament's 17.5% cut to the KRG's budget allocation (from what was agreed with the GoI in the initial budget proposal)[29] as part of Parliament's broader cuts to the overall federal budget.[30]

The resulting compromise still leaves the Kurdish Region in a situation where the KRG will ultimately have no choice but to undertake significant cuts to its expenditures, the majority of which would likely need to be made to its large public sector payroll; however, these cuts would be much less than what would have been required in the absence of the compromise. The failure or delays by the KRG to implement cuts to expenditures, whether to the public sector payroll or to the KRG's oil export infrastructure, to match revenues would replicate the conditions that prevented the KRG from fulfilling its obligation in 2018-2020. The fluidity and the flexibility of the language employed in the budget compromise could recreate and justify the demands of non-Kurdish politicians to end transfers to the KRG should frustrations arise over delays in submitting the requisite export proceeds.

4. Policy Implications of the Deal

The compromise in the 2021 budget deal is a major step forward*:* The compromise reached in Parliament in the budget's passage is a major positive step forward in addressing the contentious issue of IOC compensation in the KRI. It should be expanded into a political acceptance of the legitimacy of both the KRG's PSCs and the GoI's TSAs in satisfying the requirements of the Constitution's article 112-2, acknowledging that each type of contract is best suited to the different situational profiles of their respective fields.

Ultimately a mutually acceptable federal oil and gas law will be necessary: Such an acceptance of each side's contracts with IOCs would create a foundation for both parties to craft and adopt a federal oil and gas law that works equally for both in line with a shared vision for the country's federal structure, and hence implement Articles 111 and 112 for the benefit of the people of Iraq. This would end the constant conflict over the KRG's share of the budget, cementing the rights and obligations of the federation's subnational entities and the centre through a permanent law that eliminates the unpredictability and ambiguity of past politically expedient agreements that have always failed.

In future talks, both sides should be realistic about broader structural factors: Despite its strengths, this agreement and the ensuing compromise reached in parliament depend on continuously high oil revenues over the years to finance these ever-increasing federal government expenditures and, the resultant increasing KRG allocations. Working against this

---

[28] This is based on data on federal exports from federally controlled Kirkuk fields that are exported through the same export routes used by the KRG, which show that federal Kirkuk oil's discount to Brent crude is meaningfully less that of the KRG's oil discount to Brent (table 1) –even after accounting for the different oil qualities. Sources: SOMO on oil exports https://somooil.gov.iq/exports, and discussions with Nikloas Stefanous of Renaissance Capital.
29 "Republic of Iraq Federal Budget Law for the Year 2021". Ministry of Justice. Available at https://www.moj.gov.iq/upload/pdf/4625.pdf
30 Tabaqchali et al., 'The National Budget: Short and Medium-Term Prospects,' IRIS.

unsustainable process are the powerful pressures exerted by the country's demographics,[31] which over the years erode the ability of these high oil revenues to finance such expenditures, rendering these short-term politically expedient agreements into an exercise in futility as well as creating the conditions for future social unrest.

Part II: Prospects for Economic Diversification in the Kurdistan Region of Iraq

The negotiations between the dominant Baghdad-based political parties and the KRG delegation took months to finalize, ultimately generating the text of a clause within the federal budget that is only valid for one year. In the absence of a federal oil and gas law that solidifies the fiduciary relationship between the GoI and KRG, such negotiations are an annual feature of the budget process, injecting ambiguity in the size and timing of budget transfers to the KRG. Given this uncertainty, the KRG will perpetually face struggles in meeting its financial obligations, especially if negotiations break down and revenue transfers from Baghdad halt in the process. Consequently, the KRG must generate new and steady revenue streams, and for that to happen, the KRG must urgently diversify its economy away from oil.

As with the country at large, oil is the primary source of revenue in the KRI, contributing nearly 80% of the region's GDP. Agriculture constitutes roughly 10% of GDP; tourism is 4%; and services and industries only 6%. Oil also constitutes up to 90% of the exports from the region.[32] This section explores whether economic diversification in such an oil-dependent region is possible in the short-term, and then identifies the sectors that could drive that development and generate much needed revenues. The most likely sectors to drive economic diversification in the KRI are agriculture, industry, and tourism. Each sector faces notable challenges that could limit development over the next few years.

1. Agriculture: Buying Local

In 2008, the KRG put forward an agricultural sector development plan with a budget of $10 billion USD to be invested over ten years by both the public and private sectors. In the end, the KRG only allocated $50 million USD, which was clearly insufficient to enable the sector to grow and substitute for the dependency on imported produce – primarily from Turkey and Iran. In addition to weak governmental commitment to the plan at the outset – as evidenced by the inadequate funding relative to the 2008 plan – the KRG spending, and implementation lacked transparency and it remains unclear which if any of the sector's development goals were actually achieved.[33]

Furthermore, as trade through border-crossings constitutes a significant non-oil revenue stream for the KRG, imposing strict tariffs to protect local agricultural products from much cheaper imports may prove a costly decision.[34] As previous research has indicated, dominant Kurdish parties depend on rent extraction from border-crossing activities to finance their patronage networks.[35, 36] Consequently, the lack of political will on the part of the Kurdish

31 Ahmed Tabaqchali, 'How Demographics Erode the Patronage Buying Power of Iraq's Muhasasa Ta'ifia,' Arab Reform Initiative, July 2020.
https://www.arab-reform.net/publication/how-demographics-erode-the-patronage-buying-power-of-iraqs-muhasasa-taifia
32 Pankaj Dixit and Ramyar Rzgar Ahmed, "Diversification of Economy–an Insight into Economic Development with Special Reference to Kurdistan's Oil Economy and Agriculture Economy," Russian Journal of Agricultural and Socio-Economic Sciences 85, no. 1 (January 2019): p. 395-404.
33 Author interview with an economist in Kurdistan, March 5, 2021.
34 Author interview with a former agriculture minister in Kurdistan, March 7, 2021.
35 Zmkan Ali Saleem and Mac Skelton, "Searching for Ghosts: Fighting Corruption at Iraq's Border Crossings," LSE Conflict Research Programme Blog. February 24, 2021. Available at: https://blogs.lse.ac.uk/mec/2021/02/24/searching-for-ghosts-fighting-corruption-at-iraqs-border-crossings/.
36 Zmkan Ali Saleem and Mac Skelton, "Assessing Iraqi Kurdistan's Stability: How Patronage Shapes Conflict," LSE Middle East Centre Paper Series 38. July 2020. Available at: https://eprints.lse.ac.uk/105775/1/MEC_assessing_iraqi_kurdistans_stability_published.pdf.

parties is a significant hindrance to agricultural development in the KRI. The KRG will ultimately have to balance cross-border trade and the need to support local agricultural producers.

The dilemma in the KRI is that cheap products from neighboring countries benefit not only political actors but also consumers. Food products imported from Iran and Turkey (e.g., cigarettes, poultry, vegetables, and fruits) are much cheaper than KRI local equivalents. While farmers and the region's agricultural sector continue to be marginalized by competitive import pricing, local consumers welcome the short-term benefits to their pocketbooks.

2. Industry: Building on Proven Potential

Since 2003, the KRI has begun to develop efficient cement, iron, and brick-making industries as well as other services in the communications sector.[37] The region already sells cement, iron, and other construction materials to other parts of Iraq. But these other regions of Iraq offer a limited market. One industry expert asserted, "Our position is good because the rest of Iraq is underdeveloped in these fields."[38] Due to a lack of necessary skills, expertise, and resources to develop these industries, it remains difficult for the KRI to be competitive beyond Iraq's borders. In the long term, the KRI should invest in education to provide the market with the skills these industries need.

Simultaneously, the KRI must invest in modernizing the region's finance and banking sectors to build a competitive industrial advantage. Updating its cash-based financial system would facilitate greater economic activity internally, as e-banking contributes to better tracking, transparency, and oversight as well as swifter transactions. It will also provide an incentive for international companies to invest in KRI industries. Investors believe that transnational corporations are keen to do business in the KRI, but lack of trust in the region's banking system poses an obstacle to fulfilling such aspirations.[39]

3. Tourism: Capture Iraqi and Regional Interest

With the KRI boasting a range of historic and natural sites,[40] tourism holds considerable potential for revenue diversification in the region. The KRI's two international airports and four land border-crossings, as well as its stability relative to the rest of Iraq, means that access and security do not propose significant challenges to tourists. However, the lack of a well-developed tourism sector, which includes both infrastructure (e.g., easily navigated transport systems, availability of and access to accommodations) and human capital (e.g., staff trained in hotel hospitality),[41] means that the sector will not thrive in the short-term. With foreign tourists from Europe and the United States looking suspiciously at Iraq broadly due to its well-publicized safety and security concerns, the KRI will continue to suffer by association. For the near term, the KRI should invest in building its tourism sector around tourists from elsewhere within Iraq and regional countries. The KRG needs to develop a tourism strategic plan that first focuses on attracting the local market but simultaneously builds out its tourism infrastructure in anticipation of increased numbers of foreign tourists in the longer term.

37 Examples include, Najmadin Concrete (http://www.najmadin-concrete.com/), Erbil Steel Company (http://www.erbilsteel.com/), Tasluja-Lafarge Cement Factory (https://www.lafarge-iraq.com/en/tasluja), Asiacell Telecommunication Company (https://www.asiacell.com).
38 Author interview with a private sector researcher operating in a local company in the KRI, March 6, 2021.
39 Author interview with a Kurdish business person based in London. March 7, 2021.
40 For more on touristic attractions in the Kurdistan Region, see the KRG' official tourism website: http://bot.gov.krd.
41 Author interview with an economist commentator in the KRI. March 5, 2021.

4. Looking Ahead

The KRI's vision for economic diversification over the next few years remains unclear. Strong ties between the economic and political spheres in the KRI mean that revenue diversification depends on a robust political will.[42] Though diversifying the economy away from oil has the potential to create thousands of job opportunities, that redirection of effort could also reduce the dominant political parties' access to rents and, by extension, threaten the decades-old patronage systems in the KRI.[43] Reconciling these conflicting strategies at a governmental level then becomes a prerequisite to launching genuine economic reform initiatives. While better supported industry and tourism sectors can meet short-term modest revenue demands within the KRI, they will only be able to compete outside the country's borders with significant, top-level, long-term investment and development planning by the KRG. Agriculture in the KRI holds great potential due to the availability of required human and natural resources. But for this prospect to materialize, the sector needs the KRG's support and protection in the form of committing the political will to modernize agriculture and shield it from cheaper competitors.

42 Author interview with a former official in the KRG. The interviewee is now a business person and owner of a private company. March 6, 2021.
43 Said one interviewee and confirmed by a former high official.

IRIS

American University of Iraq, Sulaimani

Institute of Regional & International Studies

www.auis.edu.krd/iris