IRAQ'S INVESTMENT SPENDING DEFICIT: AN ANALYSIS OF CHRONIC FAILURES

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Iraq's deficit is not a matter of excess expenditures over revenues, but rather a deficit in investment spending. The 2019 budget proposal brings this flaw into sharp focus.

Photo credit: Ali Al-Baroodi

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Iraq's Investment Spending Deficit: An Analysis of Chronic Failures

The proposed 2019 budget law brought into sharp focus systemic failures in the crafting of successive Iraqi governments' economic policy since 2003.[1] For years, the structural imbalance between current and investment expenditure has undermined the Iraqi economy and is the primary reason why the country is vulnerable to external shocks - especially to shifts in the global price of oil.[2] This year's proposed budget perpetuates the same flaws. The lack of investment spending, particularly for non-oil infrastructure projects, is particularly concerning given that Iraq has recently emerged from the war against ISIS. Despite the promises of the political elite to reconstruct and rebuild Mosul and other affected cities and regions, the numbers indicate otherwise.

Under the proposed budget law, current expenditure would still account for the bulk of all government expenditures, at 75 percent of the total, growing by 15 percent in 2019 and then by seven percent a year to 2021 to still account then for 75 percent of the total. Investment expenditure (both for oil and non-oil projects), on the other hand are projected to grow by 29 percent in 2019 and by seven percent a year to 2012, to remain at 25 percent of the total.

While the 2019 increases of 15 percent and 29 percent for current and investment expenditures respectively seem to favor investment spending, these increases should be seen in the context of past budgets given that investment spending was cut sharply over the past few years, as seen in table 1 below:

Table 1: Year over year changes in current and investment expenditures

Years	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
	IMF data								2018 Budget law data			
Current expenditures %		19%	13%	10%	-16%	-18%	6%	14%	20%	15%	7%	7%
Investment expenditures %		14%	23%	42%	3%	-36%	-27%	3%	5%	29%	7%	7%
Non-oil %					-21%	-50%	-33%	21%	22%	37%		
Oil %					56%	-20%	-23%	-7%	-7%	21%		

*See footnote for sources and explanations.[3]

The 2019 budget spending proposals show total investment expenditures at 68 percent of 2013 levels, with oil-investments and non-oil investments respectively at 100 percent and 53 percent of 2013 levels, while current expenditures are at 115 percent of 2013 levels.[4]

Recently oil prices had a dramatic fall from multi-year highs, in a way similar to the falls of 2014—with the international crude benchmark Brent down over 33 percent in just a few weeks due to concerns of increased supply

[1] The information in this report is based on publicly available web sites, publications, presentations, and research reports. In particular, the World Bank's 2017 report "Iraq, Systematic Country Diagnostic Report No. 112333-IQ" has been an invaluable resource.

[2] Government expenditures fall into two basic categories: (a) current expenditures which cover those for the public payroll and the acquisition and provision of goods and services, all of which are in order to satisfy current consumption. (They also include transfer payments representing payments on pensions, subsidies (including electricity, fuel, agriculture, etc.) and social security.); and (b) capital or investment expenditures which cover those for infrastructure investment, goods and services, and research, all of which are needed to create future benefits.

[3] Sources: IMF Iraq Country reports 13/217 and 17/251 for 2010-2012 (no breakdown figures for this period) and 2013-2017 respectively (2017 are projections); amendments to 2019 Budget Law dated 8 October 2018 for 2018-2019.

[4] The increases in non-oil investments of 37 percent for 2019 on the surface would seem to differ from that of the appendix which showed a 43.5 percent increase, but this is explained by noting the figures in the appendix exclude items such as arrears to contractors or armament spending, while those in the above table do not exclude them to maintain compatibility with the figures used in tables 1 & 2.

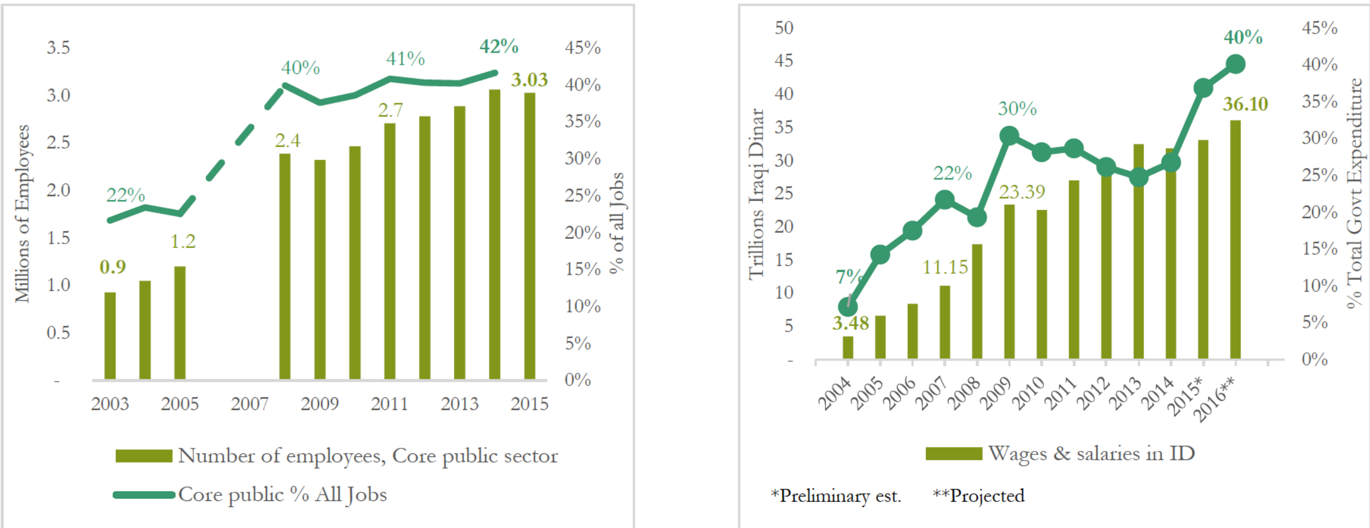
and weakening global demand as Europe continues to slow-down[5] and the US-China trade war could have negative consequences for world growth in 2020 as the IMF recently noted.[6]

The immediate consequences of the fall of oil prices for Iraq are many. The budget was negotiated under the projected price of Iraqi oil of $56/bbl for 2019, which seemed conservative a few weeks ago, but is now looking aspirational. The real number could be as much as $5-7/bbl lower, if not more depending on a number of factors. Under this scenario, revenues would be reduced by $7.0 to 10.5bn, or roughly by eight to 12 percent. Consequently, the budget deficit could increase by 29-34 percent.[7] Moreover, a weaker global economy implies less demand for oil which would affect Iraq's plans of increasing production from its southern oil fields and resuming exports form the Kirkuk fields.

A reduction in oil revenues and disruptions to plans to resume exports from the Kirkuk fields would almost certainly negatively affect the thaw in the strained relationship between the Government of Iraq (GoI) and the Kurdistan Regional Government (KRG), delaying a much needed national reconciliation. Finally, the projected growth in the deficit and debt levels would pose serious risks to Iraq's future financial stability.

This vulnerability to external shocks is primarily due to the insignificant role of the non-oil economy in the overall economy. The lack of investment in non-oil infrastructure is deeply concerning, particularly given the destruction to the country's infrastructure and productive capacity following over 35 years of conflict. As the political class competed for power and influence through a system of payroll patronage, successive Iraqi governments since 2003 have sharply increased the public payroll and subsidies (chart 1 below) at the expense of investing in infrastructure.

Chart 1: LHS: Core Public Sector Employment 2003-2015, RHS: Government Wage Bill



*See footnote for sources and explanations.[8]

[5] Claire Jones and Cat Rutter Pooley, "Eurozone economy slows further as manufacturing slumps," *Financial Times*, November 23, 2018, https://www.ft.com/content/1123d4f6-eef9-11e8-89c8-d36339d835c0.

[6] Chris Giles, "IMF warns global economic growth will slow by 2020," *Financial Times*, April 17, 2018, https://www.ft.com/content/c5718efa-4218-11e8-93cf-67ac3a6482fd

[7] Using the official exchange rate of 1 USD = 1,190 IQD, and real deficit of IQD 28,692bn (see deficit in appendix).

[8] Sources: Charts taken from Iraq, Systematic Country Diagnostic Report No. 112333-IQ (figure's 50 & 51 page: 65). Sources cited in report are Iraq Ministry of Finance (MoF), World Development Indicators, International Monetary Fund (IMF).

The dangers of these choices were masked during the years of plenty in which oil production was growing and prices per oil barrel were high, with government and consumer consumption driving economic growth.[9] Economic expansion came to an end in 2014 due to the twin shocks of the ISIS conflict and the collapse in oil prices. The subsequent crisis was exacerbated by significantly increased military expenses just as revenues were collapsing, which forced the government to resort to the shock treatment of sharply cutting investment expenditures (table 2 below). This was seen as the only available avenue of reducing expenditure given the impossibility of cutting the public payroll or subsidies[10]. It should be noted the cuts to current expenditures were mostly in the acquisition and provision of goods & services, while the public payroll was mostly unaffected and was meaningfully higher in 2017.[11]

Table 2: Investment expenditures 2010-2021

Years	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
	IMF data								2018 Budget law data			
Investment expenditures (IQD trn)	24.1	27.4	33.6	47.6	49.2	31.6	23.1	23.9	25.2	32.6	34.9	37.3
Non-oil (IQD trn)				32.3	25.4	12.6	8.4	10.2	12.5	17.1		
Oil (IQD trn)				15.3	23.8	19.0	14.7	13.7	12.7	15.5		
						MoF year end data						
Investment expenditures (IQD trn)						18.6	15.9	16.5				
Non-oil (IQD trn)						4.9	3.5	4.0				
Oil (IQD trn)						13.7	12.4	12.5				

*See footnote for sources and explanations.[12]

Non-oil investment took a major hit between 2013 and 2016 (IQD 32.3trn to IQD 8.4trn), such that successive increases only took the total to 53 percent of 2013 levels. As severe as these cuts were, the real extent of the reductions can only be appreciated in actual spending as opposed to budgeted spending. Available figures from the Ministry of Finance (MoF)[13] show that expenditures were significantly below budgeted figures, with the greatest shortfall in non-oil investments.

Non-oil investment expenditures, as small as they were, were in fact even smaller than they appeared on the books. Productive investment spending (such as those on electricity, water, housing and education) accounted for 33-75 percent of all non-oil spending during the three years 2015-2017. The rest of non-oil investments during these years were investment spending by the Council of Ministers, Ministry of the Interior, and non-ministerial entities which accounted for 67-25 percent of total non-oil investments.

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[9] The World Bank's "Iraq, Systematic Country Diagnostic Report No. 112333-IQ" notes: " The consumption needs of the population are largely met by imports, negating the potentially beneficial impact of government spending on the real economy in terms of the provision of goods and services" which ultimately "boosted short-term consumption but has also increased the country's import dependence, skewed the labor market structure, and crippled the private sector." For full country diagnostic, see here: http://documents.worldbank.org/curated/en/542811487277729890/Iraq-Systematic-Country-Diagnostic.

[10] The impossibility of cutting the public payroll stems from the fragile relationship with the governing elite and their constituencies in which constant inducements are needed to ensure continued support by the constituents. This sharply exposes the lack of legitimacy of the state and its ruling parties as continued spending was needed to ensure this legitimacy, which is compounded by the folly of squandering the oil bounty on fleeting short-term gains during the years of plenty at the expense of long-term investments.

[11] 2017 IMF data show that expenditures on salaries and pensions were 41.1, 40.3, 42.2, 41.6, 47.6 (all in IQD trn) in 2013, 2014, 2015, 2016 and 2017 respectively. Table 3. IMF Iraq country report 17/251.

[12] Sources: IMF Iraq Country reports 13/217 and 17/251 for 2010-2012 (no breakdown figures for this period) and 2013-2017 respectively (2017 are projections); amendments to 2019 Budget Law dated 8 October 2018 for 2018-2019. Ministry of Finance (MoF) end of year reports for separate figures for 2015-2017, http://mof.gov.iq/obs/ar/Pages/obsDocuments.aspx

[13] Both GoI and IMF figures, estimates and projections for the budget (revenues and expenditures) include the KRG (contributions to oil sales as well as the KRG's share of the federal budget), but the MoF figures include actual expenditures and revenues which for 2015-2017 excluded the KRG.

While three years of data (especially those reflecting the crisis years) cannot give a full picture of these spending patterns over a normal full economic cycle,[14] they serve to highlight two essential points: First, the budget has neglected non-defense priorities during the years of crisis; second, a growing cumulative deficit in spending on the country's non-oil infrastructure.

The difference between budgeted and actual spending is a function of weaknesses in the country's investment absorptive ability, and perhaps more importantly low capacity to implement projects resulting from a shortage in skilled labor force,[15] while the country's corrosive corruption exacerbated these weaknesses and squandered what was spent. Between 2010 and 2013, Iraq suffered from poor execution rates of 64 percent[16] (i.e. actual spending as a percentage of budgeted spending). Table 1 above shows that the average for 2015-2017 was 65 percent. While the available data does not cover the years 2004-2010 or 2013-2014, it is likely that the same patterns would have held during these years. [17] Moreover, the continuation of the same capacity constraints suggests a repeat of the same patterns for 2018-2019, all of which underscores the extent of the investment deficit problem.

The accumulated deficit in non-oil investment spending is made much worse by the massive needs for reconstruction after the ISIS conflict and the urgency of developing the non-oil economy. These needs require the full-attention and resources of successive Iraqi governments for the next few years. However, the sense of the importance and urgency of these issues was entirely absent in the current budget law proposal and in the subsequent discussions in parliament.

The disconnect between the allocations for investments in the budget and the development and reconstruction plans arrived at with consultations with Iraq's international stakeholders exposes both the both challenges facing the country and the failures of successive Iraqi governments. Development plans such as Vision 2030, National Development Plan (NDP) 2018-2022, or the Poverty Reduction Strategy (PRS) 2018-2022 seem to be present only in aspiration but neither in the budget allocations nor in the execution of government spending.

The latest disconnect comes with the clash between the current budget law proposal and the extensive "The Reconstruction and Development Framework"—crafted in close collaboration between the World Bank Group (WBG) and the Ministry of Planning (MoP), which was presented in February 2018 in the Kuwait Conference for the Reconstruction of Iraq. This clash is evident from the disparity between the budget's current and future allocations to investment spending and those of the aims of the framework.

The framework "focuses on recovery and reconstruction in the directly affected governorates, and on development and investment in the indirectly affected governorates. A heavy emphasis is placed on national reform priorities that will help address the structural drivers of conflict and violence."[18] The framework provides comprehensive analysis of the reconstruction needs across all sectors of the economy, and outlines short, medium, and long-term implementation plans to meet these needs.

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[14] A full economic cycle reflects periods of economic expansion and contraction. Government economic policy, Central Bank policy and the economy's performance should be considered over a full cycle. For reference, see https://www.investopedia.com/terms/e/economic-cycle.asp.

[15] Sources: Presentation by the IMF's Resident Representative for Iraq and Yemen at the "IBBC Autumn Conference" in Dubai on Nov 25th, 2018. World Bank 2017 report "Iraq, Systematic Country Diagnostic Report No. 112333-IQ"

[16] World Bank report 112333-IQ page 69.

[17] World Bank report 112333-IQ notes: "This is not merely a product of the current difficult economic conditions brought about by plummeting of oil prices and increased security spending but characterized Iraqi economic management even in the boom years preceding the global financial crisis."

[18] "Reconstruction & Development Framework" of "Iraq Reconstruction & Investment," http://www.cabinet.iq/uploads/Iraq Reconstruction/Iraq Recons & Inves.pdf

Importantly, the GoI[19] as part of the framework planned to utilize its own resources to fund the bulk of the reconstruction needs. It further aimed to augment these financing approaches to bring in syndicated bank loans, institutional investors, and international stakeholders.[20]

In conclusion, the projected two-year accumulated budget surplus of $20-24bn by end of 2018,[21] coupled with the investment and trade-credit pledges of $30bn received in the Kuwait Conference, provide the wherewithal for the GoI to address reconstruction needs and to finally begin to address the massive investment spending deficit.

The GoI needs to rethink its priorities in redrafting its 2019 budget within the frame work of a multi-year budget plan. It has the knowledge in the form of prior extensive studies including the framework, and for now the financial resources to do this, but would it have the political will to act on them or would the warring political parties prevent it from doing so? What is clear is that the Iraqi population cannot and will not wait. Absent meaningful spending for reconstruction for non-oil infrastructures, protests and voter discontent will remain a central feature of Iraqi politics.

[19] Government of Iraq (GoI).

[20] Ahmed Tabaqchali, "It's Not the Donations, Stupid: Key Points from Kuwait Conference," Iraq Business News, February 22, 2018, http://www.iraq-businessnews.com/2018/02/22/its-not-the-donations-stupid-key-points-from-kuwait-conf/.

[21] Ahmed Tabaqchali, "Budget Surplus Soars, but Markets continue to Bottom," Iraq Business News, September 6, 2018, http://www.iraq-businessnews.com/2018/09/06/budget-surplus-soars-but-markets-continue-to-bottom/.

Appendix: A Review of Iraq's 2019 Draft Budget Law

This review is extracted (with updated information on non-oil spending and KRG budget allocations) from an original article by the author that appeared in "1001 Iraqi Thoughts" on November 18th, 2018.[22]

Table 1: A bird's eye view of the budget for 2019 vs 2018[23]

Figures in IQD billions & rounded	2018	2019	Change (%)
Revenues			
Oil Price Assumption ($/bbl)	46	56	22%
Oil Exports Assumption (mbbl/d) (inc. 0.25 mbl/d from KRI)	3.88	3.88	0%
Oil Revenues (1)	**77,160**	**93,741**	21%
Non-Oil Revenues (2)	**14,483**	**11,829**	-18%
Income & Wealth Taxes	5,010	3,842	-23%
Goods & Services Taxes	3,514	2,492	-29%
Fees	743	537	-28%
Share of Public Sector Profits	927	2,761	198%
Capital Revenues	121	45	-63%
Transferable Revenues	2,063	255	-88%
Other Revenues	2,105	1,896	-10%
Total Revenues = (1) + (2)	**91,644**	**105,570**	15%
Oil Revenues (%)	84%	89%	5%
Non-Oil Revenues (%)	16%	11%	-29%
Expenditures			
Current Expenditures (3)	**83,061**	**95,852**	15%
Salaries	36,076	38,610	7%
Pensions	10,842	11,790	9%
Other Employee Benefits	7,530	8,135	8%
Goods and Services	1,724	2,431	41%
Support	11,017	14,696	33%
Debt Servicing	12,333	15,502	26%
War Reparations	772	1,553	101%
Others	2,767	3,135	13%
Investment Expenditures (4)	**25,202**	**32,591**	29%
Oil Projects	12,747	15,480	21%
Electricity Projects	570	1,528	168%
Military Related	1,063	1,484	40%
Reconstruction Projects	100	150	50%
Projects by Provinces & Regions (inc. KRI)	1,736	2,588	49%
Petrodollar Projects	400	1,000	150%
Projects by Ministries	1,419	2,890	104%
Contractors' Arrears	1,652	1,652	0%
Projects funded by Foreign & TBI Loans	5,515	5,819	6%
Total Expenditures = (3) + (4)	**108,263**	**128,443**	19%
Current Spending (%)	77%	75%	-3%
Investment Spending (%)	23%	25%	9%
Deficit			
	-16,619	**-22,873**	38%

[22] Data for the report based mainly on the following sources: (1) amendments to 2019 Budget draft Law dated 8 October 2018, (2) data as compiled by Iraq Energy Institute (IEI) research team and the budget analysis published by IEI: http://www.iraqenergy.org/iraqs-2019-draft-budget-law-analysis; and (3) the author's work on Iraq's debt: http://www.bayancenter.org/en/wp-content/uploads/2018/08/6678787.pdf including sources quoted in the report.

[23] Source cited above; author's edits of IEI's & the 2019 Draft Budget Law figures.

Main points

Revenues

Oil revenues for 2019 are based on Iraqi oil price assumptions of $56/bbl vs 2018's assumptions of $46/bbl, and the January-October 2018 average of around $67/bbl. The assumption of $56/bbl is a reasonable conservative estimate, and the budget is sensitive by about $1.4bn to every $1/bbl change in oil prices either way. Iraqi oil sells for about $5/bbl discount to Brent, while the KRG's oil sells at a discount to the Iraqi oil price due to quality and KRG specific risk factors, but which is something that can be addressed should it be shipped via the State Oil Marketing Organization (SOMO).

Likewise, exports of 3.88 mbbl/d are a reasonable conservative estimate. Exports from the Southern fields averaged 3.47 mbbl/d[24] in January-October 2018 with a peak of 3.58 mbbl/d[25] in August. Given Iraq's ability to expand production to just over 5 mbbl/d, its current downstream, midstream, and export capacity allows it to increase exports by a further 0.15-0.20 mbbl/d[26] for a total of 3.75-3.80 mbbl/d assuming near ideal conditions. The KRG reported in early November that it is currently exporting 0.400 bbl/d[27]. If the talks over resuming Kirkuk production (from the fields reclaimed by the GoI in October 2017) materialize by 2019, then this could add between 0.20-0.40 bbl/d.[28] In total, if all the stars were to align, Iraq could export up to 4.35-4.60 mbbl/d, which assumes that the KRG exports at its current capacity, Southern exports remain at their August levels, southern production increases, and the KRG and GoI broker a deal over the export of the Kirkuk related fields. While this scenario is unlikely, it would be reasonable to assume that Iraq has a total export potential of at least 4.0 mbbl/d vs the assumed 3.88 mbbl/d, which means an extra IQD 2,940bn in revenues at the assumed oil price of $56/bbl.

The budget allocation for the KRG's share of the federal budget of 12.67 percent[29] after deducting sovereign expenses is hinged on the KRG exporting 0.25 mbbl/d, but the budget does not fully address the KRG's excess export revenues if its exports are above this figure (more detailed review follows later). This needs to be addressed in detailed GoI & KRG discussions as well as in current talks over the Kirkuk fields.

Non-oil revenues are set to decline in both absolute terms and as a percentage of total revenues at -18 percent and -29 percent respectively in 2019 vs 2018. Non-oil revenues at 11 percent in 2019 vs 16 percent in 2018 are inflated by oil-related profits and taxes. First, the government's share of oil companies' profits stands at IQD 1,987bn in 2019 vs IQD 619bn in 2018, which could partly explain the increase in profits form public sector companies. Second, oil related revenues within non-oil revenues are taxes on foreign oil companies at IQD 1,000bn in 2019 vs IQD 1,1756bn in 2018. These two items combined account for IQD 2,987bn or 25 percent of total non-oil revenues projected for 2019.

The biggest declines in non-oil revenues are in taxes collected of – 26 percent to IQD 6,334bn in 2019 from IQD 8,524bn (34 percent of the decline is likely due to a decline in taxes from foreign oil companies). The declines in non-oil revenues, in absolute and relative terms, reverses the progress made following the IMF's Stand-

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[24] Author's calculations based on SOMO data available here: http://somooil.gov.iq/index.php/2015-11-14-05-40-7/46-2017-02-23-07-48-01

[25] Ben Lando, "Iraqi oil exports and revenues skyrocket in August," *Iraq Oil Report*, September 2, 2018, https://www.iraqoilreport.com/news/iraqi-oil-exports-and-revenues-skyrocket-in-august-32557/.

[26] Ahmed Mehdi, "Iraqi Oil: industry evolution and short and medium-term prospects," *The Oxford Institute for Energy Studies*, October 2018, p. 32, https://www.oxfordenergy.org/wpcms/wp-content/uploads/2018/10/Iraqi-Oil-industry-evolution-and-short-and-medium-term-prospects-WPM-79.pdf.

[27] "KRG Update on Oil Production and Operations," November 4, 2018, KRG Ministry of Natural Resources, http://mnr.krg.org/index.php/en/press-releases/605-krg-update-on-oil-production-and-operations.

[28] David Sheppard, Chloe Cornish, Henry Foy, "Iraq close to deal to restart oil exports from Kirkuk," November 9, 2018, *Financial Times*, https://www.ft.com/content/4c7d6e66-e370-11e8-a6e5-792428919cee.

[29] Amendments to 2019 Budget Law dated 8 October 2018: pages 3-7 show the calculations and details of the deduction of sovereign expenses from revenues before the allocations of the 12.67 percent for the three northern governorates.

By Arrangement (SBA) of 2016 and increases the state's reliance on oil revenues, and with it the vulnerability to adverse changes to oil prices. Projections for 2019-2021 imply that non-oil revenues will be essentially flat and, as such, imply a continuation of this reversal. Non-oil revenues as a percentage of total revenues should increase in both absolute and relative terms year-over-year as part of a long-term strategy to diversify the state's income and not the current year by year budget process.

Expenditures

Current spending is projected to increase +15 percent in 2019 vs 2018, but decrease as a percentage of total expenditures from 77 to 75 percent. Salaries, pensions, and employee benefits are the largest component of current spending and are similarly projected to increase +7.5 percent in absolute terms but decrease from 66 to 61 percent of total current spending. The increase in absolute spending is a reversal of the SBA-mandated control of the public payroll but might be explained by the recent addition of 46,000 employees to the public sector payroll[30] and the PMUs' upward salary adjustments, both of which were supposed to be one-off increases. However, the projections for current spending for 2019-2021 show increases in both absolute terms and as a percentage of total expenditures, which suggest a continued abandonment of control over the public payroll. This implies that the deficit would grow meaningfully to IQD 41,000bn in 2021, based on the assumption of unchanged oil revenues for 2019-2021. This will be evaluated in further detail under the deficit and deficit funding.

The second largest element of current spending and likely the heart of Iraq's future financial crisis is debt servicing as a result of the increasing debt load in light of projected growth in the budget deficit due to the growth in current spending.[31] The largest component of debt servicing (interest payments and repayments) are those of domestic debt accounting for 62 percent of interest payments and 72 percent of repayments. The projected debt load as a result of funding the deficit will be addressed later in this section.

The third largest component of current spending is support at 15 percent of the total, which includes increased spending on energy and electricity imports. This spending is essential given the need for electricity generation, which will be discussed further under energy and electricity imports section. Another important component of the support expenditure is the current subsidy system for agriculture, electricity, and energy, which is the subject of a future paper.

Investment spending is projected to grow +29 percent, which is a major positive, but it comes with a number of caveats. Oil-related investment spending accounts for 47 percent of the total, military-related spending, five percent, and arrears to contractors,[32] five percent. These categories account for a combined 57 percent of investment spending. If the balance (i.e. 43 percent of the total) is assumed to be actual investment spending, then non-oil investment spending increases +43.5 percent in 2019 to IQD 1,397bn, which is a positive sign. Of these, a total of IQD 5,419bn is funded by foreign creditors each funding separate projects over a multi-year lending program. These foreign loans are supplemented by IQD 400bn in TBI loans for electricity projects.

While reconstruction spending is up from IQD 100bn in 2018 to IQD 150bn, it would be augmented by a further IQD 1,000bn from current spending to be spent by the governorates according to population size. Finally, the investment budget is projected to increase to IQD 37,311bn in 2021, but would remain unchanged as a percentage of total expenditures. Given Iraq's long-term needs for reconstruction and infrastructure, this is a nega-

[30] https://twitter.com/aalmawlawi/status/1050421612577742848

[31] The author's report "*http://www.bayancenter.org/en/wp-content/uploads/2018/08/6678787.pdf*" on the outlook for Iraq's debt expected an increase in government expenditures but a continued control of the public payroll and the continued reduction of the state's role in the economy. However, the projected growth in current expenditure for 2019-2021in the budget law exceeds the report's projections for total expenditures for the same period, which themselves are based on the IMF's estimates as detailed in the report.

[32]The figures for arrears to contractors suggest that these were not paid in 2018 with indications that they would not be paid up to 2020 as these were IQD 3,900bn in 2017 and are projected to be IQD 1,652 for each of the years 2019-2022. It would be unusual that the government would run identical arrears for each of these years and so it's logical that there is an assumption that these would continue to be unpaid.

tive development as investment spending should account for an increasing share of expenditures for the foreseeable future. Moreover, investment and reconstruction spending, even if funded by debt, would increase the country's productive capacity and output to pay for the debt generated and to diversify the economy.

The deficit

The budget deficit is projected to grow +38 percent to IQD 22,873bn; however, the actual budget deficit is IQD 5,819bn higher than that, given the foreign (and TBI) funding cited above. Thus, the total deficit stands at IQD 28,692bn, up +27 percent from the 2018 levels of IQD 22,134bn.

Part of this deficit will be funded from the Ministry of Finance's (MoF) bank balances of IQD 4,000bn and other bank balances of IQD 1,820bn for other ministries and government agencies. This leaves a total of IQD 22,872bn funded by debt, and includes the issuance of IQD 1,820bn in Eurobonds and IQD 5,986bn in domestic bonds to be owed to Iraqi banks. While the issuance of Eurobonds would be relatively straightforward, the issuance of IQD 5,986bn in domestic bonds is unlikely to be taken up by Iraqi commercial banks and will ultimately be bought by the Central Bank of Iraq (CBI) in a repeat of its indirect monetary operations to fund the deficit and a decline in foreign reserves. This is primarily because these bonds' duration and illiquidity mean that Iraqi commercial banks would not be able to buy them given the fact that funding sources of commercial banks are primarily comprised of current accounts and on-demand deposits.[33]

The deficit is projected to grow to IQD 46,381bn in 2021 (as a result of a current deficit of IQD 41,000bn and continued foreign loans of IQD 5,381bn). This projected deficit will pose a serious future risk to Iraq as it means that the country would need to access the debt markets on a continued basis despite having neither a developed debt financing operation nor a debt management strategy. All of these realities are worsened by the fact that the increased debt will fund non-productive current spending—unlike investment spending that would justify debt financing and be able to service it.

Complicating matters further are the contingent liabilities that the government assumed over the last few years. These total about IQD 43,200bn, the largest component of which is approximately IQD 38,880bn in guarantees of service payments to independent power producers (IPPs) in the electricity sector for the 14-year life time of the contacts. It is therefore essential for the government to continue with electricity sector reform and ensure the collection of tariffs because if it fails to do so, it will make the state liable to the IPPs and thus add to total debt[34] over the years. The reversal of the progress made to the 2016 SBA commitments—paired with projections made about payments to electricity suppliers (explained below)—suggests that these will become real liabilities in time.

The surplus

The surpluses of IQD 1,715bn for 2017 and IQD 17,165bn for January-August 2018[35], or a total of IQD 18,880bn are neither mentioned nor addressed in the budget. This surplus is comprised of excess revenues over spending, but the draft budget law seems to indicate a continued use of earlier planned borrowing in 2019 and for the projections up to 2021. In late 2017,[36] Iraq and the IMF secured borrowings of IQD 18,500bn as part of the 2016 SBA to cover some planned deficits for 2017-2019 and were working to secure a further IQD 8,500bn for the rest. Since loans were used to cover some expenditures instead of revenues, the surplus would increase by the amounts of these loans. Without details, it is difficult to accurately assess the increased surplus, but it would be reasonable to assume that the surplus of IQD 18,880bn could be increased by at least IQD 5,515bn

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[33] This is one of the ironies of the Iraqi banking system in that commercial banks and the CBI seem to operate in different worlds as such bonds were issued in the last couple of years so that commercial banks would buy them but without taking into account the nature of the funding sources of these banks.

[34] Endnote 22, *http://www.iraq-businessnews.com/2018/06/15/forget-the-donations-stupid-new-dynamics-in-funding-reconstruction/*

[35] Source: Ministry of Finance (MoF) http://www.mof.gov.iq/Pages/MainMof.aspx. The author downloaded the August account shortly after it was published; however, it has since disappeared from the MoF web site.

[36] http://www.iraq-businessnews.com/2018/06/15/forget-the-donations-stupid-new-dynamics-in-funding-reconstruction/#_edn12

(foreign loans to fund investment spending as in table 1) and as high as IQD 18,500bn. Whatever the final level of the surplus, it is essential that it be safeguarded. One possible safeguard is the deposit of these funds in either a fund for future generations or in funds for a development bank for the reconstruction of Iraq.

Other items

The KRG's allocation of 12.67 percent is taken from federal revenues net of sovereign expenses and national expenses. While it does not mean a return to the old 17.0 percent formula, there is an implicit partial acknowledgement of the importance of the old formula in that 12.67 percent is based the KRG exporting 0.25 mbbl/d through SOMO. However, as indicated in the revenue section, the KRG is currently directly exporting about 0.40 mbbl/d and, as such, the extra 0.15 mbbl/d is not fully addressed by the budget.[37] Therefore, a case can be made that the GoI is allowing the KRG to directly earn the equivalent of up to 5.32 percent[38] of federal revenues net of sovereign expenses, in addition to paying the 12.67 percent directly.

The budget has other payments to the KRG outside the 12.67 percent share, which include: (1) a portion of the federal defense salaries allocated to the Peshmerga in accordance with the KRI's population share; and (2) Salaries, pensions and benefits of IQD 3,282bn (at 9.5 percent of the total) allocated to the northern governorates, presumably the Sulaimani, Erbil and Dohuk, within the tables of the budget and under the analysis of total federal salaries.[39]

The main bright point in the budget is the planned government spending on electricity supply through both current spending and investment spending. These are summarized in the table next page.

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[37] Article 10 of the budget discusses the oil sales of the KRG via SOMO in return for the KRG's 12.67 percent share. Point (10.a) establishes the requirement that the KRG is to export a minimum of 0.25 mbbl/d, point (10.b) deals with the paying the portion of the Peshmerga salaries from those of federal defense forces, while point (10.c) discusses mechanisms for dealing with this and the 12.67 percent share if points (a) and (b) are not adhered to. Interestingly, point (10.d) requires that any excess of exports above 0.25 mbbl/d should be paid to the federal government. However, it does not discuss the mechanisms of dealing with this in the event that these extra funds are not paid to the federal budget, nor does it discuss changes to the KRG's share of the budget. This all supports the argument that the GoI is allowing the KRG to directly earn the equivalent of up to 5.32 percent of federal revenues net of sovereign expenses.

[38] Revenues from the sale of 0.15 mbbl/d at the budget assumed oil price of $56/bbl would be equal to 41.9 percent of the KRG's allocation or about 5.32 percent of the federal budget after the deduction of sovereign expenses. However, oil exported directly by the KRG sells for a discount to Iraqi oil and hence the use of the phrase, "up to."

[39] It's difficult to establish if within the analysis the salaries, pensions and benefits allocated to the northern governorates are a part of the 12.67% KRG allocation or separate from it. However, these payments seem to be consistent with the resumption of partial salary payments to the KRG.

In March 2018, the GoI transferred to the KRG IQD 317bn to cover the KRG' employee and Peshmerga salaries, even though there is no agreement on either the KRG's oil sales or the KRG allocation of the budget.

Raya Jalabi and Ahmed Rasheed, "Iraq sends money to pay Kurdish salaries for first time since 2014", *Reuters*, March 19th, 2018, https://www.reuters.com/article/us-mideast-crisis-iraq-kurds/iraq-sends-money-to-pay-kurdish-salaries-for-first-time-since-2014-idUSKBN1GV0T1

The GoI has continued to make these payments so over the ensuing months. These payments would be equivalent to an annual transfer of IQD 3,804bn, and the so the salary, pensions & benefits payments of IQD 3,282bn in the 2019 budge draft seem to be a continuation of these payments, while the Peshmerga's salaries would be paid from the federal defense budget allocation.

Table 2: Ministry of Electricity spending on the provision of electricity

Ministry of Electricity	2018	2019	Change (%)
Current Spending (1)	**2,135**	**5,359**	151%
Fuel Imports	920	3,000	226%
Iran Gas Arrears	0	800	N/M
Electricity Imports	405	70	-83%
Electricity Arrears (Iran)	0	354	N/M
Electricity Purchase from Local Investors	810	1,017	26%
Electricity Purchase from Solar Energy	0	118	
Investment Spending (2)	**772**	**1,528**	98%
Total Spending = (1) + (2)	**2,907**	**6,887**	137%

The current spending in the table above is part of the overall support expenditure within the current expenditure items (discussed earlier) and should decline over time as the country becomes self-sufficient. However, the spending for fuel and electricity imports is projected to remain the same until 2021, which is surprising. Moreover, this would be subject to revisions given the nature of the U.S. sanction waivers and requirement that Iraq decrease its dependence on Iran. On the other hand, a positive sign is the increased buying of electricity from local investors, which is projected to increase to IQD 2,170bn in 2021 and implies that many electricity generation projects would come on stream in time. However, this also seems to imply that the government does not expect to collect sufficient tariffs to cover the increased buying of electricity from these suppliers and therefore the contingent liabilities discussed earlier would become actual liabilities and increase overall debt.

Another positive with the support budget are the payments of IQD 2,364bn (up +89 percent) to the Basra Gas Company for the purchase of gas captured, which implies significant progress in reducing the flaring of associated gas. The reason that the item appeared under the support section of the budget is the distorted pricing structure in which the price that consumers pay for gas is well below the cost of production. However, it should be noted that gas recovered from flaring is substantially cheaper than imported gas, as the Iraqi government pays the Basra Gas Company (BGC) about $2.50 per MMBtu whereas it pays about $6.6 - 7.2 per MMBtu[40] for imported Iranian gas (data as of early 2018).

[40] "A New Hope: Iraq Oil's Way Forward," *Al-Bayan Center for Planning and Studies*, February 15, 2018, p. 82, http://www.bayancenter.org/en/2018/02/1435/.