

Iraqi State Budget 2015- It Deserves Careful Reading But Needs Serious Revision

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The first reading of the draft law for budget 2015 by the Federal Parliament was done on 25 December at a presence of only 229 members of the Parliament. According to the parliamentary procedure the first reading entail reading the full text of the draft law without discussing or debating its contents. The draft law was referred to the Finance and Legal Committees of the Parliament for examination and prepare opinion that would be delivered during the second reading. The parliament adjourned and will reconvene on 7 January 2015. Until the commencement of the second reading the above two Committees, other parliamentarians, experts and interested public have to examine thoroughly the draft budget and express opinion before tabling the draft law for voting and adoption.

I have gone through the Arabic texts of the draft law (and its 13 tables) thoroughly and examined it seriously, with emphasis on the Articles that have direct and indirect relation and implication on petroleum issues- oil prices, export volumes and KRG. And based on my objective, independent and professional assessment I managed to identify many serious flaws, shortcomings and ambiguities, as explained throughout this paper. I, therefore, hope by communicating this analysis to the parliamentarians to attract their attention to some vital aspects of this draft budget law and to help them when debating these provisions during the second reading and then voting on them, article by article, and on the entire draft law.

DETERMINANTS OF BUDGET REVENUES: OIL PRICE AND OIL EXPORT

From budget law 2011 onwards oil prices (\$/ a barrel) and volume of oil exports (million barrels per day-mbd) have been specified in each annual budget law. Accordingly, annual revenues were estimated (since oil export revenues are the main contributor to state revenues); and based on such estimated revenues the expenditures were estimated. Hence, in Iraq budget was driven by oil export revenues not by genuine real development needs; resulting in an astronomical expansion of expenditure (mostly current) with little corresponding growth in fixed capital formation, infrastructure, productive capacities and human development.

Since 2011 budget laws the adopted values for both parameters deviated from what has been actually realised but on the opposite direction: the adopted oil

price in the budget laws have been much less than the realised price; while the adopted volume of export have been higher than what actually exported.

This clearly indicates that previous budget revenue estimations were proven to be inaccurate and off-target on both parameters. However, it is usual (and good) practice in all oil-dependent countries that in estimating budget revenues the adopted oil price should be lower than prevailing and forecasted oil price to avoid additional fiscal deficit beyond what was estimated in the budget. In other words, for budget purpose one needs to be cautious and conservative when estimating oil price; and more realistic and practical when estimating volume of oil exports taking into consideration the prevailing technical, logistical and geopolitical conditions pertaining to production and export capacity and outlets on one hand and the international marketing of oil on the other.

Therefore I suggest that both parameters for 2015 budget law should be considered carefully and assess the possibility of revising them downwards, taking into account that current Brent price is under the price adopted by the draft budget law (\$60/b). Also we need to remember that Iraq actual export price is less than Brent by 5 to 7 Dollar a barrel (but SOMO could give more realistic estimate for 2015 depending on its market configuration and types of crudes.) On export volume the average actual Iraqi oil export during the last six months (June-November 2014) is only 2.459 mbd, compared with 2.75 mbd (3.3mbd-0.550kbd KRG & Kirkuk oil) of a needed sustainable export capacity (including either already spare or/and new additional capacity of 291kbd) from the southern export outlet on the Arabian Gulf.

Even if we assume an export of 3.3mbd (as considered in the budget) then each one dollar reduction in oil prices below \$60/b would result in reducing annual export revenues by \$1.205 billion or by 1.7% of the budgeted oil revenues.

The above implies that a good degree of uncertainty does exist and this requires careful reading and proper revision of Article 1-b.

Total Revenues were estimated by the budget law at ca. 99.8 trillion Iraqi Dinars (TID) (\$85.6 billion at \$=1166 assumed by draft budget calculations); with oil export revenues contributing 84.4% of total revenues.

In my views this oil export revenues contribution is rather low (optimistic), administrative and unrealistic in historical perspective. Does that mean the current budget assumes higher non-oil contribution; and this, if proven inaccurate it could eventually lead to higher budget deficit than planned in the draft budget.

EXPENDITURES AND FISCAL DEFICIT

Expenditures, on the other hand, were estimated at 125.2 TID comprising investment allocation (36.1%) and current expenditures (63.9).

Despite the fact that oil prices now is almost half than their level in 2013 total expenditures in 2015 was estimated lower than 2013 by only 13.2 TID; or a reduction of 9.5% compared with 2013 (and also for 2014). But if we take into consideration the unspent funds from 2014 (estimated by the draft law at 3 TID) then the reduction becomes 7.3%.

Unfortunately, it seems current government still thinks and acts “business as usual” despite the dramatic crash in oil prices by more than 50%!

Accordingly, planned deficit stands at 25.4 TID representing 20.3% of total expenditures. Again this is much higher than planned deficit for the previous state budgets for 2011 onwards. The difference this time is that the actual export price for Iraqi oil in 2011 to 2014 was much higher than the price adopted in the budget laws, thus instead of the deficit there was a surplus. This time, the adopted price of \$60 a barrel for 2015 budget could be higher than the realised export price; contributing to an actual fiscal deficit higher than the planned magnitude thus exacerbating the fiscal crisis of the state depending on the price deviation magnitude. It is worth recalling at this juncture that actual export price for Iraqi oil is lower than Brent price by 5 to 7 Dollars a barrel; and this could shed more doubt on the validity and viability of the assumed \$60 a barrel for 2015 budget (as mentioned above.)

Moreover, if the government was compelled to act as per Article 34 then the deficit could (unless it is already included!) increase by additional 14 TID, thus increasing the fiscal deficit to 39.4 TID or 31.4%.

This level of fiscal deficit is absolutely unacceptable and unsustainable and thus total expenditures, especially current expenditures, has to be drastically reduced.

The budget expect to finance planned deficit by the following modalities: the “compulsory savings” by state employees (7.9%); residual (unspent) fund from 2014 (11.8%); Special Drawing Rights-(SDR-as per IMF (8.3%); Issue of External Bonds (23.6%); Issue of Public Debt Bonds through banks legal reserves (23.6%); Loans and Treasury Transfers through Trade Bank Iraq-TBI (11.8%) and Issue of Treasury Transfers through state banks (11.8%).

One should take note the absence of Development Fund for Iraq- DFI from the above list indicates that Iraq’s accumulated reserves estimated to be \$18 billion have been exhausted.

This also indicates that Iraqi government did not learn the lessons from its previous financial crisis of 2008 when Iraqi oil price declined from \$117.81/b in July to \$34.57/b and ignored our repeated call for the creation of Sovereign Wealth Fund or similar entity.

Moreover, measures mentioned in the draft law aimed at increasing domestic revenues (to reduce fiscal deficit) needs careful considerations and further elaborations, especially those referred to in Articles 33 (sales tax) and 37 (National Compulsory Saving System by State Employees).

PROVISIONS PERTAINING TO KRG

This draft budget law contains many provisions pertaining to KRG which needs to be carefully and thoroughly examined and assessed by the parliamentarians and take them into consideration when debating these provisions during the second reading and then voting on them, article by article, and the entire draft law.

First; Oil from KRG and from Kirkuk Province

This matter is important and should be considered very well in terms of language and substance. Let me begin by citing the Arabic text relevant to this issue.

Article 1 (-first –b) reads,

ب - احتساب الإيرادات الناجمة عن تصدير النفط الخام على أساس معدل سعر قدره (٦٠) دولار للبرميل الواحد ومعدل تصدير قدرة (3300000) برميل يومياً (ثلاثة مليون وثلاثمائة الف برميل يومياً) بضمنها (٢٥٠٠٠٠٠) برميل يومياً (مئتان وخمسون الف برميل يومياً) عن كميات النفط الخام المنتج في اقليم كردستان و (٣٠٠٠٠٠٠) برميل (ثلاثمائة الف برميل يومياً) عن كميات النفط الخام المنتج عن طريق محافظة كركوك وتفيد جميع الإيرادات المتحققة فعلا إيراداً نهائياً لحساب الخزينة العامة للدولة.

The Arabic text of Article 1-first –b causes the following concerns:

- 1- It is diluting and eliminating the term “not less than 250kbd” which was mentioned in the formal announcement by the Council of Ministers-CoM regarding 2 December 2014 agreement between KRG and the Federal government.

Therefore the term “not less than 250kbd” should be introduced in this sub- Article;

- 2- The word “**عن** for” should be deleted and replaced by the word “from **من**” in the following phrase “

” **عن كميات النفط الخام المنتج في اقليم كردستان** ”.

The rationale for this replacement is to avoid the possibility that KRG provide the 250kbd from Iraqi oil extracted from oilfields located in areas occupied by Kurdish Peshmarga after 9 June 2014.

Therefore, this phrase should be revised to read: no less than 250kbd from oil produced in three governorates of the Kurdistan Region.

- 3- This sub-article does not specify the authority and entity which export this oil. To avoid any confusion, different and opposing interpretation or the possibility of exporting this oil by any entity other than the Federal Government this sub-article should be revised to read:

oil committed by KRG (no less than 250kbd) and that comes from Kirkuk Governorate (300kbd) should be under the full authority of the Federal Government and marketed by SOMO; and all realized export revenues from these oil exports becomes revenues for the State Public Treasury.

Considering the above it becomes abundantly clear that the present text of Article 1-first –b is unacceptable and should be examined carefully and revised accordingly. Otherwise, it should be rejected voted against by the parliamentarians.

Second, KRG share of 17%

Article 9-two gives KR 17% of the total actual expenditures (Current expenditures and Investment projects expenditures) after deducting the Sovereign and Governing Expenditures. This is also elaborated in detailed tables

خلاصة الموازنة واحتساب حصة اقليم كردستان من اجمالي الموازنة لعام 2015/

It is worth noting few significant changes in this sub-article as compared with what it was in the same article for budget law 2013.

- 1- The share of KR is geared to the actually spent expenditures not the budgeted expenditures. This in my view is improvement and for the benefit of Iraq. If for whatever reason actual expenditures are lower than the planned (as is the usual case for investment allocation) then the disbursement of KRG share will be adjusted downward accordingly. This also will deter KRG from pursuing any disruptive obstructive acts or policies aiming at hindering Federal Government efforts.
- 2- Contrary to what the Kurdish politicians and the Minister of Finance himself have publically stated or hoped for, Sovereign Expenditures will

be deduction from KRG share. The net share of KRG will be 11.96% from the actual expenditure not 17% ;

- 3- As mentioned earlier war reparations to Kuwait (estimated at \$4.6 billion or at 5% of petroleum export revenues as per UNCC obligations) have been postponed to financial year 2016, and thus it was not included among items constituting Sovereign Expenditures;
- 4- Another important item that is missing from Sovereign Expenditures in the current draft law is للشركات النفطية الاجنبية المشاريع الاستثمارية investment allocation for IOCs. In my view this has been suggested by the Federal Ministry of Oil last year (March 2014 negotiation) in return that KRG refrain from asking the Federal Government to pay for the oil development in the Region and also to provide oil produced in the Region to the Federal Government.

The implication is that KRG will gain in 2015 ca.2.38TID (\$2.04 billion). This in fact an advantage to KRG and could be justified only if KRG deliver all exportable oil (not only 250kbd) to the Federal Ministry of Oil to market that oil through SOMO, otherwise this payment is made for nothing. In this juncture it is important to refer to Article 34 which authorizes issuance of Treasury Bonds and Transfers to cover the dues for foreign oil companies working in the country;

- 5- Careful and special attention should be directed also to Article 9-four, which indicates the possibility of transferring items from “Sovereign and Governing expenditures” to the “General expenditures”, since such transfer would lead to relive KRG from contributing its share in the “Sovereign and Governing expenditures. This should be resisted and amended as suggested below.

Third; The Financial Entitlements due for all Foreign Oil Companies Working in Kurdistan Region

Article 21 of the current draft law says;

يتم احتساب مستحقات الشركات الاجنبية العاملة في اقليم كردستان لغرض استخراج النفط من ضمن حصة الاقليم البالغة (١٧%) ويستمر العمل بذلك.

The above text is ambiguous and mimixes «accounting» with «payment» and in order to avide confussion and different interpritation the said article should be redrafted to read “All financial entitlements due for all foreign oil companies working in Kurdistan Region shall be paid from the 17% share of the Region.”

Moreover, the following Article 34 should be redrafted:

لرئيس الوزراء باقتراح من وزير المالية اصدار حوالات خزينة او سندات خزينة عند الحاجة ولتغطية مستحقات الشركات النفطية العاملة في البلاد على ان لا يتجاوز مجموعها على (١٢) مليار دولار (أثنى عشر مليار دولار)، بإصدار واحد او بإصدارات متعددة خلال عام / ٢٠١٥.

by adding the following text “excluding all foreign oil companies working in the Kurdistan region as per Article 21”. This has to be inserted after the Arabic

word “the country **البلاد**”

Fourth, Reciprocal Sanctioning!

Article 10-three reads the following:

في حالة عدم ايفاء اي طرف (الحكومة الاتحادية ، حكومة اقليم كردستان) بالتزاماته النفطية او المالية المتفق عليها في هذه الموازنة يكون الطرف الاخر غير ملزم بالإيفاء ايضاً بالتزاماته نفطية كانت او مالية.

From past experience KRG did receive all its entitlement from the Federal Government for the years 2012 and 2013 without delivering oil. Under these budget laws KRG was committed to deliver 175kbd and 2500kbd respectively. If KRG decides, for whatever motives, not to deliver the 250kbd and disrupt the flow of 300kbd of Kirkuk oil, that would exacerbate the fiscal deficit even further through reducing oil revenues by 16.7%, and that could bring fiscal deficit to 50%. This is too much vulnerability requiring serious precautions and ramification measures. But the draft budget law provides none! Moreover, if KRG acts independently and export oil instead, they could inflict even more serious damage on the national economy especially if they use Iraqi oil in the areas they occupied after 6 June 2014.

The above article should be revised and redrafted to:

- 1- Oblige KRG to make the daily delivery of oil first as per specific arrangement with SOMO and payment of KRG dues should also be made in accordance with SOMO’s marketing and payment procedure;
- 2- KRG will be considered as violating the budget law if it export independently and by whatever mean any volume of crude oil, gas and petroleum product;
- 3- Introduce a practical measure of proportionality since the term “petroleum or financial obligations” under the draft budget law are many with very different magnitudes;
- 4- Reinstate the principle of referring to any unresolved dispute between the Federal Government and KRG to the Supreme Federal Court.

Fifth, Settlement of Financial Entitlements تسوية المستحقات

The draft law (in Article 9-four) is ambiguous about the settlement of these financial entitlements for the previous years. Moreover, it gives the Ministry of Finance alone the authority to make such settlement.

In the previous budget laws a clear reference was made to these settlements since 2004 and also mandated the Federal Financial Auditing Board and KR Financial Auditing Board to audit them. **Moreover, the final decision on such settlement should be the prerogative of the Federal Council of Ministers not the Ministry of Finance.**

The Council of Ministers should use these entitlements as guarantee against any possible default by KRG as discussed above “Reciprocal Sanctioning”.

Therefore, a new sub-Article should be introduced to Article 9 and could read as followings:

يتم تسوية المستحقات بين اقليم كردستان والحكومة الاتحادية للسنوات من (2004 ولغاية 2014) بعد تدقيقها من قبل ديوان الرقابة المالية الاتحادي بالاتفاق مع ديوان الرقابة المالية لاقليم كردستان في موعد اقصاه 15/10/2014

MINISTERIAL ALLOCATIONS

Four ministries take collectively more than half (51.2%) of all expenditures. At the top comes the Ministry of Finance-Mof (14.1%) reflecting the significance of the external financial obligations of the country despite the fact that the last amount estimated at \$4.6 billion payment of war reparations to Kuwait (at 5% of petroleum export revenues as per UNCC obligations) have been postponed to financial year 2016.

Security sector comprising the allocation for the ministries of Defense and Interior take (12.2% and 11.8% respectively) more than quarter of the budget, reflecting the drain of a deteriorated security conditions on state budget and on diverting financial resources away from economic, service and social sectors. Finally, the Ministry of Oil share comes number two after MoF with 13.2% of the total expenditures.

It is important to note that in terms of investment allocation vs. current expenditures the Ministry of Oil and Ministry of Defense each have higher investment allocation than current expenditures, while it is the opposite for the other two ministries- Finance and Interior. This is expected and can be explained by the expansion of upstream development and oil export capacities for the Ministry of Oil and for the military purchases by the Ministry of Defense.

Considering the importance of development projects and their related contractual implications it is vital to consider carefully Articles 25 (Deferred Payment Financing) and 26 (July 2015 deadline).

THE COUNCIL OF MINISTERS NOT THE MINISTRY OF FINANCE

Certain provision in this draft law gives the Ministry of Finance alone the authority to take actions, such as Articles 9 and 23.

These articles should be amended by inserting the Council of Ministers to replace the Ministry of Finance according to the constitutional principles.

THE NEW SUPREME DEVELOPMENT COUNCIL-SDC

Article 27, concerning SDC, is redundant and unconstitutional, thus, should be removed from this draft law. The laws are promulgated based on provisions and principles enshrined in the Constitution or for public interests; they are not promulgated based on another laws. This is why Article 23 is unconstitutional and should be removed from this draft budget law.

Instead, the Government could propose the needed draft law for SDC separately.

CONCLUSIONS

- 1- The Arabic text of draft budget law 2015 have, as outlined above, many problems, shortcoming and ambiguities from linguistic, procedural and substantive perspectives;
- 2- Therefore, it is absolutely necessary for the Iraqi Parliamentarians to read carefully and thoroughly this draft law and our assessment on it; debate and propose the needed amendments and revision during the second reading of the draft law;
- 3- The time is short, the challenges are formidable, the crisis is imminent and we all have to act promptly, jointly and effectively to improve and correct this important budget law;
- 4- As it stand the current text of the law is inappropriate, unclear and could cause confusion and exacerbate the fiscal crisis in the country. Thus it should be rejected unless it is revised and amended as suggested in this assessment, among others.

Norway

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