

**IRAQ Extractive Industry-  
Legal, Fiscal and Revenue Allocation and Management Issues  
“Executive Summary”**

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**Introduction**

This is an Executive Summary of a research work commissioned by the Natural Resource Governance Institute-NRGI (USA) as part of the preparation for NRGI’s strategic plan for interlinked and complementary interventions in Iraq during the upcoming three years.

The research was prepared according to a signed consultancy contract based on a mutually agreed-upon Terms of Reference and a Methodology Note that was prepared by this consultant and accepted by NRGI. The commissioned assignment commenced on 20 February 2015, draft report was delivered on 15 March 2015 while the final report was delivered on 30 March 2015.

Moreover, this consultant had actively participated in NRGI Iraq Strategy Meeting that was held in Beirut, Lebanon during 19-21 May 2015.

Specifically, this research was structured to address and analyze four broad topics, review development of related issues and answer with benchmarking main questions therein. The work is guided by the methodology of and contents of Precepts 7, 8 and 9 of the Natural Resource Charter-NRC.

The four topics, their related reviews and main questions are:

**I-Legal and Institutional Framework Governing Extractive Industry Sector in Iraq**

- Review policies and laws that govern the extractive sector, their coherences and overlaps;
- Review the roles of institutions that implement the laws governing extractive sector laws, their consistencies and overlaps.

**II-Revenue distribution:**

- Does the government invest revenues to achieve optimal and equitable outcomes, for current and future generations?
- Does government invest savings in assets to earn the highest expected social returns over the long-term, and to avoid domestic inflation?
- Does government balance local and regional demands for revenue distribution with the needs of the entire country?

**III-Revenue volatility:**

- Does government smooth’s domestic spending of revenues to account for revenue volatility?
- Resource revenue volatility: Is government spending stabilized relative to resource revenues?

- Savings fund: Does government use saving funds efficiently to limit the economic impact of large and volatile resource revenues?
- As a test of its volatility protections, how effectively has the government been able to manage the recent drop in oil prices?

#### **IV-Government spending:**

- Does government use EI revenues as an opportunity to increase the efficiency of public spending at the national and sub-national levels?
- Administrative capacity: Has government strengthened its efficiently capability to invest resource revenues in the domestic economy (i.e. quality of expenditures)?
- Corruption. Does government take effective steps to reduce corruption in public spending? Where is corruption in public spending most problematic?
- Economic absorptive capacity: Does the country face problems absorbing the large public spending associated with oil and gas? If so, what steps have been taken? If not, what are the main problems?

Moreover, for each of the topics above mentioned, the paper will:

- (a) Explain the current state of affairs, and
- (b) Answer the questions listed for each topic.

The four topics entail two different methodologies reflecting the nature of the involved issues and the requirements of the contracted consultancy assignment. One relates to the first topic while the other is for the remaining three topics due to the fact that for these three topics there are questions to answer and benchmarking to make.

Throughout the paper an emphases was made on three important components: legal frameworks and modalities (Instruments); involved entities and bodies (Institutions) and adopted polices, strategies, actions and plans (Policies).

Part one of the study is related to the first topic; it provides comprehensive, comparative and updated analysis of the involved issues at different levels of decision and action chains. On the level of authority the analysis follows FRP structure: Federal, Regional and Provincial; while on the functional side the study addresses the ELJ branches of government: Executive, Legislative and Judiciary.

For parts two, three and four the methodology is composed of the following: it begins by listing the main questions; followed by brief note on the main premises of the related NRC Precept; then a background note on the importance and relevance of the posed questions in the Iraqi context; then each question is addressed by using the most available and updated Iraqi information and data; followed by benchmarking the related question following the NRC approach; finally, each part is concluded with “key highlights, challenges and opportunities”.

The research relied primarily on official documents, laws, plans and strategies; it used formal data, statistics and information; it consulted credible and professional opinions and publicly expressed views and finally its sources are credible, verifiable and well referenced.

Many charts are produced and included in this edition of the paper to highlight the “quantitative” magnitude of and to assist in understanding the involved issues. For each chart the source(s) and explanatory notes are provided.

The “Executive Summary” provides, of course, a quick reading to the main findings, “key highlights, challenges and opportunities” and benchmarking results.

It is important to make few caveats.

This study is directly linked, as mentioned earlier, to NRC Precepts 7, 8 and 9 only. But NRC has 12 Precepts therefore the reader should not expect to find analysis pertaining to these other precepts, though, in fact the 12 precepts are very well interconnected.

Even the three Precepts (7, 8 and 9) are closely connected and some sub-issues even overlap; thus it is not that easy to make clear and meaningful demarcation between the three parts relating to them (parts two, three and four). Hence, some minor repetition becomes unavoidable.

Most of the posed questions are either generic and/or comprising many components; thus creating many secondary questions entailing many and different answers. This had affected the benchmarking exercise and exposed the difficulty in using NRC benchmarking approach and its usefulness.

Lastly, the readers should be aware of, and thus be careful not to mix-up, the NRC 12 Precepts and NRCI “Decision Chain” with the EITI five components of the “Value Chain” or with PWYP 12 “Chain for Change”.

## **Executive Summary & Benchmarking**

The following executive summary provides the “Key Highlights, Challenges and Opportunities” for each part of the study and the Benchmarking for the main questions only raised in parts two, three and four.

### **I- Legal and Institutional Framework Governing Extractive Industry Sector in Iraq**

Legal instruments relating to and governing extractive industry, particularly for the upstream petroleum in the country do exist on different levels from national level down to field or block level. Also they exist on federal and regional layers. Throughout the paper all such instruments were appropriately addressed.

Many serious challenges and difficulties are identified and explained; some are resulted from the instruments themselves (such as the Constitution and FOGL), other challenges are due to how different parties perceive these instruments (such as KRG interpretation of the Constitution and its own KOGL) and others are the outcome of lack of harmonization, overlapping and incoherencies among them (such as FOGL, Provinces Law and Public Commission to Audit and Appropriate Federal Revenues Law).

The existing involved institutions play critical and vital role in all phases relating to these instruments: legislating, executing and oversight. Again, these entities are structurally many: on the federal, regional and sectoral levels.

In exercising their authority and function the relationship between these different entities is very important to ensure proper and effective implementation of the laws and regulations. The study highlights cases when lack of coordination and cooperation between these entities had created a gridlock and dysfunctional government. The divergence between federal and regional entities has been the most obvious challenge with very visible and repetitive occurrence.

Entities or institutions are not only vital for the promulgating and implementing legal instruments; they also draw, formulate and adopt policies. But more often than not, and within the current Iraqi political order it is not easy to identify coherent, clear and formal policies. However, if we consider petroleum contracts as manifestations of broad policies then it is safe to suggest two very different policies and again on federal (MoO) and regional (KRG) levels.

The above analysis suggests strong inseparable linkages and mutually enforcing relationship between the three issues: institution (entities), instruments (laws and regulations) and policies (despite their vagueness). Accordingly, the challenges they face are interconnected and the same applies to opportunities.

Federalism vs. Regionalism has been effectively impacting the three issues, especially on the KRG level. Gradually, this political orientation has prompted the emergence and strengthening the calls for establishing other regions in the country, which is mandated under the current Constitution. So far, more powers to provincial authorities are contemplated in the centralization vs. decentralization with the exclusion of upstream petroleum extractive activities; the debate about the Provincial Law 21 of 2008 and its amendments are the manifestation of this thinking. The resolution of these amendments will have serious ramification on the delegation of powers.

In all the above, politicization has been and remains the common and very serious challenge facing the effectiveness of the legal and institutional framework in the extractive petroleum industry.

Consequently, de-politicization efforts, modalities and measures could offer a window of opportunity. But within the prevailing political conditions in the country order de-politicization is, unfortunately, easier said than done. It is a matter of attitude, mind-set and rigidity.

Nevertheless, with concerted comprehensive and forward looking efforts focusing on capacity analysis (specific capacity gap identification and capacity development roadmap) relating the three main issues (and related sub-issues) could contribute to create a viable and enabling environment. For these efforts to be effective, successful and functional there needs to undertake professional, objective, independent and target-oriented research work. The involvement of the concerned civil society organization, professional associations, academia,

and research institutions among others is vital, especially when such involvement is non-partisan.

But again, there are no quick fixes and ready recipes.

Finally, non-petroleum extractive industry activities are many; some of such activities are within the private sector while the most advanced and larger operation scale of them falls within the domain of the MIM through known State Owned Enterprises- SOEs.

For governing these non-petroleum extractive industry activities there are also formal entities and legal instruments but with not very specific policies.

IEITI attempts to cover these activities in its annual reports but fails to cover them as so required by EITI new Standard. Challenges are not as strong, deep-rooted or complex as those for upstream petroleum extractive industry. Thus opportunities to cover better non-petroleum extractive industry activities are more feasible through good coordination, inclusion and capacity enhancement.

## **II- Revenue Distribution**

Throughout the entire period covered by this study investment allocation has been much lower than recurrent expenditures (maintenance and consumption) giving the impression of less equitable allocation of resource revenues between current and future generations, though the oil reserve/production ratio is high enough to safeguard the interest of future generations. Moreover, the share of investment allocation was fluctuating though the general trend is modestly upward.

What should be emphasized at this juncture that investment allocation is one thing; the quality of execution and the efficiency of implementation is totally another and could be very different. Hence, there is a real challenge to ensure the “value-for-money” principle.

State budget laws for the last few years contain neither mandatory nor voluntary implicit or explicit fiscal rule requiring savings for investment and or for control inflation purposes. The inflation was kept under control through exchange rate mechanism not an outcome of deliberate investment/saving policy.

The Regions Development Program RDP allocation had been confined to population factor only without giving due regards to regional disparities in needs or development requirements. And since there was no population census in the country, the population distribution among different provinces remains, proportionally, the same since the adoption of the RDP, leaving any regional disparities almost unchanged.

This is a serious challenge for regional revenue allocation and the Ministry of Planning could undertake comprehensive survey to assess the prevalence of regional development disparities and suggests budgetary measures to eradicate them within defined period of time.

Though Regions Development Program and Petrodollar allocations could contribute into balancing the needs of different provinces, the fiscal performance in utilizing these funding appears to be disappointing and below average.

The challenges appear to be in the weak institutional capacities at both local and federal levels on the dimensions of policy formulation as well as execution skills and implementation procedures. Further needs assessment in capacity and skill enhancement is critical. Moreover, introducing fiscal rules and creating governance modalities regarding mandatory or voluntary government savings could contribute to improve resource-revenue management. International cooperation partners play a decisive and important role in this respect, and should be effectively utilized.

The following table provides summary of scoring/benchmarking of the questions raised in this part of the study.

### **Scoring/ Benchmarking for questions of part two**

<b>Does the government invest revenues to achieve optimal and equitable outcomes, for current and future generations?</b>	<b>YES/ NO</b>
<b>Does government invest savings in assets to earn the highest expected social returns over the long-term, and to avoid domestic inflation?</b>	<b>YES/ NO</b>
<b>Does government balance local and regional demands for revenue distribution with the needs of the entire country?</b>	<b>YES/ NO</b>

### **III- Revenue Volatility**

The “fire-fighting” approach appears to have been used to deal with circumstantial volatility when it occurs. But once circumstances change and revenues begin to recover the government spending returns back to business as usual; and the “boom-bust” characteristics of revenue flows and their consequences are quickly forgotten.

The experience of 2008 price collapse and their recovery afterward was an outstanding example. Now some admits, “We made a major mistake in the past 10 years: when the price of oil was high, we did not use the surplus funds to create a reserve for the country.” But will they act to remedy that mistake; only time will tell!

The proposed budget 2014 (not approved yet!) stipulates that any surplus revenue generated during the year would be allocated to the reserves of the Development Fund of Iraq-DFI. That goes without saying when it comes to oil revenues; but the question is: does this provision cover the budget surplus resulting from actual spending that lagged behind allocation?

Hence when addressing surpluses it is vital to distinguish between fiscal surplus (actual oil export revenues are more than budgeted oil export revenues) and budget surplus (actual spending are less than budgeted allocation).

Within budget surplus it is important to know the source: investment allocation vs recurrent expenditures; and whether budget surplus resulting from investment spending deficiency are “carried forward” to finance next year budget. If this occurs it indicates absorptive capacity limitation leading to reallocating investment funding to recurrent consumption.

A safeguarding opportunity could be considered by adopting mandatory fiscal rule obliging the government to deposit unspent investment allocation in a special “investment fund” instead of carrying that surplus forward to finance recurrent expenditures.

The mid-term budget strategy proposal of July 2013 was good opportunity and a step in the right direction, but the ad-hoc nature and the failure to develop the initiative further had aborted the entire strategy. Alternatively, this author had proposed earlier a “Coping Strategy” to manage revenue volatility at different resource-revenue situations; with defined legal framework, institutional structure, policy mandate and operational arrangements.

The following table provides summary of scoring/benchmarking of the questions raised in this part of the study.

**Scoring/ Benchmarking for questions of part three**

<b>Does government smooth’s domestic spending of revenues to account for revenue volatility?</b>	<b>YES/ NO</b>
<b>Resource revenue volatility: Is government spending stabilized relative to resource revenues?</b>	<b>NO</b>
<b>Savings fund: Does government use saving funds efficiently to limit the economic impact of large and volatile resource revenues?</b>	<b>NO</b>
<b>As a test of its volatility protections, how effectively has the government been able to manage the recent drop in oil prices?</b>	<b>NO</b>

**IV- Government Spending**

The review done in this part of the study identifies many serious capacity gaps at all levels of decision and implementation chains at federal, provincial and sub-national levels. The most serious, apparent and effective capacity gaps are evidently persistent in managing resource revenues, especially those allocated for investment purposes and the surplus at boom times. The country is in a desperate need to enhance human and institutional capacities by addressing and eliminating the identified capacity gaps at all levels.

Corruption has an epidemic scale it takes different forms, uses variety of channels and represents the most formidable challenge in the face of optimal utilization of resource revenues for sustainable development. More is needed to combat corruption and minimize its negative consequences. The already taken measures need real and effective enforcement and the related others need enactment such as draft law on the “Right to Information”, which is vital for enhancing people’s role and civil society organization-SCO in strengthening good governance, promoting transparency and accountability, and combating corruption. In this regard, Iraqi authorities could utilize the US Department of Justice “Kleptocracy Asset Recovery Initiative” to recover financial assets of corruption source that are deposited/

invested in the US by Iraqis who hold dual citizenship; and as deterrent against future corrupting attempts.

There are many international cooperation modalities providing excellent opportunities for capacity development to address chronic gaps’ institutional, systemic and human resources at different layers within the three branches of authority. But this requires critical, objective and professional stocktaking by both Iraq and its cooperating partners on how effective and successful these modalities are and what are the identified or parameters for their impacts.

The following table provides summary of scoring/benchmarking of the questions raised in this part of the study.

**Scoring/ Benchmarking for questions of part four**

<b>Does government use resource-revenues as an opportunity to increase the efficiency of public spending at the national and sub-national levels?</b>	<b>NO</b>
<b><i>Administrative capacity:</i> Has government strengthened its efficiently capability to invest resource revenues in the domestic economy (i.e. quality of expenditures)?</b>	<b>NO</b>
<b><i>Corruption.</i> Does government take effective steps to reduce corruption in public spending? Where is corruption in public spending most problematic?</b>	<b>YES/ NO</b>
<b><i>Economic absorptive capacity:</i> Does the country face problems absorbing the large public spending associated with oil and gas? If so, what steps have been taken? If not, what are the main problems?</b>	<b>YES</b>

It is vital to mention that this study is by no means an exhaustive or comprehensive on the extractive industry in the country; far from it absolutely. There are too many important issues, entities, policies, legal instruments, proposals data and information of direct relevance to this industry that need further research and analysis.

The details of the four parts of the study will be posted soonest in sequence each at a time.

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