IRAQ BUDGET 2013

BACKGROUND PAPER

Key Messages:

- The Government expenditure for 2013 totals IQD 138.4 Trillion ($ 118.3 Billion), with an increase of 18% over 2012 and exceeding 70% of GDP. The budget has three main headings: Energy, Security / Defense and Social Services, accounting for 21%, 14%, and 13% respectively of total budget.

- Investment Expenditure represents 40% (IQD 55.1 Trillion) of government budgeted expenditure, the largest ever for Iraq. Investment in Oil and Electricity amounts to over 43% of the investment expenditure.

- Government budgeted revenues amount to IQD 119.3 Trillion, with revenues from oil making 93%. The increase in oil revenues, made it possible for the government to cover its operating expenditure and allocate more to investment, yet heavy reliance on oil resulted in a budget fragile to oil shocks, and government going through complementary budgeting, and excessive delays in investment projects implementation.

- Notwithstanding the increase in oil production and revenues, oil alone is not enough to cover budget deficit and contribute to a financial resilient Iraq; financial reserves in Iraq can cover government operating expenditure for less than a year. In order to improve Iraq financial resilience and reserves in the short run, Iraq needs, in addition to its plan to increase oil revenues, to increase non-oil revenues (which are stable, around IQD 7 Trillion, since 2008), and to rationalize operating expenditure (Iraq has one of the largest public sectors relative to population). While in the long run, revenues diversification goes hand by band with diversification of the economy and expansion of the private sector.

- About 60% of Iraqi households are suffering from the lack of at least one of the following: access to improved drinking water source, access to improved sanitation facility, a minimum of 12 hours of electricity from the public network a day, or food security.

- Two factors undermine government's budget contribution to Iraqi development needs on the ground: first, funds allocated to the key development sectors are insufficient vis-a-vis Iraq's development needs. For example, in 2013 the total investment budget allocated to Education, Health and Environment, Culture and Youth, and Water and Sanitation, is only IQD 6.5 Trillion, which is equivalent to 50% of the Energy sector investment budget. Second, low execution of investment budget remains a concern, specifically for the aforementioned sectors, having been slightly above 50% in 2011. Not only are the development sectors receiving too little, they are also suffering from inadequate operationalization of pertinent approved funds.

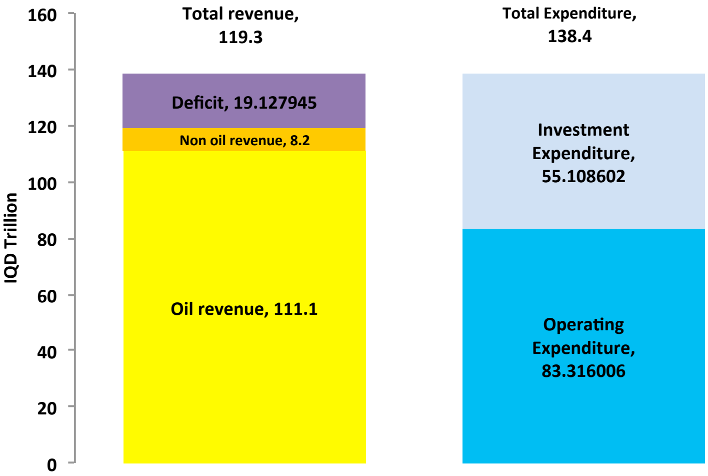
- Iraq is making progress in decentralizing planning at the local level, with governorates identifying their plans through a participatory and evidence-based approach. This progress is not matched with governorates/KRG participation in budgeting and this lack of participation has led to a longer period needed to approve and amend the budget, and to some extent to the low investment execution rate for the Regional Development Plan.

Introduction: Iraq Budget for 2013

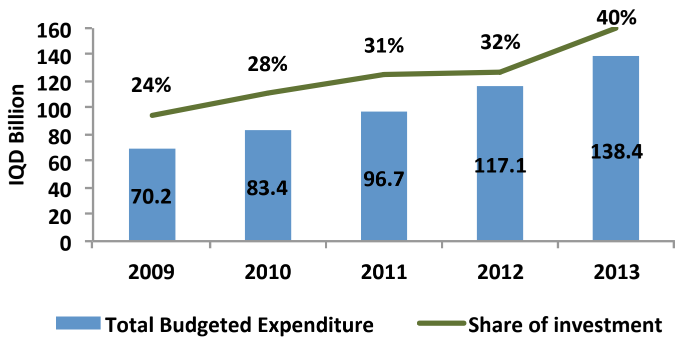
The Government of Iraq is in the process of approving the draft budget for 2013; the largest ever for Iraq[1]. Government expenditure totaling IQD 138.4 Trillion ($ 118.3 Billion), exceeds 70% of GDP[2]. The present budget is an increase of 18%, equivalent to IQD 21.3 Trillion, over 2012 total budgeted expenditure of IQD 117.1 Trillion. Since 2009 Iraq budgeted expenditure has consistently grew by an average of 17% annually. Investment expenditure of IQD 55.1 Trillion, or 40% of government expenditure, is at record high for Iraq. Investment expenditure has increased by 48% over 2012 levels, accounting for 85% of the increase in 2013 total budgeted expenditure.

Accounting for the development needs of Iraq - suffering from daily power cuts, high under five mortality and malnutrition, and high youth and women unemployment - an increase in total and mainly investment expenditure is a positive development. But the present budget may not fully meet those expectations.

Iraq 2013 Budget



Government Expenditure and investment share 2009-13



Revenues

Budgeted government revenues totaling IQD 119.3 Trillion, have more than doubled since 2009, and are at record high. Oil revenues amount to IQD 111.1 Trillion equivalent to 93% of total revenues, while other revenues now reduced to IQD 8.2 Trillion; mainly composed of income, corporate, and other taxes. The government used an oil price of $90 per barrel and estimated 2.9 Million barrels per day (bpd) in exports for budgeting purposes[3].

The heavy reliance on oil revenues is more pronounced when looking at end of year balances; oil revenues made 99% of actual 2011 total revenues[4]. The increase in oil revenues made it possible for the government to progressively expand expenditure and allocate more for investment. This in turn justifies oil being Government's investment priority, accounting therefore for one third of 2013 investment expenditure, and

1 Budget was approved by the Council of Ministers on Oct. 23, 2013 and submitted to the Council of Representatives for endorsement expected early February 2013. From previous years minor changes take place at this stage, and hence the analysis will not change significantly.

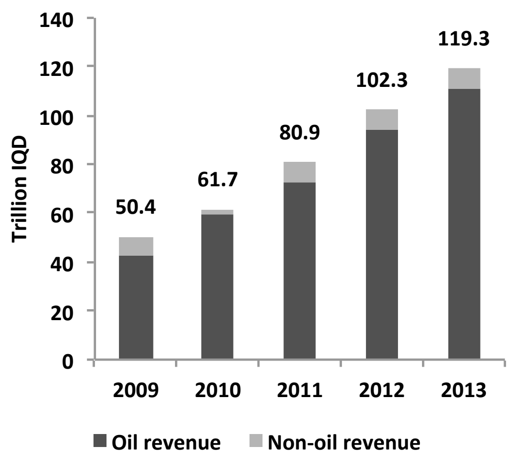
2 Calculated by staff using budget law assumption for 2013 GDP of IQD 192 Trillion.

3 This includes 250,000 bpd from KRG.

4 Data obtained from the Council of Representatives Finance Committee.

this is expected to increase through the next several years with the government planning to increase its oil exports to more than 3.75 Million bpd. The negative consequence to this plan is a budget fragile to oil shocks, which resulted in the government's complementing the budgets and to the excessive delays in executing investment projects in previous years.

Total revenues 2009-2013



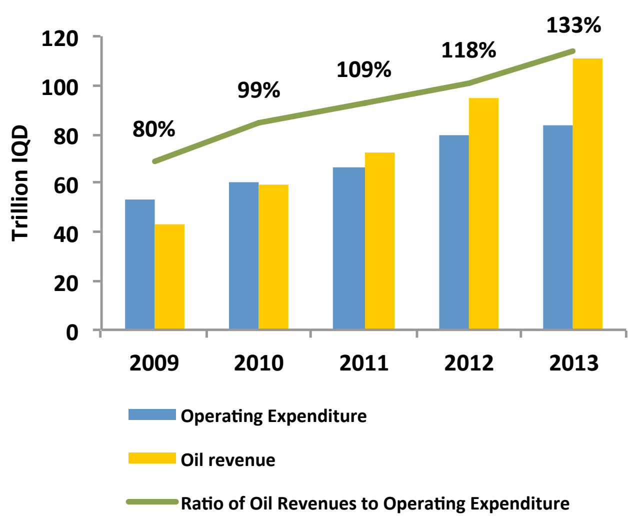
To avoid the fragility of an oil dependent economy, the Iraqi government should take action to diversify revenues away from oil; one immediate place to start is passing the customs law, which had been postponed for two years and could arguably lead to IQD 1.5 Trillion in increased revenues.

Given that Oil constitutes 60% of GDP, offers only 1% of total employment (small tax base from a revenue point of view), and impacts on Iraq exports with a strong Dinar; revenue diversification in the medium-long run must go hand in hand with diversification of the economy. This will allow for expansion of the private sector, and consequent contribution to growth and revenues.

Structure of Expenditure: Investment and Operating

Government budgeted expenditure of IQD 138.4 Trillion has Energy, Security and Defense, and Social Services as the main headings, constituting of 48% of total expenditure (21%, 14%, and 13% respectively), and accounting for 64% of budget increase over that of 2012.

Oil revenues vs. Operating Exependiture

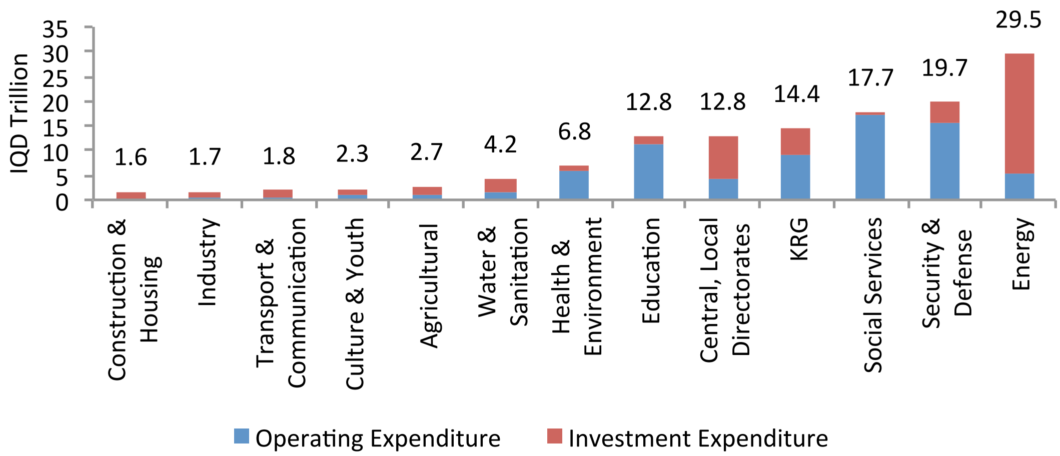


The continued increase in oil revenues over operating expenditure, since 2011, made it possible for the government to expand investment expenditure, moving away from a situation where budget deficit has by large been equated by investment expenditure. 2013 budgeted investment expenditure of IQD 55.1 Trillion depicts an increase in all sectors of investment budget to varying extent. Investment in Oil totaling IQD 18 Trillion, 33% of budgeted investment expenditure, presents Government's first priority.

Oil investment plan aims at enlarging production, storage, transportation, and export capacity[5], this all to accommodate the expected increase of oil production to reach 13 million bpd over the next seven years, as the present government contracts with foreign oil companies suggest. Investment in electricity of IQD 6.1 Trillion has the second largest share of budgeted investment targeted at infrastructure reparations and increasing production.

Investment in Security and Defense of IQD 4.3 Trillion increased by more than 9 folds over 2012 levels. The security and defense investment plan aims at improving the security of citizens, access to services, and oil production. The main component to this is a newly introduced government program to build the capacity and armaments of Iraq Armed Forces accounting for 3% of 2013 total budget (IQD 4.2 Trillions).

2013 Budget by Sector



Iraq investment budget allocates less than IQD 6 Trillion to the sectors of Industry, Health and Environment, Water and Sanitation, Culture and Youth. Another sector of critical importance for Iraq is Housing and Construction with investment budget of only IQD 1.6 Trillion, notwithstanding the urgent need for 2 Million housing units for which the ministry of Construction and Housing cannot finance[6].

Investment in Oil is key to economic prosperity in Iraq, this being also the Government's vision, but this should be balanced with investment in infrastructure and services in order for growth gains to be extended to the population in the form of improved services and employment opportunities.

Another way for allocating more funds to development is to rationalize operating expenditure of the government IQD 83.3 Trillion of which 60% are salaries and social benefits of employees.

5 This includes the reparations of the pipeline to Syria and expansion of Basra port.

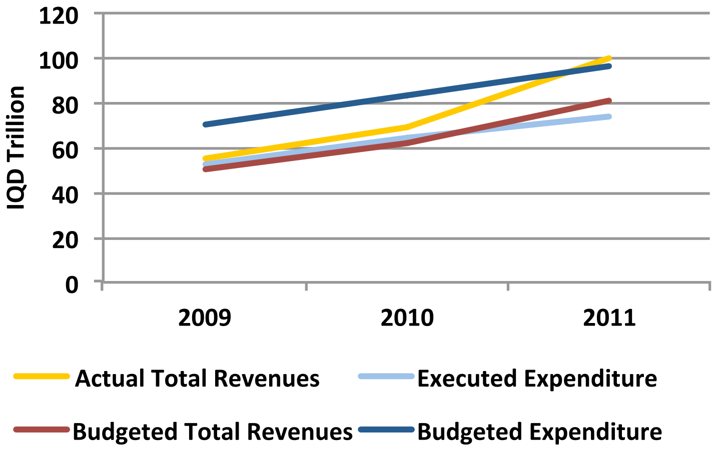
6 Minister of Construction and Housing, in his statement in Oct 2012, added that only 65 thousands are being built.

7 There is a surplus for the years 2004-2009, but data is not available to assess whether this is due to low budget execution.

"Budgeted" Deficit

Budgeted deficit totaling IQD 19.1 Trillion has fallen to less than 14% of total expenditure. The deficit will be financed by funds retained from 2012 budget (estimated between IQD 5-7 Trillion), borrowing from IMF and WB (close to IQD 6 Trillion), and the remaining will be covered from the Development Fund for Iraq, domestic borrowing, and unexpected rise in oil revenues.

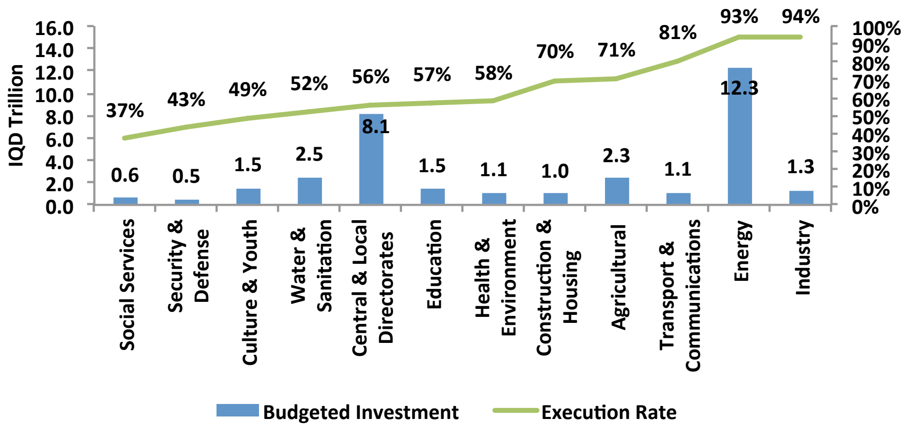
By looking at budget execution for the years 2009-2011 [7], Government end-of-year balance ended with a surplus. Budget surplus was driven primarily from low-spending-budget execution, mainly the investment share of the budget; the second factor being an unexpected rise in oil prices (or it can be seen as a result of Government cautious budgeting assumption on oil price).



Budget Execution

Government has consistently executed its operating budget at 80%-90%, financing primarily public servant's salaries and social benefits, as well as day-to-day government operating expenses. Execution of investment expenditure is lower, reduced to 75% in 2011. The execution rate falls to less than 60% in key development sectors including culture and youth 49%, Water and Sanitation 52%, Education 57%, and Health and Environment 58%. This is alarming, since not only these development sectors receive little of the total investment budget, but also inadequacies operationalizing these funds into the projects for which they were approved. On the other extreme we have execution rate of 93% for the Energy sector, 94% Industry,

Budgeted Investment and Execution Rate - 2011



and 100% for KRG investment budget.

Budget execution rate indicates the effectiveness or lack thereof of the financial management system and government agencies in delivering the projects for which funds are approved; in Iraq this is hampered by delays in approving the budget generally taking place in February-March, delays in approving projects and transferring the funds, and lack of accountability.

In order to improve transparency and accountability over budget execution, the Ministry of Finance and Ministry of Planning, for fiscal 2013, requested government agencies to report execution rate for each project approved in the budget, and for projects with less than 25% execution rate to be questioned by the CoM and CoR.

Iraq Development Needs

Iraq Knowledge Network Household Survey 2011 shows that in Iraq about 60% of Iraqi households are suffering from the lack of at least one of the following: access to improved drinking water source, access to improved sanitation facility, minimum 12 hours of electricity from the public network a day, or food security[8]. 15% of youth (15-29) are illiterate and this reaches 20% among female. Youth are faced with high unemployment rate of 18% (over 30% for female). These figures are matched by population outcry and dissatisfaction with the services provided.

Iraq MDGs situation 2011[9]	
Proportion of population below $2.5 (PPP) per day	**12%**
Prevalence of underweight children under-five years of age	**8%**
Prevalence of Food Insecurity	**6%**
Under-5 Mortality rate (per 1000)	**37**
Net enrollment ratio in Primary Education	**90%**
Net enrollment ratio in Secondary Education	**49%**
Ilitracy	**23%**
Proportion of people without sustainable access to safe drinking water	**32%**
Proportion of population without access to improved sanitation	**10%**
Percentage not living in a sustainable housing unit	**9%**
Percentage of households receiving less than 12 hours of electrcity from the public network	**25%**

8 Calculated by staff using Iraq Knowledge Network Survey.

9 Millennium Development Goals Governorate Level Monitoring Report, Iraq Central Statistics Office, August, 2012. Figures are calculated using Iraq Knowledge Network Survey 2011, and UNICEF Multiple Indicators Cluster Survey 2011.

Two factors may undermine government budget contribution to development:

- Firstly, the allocated funds to key development sectors are insufficient against Iraq development needs. In 2013 a total of only IQD 6.5 Trillion is the total investment budget allocated to Education, Health and Environment, Culture and Youth, and Water and Sanitation; equivalent to barely 50% of the Energy sector investment budget.

- Secondly, low execution of investment budget - slightly above 50% in 2011 for the aforementioned sectors. Not only development sectors receive little, inadequate steps are taken to translate these funds into projects for which they were approved. This development challenge is exacerbated by foreign aid drying up as a result of the increase in oil revenues, Iraq being given a lower priority by donor countries. (UNDG Trust fund will end by 2013).

Decentralized Planning with Central Budgeting

Sovereign expenditure totaling IQD 40.3 Trillion, or about 30% of total government budgeted expenditure, has doubled since 2011, contributing least to development at the provincial level. In addition this growing part is deducted from the budget before funds are allocated to the Regional Development Program and KRG.

Progress to decentralize planning at the provincial level is being made, with UNDP Local Areas Development Program aiding governorates in setting their annual plans, through a participatory and evidence-based approach. From that experience, the progress in planning was however not matched by improvement in financial management: funds are insufficient, there are delays in budget approval, as well as bureaucracy between governorates and concerned ministries, lack of accountability, and restrictions on commitment of funds for long run infrastructure projects. All these factors resulted in an execution rate of 56% in 2011 for the regional development plan.

2013 and Beyond

Budgets beyond 2013 will continue to be oil-centric; given Iraq's current economic strategy, commitment to foreign companies investment, and increased demand for hydrocarbons from the east (China and India). With regards to other sectors of the economy, the process should be clarified further. The trend today tells us that Iraq is focused on expanding oil and possibly gas production and exports to improve its financial resilience and foreign currency reserves. This has resulted over the years in growing government expenditure, smaller budget deficit, more investment in Oil, as well as in sporadic increase in other sectors' budgets.

Iraq needs to adopt a more evidence-based approach to identify development priorities and set investment budget priorities accordingly; so economic growth (primarily oil) can be intertwined with human development (Education, Health, Basic Services, and Employment). Otherwise, Iraq's human development rate will continue to have a slower pace in catching up with economic development, and citizens will continue to endure difficulties in food security, poverty, and access to basic services.

10 Iraq Energy Outlook, World Energy Special Report, International Energy Agency,

11 Ibid

Security and Defense are prominent in 2013 budget. Investment in these two sectors has increased immensely as compared to 2012. Part of this trend is to secure oil production and exports, as well as enhancing the state power. This sector will continue through 2014, as per the Government's plan to build the capacity and equip its armed forces.

Currently, Iraq allocates 40% of its budget to investment projects. Given the size of the public sector, and Government's ability to execute the budget, this share will remain relatively stable over the years to come. In addition, Iraq saves little of its Oil revenues; whereas reserves of oil revenues can cover Iraq operating expenses for less than a year[10] .

Iraq is putting a large effort in increasing its Oil revenues, but in order to improve financial resilience and reserves, it also needs to increase non-oil revenues (which are stable, around IQD 7 Trillion, since 2008), and to rationalize its operating expenditure (Iraq has one of the largest public sectors relative to population[11]).

Selected recommendations for 2013

- Firstly, GoI should revisit its budget implementation process and work to eliminate all bottlenecks resulting in low execution rates for some provinces, ministries and sectors. This should include areas such as disclosing performance by implementing bodies and reducing bureaucracy in transferring funds.

- Secondly, GoI should request ministries to provide feasibility studies on their projects and generate the capacity to examine and verify those studies (this function is not prominently visible in the central and/or KRG governments).

- Thirdly, for the next budget cycle, GoI should start the budgeting process earlier and make it further participatory (including KRG). In Iraq, the process starts in June, while in most countries it starts around March-April.

For more information and feedback please contact JAPU via info@iauiraq.org

10 Iraq Energy Outlook, World Energy Special Report, International Energy Agency,
11 Ibid