

RESEARCH ARTICLE

Funding and Financial Reform Process in Iraq

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Abstract

This paper attempts to provide an overview of the financial reform process in Iraq by providing in the following sections information regarding sources of financing in Iraq, negatives and positives of finance in Iraq, the problem of financing in Iraq and some proposed sources of finance. The final part will provide a conclusion and several insights on the road ahead for financial reforms in Iraq. The mainstream of finance is based on the process of insuring funds and using them to operate or develop projects, mainly focusing on choosing the most suitable source of funding.

Keywords: *Financing, Direct finance, Indirect finance, Central Bank of Iraq, Fiscal policy, Oil and non-oil resources*

Literature Review

In the contemporary economy, the development and strengthening of capital are possible only by taking advantage of the benefits offered through the financial environment. International finance concept is believed to be defined by the following assertions:

- Morris Dube: “funding in reality is not only a means to mobilize resources”;
- Funding consists in ensuring the necessary amount of money for developing and funding a certain project in a proper moment;
- Funding is related to the administrative sector and the administrative functions involved in the management process, enabling institutions to fulfil its objectives and the obligations on time. Generally, funding is part of all executive actions engaged in obtaining funds to support investments and the maximization of their expected returns.
- Individuals look forward to achieve the maximum possible return on their investments, thus, funding is defined as the knowledge applied in fields concerned with financial management.

Correlating the definitions presented above,

it can be concluded that funding represents the action of providing the necessary funds to carry out economic projects that aim to develop in times of need. Funding is concerned mainly with the cash flow and not with goods and services sector. Its aim is to develop public and private projects within the required time frame. Funding includes monetary and fiscal areas, “which coincides with the flow of goods and services and therefore falls within the second dimension, as the first dimension includes the commodity side of the international economy” [1].

Financing is Represented Mainly by Direct and Indirect Funding

Direct funding reflects the direct relationship between the lender and the borrower and the investor without the intervention of any bank or financial intermediary. This type of financing can take multiple forms, also varying depending on the borrowers:

- Institutions: the borrower can receive loans and credit facilities from their suppliers or the customers, or even from other institutions. They can include a broad sector of savers who want to invest their money without their activity directly linked to the economic activity of the institution.

- This case is associated with issuing shares to the public or private sector, bond issuing, commercial credit, self-financing and dependence facilities.
- Government: refers to direct financing by borrowing from individuals and institutions through issuing multiple forms bonds with different time periods and variable interest rates. Treasury bills are the most important of these bonds.

Indirect funding: includes all kinds of ways and methods of indirect financing in which all the financial sources are provided by financial intermediaries, such as banks. In this form of funding, the financial intermediaries collect the financial savings from economical surplus and distribute these savings to the economical units that need them. The financial intermediary institutions are trying to reconcile the sources of savings requirements and the sources of funding requirements. Other forms of indirect funding are the guarantees

[2].The main problem in many developing countries is a severe shortage of savings, especially in poor areas, where the resources are not sufficient to cover the current consumption and the result is that very little investment is directed to accelerate the process of economic development.

The waste of resources that affect the savings in developing countries can be referred to as the most important aspects for the loss of savings in developing countries, namely:

- Different types of unemployment, especially idle production capacities;
- Compactness (lack of local compactness);
- Irrational foreign exchange;
- Irrational consumption (public or private);
- Tax evasion, tax liabilities owed to the public authorities, or tax exemptions for some productive activities without solid economic justification.
- Capital flight abroad;

There is no doubt that the mobilization of these lost savings will raise the rate of domestic savings and domestic investment without any damages to individuals' living standard.

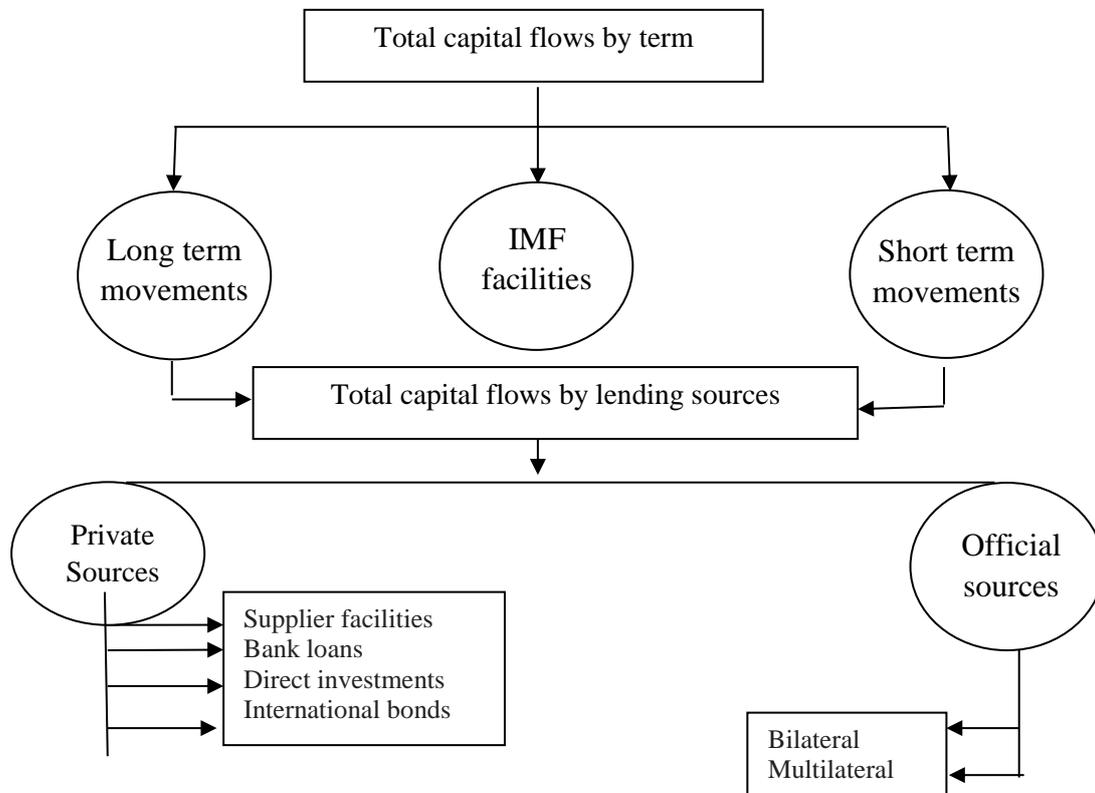


Figure 1: The general framework of the total capital flows at the international level
Source: Created by author

International capital flows are divided into short-term flows and long-term flows. In terms of creditors, the sources are divided into official sources and unofficial sources. The official sources may be bilateral or multilateral, while the private sources include supplier facilities, bank loans, international bonds as well as direct investment.

The official sources of international finance are represented by bilateral and multilateral sources, regional and international sources. Multilateral sources of international financing are the facilities granted by the International Monetary Fund for its members.

Bilateral Funding Sources

The bilateral sources in international finance are loans and aid provided by the governments of the countries. These loans are granted after several rounds of negotiations between the government of the lending country and the government of the receiving country. The points negotiated usually are the value of the loan, loan maturity, interest rate, link costs, withdrawal of the loan, loan repayment policy, and the grace period, if any.

It must be recalled here that there is a difference between what is known as privatization and contracting foreign loans. In case the funds are accessed through a loan in a cooperation agreement to assist the borrowing state, the amount is included in the external debt of the state. In this case, there is an obligation of the government receiving the loan.

In case the government agreement is on the supply of goods and services within the framework of the previous allocation, the amounts that have been contracted arrange an obligation owed by the receiving state. The amount of this obligation is determined by commonly referred expenses and in this case, the benefits are not calculated on the contracted amounts as long as the contracted amounts are used according to the original allocation. The benefits are not included in the external debt of the recipient state. When the state is supplying the agreed goods under contract,

the benefits are included in the external debt of the state.

Multiple Sources of Funding

The two main official sources of international finance are international financial institutions and regional funding institutions. The international funding institutions include:

- International Bank for Reconstruction and Development;
- International Finance Corporation;
- International Development Association;
- International Monetary Fund.

The regional financial institutions are:

- The European Investment Bank;
- African Development Bank;
- Asian Development Bank;
- American Development Bank;
- Islamic Development Bank;
- Regional development funds;
- The Arab Monetary Fund.

It is known that the Arab countries had a significantly different economic policy orientation, degree of openness of the economy, availability of resources and economic structure apart from other regions.

While some of the countries have followed economic policies that were based on government intervention, protectionism and the dominance of the public sector, others allowed larger role for the private sector and for market forces in the process of economic production and resources allocation. Taking into consideration the differences between the financial systems adopted by each country and the types of reforms implemented, there can be observed significant various impacts on the development of those countries' economies.

Nevertheless, the majority of Arab countries have developed and implemented financial reform programs and some of them were pursuing macroeconomic strategies that targeted increasing the efficiency of financial intermediation through policy of civil freedom, adoption of modern concepts, enhancing transparency and focusing on

attaining rigorous system in order to achieve better risk management. Those financial restructuring programs were implemented gradually: the early stage involved mainly some measures to free the interest rates, the foreign exchange market and moving from direct credit control to the use of indirect monetary policy instruments. The next stage consisted in reforming the banking system through restructuring and privatization, developing the non-banking financial markets, especially stock exchange markets and government securities primary markets and redefining the relations between the banking sector and the public sector.

A later stage of financial reforms involved reforming the regulatory and supervisory environment, moving towards a more advanced monetary policy framework, developing secondary markets for government securities, reforming the non-banking financial intermediaries-such as insurance sector and pension funds and developing modern payment systems.

In this regard it is worth to mention that the gradual approach to implement financial reforms do not mean that it is always been done in the above-mentioned order or that each stage is self-contained. The financial reform process, in general, is a continuous process that contains overlapping activities aimed at achieving a modern financial system that will promote the efficient allocation of resources and will accommodate both the technological progress and the new financial innovations.

Accordingly, while almost all the Arab countries are currently active working on reforming the financial sector and while some of them are advancing in this process and some are lagging behind, there are still lots of space for increasing the efficiency of the financial system in all the Arab countries.

Financing in Iraq

The oil sector is prevailing in Iraq's economy, providing approximately 95% of its foreign exchange earnings. Due to the fact that the government relies mainly on the revenues obtained from this sector, the budget allocated to public expenditures is

extremely sensitive to the changes in the international variables; market price of oil and exchange rate value of the US Dollar.

Furthermore, oil resources are limited as most government agencies such as Us Geological Survey, oil companies or economies estimated that worldwide oil production peak will be reached between 2035 and 2050 [3].

The persuasive state intervention, costly militarization, three wars and over twelve years of international sanctions resulted in a weak economy due to the heavy debt and underdevelopment. The 2003 War had major impact on the Iraq's economy which suffered from complete destruction. Therefore, reconstruction reforms needed to be implemented in order to improve the economy and the quality of life. The economic growth has to be sustained by an increased public investment in infrastructure and reconstruction, a wider level of freedom in the private sector and tax rates reductions. The policies described above are based on correction in economic policy, particularly in fiscal policy.

Iraqi Financial System and Its Characteristics

The Iraqi financial system is dominated by the banks. According to official figures, total assets of the banking system amounted to 329 trillion Iraqi Dinars (ID) surpassing the market capitalization of the stock market of only ID 3.5 trillion. The enormous amount reported as bank's assets is considered to be inflated by the integration of large exchange rate valuation losses on the bank's balance sheets and is estimated to ID 70.1 trillion. In accordance with the lower asset figure from above, credit extension by banks amounts to only ID 9.4 trillion, representing a diminished level compared to international standards. As regards the insurance market, there is no significant contribution reported by far. There are no private bonds issued.

The banking system accounts of 46 banks from which 7 are state owned banks. The state banks operating in Iraq have control over the majority part of assets and credits.

The private banks are relatively small, seven of these have foreign participation and nine operate according to Islamic principles. (Sahar Nasr) The services provided by the banks are limited and credit is mainly short term and trade related. The financial strength of several banks is questionable.

The capital market is focused on the ISX (Iraq Stock Exchange), which provides a private sector, a regulated market place for the issuance and subsequent sale and purchase of securities by investors. There are 48 licensed intermediaries companies, which carry out the sale and purchase of securities, by the ISC (Iraq Securities Commission) and are regulated primarily by the ISX.

The government should focus on new methods to finance its public expenditures by developing their actual financing system particularly the Government Bonds (GB) market. Moreover, Iraq's economy has a huge external debt. As far as it concern external debt department, the status of external debts of Iraq is listed below:

- Total debts which had been settled with Paris Club countries was around (51.6) billion dollar in 2004 and became around (10.58) billion dollar at the end of 2011;
- Total debts which had been settled with countries not with Paris Club around (18.33) billion dollar in 2004 and it became (2.88) billion dollar at the end of 2011;
- Total of commercial debts, which had been settled, was around (19) billion dollar in 2004 and it became (3) billion dollar at the end of 2011 [4].

In addition, the financial sector includes the following companies; aggregate asset size is not available, but is believed to be relatively small:

- The Postal Saving Fund;
- Exchange Companies;
- Financial Transfer Companies;
- Financial Investment Companies;
- Companies providing small and medium loans.

The Iraqi financial system is characterized by the large size of state ownership among banks and insurance companies and ambiguous strategy for development. Moreover, the capital of operating companies in the Iraqi financial system is limited, except for banks where CBI (Central Bank of Iraq) has requested its capital to be increased.

Another characteristic of the Iraqi financial system is the inadequate legal framework. There are major weaknesses in company law regulations, corporate governance codes and bankruptcy law which hinder the evolution of the Iraqi economy. In order to benefit from the participation of foreign investments, Iraqi economy needs to be restructured: the system must ensure a certain level of transparency and the financial statements must be complete and accurate. In addition, the interest rate and loan structure are characterized by a lack of flexibility; banks grant mainly short term funds and the medium and long term loans are limited.

Furthermore, the investors encounter difficulties while buying or selling securities due to the low levels of capital in market intermediaries. The SME-s (Small and Medium Enterprises) have reduced access to finance.

The main financial regulator is the Central Bank of Iraq (CBI) having as primary objectives achievement and maintenance of domestic price stability and also promotion and maintenance of a stable and competitive market based financial system. In accordance with these objectives, the CBI shall foster sustainable growth, employment and prosperity in Iraq.

The main functions of the CBI comprise the following:

- Formulate and implement monetary policy, including exchange rate policy
- Hold and manage all official foreign reserves of Iraq, other than working balances of the Government of Iraq
- Hold gold and manage the Government of Iraq reserves of gold
- Provide liquidity services to banks
- Issue and manage Iraqi currency

- Establish, oversee and promote sound and efficient payment systems
- Issue licenses or permits to banks and to regulate and supervise banks [5].

On 26 August 2013, the Board of CBI adopted a new Reserve Requirement regulation and a new Banking Facilities regulation with the purpose of strengthening CBI's conduct of monetary policy and supporting the Ministry of Finance's (MOF) new government securities issue program.

The changes in the CBI's regulations and operations were meant to increase the efficiency of short-term liquidity management by banks and to achieve the desired monetary policy. In terms of liquidity management, the central bank's policy instruments must act jointly with money and securities market and a more reliable payment system should be developed.

Excess reserves are the most certain form of liquidity but also the most expensive. The difference between interest rates on deposits and on loans which represents intermediation spreads "can be narrowed by enabling banks to minimize their holdings of non-interest yielding excess reserves [6].

CBI had the possibility to employ several active and passive instruments that were affecting the monetary base: foreign exchange auctions, a reserve requirement regulation (requiring bank to maintain different levels of deposits), an overdraft facility, a discount window for bills of exchange and similar bank's papers, lender of last resort facility and MOF securities Window. The above instruments are not suitable for conducting an efficient market based monetary policy. The reserve requirement does not provide banks with a useful liquidity management tool and would have complicated the implementation of a monetary target. Nevertheless, the new regulations were intended to improve banks`

ability to manage their liquidity in a more effective approach.

Reserve requirements are perceived as an instrument for monetary policy instead of banking supervision tool. For monetary policy reasons, in order to have equilibrate deposits, is desirable to attain a uniform requirement. The ratio shall be applied to all deposits so as to provide a more stable money multiplier.

Fiscal Policy in Iraq

Determining the financial resources of the state means fiscal policy and different allocations of these resources are distributed to the tax system, bank system and insurance system in order to achieve economic and social development. The management of Iraq's budget is still primitive, funds are distributed on the basis of sectors, and are not linked to development plans and economic and social indicators.

The state budget did not disclose imports of loans, grants and international aid before receiving and spending it. The oil resource increased from about \$ 8 million in 2003 to more than \$ 94 billion in 2012, while investment expenditure ratio raised from 14% in 2004 to 40% in 2006.

Iraq's state revenue is mainly obtained from oil and duties, taxes, loans and grants received. In 2013 it was more than \$ 600 billion, a huge amount compared to other oil and non-oil producing countries revenues. However, Iraq still suffers from many of the economic and social problems as a result of poor management of these funds and poor management mechanisms available.

The allocated budget for investment projects of 39%, as compared to international standards of investment budget of 65% - 70%, had negative implications for the development of the infrastructure [7]. The following table outlines the total expenditure, revenue and budget deficits in Iraq during the period from 2011-2013:

Table 1: Iraq's budget for the period 2011 - 2013, Iraqi Dinars

	2011	2012	2013
Total Expenditures	96,662,766,700	117,122,930,150	138,424,680,000
Total Revenues	80,934,790,500	102,000,000,000	119,296,663,096
The Surplus and Deficit	(15,727,976,200)	(15,000,000,000)	(19,127,944,904)

Source : Report for the draft financial budget for Iraq, [7]

It can be seen from the above table that the highest deficit budget appeared in 2013 indicating a waste of resources due to the weak tax system which cannot cover the tax revenue.

The table below represents the analysis of public revenue structure in Iraq for the period 2007- 2012:

Table 2: The structure of public revenues in Iraq for the period 2007 - 2012, trillion dinars

Revenues	2007	2008	2009	2010	2011	2012
Oil Revenues	51.7	76.9	43	53.2	61.9	72.6
Taxes and Fees	0.79	0.82	1.98	1.17	1.34	1.57
Benefits	0.35	0.39	0.84	0.43	0.52	0.60
General Corporate Profits	0.32	1	2.9	2	2.2	2.4
Non-Tax Revenues	1.4	1	1.6	1.5	1.57	0.97
Total Revenues	54.6	80.2	50.4	58.3	67.5	78.1
The Annual Rate of Public Revenue	-	(23.1)	(57)	(46.1)	(38.1)	(27.4)
Relative Importance of Oil Revenues from General Revenues	94.6	95.8	85.3	91.2	91.7	92.6
Relative Importance Non-oil Revenues from General Revenues	5.24	4	14.52	8.75	8.43	7.09

Source: The world Bank, [8]

Analysing the table, it can be observed that oil revenues had a continuous growth during the period 2009-2012, reaching 72.6 trillion dinars in 2012. In addition, the data from the above table are sustaining the assertion that revenues from oil are the major factor in the evolution of the budget [8].

Recently, the worldwide increase in oil prices has enabled the Government of Iraq (GoI) to generate higher revenues than budgeted. Therefore, the government has not encountered difficulties in sustaining public expenditure, even more through budget surpluses GoI succeeded in acquiring significant reserves of foreign currency. As long as the oil prices tend to increase, almost no problems may incur due to macro-fiscal policy, but the allotment of capital investment budget need to be reconsidered [9].

The public expenditures are divided on several sectors and each sector has its share of budget expenditures:

- **The Security and Defence Sector:** The proportion allocated to this sector is almost the largest share of the budget, ranging between 14.2%-14.6% due to the necessity of security and political reasons. The aim of this section was to prioritize the most in need regions from the country, to achieve security, stability and provide an efficient security plan by increasing the security of the Iraqi people.

- **Education and Teaching Sector:** During 2011-2013 the proportion allocated remained at the average of 9.5% even though growth of population was expected and numbers of students enrolled continued to increase. Moreover, there is a crucial need for increasing school reconstruction projects in various stages, especially for basic education, as well as expanding universities, educational institutions and institutes.

- **Energy Sector:** the percentage distributed to this sector was very low despite the needs experienced in this sector, although in 2013 was registered a higher allotment proportion of 21%.

- **Environment and Health Sector:** Iraq suffers from non-clean environment and a large shortage in the area of health in terms of number of hospitals, various divisions, and health institutions in rural areas. Furthermore, Iraq lacks professional personnel: doctors, specialists, health care staff, advanced medical devices and untrained personnel that work on these devices. Despite the presence of the private sector which works in the field of Health (private hospitals), the percentage of budget allocations for health and environment sector, which is one of the most important sectors in Iraq, does not exceed 4.9%, which is a very low rate.

- **Social Services Sector:** the percentage allotted to this sector exceeds 13%. In

2013, through programs of federal budget were created centres for people with special needs and were secured the necessary allocations for social network citizens. The agricultural and industrial banking and housing fund started to grant loans to retired military veteran pensioners.

- **Water, Sewerage and Sewage Sector:** constitutes 3% of public expenditure. The urban and rural areas in Iraq are still suffering from drinking water scarcity, problems of sewage in many areas and some regions are experiencing drains of drinkable water. The need to solve these problems is fundamental.
- **Transport and Communications Sector:** due to the dominance of the private participants in this sector, the budget allocated, 1% is relatively insignificant regarding its importance. The budget distribution should focus on the rehabilitation of airlines and railways, ports and secure the development of the telecommunications sector.
- **Agricultural Sector:** In the last period, the agricultural sector experienced a significant decline of the state and private sector's interest. The farmers prefer to leave their homes and migrate to the city, neglecting the agricultural sector due to the low increase in the percentage allocated (3.5% from 2011 to 2013). These events have led to a dependence of imports of agricultural products. The 2013 budget have focused on agricultural production and self-sufficiency, maintenance and operation of irrigation projects, securing Iraq's share of common rivers with neighbouring countries, and the development and rebuilding of the Ministry of Agriculture companies.
- **Industrial Sector:** Before 2004, the Iraq possessed large, medium and small factories producing consumer goods and collecting some types of electrical devices, tools, carpets, cement, sugar and other commodities. Although, the industrial sector got a significant slowdown after 2004. After the privatization took place,

most of the factories confronted with losses of the great burden, especially those factories and plants that needed radical changes in terms of machinery, raw materials knowledge and highly experienced employees to cope with large technological changes in the production of goods. The privatization project carried out by the state was not fully successful as it was expected and faced weaknesses in terms of attracting local and foreign investors. Iraq's industrial sector received a slowdown and investors showed lack of interest concerning this sector. The budget allocated to the industrial sector suffered a gradual decrease during 2011 and 2013.

- **Construction and Housing sector:** Iraq is facing housing and infrastructure difficulties, which have worsen during 2004, and have continued to some extent in other areas like ports, airports, streets, water and sewage networks, electricity and others. Evidences from previous allocations of public spending show a gradual decrease between 2011 and 2013. The importance of this sector must be taken into consideration and the awareness towards construction and housing sectors should be increased. It should be remembered that the infrastructure is the basis of all civil and military sectors of the economy. 2013's budget was focused on building an increasing network of roads and bridges and fostering the ability of the citizens to benefit from the creation of housing complexes.
- **Youth Clubs and Unions Sector:** In the past, the state granted a clear interest to this sector, but lately the state became less interested. It has allocated 1.9% of public spending in 2012 and then the allocated figure rose dramatically and became 16.8% in 2013. This sector is one of the vital sectors that affect young people and their physical and intellectual activities. The budget for Iraq in 2013 had an important role in the development of sports and cultural talents for teenagers through the open sports clubs and interest accorded to the creation of new cultural centres and rehabilitation of the infrastructure of the culture.

- **International Commitments and Debt Sector:** this share should be almost constant because the debt and international commitments are distributed almost equally over years.
- **Central and Local Public Administration Sector:** is characterized by projects employed in the State's service. The percentage allotted to this sector was 14.5% and decreased gradually, becoming 9% in 2013. The budget of 2013 included important and necessary programs, through the preparation of development plans, and raising the administrative efficiency of Iraq's system and anti-corruption system.
- Moreover, Iraq should raise the efficiency of the development programs throughout its provinces, focus on developing projects for the petro-dollar allocations to the provinces involved in the production and

promote programs that tackle poverty in the areas that suffer from this problem.

Sources of Financing in Iraq

The dominant role that revenue generated in the oil sector plays in financing government activities in Iraq is well recognized. No other significant alternative financial resource exists. Even though oil sales provided the majority of the revenue, the percentage obtained gradually declined "due to an extensive campaign of airstrikes by the United States and coalition partners against oil and gas facilities. (Carla E. Humund, Robert Pirog, & Liana Rosen, 2015) The nature of the oil sector is, however, an enclave sector, characterized by weak forward (production) as well as backward (consumption) linkages with the rest of the economy, making the role of the oil sector an important factor in the overall development process in Iraq.

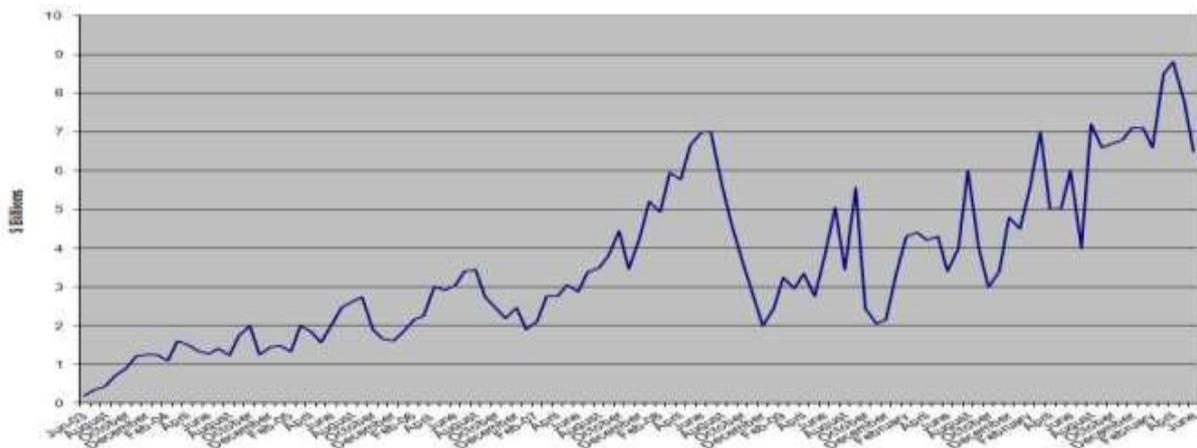


Figure 2: Monthly oil revenue from exports, June 2003 - June 2013

Source: Created by author

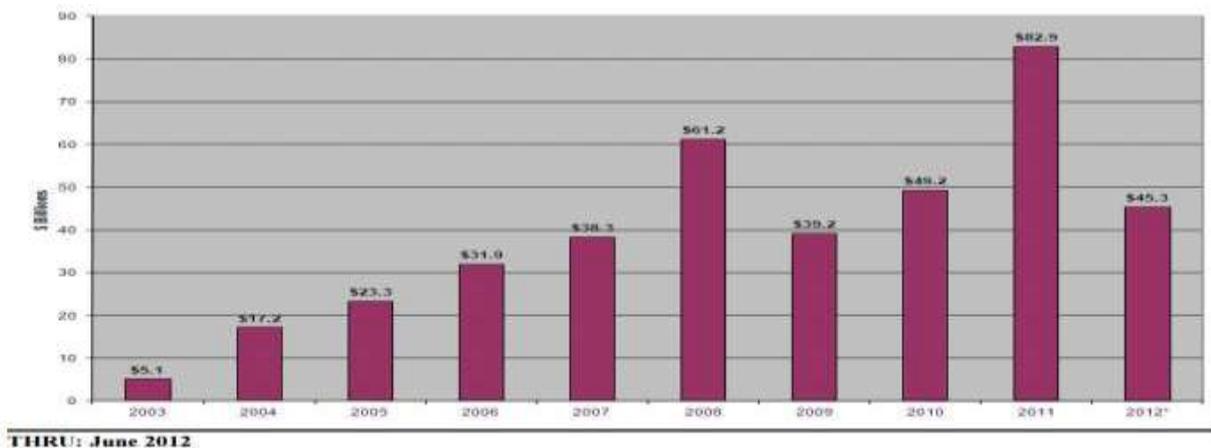


Figure 3: Comparison of oil revenues from exports, 2003 - 2012

Source: [10]

For the fiscal year (FY) 2014, the estimated government revenue about IQD 139 trillion revenue has more than doubled since 2009 reaching a new record high. An oil revenue accounts IQD 130 trillion, almost 93% of total revenues while other earnings increased to IQD 9 trillion. Other sources of revenue are mainly composed of income, corporate, and other taxes.

For the FY 2014, the oil price was US\$ 90 per barrel and approximately 3.4 million barrels per day (bpd) were exported for budgeting purposes; as the Government of Iraq plans to increase this amount to more than 3.75 million barrels per day, the oil

revenue is expected to increase over the next several years. As a result, a sharp decline in global oil prices will have a huge impact on Iraq economy due to the delays occurred in developing Iraq's oil field, oil export capacity, or delays in the construction of warehouses and pipelines for transporting crude oil. Facing a situation like this, Iraq may experience a fiscal crisis if the government does not reduce expenditures, which may lead to the depreciation of the exchange rate.

The Government revenue during the past four years, 2009-2014, is represented in the graph below:

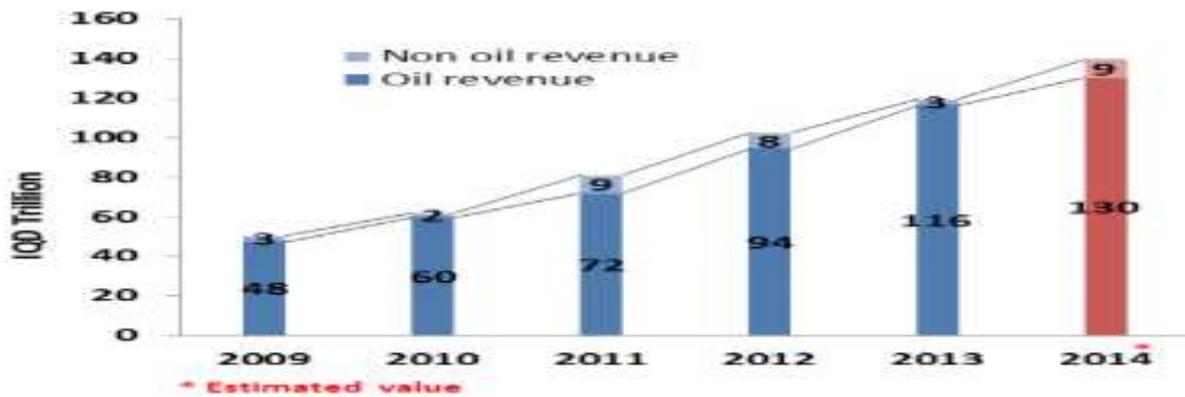


Figure 4: Goi revenue sources, 2009-2014

Source:[11]

To dodge the possibility of an oil dependent economy, the Government of Iraq should assemble a “diverse financial portfolio”. (Bryan Price, Dan Milton, Muhammad al-'Ubaydi, & Nelly Lahoud, 2014)A critical step in assembling this portfolio, is

implementing the customs law, which have been avoided for almost three years “because of a dispute between Baghdad and the Kurdistan Region over the collection of customs revenue at border crossings” [11]. The Iraq's revenue could increase with IQD 1.5 trillion by using these customs law.

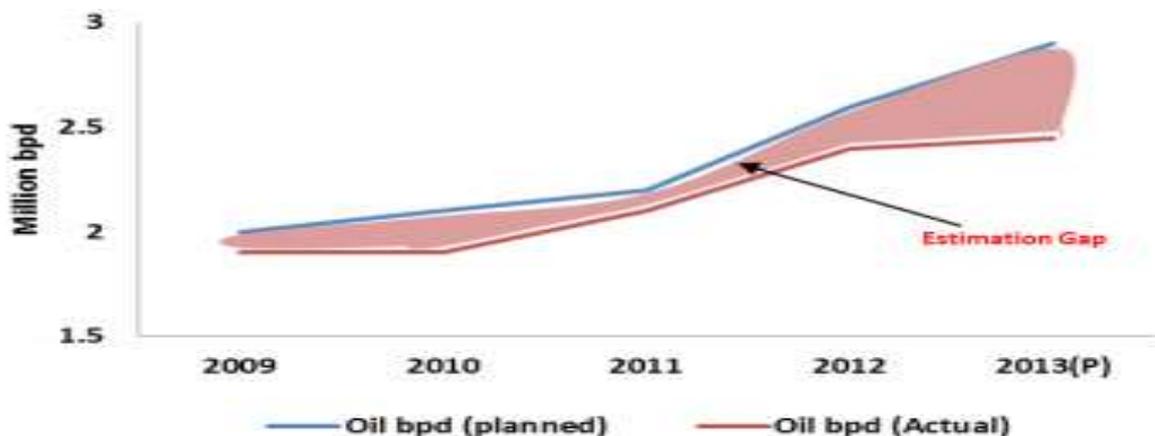


Figure 5: Iraqi oil exports, 2009-2013

Source: Created by author

80,000 workers out of a total of 8 million in the labour force are employed in the oil sector, a minimum percentage (1%). The earnings from oil export representing 40% of Iraqi gross domestic product (GDP), play an important role on Iraqi exports. Revenue diversification in the medium to long run must work together with diversification of the economy. This will enable the development of the private sector and therefore, will contribute to growth and revenue.

Iraq could benefit also from other non-oil sources such as:

- Speed up implementation of the tax law on the sales of mobile phone to be applied in 2015;
- Tax on restaurants, luxury hotels and Cigarette;
- Prohibit legislation that encourage investments involving tax exemptions as an incentive;
- Investment of resources to improve the tax and customs administrations in Iraq.

During 2013-2017 the private sector will be reintroduced by the new domestic product (NPD) into a framework of a restructuring strategy for state-owned enterprises (SOEs), mainly in manufacturing. This is meant to increase the contribution of the private sector to the GDP and the accumulation of fixed capital. The private sector is a significant factor for the economic development, as the NPD is expected to have a share of 21% of the total investments equalling over US\$ 75 billion.

However, these recommendations proposed above are still at the concept level as this plan did not materialize. Many questions are raised regarding the transformation of the NDP new targets into a reality.

Positives and Negatives of Financing in Iraq

Advantages

Because the bulk of government revenues is raised through oil revenues rather than anything else, a need has arisen for an alternative means which can be used to compensate for this lack of strong

interaction between the oil and non-oil parts of the economy.

One way to achieve this is by employing the government budget as a medium to spread the development which has taken place in the oil sector across other sectors of the economy. As a result, the government budget will play a dual role:

- Firstly, as a means by which developments in the oil sector are directed to induce and facilitate the development of other sectors in the economy;
- Secondly, as an instrument for economic stabilization and development policies.

These roles cannot be successfully carried out unless two conditions are met. One of these conditions is the willingness of government to transmit the oil sector development into other sectors by making the revenue gained from oil exports available for the financing of the development of other sectors. In other words, increasing budget allocation. This condition, although it is necessary, is not in itself sufficient unless such willingness is matched by the ability to spend in an efficient and productive way, i.e. proper and well thought out methods of allocation.

Taxation, as a fiscal instrument and a vital source of government income, is negligible in the country's economy. From these considerations, it can be said that public finance in Iraq differs from that of other countries. There exist different characteristics, different problems and, therefore, different solutions are needed.

An inevitable starting point is Wagner's law of "expanding state activity" which was formulated at the end of the nineteenth century. This law stated that with rising per capita income in industrializing countries, the relative share of the public sector in national output will rise.

Wagner offers three reasons for this:

- With industrialization there would be increased the need for the administrative and protective functions of the State;
- The cultural and welfare functions of the State will expand, especially those

connected with education and income distribution;

- With the change in technology following on from industrialization and the increasing capital requirement of many industries, the State will intervene to protect consumers from private monopolies and, therefore, the direct investment role of the government will expand.

Wagner did not see war and defence as a playing role in the expansion of public expenditure. War and defence expenditures in some countries at least, proved to be one of the important causes of the growth of public expenditure in this century [12].

Wagner's law is broadly supported by the empirical evidence of public sector growth. However, some of his assumptions have to be modified to make them in line with actual facts. Current knowledge suggests that there are a variety of reasons for the phenomena of public sector growth, which can be summarized as follows [13].

- The effect of economic growth on public sector outlays as proposed by Wagner's law, plus the need for growth in defence spending as a product of industrialisation either because of the rising significance of the protective function of the State or, as the pressure for territorial and market expansion, safeguard foreign investment, trade routes, the supply of essential materials etc.
- The high income elasticity of demand for public goods at a certain stage of development: Musgrave, in his study of fiscal systems, found variation in the income elasticity of demand for public goods in three ranges of per capita income levels. At a low level of per capita income associated generally with pre-industrial society in developing countries, demand for public goods was generally very low because almost all income is devoted to satisfy basic needs. When per capita income starts to rise a demand for goods supplied by the public sector becomes more important [14]. Hence, public sector outlays expand at a rate faster than that of private sectors. Finally, at a high level of

per capita income in developed countries, public sector growth will slow down until public and private expenditure grow almost at the same rate.

- Differential productivity between public sector and private sector: When resources' productivity used in the public sector grows slower than that of similar resources employed in the private sector then there is an essential need for inputs to produce a given output in the public sector. This tends to increase overtime.
- The displacement effect and the concentration process: In their research of British government expenditure growth, Peacock and Wiseman observed changes in the rate of growth of public expenditures which they associated with wars [15]. What was important in this context was not the rise in expenditure during the war years but rather the fact that post-war expenditure levels did not return to their pre-war level but remained significantly above them. War expenditure appeared to have what they called a "Displacement Effect".

Peacock and Wiseman study points to a further characteristic of public expenditure growth in the UK that is the concentration process. The consequent desire for greater uniformity and standardisation of services like planning the war economy, anti-cyclical action after the 1930 Depression and improved transportation and communication, for example, required central government intervention through the provision of equalisation grants to remedy the different standard of public services in various parts of the country. Although the concentration process may be explained by many factors, at least in some extent, is associated with the displacement effect.

The most important cause for the problem of the decline in economic structural development and activity is the lack of effective allocation of government expenditure and the inability of private sector to offset this effect. In order to prevent a further deepening of the problem some adjustment in the size and the composition (pattern of allocation) of the

budget may be warranted. Measures to that effect may take one of two forms: rationalisation of expenditure or mobilisation of additional skills to reshape the economic management of the country. These may be considered as the main positive effects of well structure financial system.

Rationalisation of expenditures would comprise the restructuring and prioritising of public expenditure. This could mean the elimination of unproductive and wasteful spending, a reduction of unnecessary subsidies on various goods and services and a review of the enormous amount of government expenditure on public administration. In addition, an elaborate cost-benefit analysis or value for money audit may be undertaken to ensure the optimal spending policy.

While economic efficiency is an appropriate criterion for resource allocation in spending money to maximise the benefits to and from the private sector, a higher importance should be given to those sectors which have long-term prospects, strategic significance and wider linkages in the economy, i.e. those having the maximum impact/multiplier.

Government should adopt a declared stable budgetary policy. This is the most important from the private sector point of view, since it eliminates speculation and reduces uncertainty in private sector planning. Such an adjustment would be more effective if carried out within the long term development planning framework.

Measures to raise additional government revenue so as to reduce the effects of uncertain oil revenues and increase budget allocations could include a wide range of tax and non-tax measures. The latter may be the easiest for government to administer, at least in the short-run. All that needs to be done is to rationalise subsidies and put a price on goods and services which are currently provided by government free of charge or heavily subsidised. Of course, tax and non-tax measures have to be studied and evaluated in the light of the government's commitment to raising the standard of living

Disadvantages

The current economic situation is mainly a consequence of past undue spending policies. During the past period, budgets have always deviated from plan in such a way that actual expenditure far exceed its planned level and, in many instances, was different from the planned structure. The concentration on high consumption is one example of such a deviation from the planned sectorial and functional structure of spending. Such changes could influence the private sector's attitude by investing heavily in areas like trade and so on. This could lead to an increase in the supply of such activities to a higher level than the market required and negatively influence investment in industrial and other productive projects.

The failure to achieve improvements in the economy is partly related to the current unstable environment. However, the most important factors are related to the weakness and vagueness of the administrative arrangement of government organisation and the process of budgetary planning and control system such as:

- Lack of clarification and delineating the responsibility of the central and local government: This stems from the confusion between federal and decentralised structure of the state organisation, leading to a distortion in the authorisation and accountability arrangement that is necessary for good performance;
- Weak and limited skill capacity to plan and manage the economic resources by linking budgeting to development planning;
- Government budgeting during the previous year's didn't accorded too much importance to the development of different aspects of the economy. Almost no actions were taken in order to achieve any improvement in the economy. This is because policies of allocation during the previous years were biased towards short-term rather than a long-term strategic framework;

- Budget expenditures allocates a large proportion to purposes which neither serve to promote investment nor consumption, but rather to provide an ad hoc assistance used to create a pseudo-structural change. The existence of which may hinder the achievement of the required real and sustainable structural transformation;
- The experience of the previous year's shows that budget allocation decisions are made without concerning the planned target. This lack of harmony often causes hesitation in the market concerning which aspiration to follow- that of plan or that of budget;
- The allocations made during the past period were made without the knowledge of either the nature or the size of the interaction between the different categories of expenditure (type or function) and the various sectors in the economy. This has resulted in a disparity between both the level of expenditure and the level of sectorial development requirement;
- The state of the limited skill capacity of the economy indicates that a higher level of expenditure is not necessarily always desirable. On the contrary, it may create a situation where unnecessary projects are undertaken irrespective of their economic or social viability;
- Government expenditure levels of the past period have created a pattern of activities which has relied heavily for its implementation and operation on the importation of material. This, apart from social side effects, has left its mark on the characteristic and magnitude of the Iraqi development. Through keeping development within the capacity of indigenous resources, especially manpower, with some degree of foreign supply, the process could evolve smoothly without experience of the past. Moreover, it would have reduced the leakage out of the economy by reducing the size of imports.

The essence of the new situation is that, despite (and because of) the inefficiency in government expenditures more is now

required from the private sector, as a parallel force shaping the economy than ever before. The most adequate measure is, therefore, for the government to improve the efficiency and effectiveness of its support to this sector. To this end, several steps could be taken.

First, new incentive schemes for the private sector are needed in order to make it more sensitive to the scale of private commitment, to the marketing risk involved and also, to the developmental priorities. Most of these are possible and can be administered easily. Technically, they require a recalibration of the existing system of incentives together with the appropriate priority ranking for the nature of activities concerned.

Second, for domestic developments, a sector by sector review of private investment intentions, market potential, technology transfer requirement and financing possibilities will have to be carried out as a joint government/private sector exercise. Special attention should be given to those sectors (or activities) which promise a growth potential and substantial linkage effects such as those sectors with high impacts shown in this study or an extension of them, e.g. agricultural processing and secondary petro-chemicals etc.

Thirdly, a serious problem facing businesses is the lack of adequate information on the local market to enable the decision maker to take the correct decision. Businesses wishing to enter into new fields have difficulty in identifying, for example, the size of government purchases of various goods and services, future prospects for government spending in areas of relevance and other market information. Often such information is available but is not made public because of the misplaced emphasis on confidentiality. An adequate policy should, therefore, be derived regarding the process of making public information more of value and of relevance to the making of sound decision and judgements.

The problem of financing in Iraq

Iraq experiences large fiscal policy difficulties following more than 30 years of sanctions and conflict, which have resulted

in very large infrastructure and social needs. Iraq should use the revenue obtained from the financing sources to support reconstruction and development, while avoiding boom-bust cycles that stem from volatility in natural resource revenues by adopting different mechanisms.

In this section, several solutions will be proposed for the assessment of a long-term fiscal sustainability. To improve macroeconomic management of the economy, a fiscal policy framework will be implemented, including a procedural fiscal rule in order to separate the budget process from fluctuations in international oil prices.

Iraq's government plays the main role in deciding how much of the oil revenues to save abroad or if to channel all the earnings

into domestic economy via government expenditures. Therefore, the chosen expenditure path has a significant result on macroeconomic developments in the non-oil economy, macroeconomic stability and intergenerational equity.

The fiscal policy framework should include a medium-term fiscal plan for Iraq to ensure solvency. This plan suppose that the medium-term spending path is consistent with long-run development and that is based on Iraq's oil wealth and its exploitation. Because oil export revenues represent more than 90% of the total revenue, Iraq's government should accord a great importance to their vulnerability regarding the fluctuations in international oil prices. As the government is dependent only on a single main source of revenue, high level of fiscal buffers should be taken into consideration.

Examples of fiscal buffers could be:

- Coverage of current expenditure like salaries or pensions, reflects if the government has enough liquidity to pay its short-term liabilities in case of a complete deficit of oil revenues;
- Coverage of additional expenses in the case of lower oil prices or a lower volume of oil exported than the ones estimated in the baseline scenario; the buffer should be capable to finance the government in case of shocks to oil markets

Unfortunately, the government still has to work to increase their fiscal buffers as they are not yet sufficient to support large oil revenue shocks.

The new fiscal policy should be focused on separating the spending from the fluctuations of oil revenues. Thus, new alternative sources of finance should be develop.

Propose Alternative Sources of Finance

Advancement in the non-oil sectors from Iraq seems to be a major step for the achievement of a better economic status. In order to surpass the threatening risks of possible decreases in crude oil prices, the government should focus on the economic sectors that are less dependent on oil and develop strategies to sustain a different approach. Moreover, the contribution of non-oil revenues in the budget preparation in Iraq did not exceed 5% at best during the period 1921-2012. Table x shows the outcome of the general non-oil revenues during the period 2003-2007, which ranged between 1.6 % and 1.7%.

The contribution to the outcome of the general non-oil revenues during the period 2003-2007, Million Dinar could be seen in the table below:

Table 3: Non-oil revenues, 2003-2007 - Million Dinar

Year	2003	2004	2005	2006
Non-oil revenues	257,140	395,839	987,226	2,359,096
The proportion of revenue contribution of oil in the General Budget	98.4	98.80	97.6	95.3
The proportion of revenue contribution in oil sector	1.6	1.2	2.4	4.7

Source: [16]

From the table above, the following data can be concluded

- Weak impact of the contribution of non-oil revenues in Iraq in the financing of the general budget.
- Oil resources are the basis of the General budget and explain the budget's dependence on oil revenues and thus reflect the reality of the Iraqi's economy. The republic's economy depends on the evolution and the disruption of oil production structure, one of the most important economic backwardness attributes.
- The percentage of non-oil revenues' contribution in the budget is very low if compared to both developed and developing countries.

The Iraqi government should promote new economic policies in order to foster the activation of non-income sources. Iraq could create a more secure and stable macroeconomic environment in order to achieve their goals and leave behind the risks stemmed by the possible cut downs in

oil prices. The volatility of oil prices induces unstable conditions for the budget. Iraqi's government can build national strategies to hedge the imbalance in both ends: planning, financial, agriculture, industry, tourism, service ministries, etc.

The first actions should be taken in the taxes' sector.

At the current stage, taxes in Iraq occupy a less important place in terms of revenues generation and the activation of non-oil sources of income tends to support the preparation of the general budget and diversify its resources. The generating tax revenue areas consists of ten forms as follows:[17]

- Drawing the reconstruction of Iraq
- Corporate income tax
- Staff income tax
- Interest income
- Revenues of companies and public institutions on tax
- Fees for services
- Contribution pension deductions
- Max tax
- Taxes and fees
- Personal income tax

Table 4: Estimated revenue: comparison between year 2012 and year 2013; billion dinars

Sources of revenue	2012	2013	Growth rate %	Relative importance %
Oil revenue	94,378.05	111,078.99	17.7	93.11
Tax Incoming Customs	965	1,061.5	10	0.89
Special income tax for individuals	464.05	175	(62.3)	0.15
Income tax for companies	304.678	374	22.8	0.31
Income tax for foreign oil companies	300	300	0	0.25
Staff income tax	116.6	318.015	172.7	0.27
Benefits income	50	50	0	0.04
Transferred from public bodies and state-owned companies	2,591	2,810.1	8.5	2.36
Fees for services	86.75	165.414	90.7	0.14
Taxes and other charges	2,740.770	2,613.644	(4.6)	2.19
Max tax	330	350	6.1	0.29
Total	102,326.898	119,296.663	16.6	100

Source: Created by author

The weak impact on the financing of the general budget can be attributed to the following reasons:

- The current tax system of Iraq was designed to a national economy internal dominated;

- The tax system and the laws of any tax legislation has not received any attention in the community or the Iraqi state institutions;
- Lack of financial laws that define the tax administration in terms of legislation and requirements of compliance with the law clearly;

- The complexity of the tax measures that accompany the process of settling accounts;
- The reluctance of taxpayers to pay taxes and try evasion;
- Weak tax awareness among community members in order to understand the role of taxation in achieving economic and social objectives.

The reasons that led to a weak outcome of the tax contribution rate are supported by the lack of preparation of the general budget for Iraq. In order to address the issues presented above the Iraqi government

should implement reforms in the tax system and promote them until the budget attains required amount of public funding.

Secondly, the role of the production and service sectors should be fostered and the ministries should involve in the development of various sectors apart from those related to oil production. In order to increase the proportion of the proceeds arose from the production and service sector, and thus, their contribution to the GNP, governments should concentrate on Iraq's great wealth, raw materials and their availability.

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