

# **The Need to Establishing An Integrated Macroeconomic and Medium-Term Fiscal Framework for the Iraqi Economy**

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## **1. ABSTRACT**

Though the fact Iraq is preparing and issuing a federal annual budget, on yearly basis, since 2004. Besides, and to some extents, Iraq is also adopting few well acknowledged internationally advanced norms in the structure and preparation of the annual budget. Notwithstanding, the existing practice of preparing the budget, being recurrent and/or investment version, its composition, sectoral allocation of resources, and its implementation path, all are far from reflecting the actual socio-economic development priorities and restructuring requirements of the economy on; national, regional and sectoral level.

The main objective of this short paper is to shed a light on the importance of a functional link between medium-term macroeconomic framework, investment programme and fiscal framework, in preparing and establishing an effective federal budget, and hence, using such a budget as an operational tool to steer the economy towards achieving its development objectives, and priorities in a coordinated manner. A medium-term macroeconomic framework should, however, delineate and quantify the main development objectives reflecting, to greater extent, the actual needs of the society and the strategic goals of the economy, such as; positive real GDP growth, economic diversification, low rate of unemployment, manageable inflation rate, and sectoral development priorities and sectoral allocation of investment/contribution to growth and development, poverty reduction and uplifting the society's wellbeing. These and other objectives are obviously, subject to a number of financial, investments, technical and absorptive capacity constraints. Accordingly, it is imperative, nonetheless, to optimize the state of the macroeconomy given the main objectives and these constraints. Thus, this derived feasible macroeconomic setting, should be used as the main developmental base to structure the country medium-term fiscal and budgetary framework. By doing so, the national economy would achieve, the aimed at, macroeconomic stability –achieving real growth without bottlenecks- and longer term fiscal sustainability.

Furthermore, the paper would attempt to bring together, all significant development pillars in an integrated framework to produce a more developmental oriented federal budget for the Iraqi economy. This would be approached analytically with relevant illustrations.

## **2. INTRODUCTION**

The main objective of this short paper is to shed a light on the importance of a functional link between medium-term macroeconomic framework and fiscal framework, to steer the economy towards achieving its development objectives, in a coordinated manner. A medium-term macroeconomic framework should, however, delineate and quantify the main development objectives, such as; real GDP growth, rate of unemployment, inflation rate, investment requirements, economic and sectoral priorities and sectoral contribution to growth and development, poverty reduction and uplifting the society's wellbeing. These objectives are obviously, subject to a number of financial, investments, technical and capacity constraints. Accordingly, it is imperative, nonetheless, to optimize the state of the macroeconomy given these constraints. Thus, this derived feasible macroeconomic setting, should be used as the main developmental base to structure the country medium-term fiscal and budgetary framework. By doing so, the national economy would achieve, the aimed at, macroeconomic stability –achieving real growth without bottlenecks- and a longer term fiscal sustainability. With this in mind, the stated analytical and methodological illustration, in this paper, would attempt to achieve feasible macro-fiscal integrated approach for more coordinated socio-economic development of the national economy.

### **3. The Public Finance Systems and Medium-Term Macro-Fiscal Framework Linkages:**

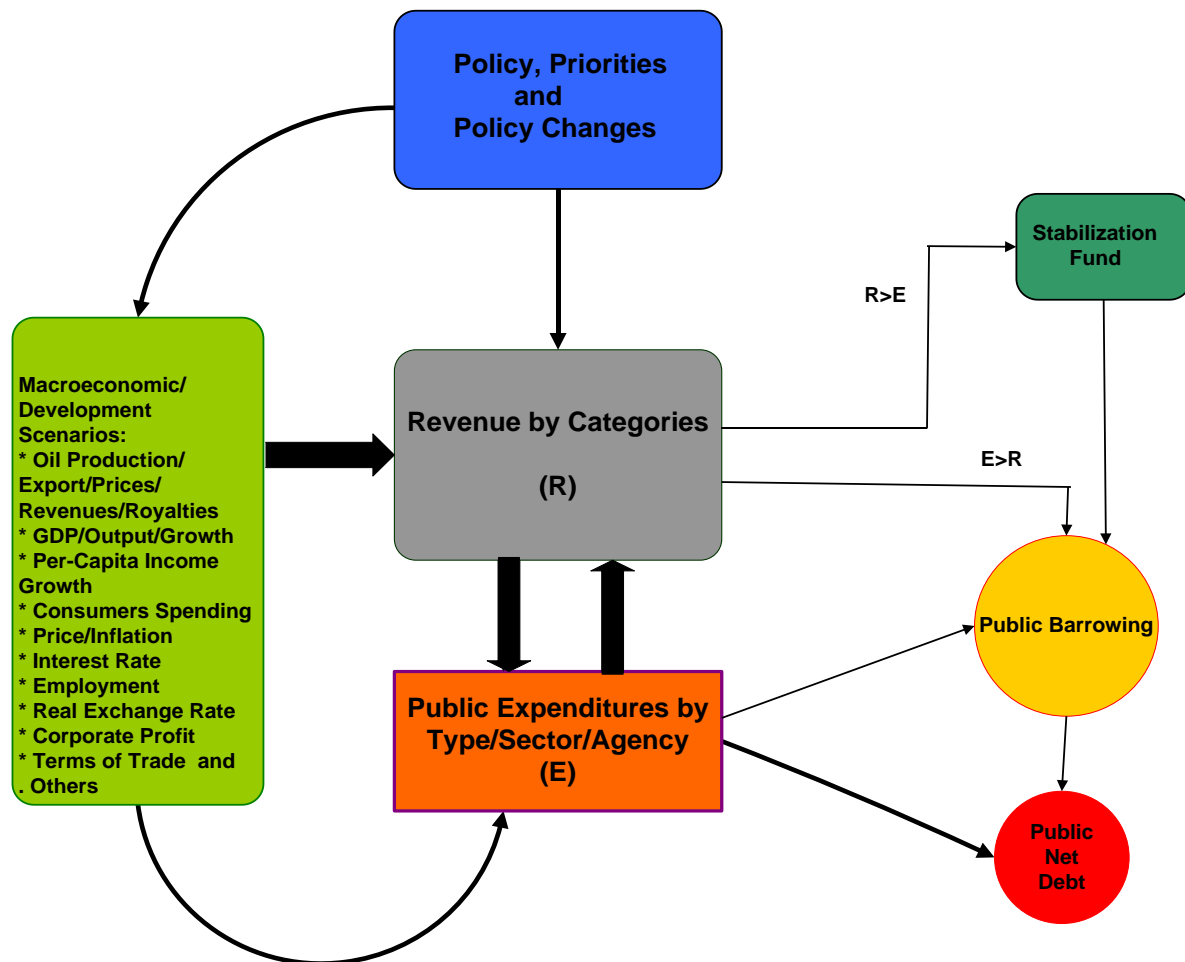
In many developing countries, it is a well known reality that budget preparation and sectoral allocation of government expenditure are carried out without full consideration and adaptation of a structural integrated developmental approach. Besides, revenue forecasts are frequently manipulated and adjusted during the budget preparation process, so that it could be in line, somehow, with the budget spending content and trend. This usually has shed some doubts on the credibility of the official –governmental- carried out revenue and expenditure forecasting and allocation process, and would, by and large, create significant public finance management and budget planning problems, as well as reducing transparency and undermined the importance of the adopted, an economically viable, fiscal policy.

It is a well-known fact that government expenditure and revenue forecasting intervention, is, ultimately, resulting of a major deviation of the budget estimates and the technically driven forecasting. Notwithstanding, the technical practice of budget preparation and forecasting of its components and content is differ across countries, reflecting a mix of factors, such as; skills level, technical capability, data availability, political constellations and administrative environment and needs. Thus, macroeconomic framework setting, outlook and estimation of the main macroeconomic variables have an influence on the reliability of revenues forecasting and the priorities of expenditures allocation of the central government budget.

However, revenue forecasting and sectoral allocation of expenditure should be attempted as an integral part of a comprehensive public finance system that to be established and followed in the economy.

Developing a macro-fiscal forecasting model with the capacity to generate and update a medium term fiscal framework including; revenue forecasting and expenditure forecasting and allocations patter, should be formed within a comprehensive understanding of interactions within a public finance system. Figure -1- illustrates the public finance systems interactions.

**Figure -1- Public Finance Schematic Structure**



The starting point in public finance system can be summarized here, with the key elements being the link between economic variables and determinants on one hand and oil and gas revenues, taxes and other revenues components on the other hand. The system will allow projection to be conducted for medium term for all the key public finance indicators used by the ministry of finance (MOF) in Iraq, under a range of alternative economic and fiscal policy scenarios. A key element in this analysis, for revenue forecasting process, will be the estimation of the sensitivity of oil revenue to the international economic situation, world crude oil price, Iraq oil/ gas production/export and corporate taxes, Sensitivity of tax revenues to their key economic determinants (e.g. income tax to earnings and employment), which will require a comprehensive capacity development efforts and

sensible use of the available and related models for the country. This is in addition to introducing new taxes such as GST (or VAT). With that in mind, building, improving and implementing realistic, reliable and manageable macroeconomic- sectoral-fiscal modelling links to determine forward expenditures requirements based on existing and proposed policies and investments; the results of which could then be combined with the results from the revenue forecasting model to produce estimates of key fiscal indicators, and hence generates the aimed at Iraq Medium Term Fiscal Framework (IQMTFF). However, establishing a MTFF for the Iraqi economy, as it, may be, the case at present to prepare a three year budget, is a quite viable setting and an important instrument to achieve accountability, transparency, balanced resource allocations, setting-up priorities for implementation and creating good economic governance. MTFF will, undoubtedly, create an effective procedures for annual budget preparation process, expenditure priority setting, create and mobilize resources envelop, sectoral/project investment allocation strategy, balanced district-wise/urban-rural, and community expenditures coverage, assist in establishing an effective monitoring and evaluation system for the public expenditures and their outcomes, as well as assessing the impacts of the budget cycle and contents on the socio-economic wellbeing of the population and the economy at large. In addition, the MTFF will ensure budget consistency, integration, coordination, partnership, viable implementation and populace support.

By and large, the adoption of an effective and well structured MTFF for the national economy offers **numerous benefits**, such as:

- promoting economic growth, stability and poverty reduction,
- criteria based framework for setting national expenditure,
- provision of effective and transparent tools for formulating, assessing, and implementing fiscal policy,
- creating a framework for setting an integrated national revenue and budgetary resources envelop and forecasting, including national private sector, foreign direct investment (FDI) and donors contributions,
- provision of a good platform to ensure a high level of intergenerational fair resources allocation and equity,
- structured platform for greater funding certainty to agencies, and greater clarity of policy at a program and whole-of public expenditures level, and
- providing a good basis to establish and steer an effective accountability framework and an outputs/outcomes focused budgeting framework to improve public sector efficiency.

Macroeconomic framework and revenue forecasts are widely regarded as key elements for the design and execution of sound fiscal policies. Forecasts should be realistic and have a minimum margin of error; otherwise, large forecast errors can create significant budget and fiscal management problems, such as budget deficit and hindering the spending policy, and imposing a serious obstacle to the development of a meaningful medium-term budget framework. Moreover, unrealistic budget framework settings are inconsistent with basic principles of

transparency and reduce accountability of fiscal operations. In developing countries, forecasting errors cannot be avoided entirely and in many cases revenue estimates have systematically deviated from actually realized revenue.

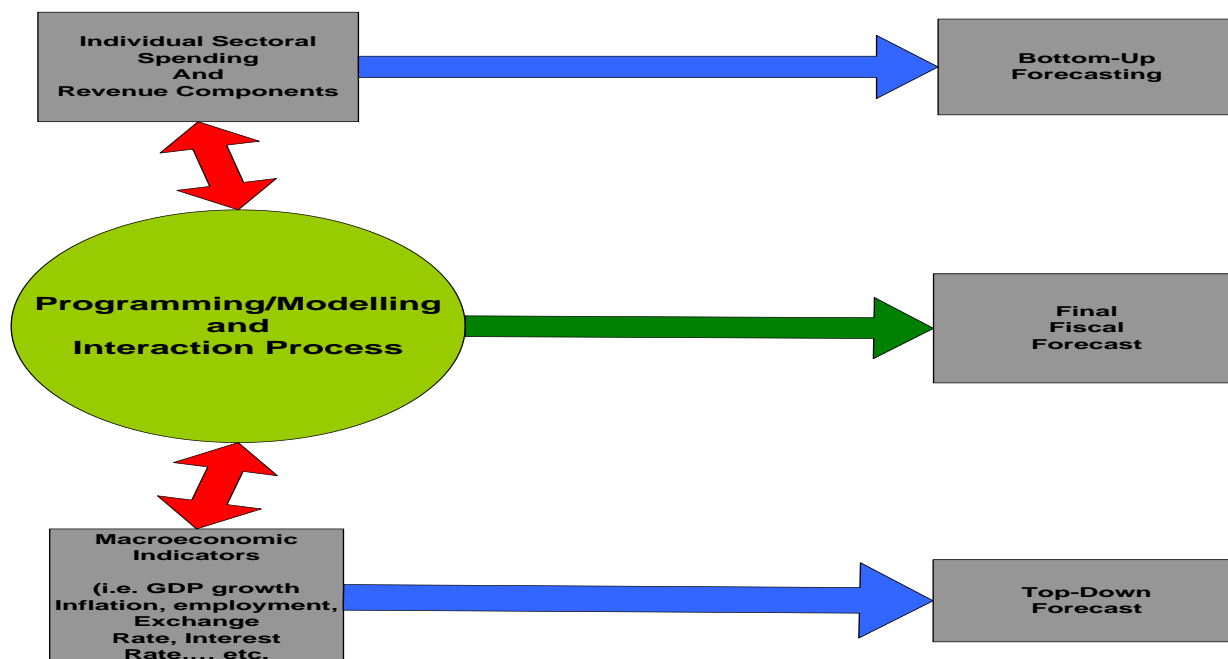
**Notwithstanding, the principle of fiscal (public finances) sustainability** requires public spending to be covered by public revenue over the medium-term (around three to four years). A key element of prudent fiscal policy is that it helps create the conditions for maximising sustainable economic growth. More importantly, it can contribute to national saving, facilitate a lower interest rate environment, promote steady and sustainable effective demand growth, provide a reasonable degree of stability and predictability of policy, and provide a fundamental base for efficient taxation and spending systems. While on the macroeconomic development stability aspects, **the principle of stable economic development and poverty reduction** engages the ideas that the authority should tax where it hurts the least and spend where it benefits the most, and that sound economic strategies are adopted by the appropriate authority to reduce poverty, achieving growth with low inflation and reduced unemployment rates.

#### **4. The Macroeconomic Framework and Fiscal Management Interactions:**

The Macroeconomic Fiscal Framework is the top-down approach (as opposed to the bottom-up approach) in establishing resource ceilings as well as fiscal and macroeconomic targets. The top-down approach calculates macro-fiscal aggregates and splits them into their components on the basis of a set of assumptions and priorities. While bottom-up models specify revenue by components and expenditure by sector/items separately and aggregates them up, this can either be done by centrally determined models or through the piecemeal budget process. The top-down and bottom-up approaches will be different. And the assumptions of each forecast and approach will affect the other, through a process of iterations, these assumptions can be brought together to produce a final coordinated forecast. It should be, however, noted that the integration of medium term macroeconomic and fiscal/revenue forecasts and frameworks is dependent on an effective System of National Accounts (SNA) and availability of the required statistical data, using and implementing an integrated modelling framework.

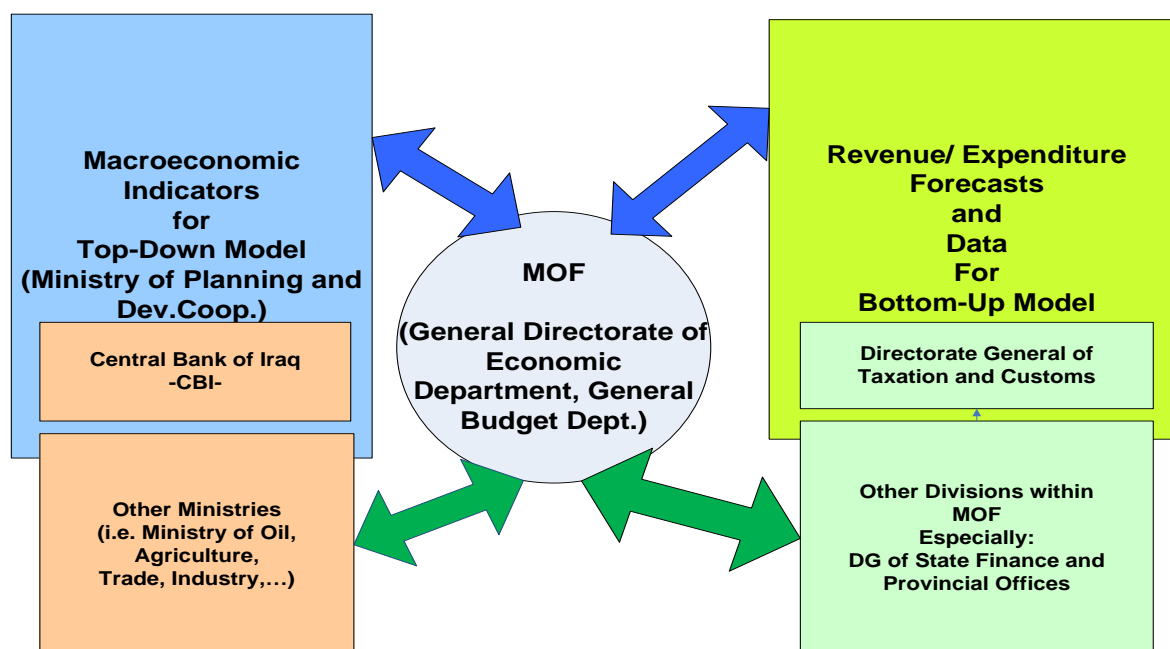
Below are further details of these macro-fiscal interrelationships and interactions, in any optimal development setting and context.

#### **Figure -2- Fiscal Forecasting Systematic Approach**



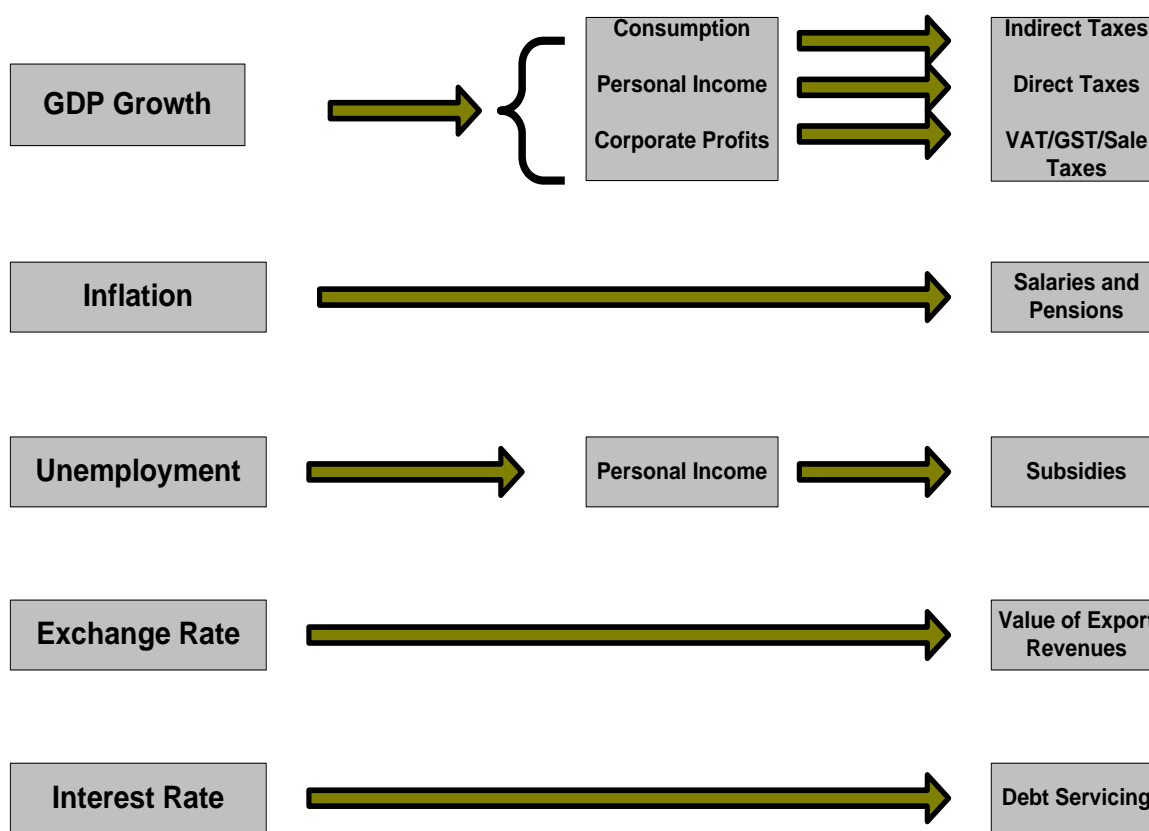
It is envisaged that the Economic Department, the General Directorates of Taxation, Customs, and State Budget at the Ministry of Finance will carry out the top down fiscal forecast and the centrally determined bottom up revenue and spending forecasting approach.

**Figure -3- Proposed Fiscal Forecasting Scheme for the Iraqi Economy**



It is a well established fact that macroeconomic policy affects fiscal policy<sup>1</sup>. The figure below gives examples of how macroeconomic indicators, such as GDP growth, inflation, unemployment, foreign exchange and interest rates influence fiscal policy and forecasts.

**Figure -4- Macroeconomic Policy and How It Affects The Fiscal Policy and Forecasts**



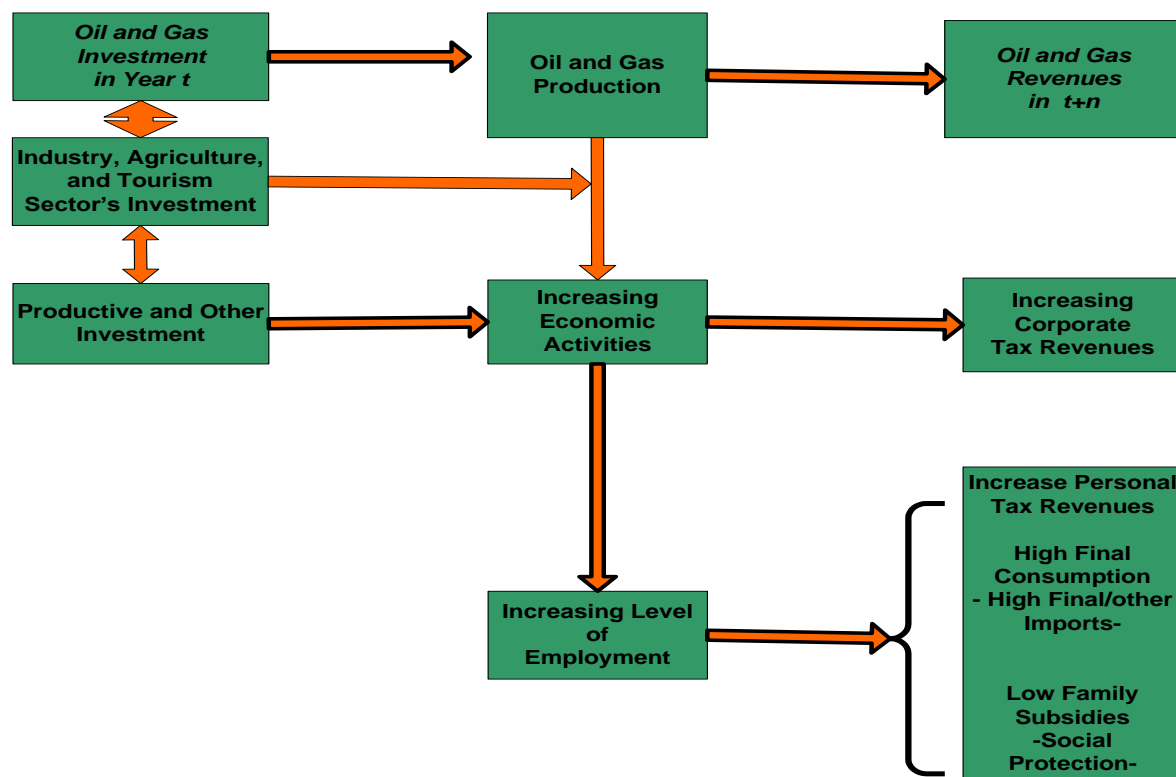
In turn, fiscal policy affects macroeconomic and fiscal forecasts<sup>2</sup>, as shown in the figure -5-.

<sup>1</sup> To illustrate such an impact, the following analytical systems would summaries this aspects in clear manner:  $GDP = C + G + I + E - M$ , with  $(C+G+I)$  is the domestic demand and  $I = I^p + I^g$ , while;  $GNDI = GDP + Y_f + TR_f$ , where; GNDI is gross national disposable income,  $Y_f$  is net factor income (labour, capital) from/to abroad and  $TR_f$  is the net transfers.  $CAB = E - M + Y_f + TR_f$ , Where CAB is the current account balance. Accordingly,  $GNDI = GDP + Y_f + TR_f = C + G + I + E - M + Y_f + TR_f$ , hence:  $GNDI = C + G + I + CAB$ . With the rearranging the above;  $CAB = GNDI - (C+G+I)$ , this implies that if  $GNDI < (C+G+I)$  the  $CAB < 0$ . Again,  $CAB = GNDI - (C+G+I) = [Y^p + Y^g] - [(C + G) - (I^p + I^g)] = [Y^p - C - I^p] + [Y^g - G - I^g]$  which is  $[S^p - I^p] + [S^g - I^g]$ . Hence;  $CAB = [S^p - I^p] + [S^g - I^g]$  and therefore  $CAB = \text{Private sector Gap} + \text{Public (government) Sector Gap}$ .

<sup>2</sup> For instance, fiscal policy impacting the macroeconomic , both; on demand and supply sides. Taxation would affect domestic demand  $(C+G+I)$  in negative direction, the effect of increase in government expenditure on  $(C+G+I)$  is positive. While the impact



**Figure -5- Fiscal and Government Policy Affects Macroeconomic and Fiscal Forecasts**



Macroeconomic and Fiscal framework provides a consistency check and interlink between different sectors (and variables) such as the real economy, monetary, fiscal and external sectors. The macro-fiscal framework is a top-down approach to establishing resources ceilings/revenue as well as fiscal and macroeconomic targets. The **top-down** approach calculates macro-fiscal aggregates and splits them in their components on the basis of a set of assumptions. The tools that can be used will include: i) integrated macroeconomic models, ii) fiscal forecasting models and iii) poverty and other impact models. The **bottom-up** models specify revenue and expenditure items separately and aggregate them up. This can either be done by centrally determined and structured models or through the budget/revenue process.

of taxation on CAB and BoPs, would narrow the fiscal deficit, reducing domestic demand which in turns strengthen the CAB. While fiscal policy affecting BoPs through the impact on private sector income and demand. On CAB, where demand and expenditures would have to be reduced and hence, requires tighter fiscal and monetary policies and exchange rate regime. On the supply side, the impact of fiscal policy on macroeconomic setting can be easily identified. Taxes and government spending affect the supply in the economy, i.e. (X+M). These, by and large, affect the labour/employment decisions, saving/consumption choices, investment decisions and directions, as well as overall economic and development perspectives. Hence, if  $(S^p - I^p) > 0$  and  $(S^b - I^b) < 0$ ,  $CAB < 0$  if  $[(S^b - I^b) > (S^p - I^p)]$ , if  $(S^p - I^p) < 0$  and  $(S^b - I^b) < 0$ ,  $CAB < 0$  finally, if  $(S^p - I^p) < 0$  and  $(S^b - I^b) < 0$ ,  $CAB < 0$  if the absolute value  $[(S^p - I^p) > (S^b - I^b)]$ .

As it is mentioned elsewhere, the top-down and bottom-up approaches will be different, and the assumptions of each forecast will affect the other, through a process of iterations, these assumptions can be brought together to produce a fully integrated macro-fiscal-revenue forecast.

However, the integrated macroeconomic framework allows for considerable flexibility in adapting parts of the framework to emphasize particular fiscal issues in the medium term. Hence, the forecast cycle will be synchronized with the budget preparation cycle, but will be sufficiently flexible to provide regular updates on macro and fiscal performance for the accounts, cash management and budget departments, during budget execution.

That said, comprehensive integrated macroeconomic and fiscal policy analysis tools are used to facilitate the forecasting processes and impact analysis on various dimensions. This is another reason why an integrated modelling framework approach is needed for the Iraqi economy.

## **5. MTFF Activities, Tasks and Methodologies on Line-Ministries Level**

It is imperative that the process of embarking on MTFF for the economy, should also aimed at supporting the line-ministries (LMS) in developing and enhancing the LMS technical capacity in the planning of sector policies and in budgetary management, in order to ensure that the sectoral strategy's objectives and programmes are translated in the sectoral budget and help the ministries make necessary budgetary projections for current and future reforms'. This, however, means developing, adopting, widening and deepening the MTFF/MTEF at the Ministry level. This, however, can be achieved through:

- rolling out policy-driven budget processes to the ministry;
- developing institutional processes and arrangements, within the ministry;
- procedure enhancement through promoting transparency of the budget and resources of the sector reform; and,
- building capacities in ministry to enable it deepening the MTFF/MTEF process, implement effective internal controls, and manage resources to achieve results in line with the devised policies and strategies of the line ministry.

The following **activities** would be considered to support the line ministries, in their MTFF/MTEF efforts::

- roll-out of the MTFF/MTEF process in the Ministry
- deepening and Institutionalising the MTFF/MTEF process within the Ministry
- strengthening capacity in medium term strategic planning and determining intra-sectoral policy priorities
- strengthening internal organisation of fiscal management functions of the line Ministry
- integration of projects/programmes planning with budget formulation.

To handle the above activities, the following **undertakings** have to be introduced:

1. developing annual and medium term budget frameworks that better reflect the linkage between the sector's strategic framework and resource allocations
2. strengthening Budget Management Committee (BMC) and establishing Budget Working Group (BWG) in each line Ministry

### **The Aspects of MTFF/MTEF on LMS**

The main aspects and features are:

- Aggregate and sector/sub-sector targets over the medium term
- Institutional mechanisms that support a medium term policy based perspective in making the allocation and its trade-off
- Forward estimates of existing policy/indicative allocation
- Sector strategies delineation and setting
- Top-down and bottom-up coordination and objective harmonization
- Focus on performance and achievement
- Enhancing forecasting and predictability

### **Sectoral MTFF/MTEF Approach and Allocation of Resources to Priorities**

- A well-structured and thought of vision
- Sectoral (Ministerial) strategies in place
- Political leadership and determination
- Comprehensive coverage of the all issues within the annual budget process
- Determining a realistic sectoral ceiling and the role of such a ceiling
- Information on the performance of existing policies and data on various implementation aspects
- Systems for monitoring and evaluation with defined and quantified appropriate indicators

## **6. Methodology for Practically Approaching and Handling the Above Activities and Tasks**

The line ministry (LMS), would be assessed in a two-step process. First a checklist for determining the institutional arrangements and systems capability for effective designing and implementing a sector-wise MTFF; and second, business process reviews of key PFM processes within the line ministries in order to identify prevailed strengths and gaps that may support and/or hindering designing and implementing a MTFF within any of the line ministries and its various departments.

- An extensive review of Financial Management Programme (FMP) and associated documentation, together with fact-finding interviews to establish further proceedings
  - Interviews with senior Ministries personnel and General Budget Department (GBD) to ascertain conditions of PFM conditions and budgetary process in Ministry.
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- Detailed diagnostic studies of each Ministry would be carried out regarding budgeting working process and training need assessment analysis (TNA) to assess the current scope and quality of preparation of medium term strategic planning and public investment management. A diagnostic report described issues and a work plan to integrate medium term planning with medium term budgeting and public investment management, as well as describing training needs of the Ministry in preparing medium term strategic and business plans, project feasibility reports and financial-economic-social cost benefit analysis and a methodology for results-based monitoring, would be prepared.
  - It is of paramount importance to building capacities for better sector-specific program design, project preparation and monitoring of capital investment projects in each line ministry, as well as ex-post project evaluation with respect to how they contribute to the achievement of sectorial policies, priorities and outcomes
  - There are well established procedures and formats for project preparation and approval involving all relevant stakeholders as outlined by the Ministry of Planning and Development Cooperation (MOPDC). Project proposals are prepared by departments/agencies in the line ministry. The Planning wings of the said line Ministry, if and when in existence, initially appraise projects, which are subsequently evaluated and forwarded to the MOPDC, if the total project cost exceeds certain specified limit.
  - Within the line Ministry there is urgent need to create a central focus on project conceptualization. Ideas and concepts for projects/ programmes originate from many sources such as the line ministry, donors, on-going project managers, implementing divisions/ agencies etc. Without a strategic planning and thinking process, projects are driven by force of personality of proponents, funding possibility (by donors) and/or political economy, to the detriment of allocative efficiency.
  - Inadequate staff capacity and human resource management issues would, undoubtedly, impacted the ability of the line Ministries and their related divisions to appraise large and complex projects. Project appraisal should be carried out in each line Ministry planning wing, which may resulted in appraisals being performed by in-house experts and/or external consultants. Planning wing officials, in this case, may generally only focus on routine functions or tasks, and many projects are put up to sector or programming division for approval that have not been adequately appraised due to the lack of skilled staff.
  - However, result-based project evaluation basically implies an impact analysis of a

project in terms of exact outputs and outcomes. A results-based monitoring and evaluation system will be a valuable management tool that will help internal performance management and to monitoring and reporting of output and outcomes against targets in the Sector MTFF. Efforts will be directed towards assisting each line Ministry in creating such an effective M&E systems.

- Extensive training would be provided to the line Ministries and its related departments and divisions' staff, in this area and other important areas of MTFF/MTEF and fiscal planning, at large. Interactions with the line Ministry and its different divisions and counterparts point, will be an important means to identify further areas for training intervention. These, by and large, would cover reviewing and strengthening internal organization to ensure integrated and better coordinated budget and financial management functions at the line Ministry level; that include planning, budgeting, accounting, reporting, and monitoring and evaluation of budget implementation, improving collection, consolidation and analysis of financial management data, besides, building required capacities for evaluating and monitoring budget implementation.
- Moreover, the analysis will be based, amongst other things, on a combination of desk work and interaction with the line Ministries and their various divisions and constituencies, by both MOF and MOPDC.

Below two charts depicting the process of preparing the MTFF and the top-down/bottom-up interactions, between the centre authority and the line ministries.

**Figure -6- Overview of a MTFF**

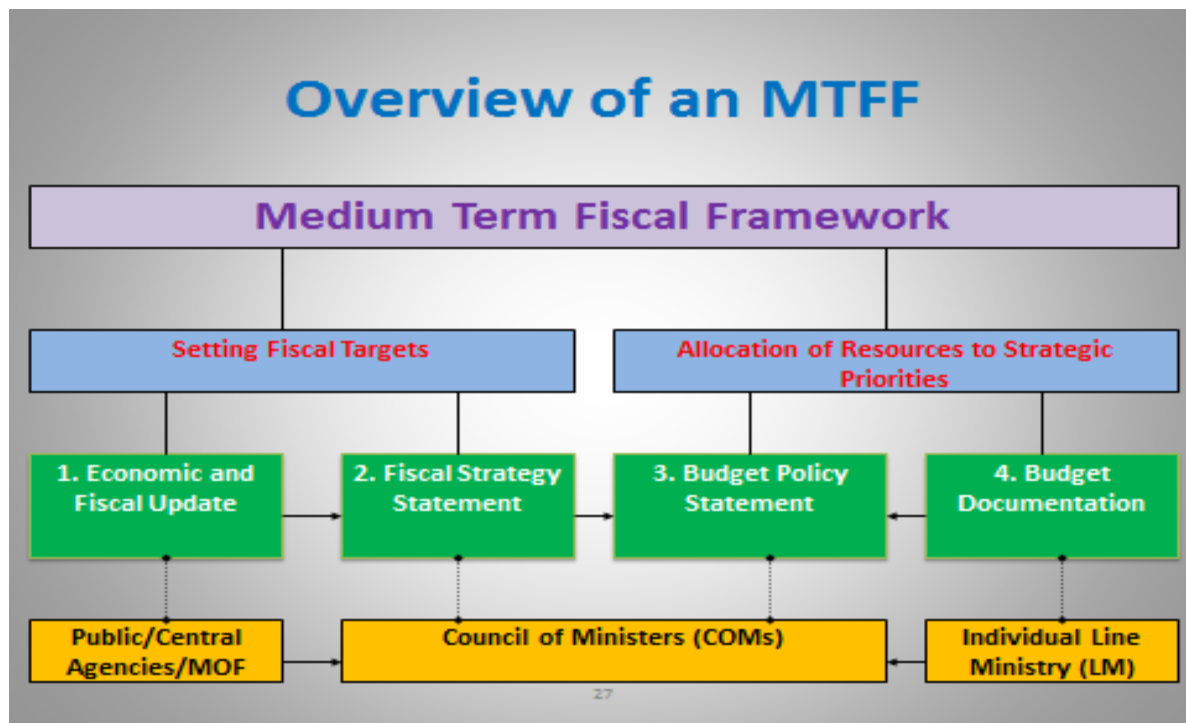
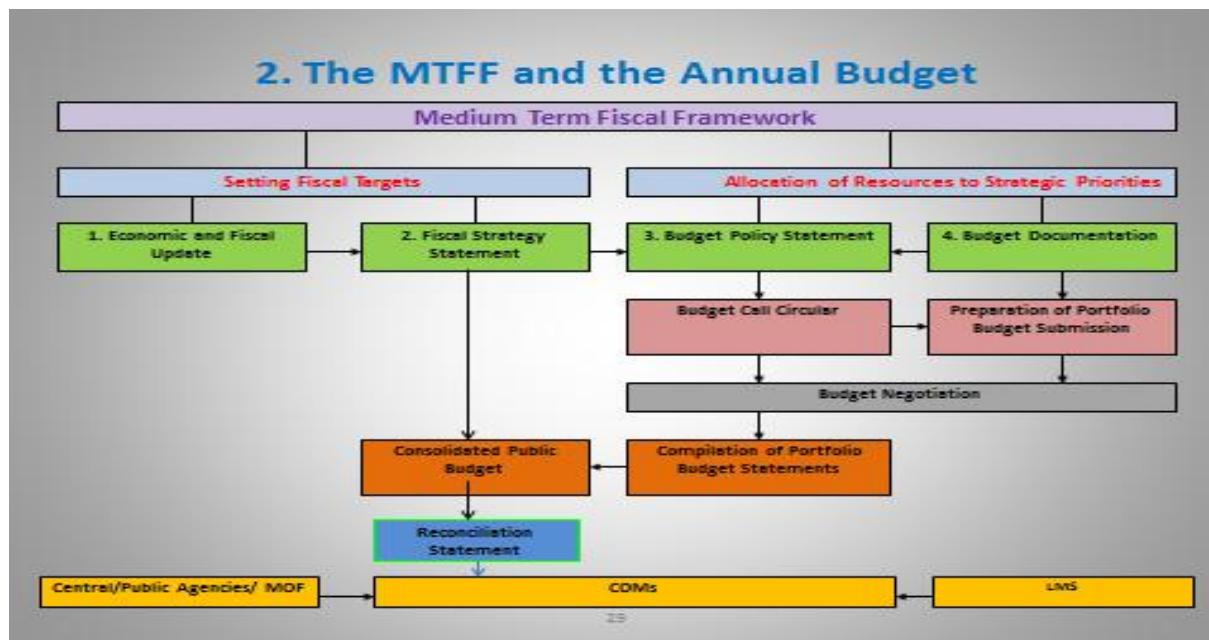


Figure -7- The MTFF and the Annual Budget



## CONCLUDING REMARKS

Iraq could be considered as a unique example for macroeconomic and fiscal management irrationality, now a days. The economy has endowed and characterized with vast economic resources, especially, crude oil and gas and with a well-educated and skilled manpower, yet the economy and the people of Iraq are suffering, mostly, on all dimensions and life aspects. Accordingly, the main features characterizing Iraq at present, for instance, are: high rate of poverty, staggering level of unemployment and among the educated/skilled and active labour force, debilitated infrastructure and on all components and dimensions, lack of utilities and public services, incredible low productivity, lack of domestic supply in general and of the basic goods and commodities in particular, high trade openness rendered declining of non-oil trade balance which, undoubtedly, has exerted a greater pressure on the country balance of payments, astonishingly deep regional disparities and imbalances, to mention but a few. This is the actual present conditions of the Iraqi economy, despite the availability of ample revenues and generous funds that allocated for both; the annual and the medium term rolling over budgets. These weakness and development drawbacks, by and large, can be attributed, amongst others, to the prevailed public finance mismanagement, absence of a realistic and proactive socio-economic development strategic vision based on, well-articulated, actual needs and priorities, and, apparently, lack of effective, realistic and constructive interactive, interrelated and integrated economic development and fiscal management approach and policy alternatives. Notwithstanding, the stipulated ideas in this paper could be considered as a modest attempt in contribution, methodologically and analytically, towards establishing, in an objective manner, the right and applicable procedures in order to handling Iraqi existing development issues and fiscal balancing, in more systematic orderly process, and without bottlenecks, inconsistencies and undesirable economic waste.

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