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Papers on the Political Economy of Public Finance Management

Public Finance Management as a Driver of Instability in KRG. By Mohammed Hussein*

Introduction

The Kurdistan Regional Government (KRG) stepped into 2022 with not enough cash to pay the December salaries of civil servants and pensioners; delayed to January 2022. Now, at mid-March, civil servants are going on strike and taking to the streets of Sulaymaniah to demand their February salaries.

The evidence on the ground shows that the government developed a clear set of reform policies, and a special law was passed to reform public finance management (PFM) that has been followed in recent years. Nevertheless, there is no evidence that these reforms were implemented. The government did not demonstrate its following of better practices although there have been an observable opportunity and available political and institutional capacity to do much better. As a result, the government is still struggling to meet growing demands for services and allocating resources according to policy priorities.[1]

This article aims at evaluating the KRG's PFM in 2021 and estimating the economic consequences of neglecting the reform of law and policy.

Conventional objectives of PFM are known as aggregate fiscal management (making sure not to accumulate too much debts); maximizing the mobilization of resources and allocating them according to policy priorities; ensuring the value of money in services-delivery with the best combination of efficiency, effectiveness, and economy; and finally financial governance that has transparency and accountability by putting rules, procedures, and practices in place to achieve the entire four

[1] The KRG's finance ministry announced on its website a reform agenda that includes reducing debts, diversifying the economy, and improving business enabling environment; https://gov.krd/english/the-governments-mission/reforms/

goals (Parry). Each government has a different strategy in prioritizing any of these objectives. However, successful PFM basically pursues all of them simultaneously. Thus, the article assesses the KRG's PFM from the perspective of the aforementioned objectives.

The Setting

The last time that the KRG had a budget law was in 2013. The government has been struggling with continuous financial and economic crises since 2014, when the ISIS war started, crude oil price crashed, and the region's national budget-share was cut off by the Federal Government of Iraq (FGI) as a result of their oil disputes. Therefore, the KRG's PMF is faced with a set of political, security, and economic challenges. To tackle the challenges, the region's leadership has been advised to reform the PFM by several international organizations such as the World Bank, USAID, and EU. It was also offered technical support to do so (World Bank).

The Kurdistan Parliament passed Law Number 2 (2020) to reform the region's payroll and revenue streams on January 16, 2020 (Kurdistan Parliament). The law mandated the government to reduce wasteful expenditures, unify pensioners' directorates, resume pensioners' fund and financial entitlements. However, the law has neither been fully implemented nor has it led to any tangible results due to political constrains. The KRG still struggles with the same challenges as it has prior to 2020.

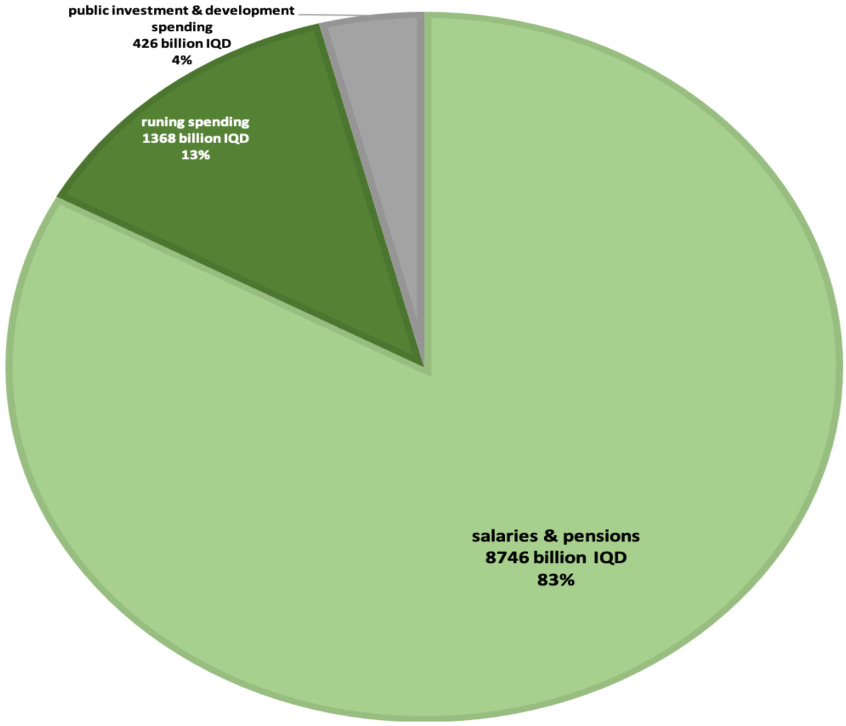
As in December 2021, ghost employees still take a large portion of the payroll funds, some revenue sources are controlled by deep state power networks of the ruling parties. Border ports such as Peshkhabir and SairanBand are controlled by networks belonging to Masud Barzani's Kurdistan Democrats Party (KDP) and Bafel Talabani's Patriotic Union of Kurdistan (PUK). By June 2021, the public debt of Kurdistan Region of Iraq (KRI) increased to $31.6, unfinanced public expenditures are estimated at 300 billion Iraqi Dinar (IQD), about $205 million. Also, the government was not able to pay December salaries till January 2022 due to lack of liquidity. Even if the crude oil price is bounding and COVID-19 restrictions on economic activities are relaxed, the fiscal situation still poses many threats to the stability of the region. The World Bank projected Iraq's GDP growth (including KRI) at 2.6% in 2021 and over 6% in 2022-2023, but it has pointed out that "Nevertheless, without accelerated economic reform, unforeseen domestic and fiscal risks could cause reverses." (World Bank)

The pitfalls of the KRG's PFM played out in many areas, posing multiple political and security challenges. Civil servants' protests for unpaid salaries and increasing public debts are the most reported consequences. Moreover, less reported but most effective is the underfunded infrastructure. The fiscal trend has reduced investment and development spending under pressures of bloated payroll and operational expenditures. The payroll took 83% of the region's revenues in 2021. Only 4% of the total government spending was allocated to infrastructure and development projects as Figure 1 demonstrates. Public debt rose to $31.64 billion (Zhyan News Network), which is more than 119% of the region's GDP[2].

Contrary to the frequent announcements made by successive governments, the economy is still far from being diversified as crude oil revenues and transfers from FGI comprise 64% of total public revenues as Figure 1 demonstrates. Thus, the PFM inform policy makers for immediate reform-actions.

[2] The KRG's GDP was estimated at $26.5 Billion in 2016; there is no annual GDP figure in the region. The debt to GDP ratio is based on the total debt in 2021/ 2016 GDP. ($31.64/26.5 (total debt/GDP). The calculation does not account for inflation and the new foreign exchange rate, in which the Iraq's Dinar is deprecated by more than 23%.

Figure 1: The KRG's total spending in 2021



Source: The figures are not verified by any formal institutions in KRG. They are collected from members of Kurdistan Parliament's finance and natural-resources committees, two employees at the finance ministry. They show the trend rather than deep econometric analysis.[3] They are unlikely that they were updated on a regular basis. The KRG sometimes gets private firms to finance certain development projects in exchange of awarding them certain services or construction contracts. The costs of these privately funded projects are not counted in these data

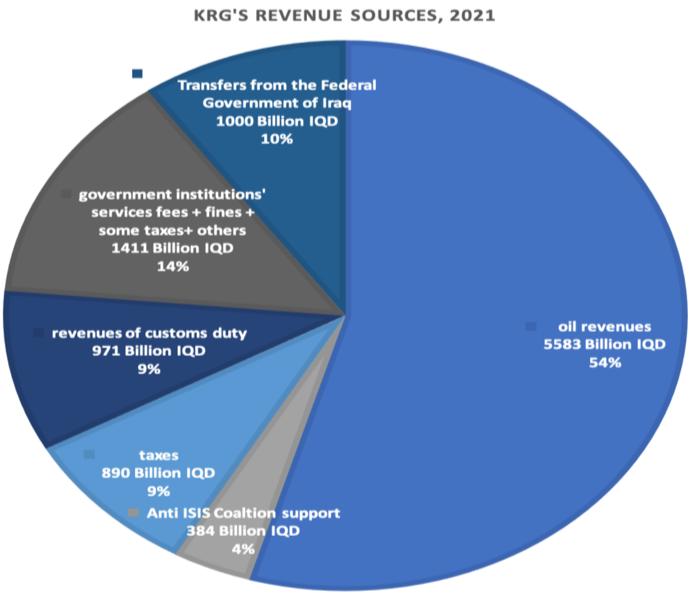
Fiscal policy, which is a clear outcome of the ruling elites' short-term gains, has led to underfunded infrastructure but extremely bloated

[3] The KRG does not publish monthly/annual financial reports. Kurdistan parliament's committees and other public institutions have no detailed reports on the region's total revenues and spending. No media outlets and any financial organization have published complete reports on the region's spending and revenues. Deloitte's reports on oil and gas sector are good to show oil and gas sector revenues in the first half of 2021, but the rest of the revenues are not reported by the government institutions.

payroll. Nearly one fifth of the region's population (about 1.2 million people) is on the public payroll. That is certainly at the expense of development projects and infrastructure investment. For instance, a road construction project (between Sulaymaniah and Kalar) started in 2012 but still not completed due to lack of finance. Only 56% of the project is completed as promised funds have not been delivered (Radio Deng).

On the revenue side, the KRG still wastes huge amount of resources on poor management and illicit activities. The KRG's revenue streams including, but not limited to, independent oil sales, taxes on goods and services, fees and fines, property income, monthly transfer from FGI, customs duty, and financial support for the Peshamrga from Anti-ISIS Coalition, as Figure 2 demonstrates:

Figure 2: KRG's total revenues in 2021



Source: The KRG's oil revenue for the first half of 2021 is taken form Deloitte reports. The other figures are not verified by formal institutions of KRG. They are collected based on interviews with members of Kurdistan Parliament's finance and natural resources committees, two employees at the KRG's finance ministry, and several employees in the border ports of KRI. The figures show the trend rather than any econometric analysis. They are taken from various institutions and it is unlikely that they are updated on a regular basis. Revenue calculation does not include any forward oil sale that the KRG usually does due to lack of formal data. It probably is underreported in the government's total net oil revenues. To have a unified monetary unit, revenues in USD are converted to IQD based on the official exchange rate at $1=1460 IQD, which is very close to the market exchange rate that is still about $1=1480.

Evaluating the KRG's PFM in 2021

The KRG's 2021 PFM is a good indicator to assess the region's leaders' commitment towards their declared reform agenda although the whole economy is yet to recover from COVID-19 implications and the oil price downturn in 2020. On its website, the KRG's ministry of finance and economy announced an ambitious reform agenda to reduce public debt, encourage investment, and diversify the economy. It also aims to develop key job-creating sectors such as industry, agriculture and tourism in addition to improving the business enabling environment (Kurdistan Regional Government). The government's 2021 spending and revenue-management shows no political commitment towards these goals. No public debt was reduced and no payroll reform was properly implemented. Although it is not realistic to expect fixing the region's fiscal issues in one year, but the 2021 PFM (which is aligned with the region's fiscal trend over the past 19 years) shows how the leadership approached the challenges from the perspective of the conventional objectives of PFM.

First, starting from aggregate fiscal management, the KRG's debt management tells how the government's aggregate fiscal discipline is poorly managed. The increased oil price in 2021 created expectations among Kurdistan's citizens for gradually reducing debts; though by the end of the year more debts were accumulated especially arrears to the private power producing companies which increased to almost $5 billion (PORTER).

The KRI's debt to GDP ratio is about 119%[4]. There are no official reports and data on debts, that are mostly internal, including $5 billion of the private power producing companies, about $12 billion of unpaid salaries of civil servants and pensioners (over the past 7 years), $4 billions of local banks. The rest are financial dues of local contractors, international oil companies, and oil traders.

The burden will be high on the future generations. Every baby born today in the KRI owes more than $5273 (equal to 7.6 million IQD) in the KRG's debts. Additionally, the government, again, rolled back in paying December salaries due to lack of liquidity[5]. Studies show that in emerging markets the threshold of debt to GDP ratio should not exceed 64%. Any percentage point higher than this threshold would lead to a loss in annual real growth by 2 percentage points (Mehmet Caner).

Second, another indicator to assess the KRG's PFM in 2021 is the way the public resources are allocated to deliver services and address the KRI's overall development deficit. The 2021 data shows that 426 billion, of approximately 11 trillion IQD (only 4%), of public spending is allocated to infrastructure and development projects. This allocation cannot help lifting the economy out of its structural imbalances. Furthermore, it would not help improve the basic infrastructure needed to develop the region's business enabling environment.

The fiscal trend did not support, but rather contradicts, the government's reform agenda for diversifying the economy and making the private sector create jobs. The policy on the ground as well as the reform agenda needs a sound business enabling environment and supportive infrastructure to attract investments. It requires spending more on the underfunded infrastructure rather than the bloated payroll. It is also one of the reasons that led to the bloated payroll since the private

[4] The KRG's debts reached $31.637 billion by June 2021. The debt to GDP ratio calculation is based on dividing this debt by the region's estimated $26.5 billion GDP. Although there is no regular GDP counting in KRG and the figure dates back to 2016. https://zhyan.co/En/news.aspx?id=1429&mapid=1

[5] The per capita debt is based on dividing all the KRG's $31.64 billion debts on the region's 6 million population.

job market does not afford enough opportunity for youth. The government had to absorb unemployed youth by offering public jobs.

Third, ensuring the value of money in service delivery is another area where the KRG's PFM performance should be examined. One way to see how the KRG's services are delivered is examining the government's policy for outsourcing some services. The government has more than 800 thousand employees on its payroll, but it hired an international accounting firm, Deloitte, to produce financial reports on its oil sector. Of this number on the payroll, more than 300 thousand are armed men (including members of Peshamrga, police, and other types of security forces,) but the government has hired various private security companies to protect oil fields and facilities.

In the financial sector, similar to the rest of Iraq, the KRI's public banks deliver no digital services to better meet consumers' expectations and needs. The economy is still heavily cash-based, and most of the transactions are taking place through money transfer offices in the informal market.

Finally, with the above-mentioned issues, not surprisingly, the KRG has not done well in term of financial governance. No statistical data are available on the government's public spending and revenues. It has been 8 years during which the government functions without a budget law. Neither the Kurdistan parliament nor Kurdistan's Board of Auditing receive data or statistical reports on the government's total spending and revenues.

Additionally, the government has no rules, procedures, and practices to ensure transparency and accountability that could help achieving the entire PFM objectives. It has no published data on the whole government's revenues and spending; access to information is very poor even compared to what FGI has provided. For instance, the FGI's ministry of finance regularly publishes basic statistical reports on its revenues, expenditures, and allocations. However, the KRG has never published any similar report.

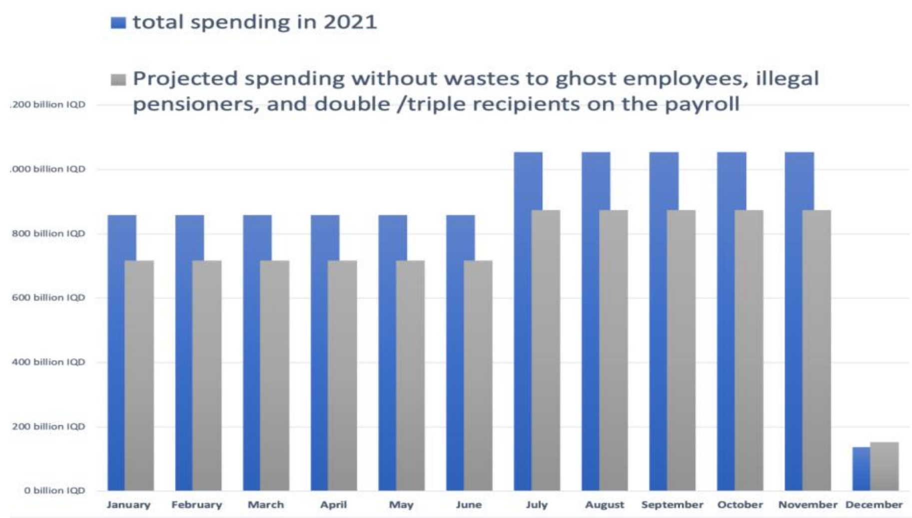
Good PFM requires some level of transparency and accountability more than what KRG has afforded. It needs real public access to key fiscal information on different aspects of budget performance as a measure of fiscal transparency. It basically means increasing visibility of what the public entities do and how they do it. It also means full information to be available about public expenditures, revenues, and debts. However, the KRG's performance is the opposite.

Partial Reforms Turned Unfruitful

Facing the dramatic twin shock of oil price downturn and COVID-19 implications in 2020, the KRG's leaders promised to take anti-corruption measures and diversify revenue streams of the government to move away from oil dependency. Usually, with each cyclical oil price downturn, fiscal pressures push FGI's and KRG's leaders to promise ambitious reform actions such as diversifying the economy and rationalizing expenditures. When oil price goes up, they leave reform promises undelivered and come back to the same business as usual. This trend, which has dominated Iraqi and Kurdish politics since 2003, might not work anymore for the KRG due to its relatively limited oil revenues. The region is in dire need to reform the PFM; otherwise, civil unrests and general strike is going to be the most expected scenarios based on past records.

Given the KRG's structural PFM issues, some challenges can be handled with the available resources and conditions. Some immediate reform actions would yield substantial results. There has been discussion among politicians about ghost employees and illegal pensioners on the public payroll. This led to a biometric registration system introduced by the government in 2017 to reform the payroll and remove the ghost employees and illegal pensioners. However, the payroll reform has been too slow and faced huge political constrain since most of the ghost employees are members of the ruling parties' cadres. The payroll waste in 2021 is estimated at more than 1 trillion IQD as the following graph shows.

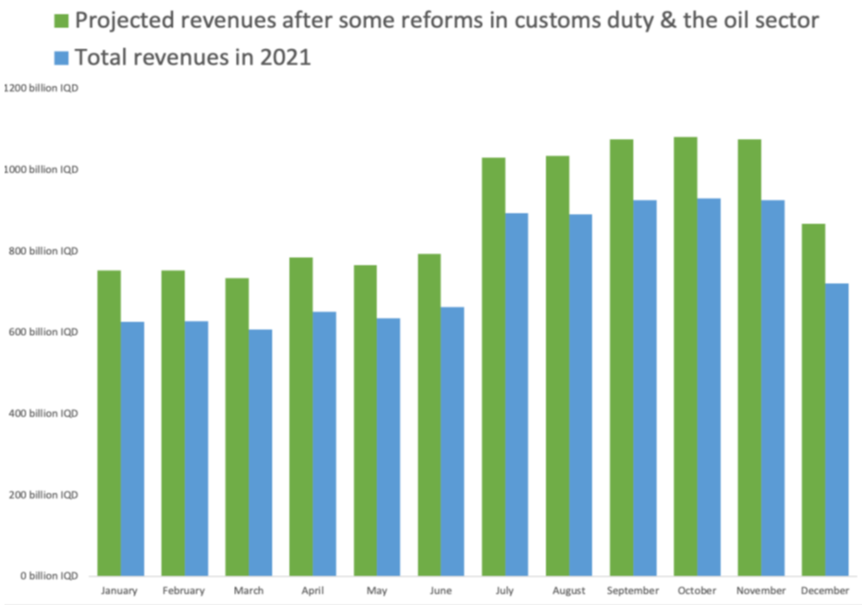
Figure 3: The KRG's 2021 spending, compared to projected spending (Counterfactual) after taking some reform actions



Source: The KRG's oil revenue for the first half of 2021 is taken form Deloitte reports. The other figures are not verified by formal institutions of KRG. They are collected based on interviews with members of Kurdistan Parliament's finance and natural resources committees, two employees at the KRG's finance ministry, and several employees in the border ports of KRI. The figures show the trend rather than any econometric analysis. They are taken from various institutions, and it is unlikely that they are updated on a regular basis. Revenue calculation does not include any forward oil sale that the KRG usually does due to lack of formal data. It is probably underreported in the government's total net oil revenues. To have a unified monetary unit, revenues in USD are converted to IQD based on the official exchange rate at $1=1460 IQD, which is very close to the market exchange rate that is still about $1=1480. The projected spending is based on the scenario that removing ghost employees and illegal pensioners would reduce payroll spending by nearly 12%.

In addition to the payroll reform, there are other reform opportunities in the revenue streams that can yield immediate results. Taking some procedures to manage the oil sector better is likely to increase the KRG's net oil revenues by approximately 18%[6]. For instance, the KRG have undersold its crude oil at $9 per barrel (pb) less than Iraq's oil price and $11 pb less than the Brent benchmark oil price in the first half of 2021. The KRG's discount is a clear outcome of its political disputes with the FGI over the oil sector management. Iraq's 2021 budget law laid foundations to resolve these disputes and put Iraq's ministry of oil in charge of selling KRI's oil. That could have been an opportunity to add more than 1 trillion IQD to KRG's oil revenues just by reducing this discount by half.

Figure 4: Actual 2021 revenues, compared to the projected revenues (counterfactual)



Source: The figures are not verified by official institutions of KRG. They are collected based on interviews with members of Kurdistan Parliament's finance and natural resources committees, two employees at the KRG's finance ministry, and several employees in the border ports of KRI. The figures show the trend rather than any econometric analysis. They are taken from various institutions and it is unlikely that they

[6] This number changes according to the international oil price fluctuations. Usually, the KRG's net oil revenues increase as oil price increase and vice versa. Due to the nature of the KRG's production sharing contracts the government's net oil revenue approaches zero when price of a barrel of oil goes down to any number below $15.

are updated on a regular basis. Revenues calculation does not include any forward oil sale that KRG usually does due to lack of official data. It is probably underreported in the government's total net oil revenues. To have a unified monetary unit, revenues in USD are converted to IQD based on the official exchange rate at $1=1460 IQD, which is very close to the market exchange rate that is still about $1=1480.

Likewise, there is an opportunity to increase customs revenues of KRI's border ports by approximately 26% if illicit activities and smuggling operations are prevented in the border ports. Overall, the revenue differences, as a result of the above-mentioned reform actions, are estimated at more than 2 trillion IQD in 2021 as Figure 4 shows.

Reforming the KRG's revenue streams and public spending basically implies a set of actions starting with improving capacities of law enforcement institutions, public finance inspectors, and introducing components of e-governance. Improving revenue collecting capacity is viable once it is associated with a strong political willingness to fight corruption. Taking partial measures to improve PFM in certain areas but exempting illicit activities in other areas proved unfruitful over the past 3 years.

For instance, the government introduced a sophisticated computerized system to replace the old manual system for calculating customs duty and facilitate trade exchange in the KRI's border ports. Technically, the system works well in three major KRI's border crossings (Parwezkhan, Bashmakh, and Haji Omeran); however, it has not been introduced in the other 7 border ports (official and unofficial ones from Peshkhabir and Ibrahim Khalil in Duhok to Pshta in Sulaymaniah).

The computerized tariff calculation system works well in reducing losses arising from petty corruption and some forms of bribery. But, the entire system is bypassed when the smuggling cartels (belonging to the ruling elite) are involved in letting in imports without paying tariff. It cannot stop powerful political and security officials from smuggling operations and taking in imports beyond the tariff calculation system. This is a stark example to show how useful tools for reform cannot yield good results if there is no political willingness to back it. The literature shows that similar issues happened in many middle income countries where technology innovations that led to the creative destruction of existing technology are subdued as they harmed the interests of influential ruling political figures (WANG).

There are technical solutions for most of the KRG's fiscal and economic weaknesses. Several international entities and development agencies such as the World Bank, UNDP, USAID, EU have advised the government to better handle its PFM. However, political constrains have hindered the required reform actions. One of the most resilient challenges is the political economy of KRI. The way the political dynamics have played out hampered efforts to reform the PFM. Like the chicken or the egg causality dilemma, it is not clear whether this political economy created the poor PFM, or vice versa.

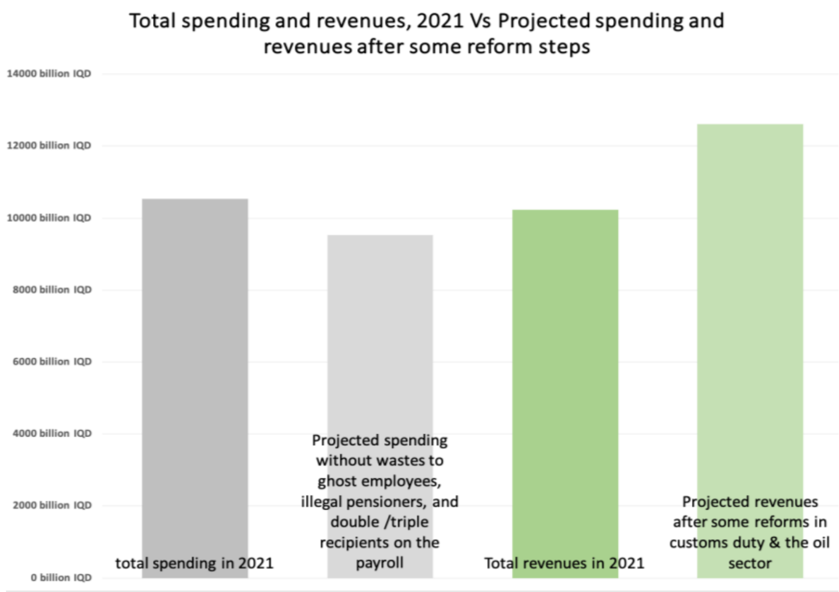
The region's economy has been strictly controlled by two patronage networks of Masud Barzani' Kurdistan Democrats Party (KDP) and Bafel Talabani's Patriotic Union of Kurdistan (PUK). The two rival parties control economic activities in the private sector and manipulate public jobs to keep their domination. They monopolize construction and service contracts to politically linked companies that usually bypass competition in exchange for sharing some profits with the key figures in the ruling parties, which have governed the KRI since 1991.

Moreover, the patronage networks have a few cartels to conduct illicit and extortion activities that clearly undermine the KRG's ability to collect revenues. Some leaders of the parties facilitate imports without paying tariff in the border ports of KRI (Skelton). The smuggling activities (conducted by the cartels belong to the same parties) still take huge part of the customs revenues. According to one of the border ports' directors, 80% of customs revenues go to some companies and not the KRG's treasury (Wali).

Apart from the high level of corruption, KDP's and PUK's deep-state networks of power have divided KRI into two zones (yellow and green zones respectively) according to their parties' military influences. They monopolize extortion activities and other gains from the revenue streams. This political economy that basically generated the fiscal challenges always hinders reform efforts. Therefore, technical and fiscal solutions might not yield desired results unless they are backed by strong political willingness to address these challenges.

Estimated Losses to the Neglected Reform Policies

Figure 5: KRG's 2021 revenues & spending, compared to the projected revenues & spending (counterfactual)



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The expected reform actions could have yielded both short and long-term gains. The estimated return of reforming the KRG's oil sector management, payroll, and customs regime is projected to be more than 3 trillion IQD in 2021. This is about one fourth of the region's annual expenditures. The following graph estimates the differences between the actual 2021 spending and revenues, compared to the projected revenues and spending (counterfactual) after implementing the above-mentioned reform actions

Again, the KRG's challenges cannot be handled by only economic and financial tools while political commitment is absent from the ruling elites to take the needed reform measures. In the absence of real pressures and within the same political economy, partial and sectorial actions to address the impediments remain ineffective. Therefore, the region's leadership needs to think outside the box and move with a set of sharp actions that can address the fiscal issues in 2022.

Recommendations

Effective government needs to deliver sound PFM and high-quality services as pre-conditions for a stronger and fairer economy. The KRG's leadership needs to consider the following policy actions to address the PFM challenges if it wants to stop struggling with the same issues in 2022 and the coming years.

For the KRG's financial institutions

1- Introducing an annual budget law aligned with a multi-year budgeting framework that considers development needs of KRI would help the government better manage its public finance. The framework could be a comprehensive 10-year development plan including sound policies to direct annual budget laws according to the government's articulated reform goals. It would help moving out of the vicious circle of the above-mentioned political economy and rationalizing public expenditures in favor of development.

2- Apart from the usual budget laws, some expenditures can be structured to meet sectorial needs of the economy by certain development programmes. This can be part of a whole national plan or sector-based programmes according to the needs of each specific sector especially the job creating sectors such as tourism, agriculture, manufacturing, and transportation. The annual budget discussions and laws should be constrained by the development plans.

3- The government needs to put a ceiling on payroll and operational expenditures to reallocate funds for infrastructure investment. Funding infrastructure projects is the key pre-condition for any sustainable economic growth.

4- Introducing performance-budgeting tools to measure adequacy of public expenditures (what they are achieving, not just what they are spent on) is crucial. There should be an input/output calculation for spending and improving the efficiency of public institutions.

5- One way to address the KRG's PFM is to improve productivity in the public sector. While the productivity issue has not been addressed yet, the KRG outsources some services to politically linked companies. This has brought public private partnership (PPP) to policy discussions. Indeed, PPP can be a useful mechanism in some areas and sectors but not for the low skilled services where the government already has a large number of civil servants to do it. For instance, privatizing the bill-collecting process in the electricity sector would be beneficial as the governments have failed to manage it whereas sonar and health checking at border ports are not something beyond the technical capacity of the public institutions.

6- Sharing statistical data and financial reports on the revenues and expenditures would help improve transparency and accountability. Hundreds of media outlets, NGOs, and international organizations could be involved in the discussions and debates needed to help reforming the financial sector if the KRG provides access to the financial data and reports. Reforming the KRG's PFM would be easier once it becomes part of policy discussions and public debates.

7- Revenue enhancing measures are doomed to fail if the entire government is not involved, especially security forces to limit smuggling and extortion activities in the border ports. Similarly, the wasted revenue in the oil sector is also another area where the whole government should be involved to negotiate with Iraq's oil ministry to allow the State Organization for Marketing of Oil (SOMO) to sell Kurdistan's oil and limit the waste to the disputes driven discounts. Furthermore, to cut unnecessary spending on private security services and deploy the Peshamrga and security forces, the whole government is needed as well.

For the KRG's Political Leadership

8- Bypassing the deep state power networks, the KRG's leadership can separate their policy goals from the demands of their political parties' patronage networks. It is not an easy trade-off but not impossible too if they want to have a more stable financial situation. For the KRG's leaders, dealing with their political parties' members is always easier than cracking down on thousands of civil servants protesting for their unpaid salaries or youth taking to the streets to demand employment opportunities.

9- Improving the control of the border ports to decrease smuggling and reduce extortion in the region's market is highly necessary to let economic activities grow and KRG's revenues increase. Without protecting the revenue streams in the border ports and limiting the extortion in the private sector, reform is unlikely to happen in the KRG's PFM.

10- Looking at the privet sector as engineer of growth, the KRG's leadership has to move against the extortion activities of the same deep state networks. The networks have strictly controlled the market and prevented it from growing and expanding. They prevent investment, limit competition, and ultimately distort the economy. Such an environment is the main reason to keep Kurdistan's job market poor and pushing the region's youth to look for opportunities broad.

11- Sustainable economic growth is not an achievable goal without reducing inequality, especially gender inequality. It implies enhancing the role of women in the economy and increasing female labor participation.

12- Reforming the power sector is crucial for private sector activities and the whole economy. Any reform measure in this sector needs to start with the bill collecting mechanism and making the sector self-financing; otherwise, the KRG will be further indebted to the power producing companies. Also, it has to introduce some regulations to privatize services in the sector and maximize the availability of power in addition to getting rid of the expensive and polluting private neighborhood power generators.

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