Shock Therapy Will Kill, Not Cure, Iraqi Kurdistan's Economy

by Michael Knights

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Brief Analysis

Spending cuts are necessary and overdue in the Kurdistan Region, but international players need to ameliorate the impact of politicized provisions in the new funding deficit law.

During a contentious late-night meeting on November 11, Iraq's parliament approved emergency borrowing of 12 trillion dinars ($10 billion USD) to cover government expenses for the last quarter of 2020. The vote passed with the support of 173 Shia and Sunni members in the 329-seat legislature, though the 60-odd Kurdish members walked out of the session, making it a rare fiscal decision undertaken without one of Iraq's main ethnosectarian components. The move was not a surprise given steadily building tensions between the Kurdistan Regional Government (KRG) and other political blocs, but the steepness of the required cuts is arguably impossible for the Kurds to surmount in short order. For this reason, and because the new law may set expectations for the 2021 budget, it is important to accurately characterize why the Kurds walked out of the vote and how the United States and other partners should react.

LONGSTANDING TENSIONS OVER REVENUE SHARING

After the fall of Saddam Hussein's regime, the Iraqi federal government instituted a customary form of revenue sharing with the KRG, a subnational entity that encompasses four of the country's nineteen provinces. Under this system, Baghdad transferred a monthly block share of government spending—typically around 17%—to the Kurds in line with the KRG's proportion of the Iraqi population.

Yet the KRG's share was drawn from a subset of the federal budget called "non-sovereign" spending, which excluded "sovereign" items such as defense, the Foreign Ministry, the parliament, oil production costs, and so on. As a result, the Kurdish 17% was really more like 13% of total government spending, and this share shrank as Baghdad unilaterally characterized larger and larger portions of the budget as sovereign expenses. In addition, the Kurds complained that federal security forces and oil production costs were paid by the federal government out of sovereign expenses, while Kurdish security and oil costs were not covered.

Resentment also built up over oil revenues. As KRG oil exports grew to a peak of around 550,000 barrels per day (bpd) in 2016, federal authorities increasingly challenged the region's right to administer an independent energy sector and pocket the revenues while still receiving monthly transfers from Baghdad. In recent years, politicians have pressed the KRG to transfer some or all of these exports (currently 400,000 bpd) to the State Oil Marketing Organization (SOMO) and hand over its growing non-oil revenues as well. (The latter revenues totaled around $240 million per month in January, though coronavirus restrictions have since lowered them to around $100 million.)

The federal government has generally distrusted KRG employee lists as well, even when these lists were backed by a major biometric registration program. No one has subjected Baghdad's own employee lists to biometric registration, however.

WHAT IS ON OFFER IN THE FUNDING DEFICIT LAW?

Due to a combination of factors—the previous government's resignation at the end of 2019, the outbreak of COVID-19, and the protracted formation and stabilization of the new government—Iraq never passed a 2020 budget. Baghdad has therefore had to function by replaying some aspects of the 2019 budget law and coming up with temporary arrangements at the cabinet level. Since Prime Minister Mustafa al-Kadhimi was appointed in May, the government has transferred $268 million to the KRG most every month without requiring the Kurds to send all of their revenues to the federal government. The transfers from Baghdad have enabled KRG officials to meet most—though not all—of their $1.08 billion in monthly spending obligations, including the crucial $710 million portion needed to pay salaries and social security. Some may believe that this arrangement allows the Kurds to have their cake and eat it too, but the reality is that the KRG is only just scraping by even with the federal transfers.

If the new funding deficit law is implemented as is, it would dramatically change this equation. The $268 million in monthly transfers would apparently continue, but the law would also require the KRG to immediately send all of its oil revenues and the customs portion of its non-oil revenues to Baghdad. If one assumes that the Kurds sell 400,000 bpd of oil monthly at the discounted price of around $33 per barrel (vs. $45 per barrel Brent averages), this would mean they need to surrender $396 million in oil revenues each month, along with around three-quarters of their non-oil revenue. In other words, KRG income would plummet from $764 million per month (i.e., $268 million in federal transfers, $396 million in oil revenues, and $100 million in non-oil revenues) to $293 million per month ($268 million in federal transfers plus $25 million in residual non-oil income).

The KRG is currently riding a tough but manageable 30% monthly account deficit (i.e., $764 million in income vs. nominal spending of $1.08 billion). Yet by decreasing this monthly income to $293 million, the new law would increase the KRG deficit to a crushing 73% and leave Kurdish officials far short of meeting their most important obligations: the $710 million in monthly salary and social security payments. Insisting on immediate implementation is therefore an economic suicide pill for the KRG.

To be sure, the Kurdistan Region does have a higher proportion of civil servants per capita than the rest of the country (whose own numbers are already high), so it must submit to economic reforms. Yet the new law guarantees that the Kurds will not be able to pay their government employees for the remainder of the year, even as it ensures that Baghdad can continue paying non-KRG employees uninterrupted. This is fundamentally unbalanced, forcing one part of Iraq—and one ethnic group—to suffer immediate and crushing austerity while the rest of the country's benefits are protected.

U.S. POLICY OPTIONS

If the KRG is financially crushed in the near term, it could become more vulnerable to pressure from pro-Iran political blocs on a host of issues crucial to American interests, including the selection of the next prime minister and the future U.S. presence in Iraq. Indeed, the country's moderate camp—Kadhimi, the Kurds, and some Arab blocs—might shatter on this funding deficit issue just months ahead of the coming 2021 electoral campaign. A decade ago, Tehran advised Prime Minister Nouri al-Maliki to seize a second term by riding a wave of sectarianism ahead of the 2010 election, and the pro-Iran bloc is following the same playbook today, fanning ethnic hatred to divide its opponents.

Now is therefore the time for Washington to help its allies by urging Baghdad to readjust the hasty economic demands on the KRG. It is no coincidence that Iran's main proxy in Iraq—the U.S.-designated terrorist group Kataib Hezbollah—has strongly backed the KRG-related provisions in the funding deficit law via its television station, al-Etejah. Such media attacks must be viewed against the backdrop of the group's literal attacks against the Kurds, including rocket fire against the KRG capital on September 30 and the burning of Kurdish political offices in Baghdad on October 17. Both of these attacks came in response to Kurdish statements of support for the United States and the Kadhimi government amid ongoing threats by Iran-backed militias. If Washington fails to help now, this moment could be remembered as the economic version of the October 2017 Kirkuk crisis, when the Kurds felt betrayed by external partners who did not react quickly enough to prevent excessive punishment by Iran-backed factions in Baghdad.

To avoid that outcome, U.S. officials should pointedly reemphasize the urgency of KRG reform while at the same time telling federal authorities that the Kurds need more time to achieve these changes. The required reforms should be part of the 2021 budget, not a three-month emergency financing law. Baghdad has various means to ease financial pressures at the federal level (e.g., drawing on sovereign reserves; external borrowing), but the Kurds have none of these options at their disposal. Washington should still press the KRG to get more serious about implementing austerity measures over the next year, from downscaling its payroll and social security system by a significant percentage to beginning the process of transferring some oil marketing to Baghdad. But the Kurds cannot take these measures unless the federal budget provides them with a reasonable sum that ensures a net total KRG income of at least $800 million per month. A fairer recalculation of Baghdad's "sovereign expenses" would get the Kurds close to this figure without upping their share of federal spending.

As a first step, Washington should immediately press various factions in Baghdad to defer the KRG-related commitments in the funding deficit law and consider carefully how these strictures could undermine the 2021 budget. This pressure should be brought to bear both publicly and privately, and in coordination with efforts by the IMF, World Bank, UN, and European Union. Such an international compact could bolster the Iraqi government's dialogue with the KRG and help the parties develop a more gradual—and thus more achievable—reconfiguring of their economic relationship over multiple years.

Finally, to ensure intra-Kurdish unity on the issue, the United States and its partners should prod the KRG's Barzani family leadership to further decentralize government decisionmaking. This could bring the region's other main player—the Patriotic Union of Kurdistan—back into alignment with the broader Kurdish position in negotiations with Baghdad.

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