What Could Iraqis Gain from Their Oil Windfall?

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Brief Analysis

Although Iraq stands to gain significant revenues from an oil windfall, urgent reforms are needed to ensure these funds benefit the people, not just the elites.

After a full year of political stalemate and fierce power struggles, Iraq's ruling elite have finally managed to form a government led by Mohammed Shia' al-Sudani. Thanks to the surge in international crude oil prices, Sudani's new government has inherited a rather large oil bonanza, with the potential for huge revenues if handled well. However, the government's ability to properly invest in this opportunity, taking into account its development and reform plans, is highly questionable due to the very political settlement that gave birth to the new government.

Locally known as the 'Muhasasa' system, this settlement dictates the ethno-sectarian power-sharing divisions that have plagued the Iraqi government since 2003. Indeed, the system is widely blamed for rampant corruption, structural imbalances, the weakening of state institutions, and the failure of the government to deliver services to the Iraqi people. Case in point, the national poverty rate in Iraq is above **25% (https://ina.iq/eng/16955-official-statistics-of-poverty-rate-in-iraq-.html)**, and the unemployment rate is higher than **14% (https://tradingeconomics.com/iraq/unemployment-rate)**.

Given the outcomes produced by the Muhasasa system in the past, it seems unlikely that Sudani's government will function any better than its predecessors or be fully able to seize on the oil market windfall to improve Iraqis' welfare instead of further enriching the ruling elite. As was the case in 2008, Iraqis will miss out on this opportunity to address some of the country's most pressing concerns unless the government can tackle several key economic and political barriers.

Nevertheless, the rising oil revenues provide great resources to address Iraq's dire needs to improve its infrastructure and enable a safer physical environment. Both are preconditions to revitalizing the country's undeveloped private sector and ultimately diversifying its oil-dependent economy.

The Oil Bonanza and Iraq's Structural Challenges

Iraq's federal government is expected to gain $114 billion in oil rents by the end of 2022, a clear spike from $75.651 billion in **2021 (https://www.iraqoilreport.com/news/september-exports-steady-as-northern-oil-sales-rebound-45184/)** and $41.948 billion in **2020 (https://www.iraqoilreport.com/news/september-exports-steady-as-northern-oil-sales-rebound-45184/)** . The government's additional cumulative oil revenues in 2022—without independent oil sales from the Kurdistan Region of Iraq (KRI)—is expected to reach $38 billion. Moreover, the previous government in Iraq was able to achieve fiscal surpluses in 2021, and the country's GDP growth is projected to reach **9.3% (https://www.imf.org/en/Countries/IRQ)** in 2022, up from 3.6% in 2021 and significantly higher than the projected global average growth of **3.2% (https://www.imf.org/external/datamapper/NGDP_RPCH@WEO/OEMDC/ADVEC/WEOWORLD)** . The government's current account has boosted gross international reserves of the Central Bank of Iraq to **$94.6 billion (https://fred.stlouisfed.org/series/IRQFAFARUSD)** , the highest since 2003.

Yet by lacking any active sovereign wealth fund—one of the means through which other regional oil rentier states manage surpluses—the rising oil revenues have generated many debates and arguments among Iraqis as to how these revenues can best be deployed. On the one hand, populist MPs and political blocs are focusing on the distributive side of Iraq's import-based economy. These figures argue for a depreciation of the value of the Iraqi Dinar (IQD) in a bid to reduce inflation and increase purchasing power of low-income citizens. On the other hand, many economic experts have warned about the danger of devaluing the IQD.

A higher IQD value would raise production costs for Iraqis while reducing domestic goods' competitiveness in favor of cheap Iranian and Turkish imports. The devaluation would also undermine the country's macroeconomic stability and cost the Iraqi government at least $15 billion given that the government sells its crude oil (about **99% (https://www.worldbank.org/en/country/iraq/overview)** of all the country's exports) in USD while accruing most of its expenses in IQD. Therefore, keeping the foreign exchange rate at its current level is necessary to preserve macro-stability and best facilitate using the oil revenues on upgrades for services institutions, infrastructure improvements, and foundational economic reforms to tackle the country's structural imbalances.

No matter how the debate ends, transforming this opportunity into truly constructive outcomes will require a lot of work from the Sudani government—a government supported by the Iranian-backed Coordination Framework. Already, this government is enduring constant demands for an increase in investments in the country's underdeveloped infrastructure and dysfunctional service institutions. Iraq's meager private sector desperately needs to be revitalized, and its oil-dependent economy needs to be diversified.

Likely the best way to spend these oil revenues would be to fund neglected public infrastructure projects. More than 1,450 public **projects (https://kirkuktv.net/AR/Details/5719)** —including hospitals, roads, schools, bridges, and more—have been halted due to a lack of funding, corruption, and bureaucratic impediments, with many lying abandoned since the 2014 financial crisis. Funding these projects would further enhance service institutions, improve the business environment, and ultimately stimulate the private job market.

In addition to these usual challenges, water scarcity and drought have exposed Iraq to a new set of crises. **Ranked (https://www.iraq-businessnews.com/2022/08/13/new-report-migration-environment-and-climate-change-in-iraq/)** as the fifth most vulnerable country to climate breakdown, Iraq's loss of water from key rivers, including the Tigris and Euphrates, might turn vast areas of the country into desert. Government officials estimated losing **50% (https://www.rudaw.net/english/middleeast/iraq/210420223)** of Iraq's water reserves from 2021. Environmental degradation and poor water management pose grave threats to the sustainability of food security for Iraq's 42 million citizens.

Internal displacement, loss of livelihood, and excessive urbanization—all connected to these environmental issues—have emerged as new domestic crises. Water scarcity also raises significant questions about the capability of the Sudani government to safeguard Iraq's agriculture, which employs **one-fifth (https://reliefweb.int/report/iraq/dry-horizon-iraqs-interlinked-drought-and-climate-crises-october-2022)** of the country's labor force without concurrently addressing the country's water management issues and limited water flow from Iraq's riparian neighbors.

Pathways Forward

Even if Iraq's new government decides to break from the status quo, how Sudani and his cabinet will actually respond to ongoing challenges remains the hardest question to answer. If they want to spend the funds of the oil bonanza on development, perhaps Iraq's lauded but unimplemented 2020 **White Paper (https://gds.gov.iq/iraqs-white-paper-for-economic-reforms-vision-and-key-objectives/)** for Economic Reforms can serve as a blueprint. This report provides a clear vision about how to tackle the country's most dire economic challenges, from its bloated public payroll to poor water management and national power shortages.

Starting with the 2023 budget law, the new government can take serious steps in the right direction by scaling up infrastructure investments, upgrading service institutions, and removing barriers to private sector development. These efforts would lay the foundation for even more structural reforms.

Moreover, activating Iraq's sovereign wealth fund (SWF) would help in properly saving and utilizing the oil revenues. The SWF is set to deposit 1% of the country's oil rents in order to build up cash reserves for future generations and create buffers to withstand the shocks of international oil price fluctuations. Since crude oil accounted for **99% (https://www.worldbank.org/en/country/iraq/overview)** of Iraq's exports, **85% (https://www.worldbank.org/en/country/iraq/overview)** of the government's budget, and **42% (https://www.worldbank.org/en/country/iraq/overview)** of the country's GDP over the last decade, this shock protection is crucial. The SWF's potential deposits could also be used to finance renewable energy projects, addressing the chronic power shortages that Iraq has faced since the 1990 Gulf War. Nevertheless, the sad reality is that the government is unlikely to move forward on any of these reforms.

Mounting Challenges and No Proper Equipment

The Sudani government likely lacks the tools to handle the myriad obstacles on itspath to implementing such investments effectively. Rampant corruption and anticipated intra-elite conflicts—especially between followers of Shia Cleric Muqtada al-Sadr and the Coordination Framework—are some of the largest of these hurdles. The fear of wasting Iraq's oil windfall to intra-elite conflicts is not entirely outlandish. Just months ago, Sadr's followers stormed the Green Zone and caused immense political paralysis in the wake of Sudani's initial government formation, and they are likely poised to do so again if they feel that they are being snubbed by the new government.

Nor would it be the first time that Iraq's oil rents were fraudulently used up in the last two decades. The most recent manifestation of this country's endemic corruption was the disclosure of a 3.7 trillion IQD **embezzlement (https://www.thenationalnews.com/mena/iraq/2022/10/18/un-envoy-urges-iraq-to-recover-billions-embezzled-from-tax-authority/)** scheme (about $2.3 billion USD) which took place over the last fourteen months within the state-owned Rafidain Bank via a network of public officials and five shady companies. Despite rhetoric claiming otherwise, Sudani's government is expected to sustain Baghdad's 'business as usual' approach to the corruption of the ruling elite unless grass root pressures resurface to combat corruption and back reformist forces within and outside the government.

Just as its predecessors did, Sudani's government is likely to try to pump up the economy through the oil windfall before the planned snap elections in late 2023. If reformist forces, NGOs, and media join together to pressure the

Iraqi government to allocate part of the oil revenues to public infrastructure investments, most Iraqis will be better off. Here, the 2023 budget law is a golden opportunity to focus on key services sectors such as education, health, and electric power rather than increasing military and security expenditures.

Obviously, it is not easy to balance the demands of the ruling elite that back Sudani against the needs of the millions of Iraqis who took to the streets to demand better governance. Sudani's trade-off is whether to appease the ruling elite or increase infrastructural investment to deliver better services and revitalize the private job market—passing on part of the oil revenues to the low-income citizens who work in the informal economy. Failure to handle this trade-off would expose his cabinet to the previous governments' challenges and likely prompt a return of civil unrest that has roiled the country in previous years. ❖

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