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## Iraq: Considerations on Intergovernmental Fiscal Relations for the Constituent Assembly

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## IMF Working Paper

Fiscal Affairs Department

### Iraq: Considerations on Intergovernmental Fiscal Relations for the Constituent Assembly

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#### Abstract

**This Working Paper should not be reported as representing the views of the IMF.**

The views expressed in this Working Paper are those of the author(s) and do not necessarily represent those of the IMF or IMF policy. Working Papers describe research in progress by the author(s) and are published to elicit comments and to further debate.

In preparing for the discussions of the Iraqi Constituent Assembly, IMF and World Bank staff and consultant experts presented to senior officials from the central and local governments in Iraq, including from Kurdistan, key options that might be relevant for the discussions. This paper reflects the thrust of the discussions, including the views on the options prepared by the Iraqi officials, and develops a short-term work plan for the benefit of the assembly.

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<sup>1</sup> The authors are respectively from the International Monetary Fund; Queen's University, Canada; the University of Turin, Italy; the World Bank and Urban Institute, Washington; and formerly the Commonwealth Grants Commission, Australia. The forward-looking proposals (summarized in the Appendix) were developed by Iraqi officials in their personal capacities and do not necessarily reflect views of the Iraqi authorities. Helpful comments were received from Lorenzo Perez, Jenny Litvack, and Dana Weist. The logistic support of the IMF's Middle East Technical Assistance Center is also gratefully acknowledged.

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## I. INTRODUCTION

In preparation for discussions leading to the Constituent Assembly in Baghdad in early 2005, a group of Iraqi officials representing central government ministries (including the Ministry of Finance, the Ministry of Planning, the Ministry of Municipalities and Public Works, and the revenue agencies), and officials from Kurdistan and selected governorates and municipalities, met with staff and consultants from the IMF and World Bank in December 2004.<sup>2</sup>

The purpose of the meeting was to identify the current structure of government and the status of intergovernmental fiscal relations in Iraq, and possible directions for reform that might be considered by the Constituent Assembly—given international experience as well as the specific characteristics of the Iraqi context. It draws on and summarizes the options as enunciated by groups of Iraqi officials, including steps that might be considered further to provide materials for the deliberations of the Constituent Assembly.

A set of questions were posed to four groups of officials—each including representatives of the central government (especially the Ministries of Finance, Planning, and Municipalities; officials from the central and southern governorates and from Kurdistan). These were as follows:

“Our task is to advise the Constituent Assembly on the structure of government in Iraq. The task of each group is to define the options and formulate a preferred option.

1. How many levels of government would you create?
2. What responsibilities would each level of government have?
3. What sources of finance would each level of government have (e.g., taxes, transfers, borrowing...)?
4. What institutional arrangements would you recommend?”

The responses to these questions are summarized in Appendix Table 1.

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<sup>2</sup> A series of papers were presented at the meeting prepared by each of the authors and by Shanta Devarajan (World Bank) and Richard Allen (World Bank).

## II. THE CURRENT STATUS OF INTERGOVERNMENTAL FISCAL RELATIONS

### A. Current Overall Structure of Government

Pre-2003 Iraq was a highly centralized unitary state. After the first Gulf War, the governorates in Kurdistan began to function autonomously from Baghdad. The Coalition Provisional Authority (CPA) envisaged the creation of a federation.<sup>3</sup> In practice, Iraq today effectively remains a unitary state, with asymmetric arrangements continuing for the Kurdish governorates.

There are 18 governorates in Iraq, of which three are in Kurdistan (Arbil, Suleymania, and Dohok).

A Parliament represents the Kurdistan region, including the governorates of Arbil and Suleymania. These also have established elected governors and councils, and they have 60 municipalities each, also with elected officials. They have developed partial controls over local services in their regions, although all public employees, including teachers and doctors, are appointed by the regional government but paid through the central government in Baghdad.<sup>4</sup>

The 15 governorates outside Kurdistan, and their associated 251 municipalities, operate as “deconcentrated” organs of the central government. The municipalities are responsible for some urban functions, such as park services and waste collection, but the major public functions are carried out by local branches of central government line ministries, such as education, higher education, and health. Local officials have little influence over such activities, which are subject to vertical (i.e., line ministry) and not horizontal controls at the municipal level. Governorate officials have some influence over the municipal staff in terms of oversight and administration.

All governorate and municipal staff are central government employees and are hired and paid by the central government in Baghdad.<sup>5</sup> While the overall staffing levels are centrally determined in the Ministry of Finance, the actual hiring is often delegated to competent ministers and heads of departments.

The CPA envisaged the creation of a federation, as well as clear horizontal responsibilities at the local levels, covering a wide range of public functions. However, the effective changes to date have been marginal at best, with “elected councils” at the governorate and municipal levels (reflecting the interests of line ministries) appointing governors. There has been no

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<sup>3</sup> See CPA, *Interim Law of Administration for the State of Iraq*, March 8, 2004.

<sup>4</sup> The civil service is managed in accordance with central government regulations.

<sup>5</sup> With the exception of local staff hired by offices of governors.

effective change in the assignment of functions. Line ministries remain responsible for most of the key social functions, such as education or health.

It should be noted that there was an attempt in 1969 to devolve functions, such as elementary education, to subnational governments, with wages to be paid from grants. There were difficulties in ensuring that the teachers were actually paid, and the function was returned to the Ministry of Education after an experimental period.<sup>6</sup>

### **B. Expenditure Assignments and Management**

With the exception of purely local services, such as street paving and feeder roads, virtually all expenditure assignments are central, with policies established in Baghdad and implementation through deconcentrated agencies of central ministries in the governorates and municipalities. While this is a highly centralized system, it permits the incorporation of local preferences through the councils at the governorate and municipal levels feeding back into spending requests and the priorities determined by the line ministries and the Ministry of Planning (for investment spending).

As mentioned above, both the number of staff and their wages are centrally determined. Thus, for teachers, the Ministry of Education proposes a list of new appointees for a given budget year to the MOF in Baghdad. The numbers are generally approved and then notified to the Education Ministry.<sup>7</sup>

The general policy of the successive governments has (until now) been that the public hiring of new medical graduates was mandatory for the Ministry of Health. The Ministry of Higher Education also submits proposals for the hiring of new graduates.

### **C. Revenue Assignments and Administration**

While there are some local fees, all the tax bases and collection are centrally determined. The main revenue sources are oil revenues, income tax, and property rental income tax. Kurdistan has enjoyed de facto limited control over rates.

With the recent hostilities, there has been a collapse of the non-oil tax bases and collections.

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<sup>6</sup> A similar pattern has been observed in recent years in Nigeria. In countries such as Colombia and Bolivia, the education function has been devolved to the municipal level, but the teachers continue to be hired and paid by higher levels—leading to incomplete responsibility and ineffective service delivery. In South Africa, the education function is assigned to provinces and not the municipal level.

<sup>7</sup> With the loss of records following the fall of the Baath regime, there has been some difficulty in establishing an accurate baseline of the actual numbers of public employees. The authorities are undertaking a census of employees at the present time, and the World Bank is assisting with aspects related to the payroll and civil service reform.

There is a central tax administration, with offices in Baghdad and field offices in each governorate, that is responsible for collecting all taxes. All tax revenues are deposited with the central treasury, with the exception of those collected in Kurdistan. All customs revenues go to the treasury, including those collected in Kurdistan. Subnational entities (except in Kurdistan) have no tax powers.

There has been substantive tax reform in Iraq since the fall of the Baath regime. For the income tax, the top marginal rate has been reduced from 40 percent to 15 percent (now with three bands: 5 percent; 10 percent, and 15 percent), and the exemption limit has also been increased in dinar terms. Civil service wages have become subjected to tax.

The tax on property income has also been reduced from 35 percent to 10 percent. The supplementary tax has been abolished.

When the CPA abolished customs duties, Iraqi Customs was transferred to the Interior Ministry. Since the establishment of the Interim Government, Iraqi Customs has reverted to the Ministry of Finance, and a 5 percent tariff has been imposed (with some exemptions for food and medicines). There is also provision for an excise tax on some sales (e.g., finished textiles) of up to 10 percent, but it is little used at the moment. There have been some studies and discussions of implementing a VAT.

#### **D. Determination of Grants and Borrowing**

Grants to Kurdistan and to the self-financed agencies in all governorates are estimated on the basis of expected spending, taking into account actual spending for the previous year minus projected own source revenues. No other factors are considered. Thus the grant system may be described as purely deficit or gap-filling.

Since April 4, 2004, there have been deficits at the municipal level. Additional grants have been made to meet these deficits, raising the possibility of reinforcing soft budget constraints. There has been no formal subnational borrowing. And, at present, it is difficult to gauge the magnitude of any buildup of arrears.

#### **E. The Budget Processes**

The current budget processes are governed by the old budget Law 107 of 1985, and Law 28 of 1940—the accounting law. The budget system was fragmented and geared toward the running of a centrally planned economy, with separate current and capital budgeting processes. The legislation was claimed to be compatible with budgetary principles, including *inter alia*:

- unity of budget functions, including full budget coverage;
- consolidation of government monies into a treasury single account; and
- prohibition of spending without appropriation.

However, successive governments had ignored these principles, leading to particularly capricious spending by the Baath administration, especially spending without prior

authorization and comprehensive reporting—which led to a deterioration of the budget process, including concerns about the spending under the UN’s Oil for Food Program. Moreover, since April 2003, there has been a significant deterioration in budgetary processes, with difficulties in the payments system and in control and reporting. This has led to additional concerns about the effectiveness of the spending process and possible diversion of public funds. All these factors will govern the direction and speed of any intergovernmental reforms in the immediate future.

A new financial management law (FML) was promulgated in June 2004<sup>8</sup> and is designed to increase transparency, unity of budget operations, and greater accountability for the spending process. However, this modern legislation is not yet in effect.

## **Budget preparation**

### ***Central government***

Under the CPA, there was an attempt at better consolidation of the budget process—with the presentation of an integrated budget by the MOF to the council of ministers.<sup>9</sup> The basic preparatory work for the capital budget in 2004 was based on feasibility studies by the Ministry of Planning (MOP), which conducted conferences with line ministries for capital spending in much the same way as the MOF for the current budget. The MOF put together the integrated budget. Further integration of the budget process is seen under the FML, including full incorporation of all spending (including by donors and international agencies) into the budget envelope.

Considerable additional work is needed to bring the budget classification used up to international standards, e.g., in line with the IMF’s Government Finance Statistics 2001 (GFS2001), and the UN’s Classification of the Functions of Government (COFOG), and this is under way with Fund support. Again it would be important to agree on the budget classification and design its implementation and use to ensure consistent reporting on government spending by all subnational levels of government. This factor, in itself, would militate against any significant changes in spending responsibility in the short run.

### ***Agencies and municipalities***

The budgets for agency spending at the local levels continue to be determined by line ministries. For example, the spending on agriculture in a municipality forms part of the budget of the Ministry of Agriculture and not that of the municipality.

With the establishment of governorate and municipal councils by the CPA, there is greater review of local priorities at these levels, with recommendations for specific functions made

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<sup>8</sup> See CPA (2004), The Financial Management Law.

<sup>9</sup> The MOP remains responsible for the follow-up of projects.

to the apex bodies (line ministries) for specific functions which decide on the regional allocations according to their own criteria. Thus, while there is greater recognition of local preferences than before, this does not equate to traditional local governments found in most other countries—with the possible exception of those in Kurdistan.

### ***Kurdistan***

In Kurdistan, as in the center, there were separate current and capital budgets in the past. However, in the recent past both budgets have been financed by the Kurdistan Ministry of Finance (MOF(K)). Using forms similar to those in the rest of Iraq, the spending agencies prepare separate capital and current budgets, which are then discussed in committees led by planning and finance departments, respectively. However, these are consolidated at the line ministry level and submitted to the Minister of Finance of Kurdistan. The MOF(K) forms a committee, including the senior officials of the ministry and competent experts, and discusses the consolidated budget with the line ministries before submitting this to the Council of Ministers. The central MOF provides some financing for the Kurdistan budget.

### **Budget execution**

Despite the variations described below, the budget execution function in Iraq (other than in Kurdistan) follows a deconcentrated pattern largely determined by the center. The central treasury has field offices in the governorates—these are called governorate treasuries.<sup>10</sup> There are three budget execution processes.

- When the ex ante controls and internal audit of a spending agency are carried out through the treasury system in the center and the governorates, the system is referred to as the **centralized system**. This is the case for most services, including health, education, higher education, and interior. Operations are monitored on a cash basis, and all checks are issued by the national treasury.
- When a spending unit is permitted to conduct its own payments, internal controls, and audits, the spending system is called **decentralized**. This is the case for the Ministry of Municipalities and Housing and Public Works. Decentralized spending units issue their own checks. The CPA converted many of the agencies of line ministries in Baghdad into the decentralized system—e.g., large hospitals in the Baghdad area.
- Self-financed institutions, including the electricity sector and the Ministry of Industries, follow a **unified system**. The accounting is largely based on accruals.

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<sup>10</sup> Limited accounting functions are carried out by treasury officials at the *qada* (city or district) level and at the *nahia* (village) level. At the lowest level, the treasury official receives cash and makes payments, keeping a daily record of transactions (according to the established budget classification). Monthly revenues and spending records are aggregated at the governorate level.

Ad hoc operations of donors that do not pass through the budget and regular treasury channels have done much to confuse the prioritization of the budget process, and the reporting on outcomes. These are generally outside the established safeguard mechanisms and subject to abuse and misappropriation.

Internal control or internal audit functions in Iraq are either nonexistent or carried out in a nontransparent manner.<sup>11</sup> The external audit functions of the Board of Supreme Audit are well defined, but there are considerable training needs.<sup>12</sup> While there is considerable support from NGOs and bilateral lending agencies for community-led supervision of spending, the experience with such efforts in the absence of proper public financial management safeguards (as described above) has been quite mixed.<sup>13</sup>

### **F. Borrowing**

Given the centralized nature of the spending responsibilities as well as the administrative structure at the present time, Iraqi officials did not see much scope for subnational borrowing in the immediate future, or even in the medium term. Iraqi officials felt that this could prove risky and may be subject to as much or more abuse as the unsupervised donor financing.

## **III. OPTIONS FOR INTERGOVERNMENTAL REFORMS**

The Iraqi officials expressed the opinion that any steps toward devolution of responsibilities must be based on the constraints of the administrative structure, difficulties of changing this structure under emergency conditions, as well as the extensive reconstruction needs of the country. They agreed that citizens must eventually have a role in decision making, and any devolution must be more than simply financial.

However, they expressed caution about applying experiences elsewhere without taking into account the context of Iraqi realities. In the light of a discussion of international experiences, three broad options were identified (see Appendix Table 1 for a summary of the views of the Iraqi officials).

### **A. Options for Reform**

#### **Levels of government**

Given the current conditions in the country, three basic options involving the different levels of government were identified.

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<sup>11</sup> The World Bank is initiating a full assessment and reform program in this area.

<sup>12</sup> These are being supported by the World Bank and the UNDP.

<sup>13</sup> See Ahmad, Albino-War and Singh (forthcoming), and Platteau (2004) for a review.

***Option 1 “The expanded status quo”—asymmetric decentralization***

This might be called the ‘expanded status quo.’ It would leave the structure of government largely unchanged but would increase local autonomy and devolve some powers and responsibilities from the central government to subnational governments.

This option would:

- maintain the Kurdistan Region Government(s) with some clarification of its (their) expenditure responsibilities and revenue capacities;
- create elected municipal councils across the nation, giving them more autonomy and more responsibilities than the current municipal institutions; and
- outside Kurdistan, continue to use Governorates as deconcentrated units of the central government.

***Option 2 “Decentralization to governorates—hierarchical federal option”***

This would change the structure of government as well as increasing local autonomies and making changes to the distribution of powers and responsibilities. Outside Kurdistan, the municipal councils would be responsible to the provincial governments.

This option would:

- transform the current governorates into elected Provincial Governments as a second tier of government—these would have more autonomy and a greater range of authorities than the present Kurdistan Regional Government(s); and
- create elected municipal councils across the nation as a third tier of government and give them more powers and more autonomy than the present municipal institutions. Across the nation, these would be responsible to Provincial Governments.

This option might be called the ‘redesigned hierarchical government’ option.

***Option 3 “Decentralization to governorates and municipalities”***

This option would change the structure of government and increase subnational autonomy, especially at the municipal level, as well as for governorates, with changes to the distribution of powers and responsibilities. Outside Kurdistan, the municipal councils would be responsible to the central government.

This option would:

- transform the current governorates into elected Provincial Governments as a second tier of elected government--these would have more autonomy and a greater range of responsibilities than the present Kurdistan Regional Government(s); and
- create elected municipal councils across the nation as a third tier of government, with more powers and more autonomy than the present municipal institutions. Within

Kurdistan, these would be responsible to Provincial Governments. Outside Kurdistan, they would be responsible to the central government.

This might be called the “**redesigned nonhierarchical government**” option.

The Iraqi officials, expressing their personal opinions, tended to favor shades of Options 1 and 2 (asymmetric decentralization/status quo and federal options) and generally concurred that:

- Kurdish regional autonomy should be maintained; and that
- additional powers be gradually devolved to the middle tier (governorates); but that
- it was premature to think about greater municipal functions at the present time.

The officials particularly cautioned about proposals by some international consultants to initiate recourse to borrowing at the municipal level in the absence of meaningful responsibilities and budgeting and reporting systems.

### *Legal relationships*

On an assumption of two levels of government, legislative powers may be defined by national laws or by the Constitution(s),<sup>14</sup> and may be exclusive or concurrent. Where legislative powers are concurrent, conflicts between laws passed by different levels may be resolved through either central paramountcy (where central law overrides subnational law), or subnational paramountcy.

The Constituent Assembly would need to decide whether:

- Legislative powers of one level may or may not be delegated (voluntarily) to another.
- Residual powers not defined in the constitution(s) may be:
  - assigned to the central government,
  - assigned to the subnational government,
  - assigned by the courts.
- Powers of subnational governments may be exercised freely or may be subject to:
  - some obligatory requirement (e.g., provision of basic services),
  - some proscriptions (e.g., satisfy certain citizens’ rights, observe nondiscrimination, do not interfere with internal trade, etc.).
- Central government may influence (control) subnational governments by:
  - mandates(i.e., by imposing legislative obligations),
  - disallowing subnational government laws, and
  - using its spending powers(i.e., influencing subnational activities by conditional grants).

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<sup>14</sup> For example by the Constitution of the State of Iraq and, if a federal structure is chosen, by the constituting regions or provinces.

- Dispute settlement:
  - disputes over legislative powers may be settled by the courts, or
  - disputes may be settled by the national government.

Thus the fiscal and legal relationships between the central and subnational levels may be either hierarchical or parallel—depending on the constitutional model chosen.

### **Institutional structure**

The reconstruction of Iraq and restoration of the provision of essential public services at satisfactory levels require a massive effort, where all segments of the society and public administrations at all levels are likely to be involved. In this setting, decentralization of powers from the central to subnational government can play a crucial role by capacity building and by increasing the level of accountability of the whole public sector.

For any level of government with substantive expenditure responsibilities, it would be important for accountability that such a **level of administration should have access to own-source revenues.**<sup>15</sup> Thus, the subnational government should be forced to rely on raising taxes on its own population to meet additional spending needs at the margin, rather than relying on other levels of government. This has implications for the design and establishment of municipal tax bases.

Officials **agreed that the present system of government of Kurdistan should be maintained,**<sup>16</sup> with the possibility of a gradual extension of this system to the other areas of the country. According to the option presented by Iraqi officials during the seminar, the new system might be based on either two levels—regions and governorates—or one level—governorates—of subnational government. The number of layers of subnational government that will be created is clearly a choice to be made by the Iraqi people.

While officials were not too keen to strengthen municipal governments at this stage, the role of municipal governments cannot be neglected, regardless of the degree of political or administrative devolution. By their nature, **municipalities are best placed to be made responsible for the provision of a range of local public services** that are presently split between line ministries. The present separation of responsibilities by sectors does not allow for the establishment of priorities concerning service delivery, and it also reduces the accountability of the public administration providing basic services. The Iraqi officials agreed that, at this stage, the municipal level might begin to operate with horizontal responsibilities—but only on the basis of derived responsibility from the center—or a deconcentrated basis.

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<sup>15</sup> See for example Boadway (forthcoming).

<sup>16</sup> There was no discussion of whether or not the current boundaries of any governorates would be redrawn.

## **Expenditure assignments and management**

Given the conventional expenditure assignments based on international experience (see, for example, Shah, 1994), the Iraqi staff made suggestions to change these traditional assignments, given the current context in Iraq. For the assignment question to be resolved, consideration should be given to service area (region), geographical size, population, administrative capability, and the initial effects on service scope and quality. The Iraqis' matrix (see Table 1) reflects several sound principles: expenditures should be undertaken by government for equity or income distribution purposes (such as unemployment insurance and payments to individuals), and stabilization should remain central. They also suggested changes to the conventional treatment of zoning and policing, which they argued would have to be kept central for the moment.

The Iraqis suggested a sequenced approach for a move to some devolution of spending to the governorate level, driven to a large extent by the enhancement of central and local staff, and institutional and political capabilities. Technical assistance by the World Bank and other agencies may be relevant in due course.

Considerable work is needed to develop the implementation of the new *Financial Management Law* and to work through the implications for subnational operations, including the budget classification and standardized accounting and reporting mechanisms.<sup>17</sup> The Fund is providing technical assistance in this area, as requested by the Iraqi authorities.

## **Revenue assignments**

It is important that levels of government that have expenditure responsibilities also have the discretion to raise some revenues from their own sources. This enhances the accountability of the government to its constituents. It also provides some safeguards against spending beyond budgetary means in the expectation of being accommodated with increased grants from higher levels of government (i.e., the soft budget constraint). Some options are available to subnational governments of all levels. These are administratively feasible and do not compromise the administrative capacity of the tax collection authorities or the ease of compliance by taxpayers.

For intermediate levels of government—regional or governorate—various options are available. One is to allow these governments to ‘piggyback’ onto central government taxes. Thus, a region or governorate could impose a surtax on income taxes levied at the central level at a rate of its choosing. The surtax would be administered by the central tax authority and the proceeds remitted to the subnational government for its own use. Alternatively, regional or governorate administrations could be assigned their own tax sources, such as payroll taxes or specific excise taxes. Even if this is the only level to establish such taxes, these could be administered by the central tax administration. To the extent that different

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<sup>17</sup> A joint Bank-Fund mission made a diagnostic assessment of the reform steps needed in this area in February 2005.

Table 1. Basis of Expenditure Assignments Proposed by Iraqi Officials

<i>Expenditure Category</i>	<i>Responsibility</i>		<i>Comments</i>
	<i>Policy, standards, and oversight</i>	<i>Provisional/ administration</i>	
Defense	F	F	Benefit and costs are national in scope
Foreign affairs	F	F	Benefit and costs are national in scope
International trade	F	F	Benefit and costs are national in scope
Monetary policy, currency, banking	F	F	Benefit and costs are national in scope
Interstate commerce	F	F	Benefit and costs are national in scope
Transfer payments to persons	F	F	Redistribution
Subsidies to business and industry	F	F	Regional development, industrial policy
Immigration	F	F	Benefit and costs are national in scope
Unemployment insurance	F	F	Benefit and costs are national in scope
Airlines and railways	F	F	Benefit and costs are national in scope
Fiscal policy	F, S	F, S,	Coordination is possible
Regulation	F	F, S, L	Internal common market
Natural resources	F	F	Promotes a common market
Environment	F,S,L	S,L	Benefits and costs may be national, regional, or local in scope
Industry and agriculture	F,S,L	S,L	Significant interjurisdictional spillovers
Education	F,S,L	S,L	Transfers in kind
Health	F,S,L	S,L	Transfers in kind
Social welfare	F,S,L	S,L	Transfers in kind
Police	F	S,L	Primarily local benefits
Water, sewage, refuse	S,F	L	Primarily local benefits
Fire protection	S,F	L	Primarily local benefits
Parks and recreation	S,L	F, S, L	Primarily local responsibility, but national and provincial governments. may establish own parks
<b>Highways</b>			
Interstate	F	S,L	Internal common market
Provincial	F	S,L	Provincial benefits and costs
Interregional	S	S,L	Interregional benefits and costs
Local	L	L	Local benefits and costs
Spending power	F,S	F,S	Fiscal transfers to advance own objectives

Note: **F** is federal responsibility; **S** is state or provincial responsibility (defined as groups of governorates); and **L** is local responsibility (at the governorate level). All municipal functions are deconcentrated from higher levels.

*Source:* Based on comments by Iraqi officials.

subnational governments have different capacities to raise revenues, these capacities could be equalized through the transfer system, using standard international practices.

Municipal governments that have spending responsibilities could also raise some of their own-source revenues. Annual taxes on property values are commonly used for this purpose and could be instituted in Iraq. Given the lack of capacity at the municipal level, the tax collection machinery would have to be developed. This could be done at the governorate level or even at the central level, provided that municipalities had the discretion to choose their own tax rates. Other sources of own finance at the municipal level would include user charges of various sorts on the kind of local services typically provided.

It is important that whenever own-revenue sources are used by subnational governments they replace transfers from higher governments on a one-for-one basis. That is, these transfers should be based on measures of need that do not simply fill the gap between expenditures and available revenues. Gap-filling transfers reduce the incentives to collect own source revenues and reduce subnational accountability.

It was agreed by **all participants that natural resource revenues are a national resource and should be assigned to the central government.** This would provide the central government with a tool to “manage” its macroeconomic difficulties and also to “equalize” across different regions in the country. The linkage between natural resource flows accruing to the center and the establishment of an equitable transfer system was repeatedly emphasized by the Iraqi officials.

### **Transfers**

Even after the allocation of some revenue capacities to governorates, and eventually municipalities, they will be unable to finance all their responsibilities. **Grants from the central government will continue to be one of the main mechanisms by which subnational governments are funded.** As suggested above, the basis of grant determination must change, however, as the current gap-filling approach is incompatible with a hard budget constraint. The absolute size and the distribution of the transfers between jurisdictions must be part of the central government budget and be subject to that restraint.

**As all groups supported an equalization of fiscal capacity of the subnational governments,** further consideration should be given to this matter. An equal per capita distribution, as suggested by an Iraqi Working Group, may not adequately reflect differences in the funding requirements of jurisdictions arising from their different capacities to raise their own revenues and different levels of need for services. More appropriate mechanisms for the determination of equalization grants were presented to the officials.<sup>18</sup> The role of special purpose grants, as well as mechanisms for reporting and monitoring, were deemed to be important.

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<sup>18</sup> See Ahmad (1998) and Ahmad and Searle (forthcoming).

## **Borrowing**

It was also agreed by the participants that the borrowing by subnational governments should be very carefully sequenced. While some borrowing might be necessary, this should only be allowed within the overall macroeconomic constraints faced by the government—this is foreseen in the Financial Management Law.

### **B. The Next Steps**

The Constituent Assembly will decide on the governance structure of the state and of territorial government, and the degree of autonomy to be given to the subnational levels. This would permit the determination of specific expenditure and revenue assignments, and fiscal relationships between levels of government, including the determination of the system of transfers; possible access to borrowing, given overall macroeconomic constraints; and systematic reporting on subnational operations.

While the Constituent Assembly is likely to take some time to work through the various political options for Iraq, the government needs to undertake a series of reforms to prepare for a more effective system of fiscal management and intergovernmental fiscal relations. These include, *inter alia*:

- implementation of regulations for the Financial Management Law and strengthening of the budget classification and reporting arrangements;
- tax reforms, including preparations for both central and subnational taxes;
- enhancement of the tax administration; and
- strengthening of the capabilities of both central and subnational officials.

At the same time it would be useful for the Iraqi officials concerned to undertake **a full diagnostic assessment of the situation, working through the details of possible options**, and for which technical assistance might be sought, e.g., from the World Bank or the IMF. This would be a prelude to the **preparation of a “white paper”** for consideration by the Constituent Assembly.

Table 2. Iraqi Comments

	Iraqi Group 1	Iraqi Group 2	Iraqi Group 3	Iraqi Group 4	IMF/World Bank team comments
Institutional structure	<p><b>Option 1:</b> Asymmetric option 2 levels based on the current 15 governorates (G); (unitary but linked to CG)+ Kurdistan; moving to</p> <p><b>Option2: Federal option</b> introduction of an explicit regional tier (RG) with 3-levels (CG, RG, G)</p>	<p><b>Option 1: Federal option:</b> CG &amp; RG (based on regions for groups of three governorates)</p>	<p><b>As is. No change</b> envisaged to interim constitution: #71/2004</p>	<p><b>Option 1: Asymmetric option:</b> federal, CG; regional government (RG) in Kurdistan; + unitary arrangements in existing governorates</p>	<p>- all groups recognize the special region of Kurdistan, some would like to see this extended by the creation of other regions</p> <p>- greater attention might be paid to the role of municipalities</p>
Expenditure assignments	<p>Detailed suggestions</p> <p>Standardized reporting</p>	<p>Principles enunciated; staffing subject to CG delegations</p>	<p>Delegated powers</p>	<p>CG: legislation by Parliament (Iraqi) for RGs: budgets; (deconcentrated); CG financing</p>	<p>- by and large the discussion was productive—we particularly like the table produced by Group 1, and principles enunciated by others</p>
Revenue assignments/financing	<p>CG: oil; taxes; loans; LG: fees, fines; local profits according to operations</p>	<p>CG LG Grants Loans to LGs</p>	<p>CG, except for delegated powers, grants for self-financed agencies</p>	<p>CG: oil, customs, taxes, fees, natural resources; Transfers according to equal population shares</p>	<p>- own-source revenues at each substantive level of government (including municipalities) needs to be discussed, including the scope for policy making and</p>

<p>administration</p> <ul style="list-style-type: none"> <li>- all groups agreed that natural resource revenues be assigned to the central government</li> <li>- all groups agreed that there should be equalization transfers</li> <li>- all groups agreed that subnational borrowing be treated cautiously, given the precarious macroeconomic conditions of the country</li> </ul>	<ul style="list-style-type: none"> <li>- it is important to ensure that institutional arrangements cover political, administrative, and financial aspects of intergovernmental relations</li> <li>- subnational capacity development is needed, as accepted by all groups</li> </ul>
<p>Institutional arrangements</p>	<p>Vertical links to Line Ministries; Horizontal interactions important at the municipal level to ensure effective service delivery</p> <p>Harmonization (using intergovernmental committees) Decentralization in an incremental manner based on capacity building and extensive use of central grants</p> <p>-CG in Baghdad; and Kurdistan PM -Governorates: would have a budget department; audit dept., and internal audit/control functions</p>

Iraqi officials emphasized the importance of:

- Decentralization at level of governorates (not lower);
- Municipalities and lower levels to be responsible to the governorate levels; and
- Dissolving state institutions without replacing them would lead to institutional chaos, and a step-by-step approach is recommended.

Notes: CG refers to central government, RG to regional government; G to governorates; LM to line ministries, and DGs to Directors General.

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