



# Journal of Frontiers in Multidisciplinary Research

## Financial Sustainability and the Trade-Off between Efficiency and Fairness in the Iraqi Financial System

Dr. Ahmed Amer Najaf <sup>1\*</sup>, Noor Ahmed Hamdi <sup>2</sup>, Dr. Ali Fakhri Abbas <sup>3</sup>

<sup>1,3</sup> Lecturer Imam Al-Kadhumi College, Baghdad, Iraq

<sup>2</sup> Imam Al-Kadhumi College, Baghdad, Iraq

\* Corresponding Author: Dr. Ahmed Amer Najaf

---

### Article Info

**E-ISSN:** 3050-9726

**P-ISSN:** 3050-9718

**Volume:** 06

**Issue:** 02

**July – December 2025**

**Received:** 18-05-2025

**Accepted:** 13-06-2025

**Published:** 15-07-2025

**Page No:** 162-170

### Abstract

An in-depth analysis of the period from 2004 to 2023 reveals an overreliance on oil revenues, which makes the public budget vulnerable to global price fluctuations and leads to recurring cycles of large surpluses and deficits. The Iraqi financial system faces profound structural challenges that require comprehensive reforms to achieve fiscal sustainability and balance efficiency and equity. This dependence limits Iraq's ability to build a diversified and sustainable economy. Data indicates structural imbalances in public spending, with average expenditures exceeding revenues over the long term, leading to the accumulation of debt, particularly domestic debt. Achieving distributive justice remains a challenge, with potential unequal distribution of oil wealth and public services. Addressing these challenges requires structural reforms aimed at diversifying revenues, rationalizing spending, strengthening fiscal governance, developing a vibrant private sector, and ensuring a more equitable distribution of opportunities and services. Achieving a balance between efficiency and equity is not simply an economic goal; it is essential for achieving long-term social and political stability and inclusive growth in Iraq.

**DOI:** <https://doi.org/10.54660/JFMR.2025.6.2.162-170>

**Keywords:** Iraqi Financial System, Financial Sustainability, Efficiency, Fairness, Fiscal Federalism, Public Choice Theory

---

### 1. Introduction

#### 1.1 Economic context: the Iraqi economic landscape after 2003

The Iraqi economy is highly dependent on oil exports, with oil revenues accounting for more than 90% of government revenues and over 80% of foreign exchange earnings. Despite its abundant resources and potential, the Iraqi economy is vulnerable to external shocks due to fluctuating oil prices on global markets. This dependence on a single commodity creates inherent vulnerabilities in the economic structure. Iraq's public financial system is described as among the weakest in the world, suffering from significant institutional gaps and weak public trust in financial intermediaries. The financial sector is dominated by the banking system, largely controlled by state-owned banks, whose primary function is to pay public sector salaries rather than provide substantial credit for economic development. This overreliance on oil and weak financial infrastructure create a fragile foundation, making Iraq highly vulnerable to external shocks, such as oil price fluctuations, and hindering economic diversification and domestic growth. These macroeconomic conditions are critical to understanding the challenges facing financial sustainability, efficiency, and equity in the financial system. (2012). Because of their limited skills and resources, micro- and small-business owners are hesitant or unwilling to capitalize on growth opportunities, according to several scholars (Chew *et al.*, 2013).

## 1.2 The importance of financial sustainability, efficiency, and equity in national financial systems

Financial sustainability, efficiency, and equity are fundamental pillars of any national financial system seeking to achieve economic stability and social welfare (Ozili, 2023).

- **Financial sustainability:** Financial sustainability at the national level is defined as the government's ability to meet its current and future financial obligations without resorting to unsustainable policies, such as excessive borrowing or high inflation. It is essential to ensure macroeconomic stability, enable the government to provide basic services, and promote economic growth. For Iraq, achieving fiscal sustainability involves reducing dependence on external grants and volatile oil revenues (James Daniel, 2006).
- **Efficiency in public finance:** Efficiency includes allocative efficiency (directing resources toward the most valuable uses), productive efficiency (maximizing output from available resources), and operational efficiency (minimizing waste in administrative processes). Efficiency ensures the optimal use of public resources to maximize social welfare and achieve economic goals with minimal waste. In developing economies such as Iraq, efficiency faces significant challenges in the form of weak administrative capacity and widespread corruption.
- **Equity and fair distribution of income:** Equity refers to the fair distribution of income, wealth, and opportunities among citizens. Fiscal policy plays a central role in redistribution through progressive taxation and public spending directed toward social programs (such as healthcare, education, and social safety nets). Achieving social equity contributes to strengthening social cohesion and stability.

## 1.3 Research objectives, scope (2004–2023), and analytical approach

This research aims to analyze the dynamics of financial sustainability, efficiency, and equity within the Iraqi financial system during the period from 2004 to 2023. The report will address the interrelationships, trade-offs, and synergies between these three pillars, using relevant economic theories and standard models to provide a robust and evidence-based assessment. The analysis will conclude with policy recommendations tailored to the unique Iraqi context.

## 2. Theoretical Foundations of Fiscal Sustainability, Efficiency, and Equity

### 2.1 Fiscal Sustainability: Basic Concepts, Dimensions, and Indicators

Fiscal sustainability at the national level is defined as the government's ability to meet its financial obligations and maintain its financial position in the long term without resorting to unsustainable policies, such as excessive borrowing or high inflation. It simply means the ability of an institution (or government) to generate sufficient revenue to cover all its expenses and achieve a profit that ensures its financial stability in the short and long term. (International Monetary Fund, 1997)

The dimensions of financial sustainability in the national system include:

- **Public financial sustainability:** the government's ability

to manage its budget and debt effectively.

- **External sustainability:** the state's ability to finance its imports and service its external debt.
- **Monetary sustainability:** the central bank's ability to maintain price stability and a sound financial system.

Key indicators of financial sustainability include the ratio of public debt to GDP, the budget balance (surplus/deficit), the composition of revenues (oil vs. non-oil), the structure of expenditures (current vs. investment), the level of foreign reserves, and the health of the financial sector.

### 2.2 Public finance efficiency: definitions and types (allocative, productive, operational) and measurement challenges in developing economies

Public finance efficiency refers to maximizing the societal benefits derived from public resources. It includes (António Afonso, 2023):

- **Allocative efficiency:** directing resources toward uses that achieve the highest social value.
- **Productive efficiency:** maximizing output from available resources.
- **Operational efficiency:** reducing waste in administrative and operational processes.

The challenges of measuring efficiency in developing economies are significant and include weak institutional capacities, limited managerial skills, widespread corruption, and a lack of reliable data. These factors lead to misallocation of resources, leakage of funds, and a gap between planned objectives and actual outcomes.

### 2.3 Equity and income distribution: concepts (Gini coefficient, Lorenz curve), social justice, and the role of fiscal policy

Income distribution refers to how total national income is divided among members of society. The Gini coefficient is a common measure of income inequality, ranging from zero (perfect equality) to one (perfect inequality). The Lorenz curve provides a graphical representation of income distribution, with a greater deviation from the line of perfect equality indicating higher inequality.

Social justice refers to fairness in the distribution of economic opportunities, social services, and protection from risks. Fiscal policy plays a key role in promoting justice through:

- **Progressive taxation:** imposing higher tax rates on high-income earners.
- **Targeted social spending:** directing government spending toward healthcare, education, and social safety nets.
- **Public debt management:** ensuring debt sustainability to avoid passing the burden on to future generations.

### 2.4 Trade-offs between efficiency and equity

Achieving both efficiency and equity is often complex. Policies aimed at increasing equity (such as high progressive taxes) may reduce incentives to work or invest, which can reduce economic efficiency. Conversely, policies that focus solely on efficiency (such as very low taxes and reduced social spending) may exacerbate inequality. The optimal balance between efficiency and equity depends on societal values and the specific economic context of each country. (Emmanuel Combet, 2025)

## 2.5 Relevant economic theories applied to resource-rich developing countries (Yinan Li, 2023)

### • Rentier State Theory

This theory suggests that countries that derive a large portion of their revenue from external rents (such as oil exports) rather than domestic productivity or taxes tend to exhibit certain characteristics. These characteristics include a disconnect between the state and its citizens (where accountability is reduced due to the lack of need for taxation), weak economic diversification, labor market distortions (with a bloated public sector as the main employer), and vulnerability to global commodity price fluctuations. The Iraqi economy is a classic example of a rentier state, with oil revenues dominating its budget. This theoretical framework is crucial for understanding Iraq's fiscal fragility, the challenges of diversifying its economy, and the political economy of public spending.

### • Public Choice Theory

This theory applies economic tools to analyze political decision-making, assuming that political actors (voters, politicians, bureaucrats) are rational and seek to maximize their own interests. It explains how individual choices lead to collective decisions that may not maximize overall social welfare, due to factors such as lobbying, rent-seeking, and short-term political gains. In a rentier state such as Iraq, public choice theory helps to understand how oil revenues are used for political support (e.g., expanding public sector employment to ensure loyalty), leading to inefficient resource allocation and fiscal indiscipline (Anderson, 2007).

### • Fiscal Federalism

It determines which level of government is best suited to provide certain public services and collect specific types of revenue, considering factors such as economies of scale, spillovers, and diversity of local preferences. (Martinez-Vazquez, J. 2011) <sup>[31]</sup>. In the Iraqi context, fiscal federalism is relevant given the existence of the Kurdistan Region, which enjoys semi-autonomous rights, and calls for decentralization. Analyzing the sharing of revenues (especially oil revenues) and spending responsibilities between the central government and regional governments is critical to understanding fiscal stability and the equitable distribution of services across the country (David N. Hyman 2010).

### • Welfare Economics

This theoretical framework provides the normative basis for assessing the “fairness” aspect of the Iraqi financial system. It helps assess whether current fiscal policies, including social safety nets and tax structures, truly improve the welfare of all citizens, especially the poor and vulnerable, and whether they contribute to building a more just society.

## 3. Overview of the Iraqi Financial System (2004–2023)

### 3.1 Macroeconomic Context: Trends in GDP, Inflation, and Unemployment

- **GDP Trends:** Iraq's GDP has experienced significant fluctuations, largely reflecting fluctuations in global oil prices and internal security conditions. For example, real GDP grew by 8% in 2022, driven by a 12% expansion in oil production, but contracted by 2% in 2023. Non-oil GDP growth was slower and more constrained. The

strong positive correlation between oil production, oil prices, and GDP growth in Iraq reveals a deep structural imbalance in the economy. This effect is known as the “Dutch disease,” whereby a boom in the resource sector can stifle the development of other productive sectors, reducing the economy’s resilience. This means that while oil provides short-term growth, it simultaneously hinders the long-term diversification necessary for sustainable growth, creating a cycle of dependency and fragility.

- **Inflation:** Inflation rates have fluctuated, peaking at around 8.4-8.6% in late 2021, but have remained low or declined in recent years (e.g., 4.4% in 2023). This is partly attributable to government support and price controls. However, controlling inflation through subsidies rather than market mechanisms can mask underlying inflationary pressures and create fiscal burdens. Iraq's dependence on imports makes it vulnerable to imported inflation, and the devaluation of the dinar contributes to higher prices and erodes purchasing power, affecting equity.
- **Unemployment:** High unemployment rates have been a persistent challenge, estimated at 25-30% in 2004 and more than 10 percentage points above pre-COVID-19 levels in 2021. Achieving fiscal sustainability is linked to reducing unemployment rates. High and persistent unemployment rates, particularly among young people, are a critical social and economic challenge. In a rentier state, labor market distortions, coupled with a bloated public sector, lead to a failure to generate sufficient employment opportunities in the private sector. This directly affects income distribution and social justice and hinders sustainable development, as a large part of the population remains outside productive economic activity.

### 3.3 The role of the Central Bank of Iraq and the Ministry of Finance in financial management

The Central Bank of Iraq (CBI) is tasked with maintaining domestic price stability and a stable and competitive financial system. The central bank has implemented various policies, including interest rate adjustments, reserve requirements, and foreign currency auctions. The Central Bank has also launched a roadmap for sustainable finance (2023-2029) to integrate environmental, social, and governance (ESG) risks, promote financial inclusion, and diversify sources of income. Meanwhile, the Ministry of Finance manages public revenues, expenditures, and public debt.

The central bank's active role in monetary policy (such as managing exchange rates and interest rates) is crucial for stability, but its effectiveness is often constrained by the dominance of fiscal policy and the rentier nature of the economy. This means that fiscal policy often dictates macroeconomic outcomes, rather than a coordinated approach. The Central Bank's roadmap for sustainable finance signals a strategic shift toward long-term flexibility, but its success depends on overcoming deep structural issues and political will.

## 4. Fiscal sustainability in Iraq (2004–2023): trends and challenges

### 4.1 Oil revenues: trends, volatility, and dominance in public finances

The Iraqi economy is deeply dependent on oil, with oil

revenues accounting for around 95% of government revenues and 99% of exports in some years.

- Trends: Oil revenues have been highly volatile, heavily influenced by global oil prices. For example, revenues fell sharply in 2009 due to the global financial crisis, and again in 2014–2016 as a result of lower prices. They rebounded in 2017–2018 and 2021–2022, reaching \$104.2 billion in 2022, before falling to \$95.5 billion in 2023.
- Dominance: This overwhelming dependence makes Iraq's public finances highly vulnerable to external shocks. Heavy reliance on volatile oil revenues generates fundamental fiscal instability, leading to procyclical fiscal policies where spending expands during booms and contracts sharply during recessions. This cyclical

hinders long-term planning and investment, undermining fiscal sustainability.

This Table 1 provides a clear picture of the Iraqi economy during the period 2004–2023, which was marked by many challenges and transformations. The data can be analyzed from several angles.

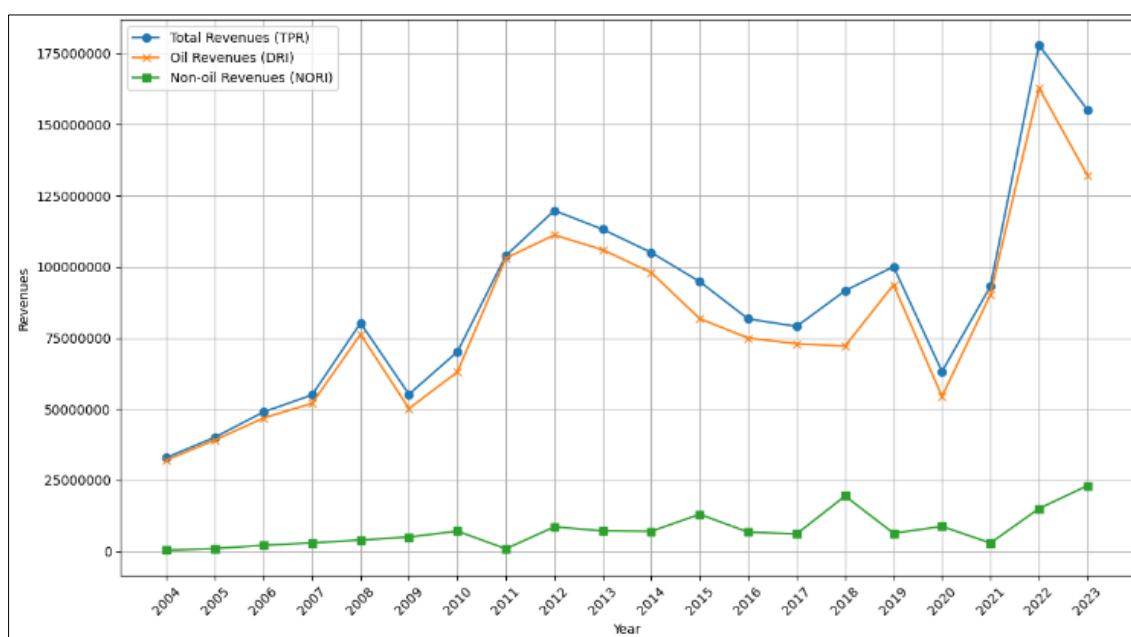
#### A. Oil dominance

- Heavy dependence on oil: The figures clearly show that oil revenues constitute the largest share of total government revenues. This confirms the rentier nature of the Iraqi economy, which relies primarily on oil exports as its main source of funding

**Table 1:** Oil and non-oil revenues and total revenues in Iraq (2004–2023)

(DRI)	Total revenues (TPR)	(DRI)	Total revenues (TPR)	(DRI)	Total revenues (TPR)	(DRI)	Total revenues (TPR)
2004	149.44	395,850	22.03	32,093,800	1.20	97.29	32,988,800
2005	115.54	987,210	19.69	39,163,550	2.46	97.54	40,150,760
2006	40.87	2,127,850	10.94	46,872,200	4.34	95.66	49,000,050
2007	33.84	2,977,600	46.73	51,999,250	5.41	94.59	54,976,850
2008	26.70	3,965,220	-34.10	76,297,270	4.94	95.06	80,262,490
2009	41.10	5,023,320	25.71	50,190,200	9.10	90.90	55,213,520
2010	-87.32	7,087,050	63.39	63,091,170	10.10	89.90	70,178,220
2011	856.96	896,280	8.06	103,092,720	0.86	99.14	103,989,000
2012	-16.48	8,591,050	-4.70	111,226,170	7.17	92.83	119,817,220
2013	-2.06	7,189,380	-7.53	105,990,820	6.35	93.65	113,180,200
2014	84.86	7,041,350	-16.96	98,011,500	6.70	93.30	105,052,850
2015	-48.26	13,017,020	-8.34	81,791,220	13.73	86.27	94,808,240
2016	-9.41	6,734,700	-3.71	74,973,100	8.24	91.76	81,707,800
2017	218.74	6,101,200	-1.12	72,990,220	7.72	92.28	79,091,420
2018	-67.36	19,447,000	29.85	72,176,290	21.22	78.78	91,623,290
2019	37.79	6,358,180	-41.91	93,721,100	6.35	93.65	100,079,280
2020	-66.61	8,751,000	65.81	54,448,000	13.85	86.15	63,199,000
2021	413.24	2,922,000	80.54	90,277,000	3.13	96.87	93,199,000
2022	53.59	15,017,000	-18.77	162,982,000	8.44	91.56	177,999,000
2023	149.44	23,065,000	22.03	132,192,000	14.85	85.15	155,257,000

Source: Republic of Iraq, Central Bank of Iraq, Department of Statistics and Research, Annual Economic Report, for the period 2004–2023, <https://cbi.iq/page/150>



**Fig 1:** Revenues over Time (2004–2023)

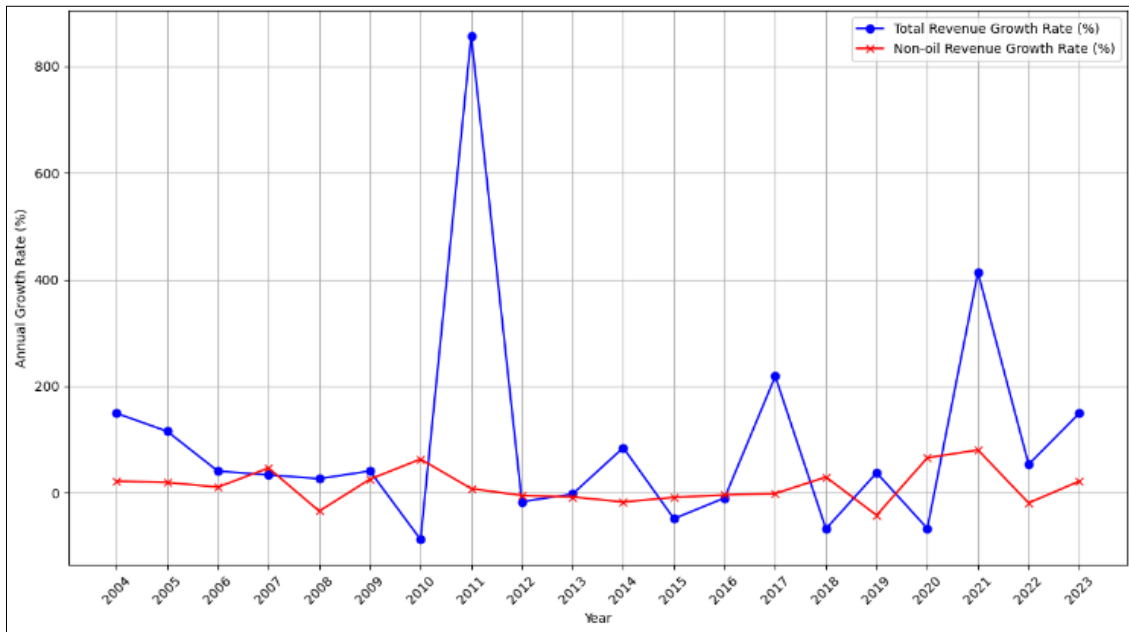


Fig 2: Annual Growth Rates over Time (2004-2023)

- **Fluctuations in oil revenues:** The annual growth rates of oil revenues show significant fluctuations (high positive growth in some years and sharp negative growth in others). These fluctuations are directly linked to global oil prices and oil production, making the state budget vulnerable to external shocks. For example, sharp declines can be observed in years such as 2009, 2015, and 2020, which may coincide with a decline in global oil prices or internal security and economic challenges.

#### B. Weak non-oil revenues:

- **Limited contribution:** Although there has been growth in non-oil revenues in some years, their overall contribution to the budget remains limited compared to oil revenues. This points to the weakness of the non-oil productive base of the Iraqi economy and the inadequacy of efforts to diversify sources of income.
- **Fluctuating growth:** Annual growth rates for non-oil revenues show significant fluctuations, with high jumps in some years (such as 2005, 2012, 2018, and 2022) and sharp declines in other years (such as 2011, 2013, 2016, 2019, and 2021). This volatility may reflect economic policy instability, the impact of security conditions, or the lack of a clear strategy for developing non-oil sectors.

#### C. Impact of geopolitical and security events:

- **Post-2003 period:** The period from 2004 onwards represents a phase of reconstruction and significant security and political challenges in Iraq. The impact of these events on revenues can be observed. For example, declines in oil and non-oil revenues in certain years may be linked to conflicts or unrest that affected production or the ability to collect revenues.
- **Recovery and growth:** Conversely, some years see significant growth in revenues, particularly oil revenues, indicating periods of relative stability or higher oil prices that allowed the government to increase its spending.

#### D. The need for economic diversification:

- **Economic risk:** Over-reliance on oil makes the Iraqi

economy highly vulnerable to external shocks. Any decline in oil prices or disruption in production can lead to a significant budget deficit, negatively affecting public services, investment, and development.

- **The importance of non-oil revenues:** Data points to an urgent need to diversify sources of income and develop non-oil sectors (such as agriculture, industry, tourism, and services). This diversification will contribute to building a more stable and resilient economy and reduce dependence on a single commodity.

#### E. Indicators of economic development:

- **Government spending:** Government revenues are directly linked to the ability to spend on development projects and basic services (health, education, infrastructure). Fluctuations in revenues affect the continuity of these projects and the government's ability to meet the needs of its citizens.
- **Structural challenges:** The table reflects the structural challenges facing the Iraqi economy, which require comprehensive reforms to boost non-oil revenues, improve the business environment, combat corruption, and activate the role of the private sector.

In summary, this table provides an overview of the challenges and opportunities that the Iraqi economy has faced over the past two decades. It highlights the urgent need to adopt economic policies aimed at diversification and reducing dependence on oil to ensure stability and sustainable economic growth.

#### 4.2 Overall financial performance and budget balances

Iraq has experienced periods of large surpluses (e.g., 25,231,423 in 2011 and 44,738,000 in 2022) and large deficits (e.g., -81,181,589 in 2020 and -64,357,424 in 2023). The average over the period 2004-2023 shows a deficit of -2,936,532.

The ratio of expenditure to revenue fluctuates significantly, from a low of 71.5% in 2007 to a high of 220.4% in 2020.<sup>[22]</sup> This indicates a lack of consistent fiscal discipline. Recent

years (2019, 2020, 2021, 2023) show a large deficit, with forecasts for 2025 also indicating a similar deficit of around trillion dinars (US\$48 billion). Fiscal policy in oil-exporting countries tends to be expansionary during periods of high oil prices and then faces financing difficulties during periods of recession, transferring oil volatility to the rest of the economy. This is evident in the fluctuations in surpluses and deficits in Iraq.

Furthermore, the government has faced difficulties in presenting budget schedules, leading to systematic

disruption, delays in salaries, project freezes, and erosion of confidence. The volatile nature of Iraq's public finances, characterized by large swings between surpluses and deficits, is a direct result of its dependence on oil and its pro-cyclical fiscal management. Chronic budget delays and the inability to manage expenditures effectively during periods of contraction, as evidenced by the 2023 budget deficit due to low oil prices, lead to dire social and economic consequences, undermining public services and stability. This points to a severe lack of foresight and fiscal discipline.

**Table 2:** General revenue, general expenditure, surplus or deficit, and ratios (2004–2023)

Years	Public Revenue	Public Expenditure	Surplus or Deficit	Revenue to Expense % Ratio	Expenditure to Revenue % Ratio
2004	32,988,800	31,521,427	1,467,423	104.7%	95.5%
2005	40,150,760	30,546,162	9,604,598	131.2%	76.2%
2006	49,000,050	38,806,679	10,193,371	126.4%	79.2%
2007	54,976,850	39,308,348	15,668,502	139.8%	71.5%
2008	80,262,490	67,277,197	12,985,293	119.9%	83.8%
2009	55,213,520	55,589,721	-376,201	99.4%	100.7%
2010	70,178,220	70,134,201	44,019	100.1%	99.9%
2011	103,989,000	78,757,577	25,231,423	132.0%	75.7%
2012	119,817,220	105,139,576	14,677,644	114.0%	87.7%
2013	113,839,220	119,127,556	-5,288,336	95.6%	104.6%
2014	105,553,850	112,192,125	-6,638,275	94.1%	106.8%
2015	72,546,340	82,813,611	-10,267,271	87.6%	114.1%
2016	62,376,260	73,570,823	-11,194,563	72.6%	137.6%
2017	77,299,659	75,490,115	1,809,544	102.4%	97.7%
2018	106,467,377	80,873,189	-25,594,188	131.6%	76.0%
2019	107,483,586	111,723,523	-4,239,937	96.2%	103.9%
2020	67,425,220	148,606,809	-81,181,589	45.4%	220.4%
2021	101,320,142	129,993,009	-28,672,867	77.9%	128.3%
2022	161,697,454	116,959,454	44,738,000	138.3%	72.3%
2023	134,552,919	198,910,343	-64,357,424	67.6%	147.8%
Average	89,885,027	92,821,559	-2,936,532	104%	103.3%

Source: Republic of Iraq, Central Bank of Iraq, Department of Statistics and Research, Annual Economic Report, for the period 2004-2023, <https://cbi.iq/page/150>

### 4.3. Public debt dynamics and long-term solvency

Public debt has fluctuated significantly, falling from 78,080,881 in 2004 to a low of 22,149,069 in 2013, before rising again to 69,495,737 in 2022. <sup>[22]</sup> The ratio of domestic

debt to public debt increased significantly, from 8% in 2004 to 70% in 2022. This indicates a growing reliance on domestic borrowing.

**Table 3:** Public debt, domestic debt, external debt, and domestic debt to public debt ratio (2004-2022)

Years	Public Debt	Domestic Debt	External Debt	Ratio of Domestic Debt to Public Debt %
2004	78,080,881	5,925,061	72,155,820	8%
2005	58,090,340	6,593,960	51,496,380	11%
2006	42,099,130	5,645,390	36,453,740	13%
2007	42,084,045	5,193,705	36,890,340	12%
2008	24,294,909	4,455,569	19,839,340	18%
2009	28,548,329	8,434,049	20,114,280	30%
2010	29,257,326	9,180,806	20,076,520	31%
2011	28,120,459	7,446,859	20,673,600	26%
2012	25,634,019	6,547,519	19,086,500	26%
2013	22,149,069	4,255,549	17,893,520	19%
2014	26,994,639	9,520,019	17,474,620	35%
2015	47,622,045	32,142,805	15,479,240	67%
2016	61,208,371	47,362,251	13,846,120	77%
2017	61,106,016	47,678,796	13,427,220	78%
2018	54,320,298	41,822,918	12,497,380	77%
2019	49,939,208	38,331,548	11,607,660	77%
2020	69,186,200	45,169,544	24,016,656	65%
2021	71,435,056	49,677,512	21,757,544	70%
2022	69,495,737	48,726,282	20,769,455	70%

Source: Republic of Iraq, Central Bank of Iraq, Department of Statistics and Research, Annual Economic Report, for the period 2004-2023, <https://cbi.iq/page/150>

## 5. The Interaction Between Sustainability, Efficiency, and Equity: Key Challenges in Iraq

### 5.1 The “Oil Curse” and Its Systematic Implications

Heavy dependence on oil revenues (more than 90% of government revenues <sup>[1]</sup>) makes Iraq's public finances highly vulnerable to fluctuations in global oil prices. <sup>[11]</sup> This leads to pro-cyclical fiscal policies, with spending expanding during boom periods, creating unsustainable non-oil deficits that are difficult to finance during downturns. <sup>[12]</sup>

The “oil curse” hinders the development of non-oil sectors and a strong non-oil revenue base, trapping the economy in a cycle of dependency and hindering long-term sustainability. Iraq's “oil curse” is not only about revenue volatility, but represents a fundamental structural impediment that undermines all three pillars: It jeopardizes fiscal sustainability by creating an unstable and exhaustible revenue base, reinforces inefficiency by reducing incentives for sound public financial management and non-oil sector development, and exacerbates inequality by concentrating wealth and power and making the economy vulnerable to external shocks that disproportionately affect the poor.

### 5.2 Governance deficits and institutional weaknesses

Corruption is endemic and systematic, leading to the theft of vast amounts of public funds, <sup>[2]</sup> distortions in public service delivery, and erosion of public trust. Iraq has one of the weakest public financial management systems in the world, <sup>[3]</sup> characterized by outdated regulatory frameworks, untrained staff, and inefficient operations in areas such as tax collection.

Ongoing delays in budget approval and disbursement highlight a breakdown in governance and political stability, which directly affects service delivery and economic planning. Governance deficits and institutional weaknesses, particularly widespread corruption and a weak public financial management system, are critical factors that increase fiscal unsustainability and inequality. They prevent the effective allocation of resources, undermine revenue generation, distort public spending, and create a vicious cycle where a lack of trust hinders reforms.

### 5.3 Budget instability and its social and economic consequences

Budgeting based on optimistic oil prices often leads to significant shortfalls when prices fall (e.g., the 2023 budget). The resulting fiscal deficits significantly reduce capital investment and force the suspension of infrastructure and service projects. <sup>[23]</sup> Delayed salaries, frozen projects, and rising prices push citizens toward “social despair” and undermine confidence in state institutions.

Chronic budget instability, fueled by oil price volatility and poor financial planning, has direct and serious social and economic consequences. This translates into a failure to deliver basic public services, exacerbates regional disparities, and creates widespread disillusionment among the public, posing a major threat to national stability.

### 5.4 In Iraq, the traditional trade-off between efficiency and equity is greatly exacerbated by rampant corruption.

Rather than a simple trade-off, corruption creates a lose-lose scenario where neither efficiency nor equity is optimally achieved. Therefore, any policy interventions must target both simultaneously, with anti-corruption and governance reforms serving as a critical bridge to unlock synergies and

move toward a more balanced and sustainable fiscal system.

## 6. Policy Recommendations and Reform Pathways

### 6.1 Strategies for Enhancing Fiscal Sustainability

Moving beyond reactive fiscal management requires a paradigm shift toward proactive, rules-based policymaking and robust diversification. Without such measures, Iraq will remain trapped in a cycle of oil dependence, vulnerability, and intergenerational resource depletion.

- Fiscal rules and frameworks: Strong, transparent, and legally binding fiscal rules should be applied to oil-exporting countries, with a focus on spending rules and budget balance rules to reduce cyclical volatility and improve primary non-oil balances. <sup>[29]</sup> Fiscal response functions <sup>[25]</sup> can be incorporated into policy design to ensure that primary surpluses respond positively to rising debt-to-GDP ratios to ensure sustainability.
- Revenue diversification: Efforts to build an effective non-oil tax system should be accelerated. <sup>[1]</sup> This includes updating the taxpayer registration system, investing in the development of rapid tax audit capabilities, adopting international accounting standards, and deploying integrated tax administration systems. <sup>[1]</sup>
- Asset accumulation: A sovereign wealth fund should be established to convert exhaustible oil wealth into financial assets. <sup>[6]</sup> This is critical for intergenerational equity and long-term financial stability.

### 6.2 Reforms to improve the efficiency of the financial system

Improving the efficiency of Iraq's financial system depends on comprehensive institutional reforms that address both technical capacity and governance. Without these reforms, even well-intentioned policies will be hampered by bureaucratic shortcomings and a lack of effective implementation.

- Public financial management reform: Public financial management systems, including budgeting, management, and oversight, must be strengthened. This includes improving transparency and accountability in the management of financial resources.
- Banking sector development: The banking sector must be modernized, moving beyond state-dominated payroll services to effective financial intermediation. This includes strengthening private banks, improving access to credit, and promoting a competitive environment.
- Modernizing tax administration: Shortcomings in tax infrastructure, regulatory frameworks, and human capacity must be addressed. <sup>[1]</sup> A self-assessment tax system with strong auditing skills should be implemented, and data sharing and monitoring should be strengthened.

### 6.3 Measures to promote justice and combat corruption

Fighting corruption is critical to achieving justice and is a prerequisite for effective reforms in sustainability and efficiency. Without addressing the systemic nature of corruption, efforts to improve financial management or diversify the economy will be undermined, perpetuating inequality and public mistrust.

- Anti-corruption strategy: A robust and multifaceted anti-corruption strategy must be implemented, including

strengthening oversight institutions, prosecuting corrupt officials, and recovering stolen funds. Transparency and accountability in public contracts and financial transactions must be enhanced.

- Equitable distribution of resources: Public budgets must prioritize care, long-term resilience, and social justice, not just short-term returns or political gains. <sup>[18]</sup> Regional disparities in service delivery and disbursement of funds must be addressed. <sup>[23]</sup>
- Equitable access to opportunities: Bureaucratic obstacles should be reduced and fair and equal treatment of all investors, both domestic and foreign, should be ensured. <sup>[5]</sup> Access to affordable credit for businesses, especially small and medium-sized enterprises, should be improved.
- Intergenerational equity: Intergenerational equity should be enshrined as a key design principle in economic and financial systems. This is directly linked to the strategy of asset accumulation within financial sustainability.

## 7. Conclusions

1. Fiscal Imbalance: The Iraqi financial system suffers from a significant structural imbalance, with federal revenues accounting for 95% of total revenues, while local governments account for only 5%. This places significant pressure on the federal budget and hinders local governments' ability to achieve financial self-sufficiency.
2. The Challenge of Efficiency vs. Equity: The research clearly demonstrates the contradiction between the goal of efficiency, which can be achieved through fiscal decentralization and local revenue diversification, and the goal of equity, which is negatively impacted by large horizontal revenue disparities between governorates.
3. The Crowding Out Effect is Real and Disruptive: The "crowding out effect" is not just a theoretical concept; it is a reality that limits federal revenues whenever local governments seek to diversify their revenue sources, making the relationship between the two levels of government competitive rather than complementary.
4. Weak Legal and Fiscal Framework: Reliance on annual federal laws (such as the Budget Law) to determine financial allocations to governorates creates financial instability and erratic growth in local revenues, as demonstrated in the case of border crossing revenues.
5. Lack of Justice Mechanisms: Despite the availability of revenues for oil-producing governorates, the absence of a clear and effective mechanism for distributing wealth to non-producing or less-revenue-generating governorates exacerbates development gaps and hinders the achievement of balanced spatial development sought by local policies.

## 8. Recommendations

1. Based on these findings, the following recommendations are proposed to enhance fiscal sustainability and achieve a balance between efficiency and justice:
2. Promote gradual and orderly fiscal decentralization: Instead of abrupt transformation, a national fiscal decentralization program should be adopted that clearly defines local revenue sources and spending responsibilities for each level of government. This program should be accompanied by building strong

administrative and financial capacity in the governorates.

3. Establish a Federal Equalization Fund: To reduce horizontal disparities between governorates and achieve justice, a federal government-affiliated fund should be established. This fund would be financed from a portion of national revenues (particularly oil) and distribute allocations to less fortunate governorates according to transparent and objective criteria such as population size, poverty rates, and infrastructure gaps.
4. Expanding and diversifying local revenue sources: Local governments should be encouraged to diversify their revenues beyond petrodollar allocations and border crossings. This can be achieved by activating local taxes, municipal service fees, and encouraging local investment through public-private partnerships, which enhances service delivery efficiency.
5. Amending the legal framework for public finance: Current financial legislation should be reviewed to establish a sustainable legal framework that ensures greater financial autonomy for governorates and provides them with a stable and predictable budget that is not subject to annual changes in the budget law, enabling long-term development planning.
6. Enhancing oversight and governance: To ensure efficiency and prevent corruption, financial and administrative oversight mechanisms for local spending must be strengthened. The process of allocating and spending funds must be transparent and accountable, ensuring that resources are optimally used to achieve local development goals.

## 9. References

1. Ozili PK. Financial stability and sustainable development. *Int J Financ Econ.* 2023;54.
2. James DJ. Fiscal adjustment for stability and growth. In: *Guidelines for fiscal adjustment.* Washington, D.C.: International Monetary Fund; 2006. p. 2-23.
3. International Monetary Fund. *Financial stability in emerging market economies.* Switzerland: Bank for International Settlements; 1997.
4. Jalles JT, Afonso A. *Handbook on public sector efficiency.* UK: Edward Elgar Publishing, Inc.; 2023. p. 4-425.
5. Luebker M. [No title provided]. Geneva: International Labour Office; 2012.
6. Combet E, [Other authors]. The equity and efficiency trade-off of carbon tax revenue recycling: a re-examination. *Energy Econ.* 2025;148.
7. Li Y, [Other authors]. Enhancing resources efficiency: studying economic development in resource-rich regions for long-term sustainability of China. *Resour Policy.* 2023;86.
8. Iraqi Proceeding. Law of the Federal General Budget of the Republic of Iraq for the fiscal year 2018. *Official Gazette of the Republic of Iraq.* 2018;4485:1-70. Arabic. Available from: <http://www.mof.gov.iq/pages/ar/federalbudgetlaw.aspx>
9. Iraqi Proceeding. Law of the Federal General Law of Governorates Not Organized in a Region No. 21 of 2008, as amended (2013). *Official Gazette of the Republic of Iraq.* 2013;4284:1-12. Arabic. Available from: [https://www.moj.gov.iq/uploaded/4284\\_1.pdf](https://www.moj.gov.iq/uploaded/4284_1.pdf)
10. Iraqi Proceeding. Law of the Federal General Budget of

- the Republic of Iraq for the fiscal year 2013. Official Gazette of the Republic of Iraq. 2013;4272:1-47. Arabic. Available from: <http://www.mof.gov.iq/pages/ar/federalbudgetlaw.aspx>
11. Iraqi Proceeding. Law of the Federal General Budget of the Republic of Iraq for the fiscal year 2015. Official Gazette of the Republic of Iraq. 2015;4352:1-50. Arabic. Available from: <http://www.mof.gov.iq/pages/ar/federalbudgetlaw.aspx>
  12. Iraqi Proceeding. Law of the Federal General Budget of the Republic of Iraq for the fiscal year 2016. Official Gazette of the Republic of Iraq. 2016;4394:1-41. Arabic. Available from: <http://www.mof.gov.iq/pages/ar/federalbudgetlaw.aspx>
  13. Iraqi Proceeding. Law of the Federal General Budget of the Republic of Iraq for the fiscal year 2017. Official Gazette of the Republic of Iraq. 2017;4430:1-61. Arabic. Available from: <http://www.mof.gov.iq/pages/ar/federalbudgetlaw.aspx>
  14. Iraqi Proceeding. Law of the Federal General Budget of the Republic of Iraq for the fiscal year 2019. Official Gazette of the Republic of Iraq. 2019;4529:1-72. Arabic. Available from: <http://www.mof.gov.iq/pages/ar/federalbudgetlaw.aspx>
  15. Iraqi Proceeding. Law of the Federal General Budget of the Republic of Iraq for the fiscal year 2007. Official Gazette of the Republic of Iraq. 2007;4036:1-12. Arabic. Available from: <http://www.mof.gov.iq/pages/ar/federalbudgetlaw.aspx>
  16. Iraqi Proceeding. Law of the Federal General Budget of the Republic of Iraq for the fiscal year 2008. Official Gazette of the Republic of Iraq. 2008;4076:1-21. Arabic. Available from: <http://www.mof.gov.iq/pages/ar/federalbudgetlaw.aspx>
  17. Iraqi Proceeding. Law of the Federal General Budget of the Republic of Iraq for the fiscal year 2009. Official Gazette of the Republic of Iraq. 2009;4117:1-27. Arabic. Available from: <http://www.mof.gov.iq/pages/ar/federalbudgetlaw.aspx>
  18. Iraqi Proceeding. Law of the Federal General Budget of the Republic of Iraq for the fiscal year 2010. Official Gazette of the Republic of Iraq. 2010;4145:1-57. Arabic. Available from: <https://www.moj.gov.iq/uploaded/4145.pdf>
  19. Iraqi Proceeding. Law of the Federal General Budget of the Republic of Iraq for the fiscal year 2011. Official Gazette of the Republic of Iraq. 2011;4180:1-31. Arabic. Available from: <http://www.mof.gov.iq/pages/ar/federalbudgetlaw.aspx>
  20. Iraqi Proceeding. Law of the Federal General Budget of the Republic of Iraq for the fiscal year 2012. Official Gazette of the Republic of Iraq. 2012;4233:1-44. Arabic. Available from: <http://www.mof.gov.iq/pages/ar/federalbudgetlaw.aspx>
  21. Iraqi Proceeding. Law of the Federal General Budget of the Republic of Iraq for the fiscal year 2006. Official Gazette of the Republic of Iraq. 2006;4016:1-8. Arabic. Available from: <http://www.mof.gov.iq/pages/ar/federalbudgetlaw.aspx>
  22. Anderson G. Introduction on federalism. In: A primer on federalism. Canada: Forum of Federations; 2008. p. 28. Available from: <http://www.forumfed.org/publications/a-primer-on-federalism/>
  23. Anderson G. Fiscal federalism: a comparative introduction. Canada: Forum of Federations; 2009. p. 50. Available from: <http://www.forumfed.org/publications/fiscal-federalism-a-comparative-introduction/>
  24. Central Statistical Organization. Early warning report for the years (2006-2020). Republic of Iraq, Ministry of Planning, Directorate of National Accounts; 2020. Arabic.
  25. Central Statistical Organization. Iraq's vision for sustainable development 2030. Baghdad: Ministry of Planning, Republic of Iraq; 2019. p. 1-59. Arabic. Available from: <https://mop.gov.iq/min.publications/view/list?id=16&lastcontent=472>
  26. Central Statistical Organization. Actual estimates of gross domestic product and national income 2019. Directorate of National Accounts, Ministry of Planning, Republic of Iraq; 2021a. p. 1-14. Arabic. Available from: <http://www.cosit.gov.iq/ar/national-accounts/income>
  27. Central Statistical Organization. Actual estimates of gross domestic product and national income 2020. Directorate of National Accounts, Ministry of Planning, Republic of Iraq; 2021b. p. 1-23. Arabic. Available from: <http://www.cosit.gov.iq/ar/national-accounts/income>
  28. Constitute. Constitution of the Republic of Iraq for the year 2005. constituteproject.org; 2005. p. 1-41. Arabic. Available from: [https://www.constituteproject.org/constitution/Iraq\\_2005.pdf?lang=ar](https://www.constituteproject.org/constitution/Iraq_2005.pdf?lang=ar)
  29. Food and Agriculture Organization of the United Nations. Decentralization and taxes on rural property. Rome: FAO; 2004. p. 11-12. Arabic. Available from: <http://www.fao.org/3/y5444a/y5444a00.htm>
  30. Local Government in Diyala. Final revenues for the month of December, for the period from 2016-2020. Accounts Department, account (137), The Republic of Iraq; 2020. Arabic.
  31. Martinez-Vazquez J. The impact of fiscal decentralization: issues in theory and challenges in practice. ECON Publications. 2011;23:1-28. Available from: [https://scholarworks.gsu.edu/econ\\_facpub/23](https://scholarworks.gsu.edu/econ_facpub/23)
  32. Iraqi Ministry of Finance. The General Authority of Customs, the financial section. Republic of Iraq; 2019. Arabic. Available from: <https://www.customs.mof.gov.iq/>