

2023

POLICY

PAPER

NO.37

مركز المنصة للتنمية المستدامة
Platform Center for Sustainable Development



Sovereign Wealth Fund: The Path towards Stability and Growth

Ali Al-Tamimi



A brief overview of the Iraq Policy Program

The Iraq Policy Program aims to bridge the gap between youth elites and decision-makers by training young elites to effect positive change through influencing the decision-making process. The program aims to empower participants to prepare policy papers and propose policy alternatives aimed at enhancing system performance and supporting its legitimacy. This program enables participants to communicate with decision-makers and understand the main difficulties and problems affecting the implementation and follow-up of public policies. Additionally, the program seeks to provide participants with a realistic understanding of the decision-making environment in Iraq, as well as an understanding of the opportunities and challenges of change.

The program stages

Preparation: Assisting participants in acquiring the fundamental skills to prepare policy papers and effective advocacy campaigns.

Discovery: Clarifying important public policies in Iraq by experts through stakeholder engagement, frameworks and institutional procedures, practical realities, and discussions surrounding each public policy, as well as reform prospects.

Engagement: Training participants to develop promotional campaigns and coordinate meetings with government officials to initiate their campaigns.

Enrichment: Supervising participants to prepare a policy paper in their area of interest to enrich dialogues, develop policy alternatives, which can help address current challenges.

About the Center

The Platform for Sustainable Development is a registered center with the Non-Governmental Organizations Department at the General Secretariat of the Council of Ministers under the number (1S2106012). It serves as a space for thought, dialogue, and action towards positive change.

Vision

We seek to establish a platform for dialogue and policies that contribute to achieving the Sustainable Development Goals in Iraq.

Mission

Filling the gap between the state and society to ensure the essence of democracy by engaging citizens in the decision-making process through training, monitoring, analysis, research, awareness, and advocacy.

Strategic Goals

- Preparing a youth elite that rises to its social responsibilities through studying problems, proposing policy alternatives, and working towards their implementation.
- Utilizing knowledge outputs and encouraging youth to work towards achieving the Sustainable Development Goals
- Presenting statistics and issues that occupy the political arenas and societal circles to reflect a deeper understanding of the Iraqi reality.
- Creating a network of active, informed, and committed citizens dedicated to the project of building the Iraqi government.

Executive Summary

The Iraqi economy faces fundamental obstacles that undermine its growth and stability, primarily its rentier nature and massive annual operational expenditure. The unstable economic conditions in recent years have led to unstable political circumstances, as there is a two-way relationship between politics and the economy. According to the Carnegie Foundation, Iraq may face financial collapse due to one or both of these factors.

In 2022, Iraq achieved a financial surplus estimated at \$15 billion due to rising global oil prices. The greatest challenge lies in how to invest these funds optimally, away from political objectives to gain public favor. Currently, surpluses are used to increase employment rates and inflate the operational budget instead of being used for real economic development that positively impacts the country's economic reality

This paper proposes policy alternatives, specifically the establishment of a Sovereign Wealth Fund. This fund would reduce the dependence on oil as the main source of budget financing, stimulate the economy in the medium and long term, and diversify the economy by investing in neglected sectors such as industry and agriculture. Additionally, it would significantly reduce the use of public funds for political purposes by converting budget surpluses into the fund's capital.



Introduction:

The World Bank considers the Iraqi economy to be among the fastest-growing Arab economies as of April 2022, with an estimated Gross Domestic Product (GDP) growth rate of 8.9%. However, this growth rate does not necessarily reflect the strength and stability of the Iraqi economy. Economic growth is supposed to be a cumulative and continuous increase in real income, with the economic growth rate exceeding the population growth rate cumulatively. This means that there should be an annual and cumulative increase in the average income per capita or in the purchasing power to meet basic needs, which are crucial indicators of an economy's strength and stability.

This is not the case with the Iraqi economy. The economic growth rate in Iraq heavily depends on oil prices, and it does not necessarily lead to an increase in the average income per capita. Iraq is one of the most rentier countries in the Middle East and North Africa, and even globally, with oil accounting for over 99% of its exports, more than 85% of government revenues, and over 42% of its Gross National Income over the past decade. Therefore, Iraqi economic growth cannot be considered realistic because it relies almost entirely on oil prices. Iraq experienced a significant economic contraction in 2020 when oil prices dropped due to the COVID-19 pandemic, with the economy shrinking by more than 11%.

Moreover, post-2003 elected governments in Iraq increased operational spending by hiking public hiring, leading to a bloated public sector, characterized by low efficiency and ineffectiveness, missing the opportunity to create real economic growth and employment opportunities.



Most oil-producing countries recognized early on that oil is a depletable resource and that its prices can collapse at any time. Therefore, they established sovereign wealth funds to optimally utilize oil revenues and protect their economies from oil market fluctuations. Iraq has some experience in this regard; it established the Iraqi External Development Fund with a capital of 50 million Iraqi dinars, later increased to 200 million dinars in 1979. However, after the fall of the previous regime, its role was limited to manage Iraq's financial contributions to international organizations and companies. This paper aims to shed light on the reality of the Iraqi economy and the potential to address some of its challenges through the establishment of a Sovereign Wealth Fund, detailing the proposed structure and its implications.

Background: The Reality of the Iraqi Economy

The national income is the most important and clearest indicator of a country's economic strength, representing the total value of goods and services produced by the state. As previously mentioned in the World Bank report, oil exports have contributed more than 42% of the total national income in the past decade. However, this percentage is practically misleading because the remaining sectors contribute to the remaining portion of the national income are also heavily dependent on the oil and energy sectors.

This high level of reliance on oil makes Iraq the world's most oil-dependent economy, excluding Kuwait. A simple look at Figure (1.2) reveals that the Iraqi economy is primarily influenced by two factors: the oil price and the quantity of oil produced. The economy grows when either the oil price or production quantity rises, and it contracts when one of them decreases. The significant similarity in the growth and contraction patterns of the two lines representing the Iraqi economy and the average oil price in Figure (3) is evident.

These data suggest that the Iraqi economy faces financing deficits with every oil shock, which has led Iraq into the trap of debt, reaching \$70 billion in 2021. This indebtedness is accompanied by a 400% increase in employee and retiree expenses for the period 2004- 2020, accounting for 47% of total public expenditures in 2019 and around 74% in 2020, with no clear increase in the quantity and efficiency of services provided. The average payments of the public sector increased by 134% for the period 2006-2018.



Figure (1): Annual Income Value Corresponding to Gross National Income for the Period (2004 - 2021)

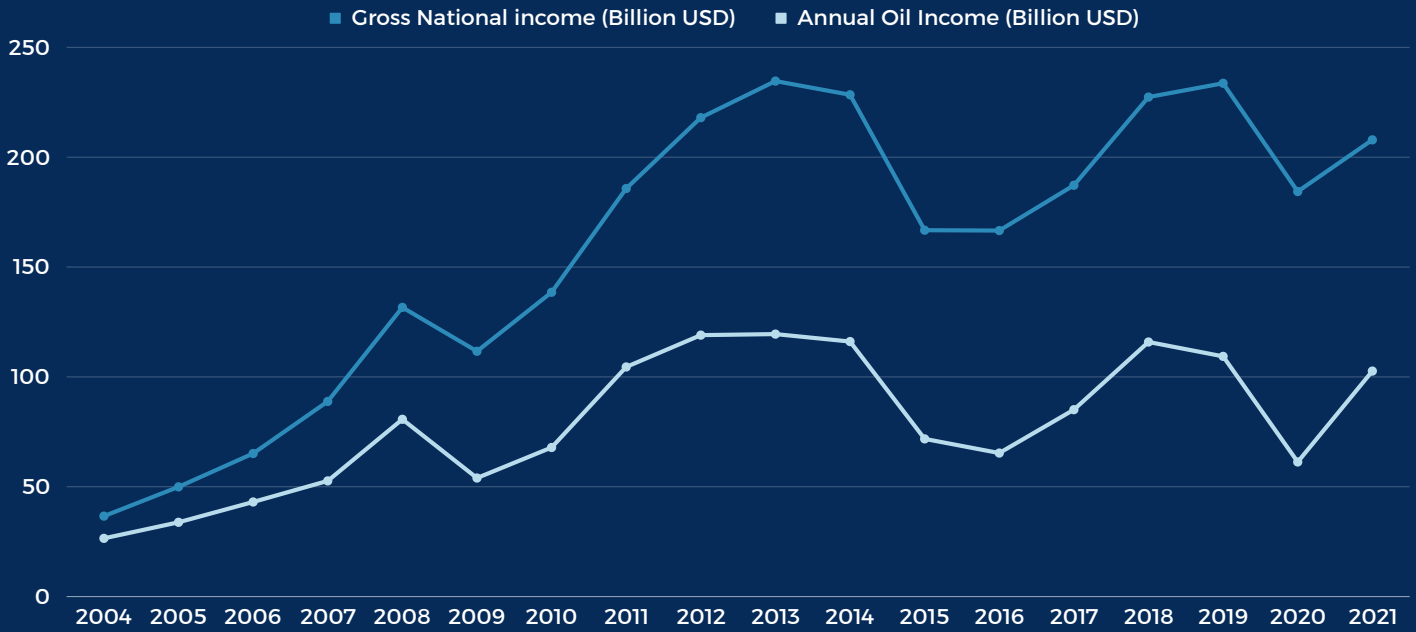


Figure (2): Percentage of Oil Contribution to Gross Domestic Product (GDP) for the Period (2004 - 2021)

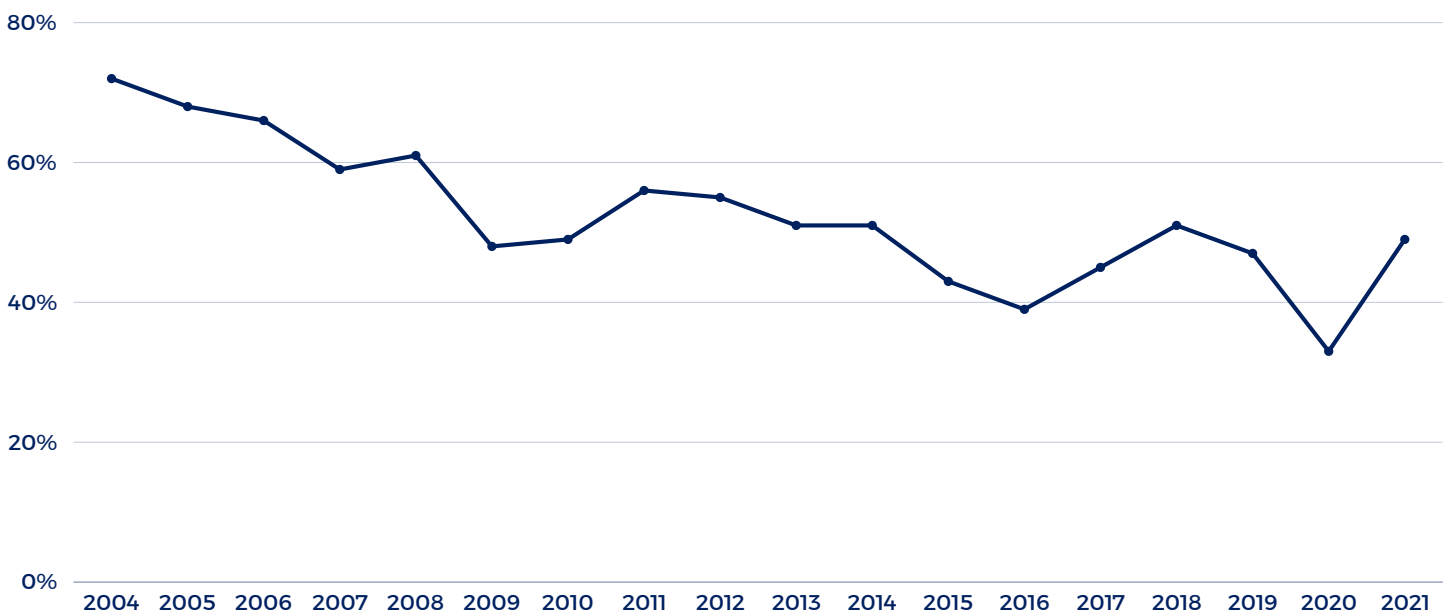
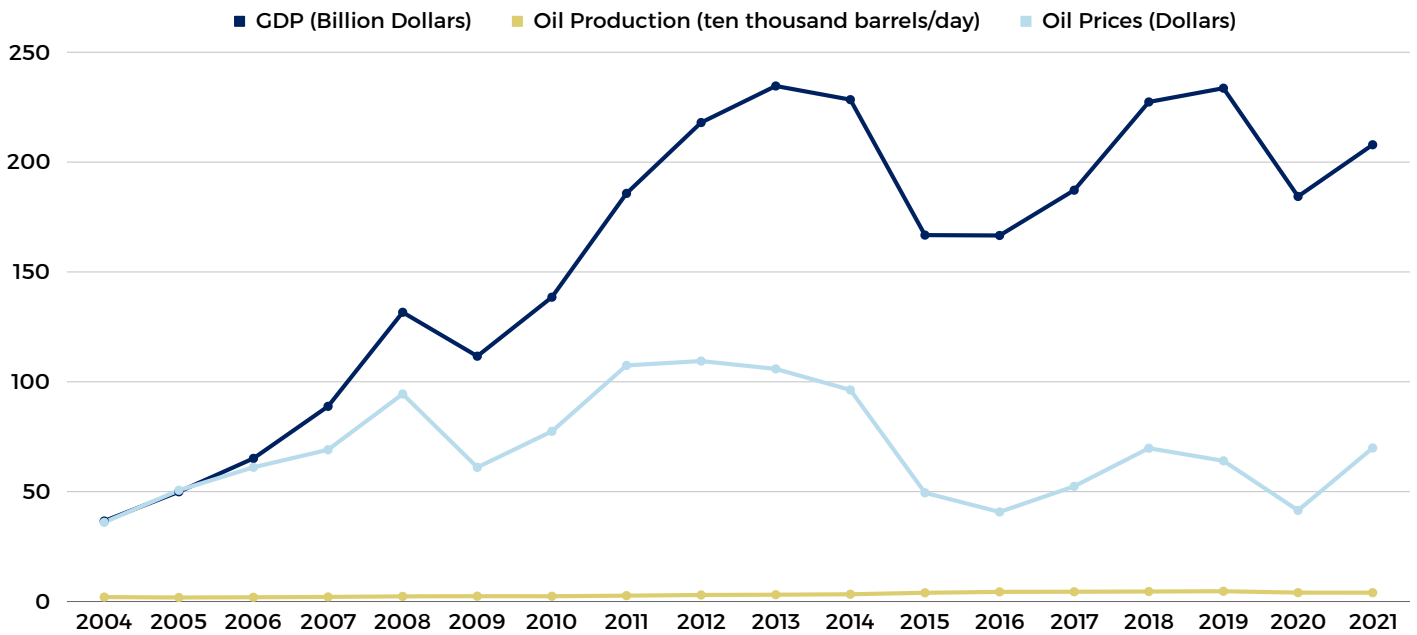




Figure (3): Growth and Contraction in the Iraqi Economy with Fluctuations in Oil Prices



Policy Alternative: The Iraqi General Investment Fund

First: Comprehensive Overview of Sovereign Wealth Funds (SWFs)

Sovereign Wealth Funds (SWFs) are funds owned by the state and financed by various sources such as land, bonds, surpluses from public budgets, or revenues from the privatization of government sectors. They invest their capital in local or global markets. SWFs are not a recent concept in the world of economics. The first known sovereign wealth fund dates back to 1817 in the United States, established to fund public government schools.

Regarding the Kuwaiti Sovereign Wealth Fund, it is considered the first modern sovereign wealth fund globally. It was created in 1953 to preserve the oil surplus for future generations. After Kuwait gained independence in 1961, the fund was restructured to serve as an investment platform to ensure sustainable growth for the modern state. In 1976, the Kuwaiti Emir issued a decree establishing the Future Generations Reserve Fund, serving as a conservative investment platform for Kuwait's future by deducting 10% of the state's annual revenues to this fund. In 1982, the General Authority for Investment was created to manage the Kuwaiti Investment Office, the Future Generations Fund, and other funds entrusted to it by the Ministry of Finance.

The authority is managed by a board of directors chaired by the Minister of Finance, with other members including the Central Bank Governor, the Deputy Minister of Finance, the Minister of Oil, and five other Kuwaiti experts appointed by decree for four years, with the possibility of reappointment. Three of the members must not hold any public office. The figure (4) illustrates the evolution of the size of sovereign wealth funds worldwide over the last (7) years, while figure (5) illustrates the top ten funds globally currently.

Figure (4) shows the growth of the assets of sovereign funds for the years 2016-2022 (10)

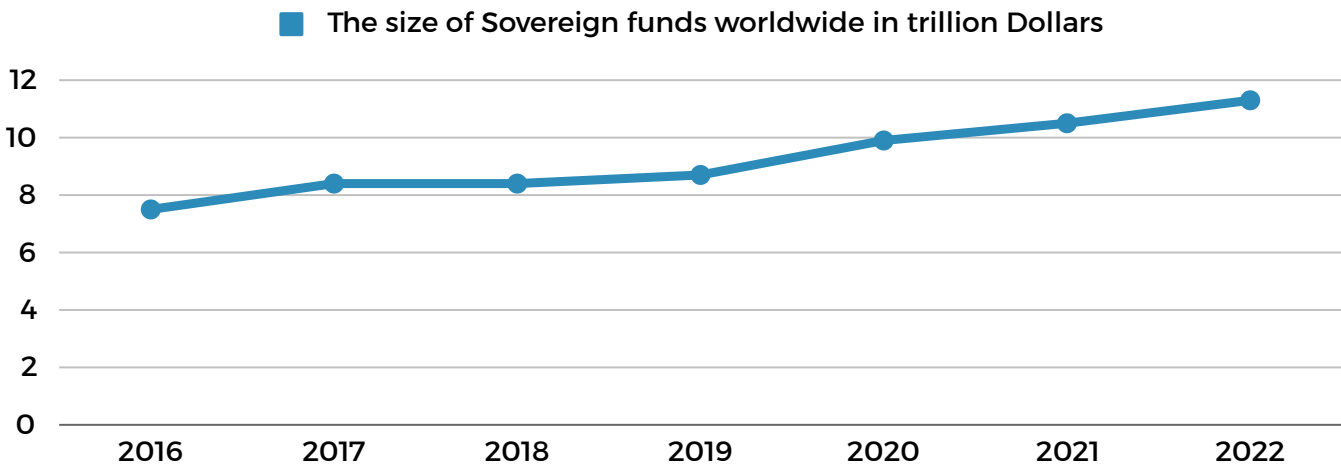
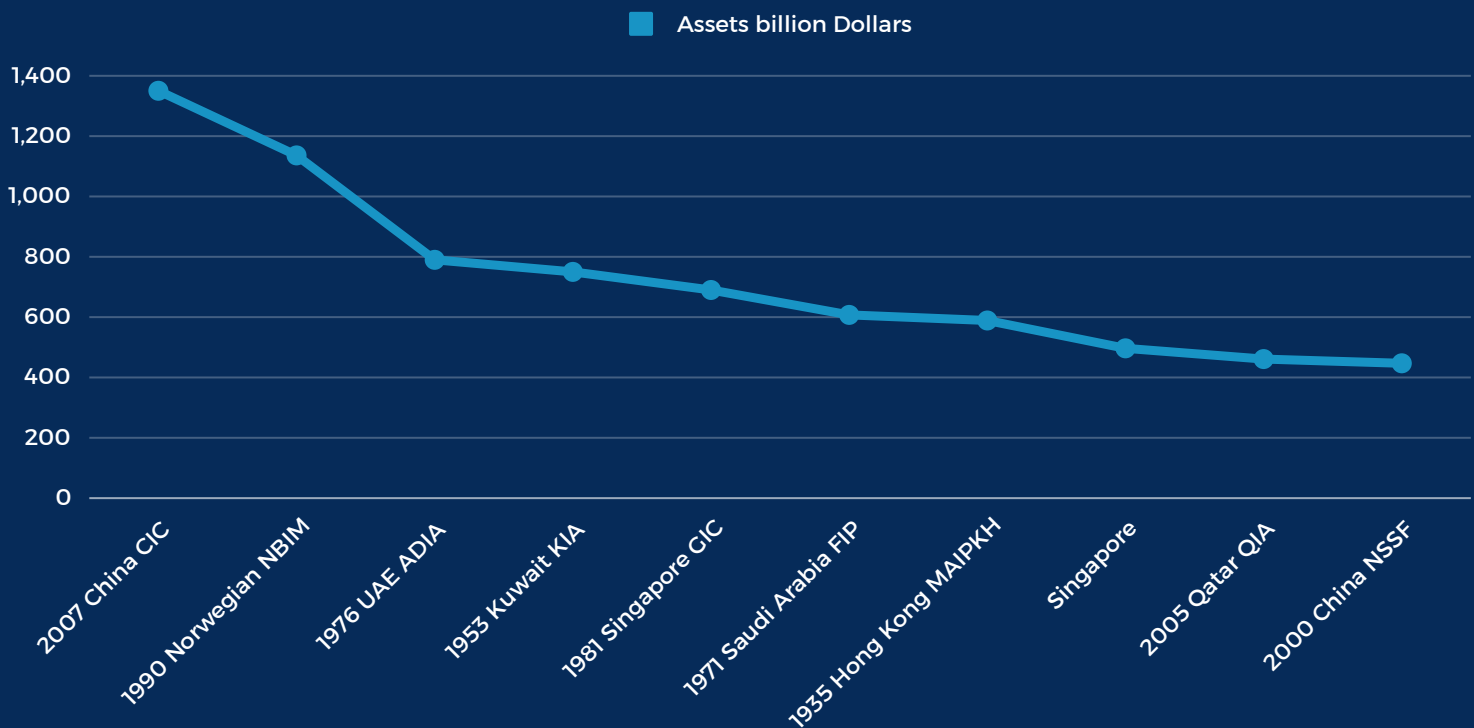


Figure (5) Top Ten Sovereign Wealth Funds in the World Currently



Second: International Experiences in Establishing Sovereign Wealth Funds:

- **Norwegian Government Pension Fund:** Norway was previously an agricultural and fishing-dependent country until the discovery of oil in 1969. After this transformation, the Norwegian Government Pension Fund (known as the Government Pension Fund Global) was established in 1990 to support the economy in the long run. The fund is managed by a specialized unit within the Norwegian Central Bank and is known for high transparency standards. Iraq can draw lessons from these experiences in establishing its own sovereign wealth fund, especially since these funds rely on oil revenues and aim to mitigate the impact of oil market fluctuations. Studying the strengths and weaknesses of these two funds and their organizational structures is crucial for building an effective sovereign wealth fund in Iraq.
- **Kuwait Investment Authority:** The Kuwait Investment Authority (KIA) is considered the world's first sovereign wealth fund (in its modern concept), established in 1953 in London under the name Kuwait Investment Board. Kuwait's rulers have long recognized the importance of oil as a primary source of income and have explored the possibility of employing this resource to achieve

ssustainable development for the country, enhance the welfare of citizens, and reduce Kuwait's dependence on a single resource. After Kuwait gained independence in 1961 and became a sovereign state, a model of modern investment was presented to ensure the sustainable growth of the modern state. Consequently, the Investment Board was replaced by the Kuwait Investment Office in 1965, just four years after independence. In 1976, Sheikh Jaber Al-Ahmad Al-Sabah, the Amir of Kuwait, issued a decree establishing the Future Generations Reserve Fund, serving as an investment platform to safeguard Kuwait's future by allocating 10% of the state's annual revenue to this fund. In 1982, the Kuwait Investment Authority was established to be the parent institution managing the Kuwait Investment Office, the Future Generations Fund, and other funds entrusted to it by the Ministry of Finance. The Authority is managed by a board chaired by the Minister of Finance, with membership including the Governor of the Central Bank, the Undersecretary of the Ministry of Finance, the Minister of Oil, and five other specialized Kuwaiti members appointed by decree for a four-year term, renewable with at least three members who do not hold any public office among them.



Third: Proposed Model for Establishing the Iraqi Sovereign

After the significant development of sovereign wealth funds (SWFs) worldwide in terms of governance, structure, funding sources, and targeted investments, Iraq can benefit from previous experiences in establishing a suitable fund for its fragile rent-based economy. The proposed model in this paper suggests that the Iraqi Wealth Fund should initially operate as an internal stability and growth fund for a period of no less than ten years (with equal capital contributions from various sources). After this initial period, it should transform into a fund for both internal stability and growth and external investment, with the proportion of capital allocation determined by the needs of the economy. The fund should adhere to international principles governing the operation of sovereign wealth funds, as recognized by the International Forum of Sovereign Wealth Funds (IFSWF), which aim to establish institutional and financial controls for these funds in international markets. These principles are essential for international recognition of the fund by institutions such as the International Monetary Fund (IMF) and are referred to as the Santiago Principles. Additionally, the Iraqi fund should undergo a thorough evaluation based on the Truman and Lindberg-Madol indicators,

through disclosing its goals, funding sources, governance, and transparency. This paper will summarize the fund's objectives, funding sources, and organizational structure.

1. Proposed Objectives and Functions of the Fund:

Considering that the proposed fund primarily aims to achieve economic and financial stability through rationalizing public expenditure, maximizing financial surpluses through investments, absorbing unwanted liquidity from the markets, and safeguarding the general budget in case of deficits by providing internal loans, it should also strive to:

- Reduce dependence on oil by maximizing and diversifying national income and ensuring equitable wealth distribution.
- Utilize capital for internal growth in neglected sectors such as agriculture, industry, and housing, to stimulate these sectors, create employment opportunities, revitalize the Iraqi stock market, and encourage both Iraqi and foreign entrepreneurs to invest in these sectors.
- After the initial ten years, part of the fund's capital should be invested in international markets.



This type of investment should yield not only financial benefits but also political gains by opening Iraq to global markets and strengthening its international relations.

2. Funding Sources:

The fund should be financed from the following sources:

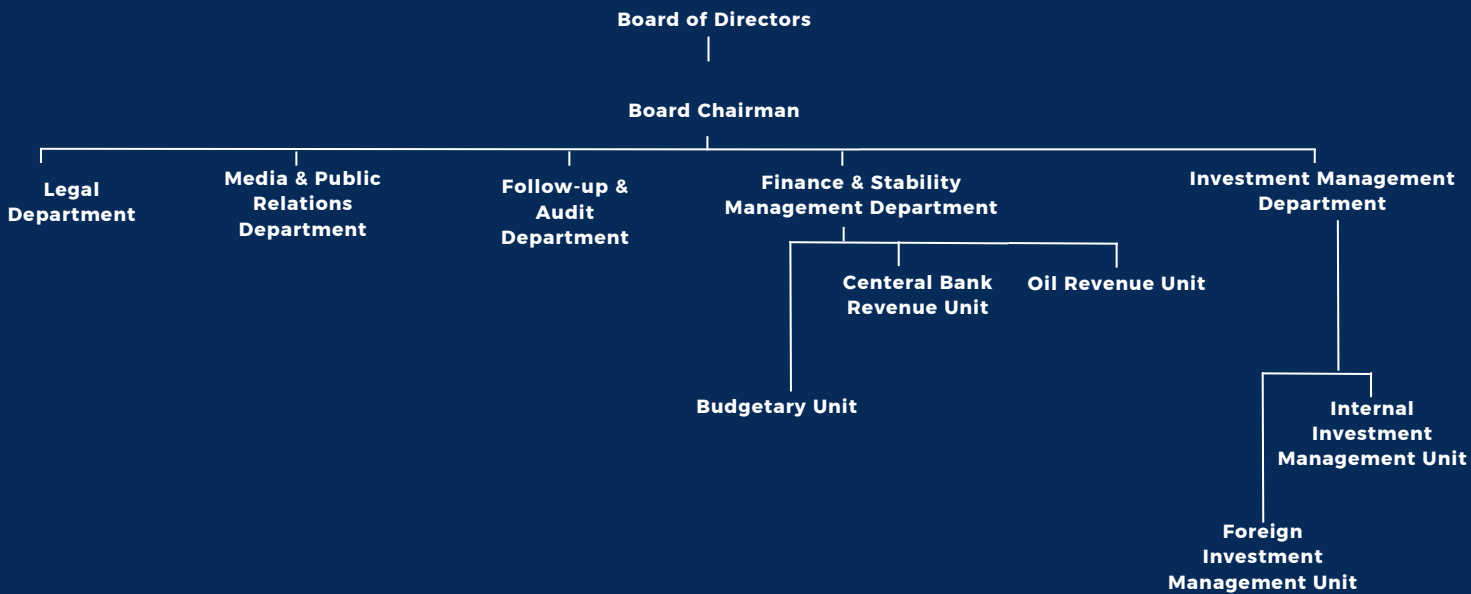
- **Oil Revenues:** The fund should receive monthly allocations from oil revenues, initially at a rate of 5%, with an annual increase of 1% of oil revenues until it reaches 25%.
- **Budget Surpluses:** The fund should receive the entire actual surplus from the budget annually. In the event of a surplus, the fund plays a vital role in stabilizing the economy and financial stability, preventing the waste of public funds.
- **Profits of the Central Bank of Iraq:** The fund should be financed 50% from the profits of the foreign currency window's monthly sales and 50% from the Central Bank of Iraq's reserve surplus after deducting the required reserve as cover for the local currency

3-Establishing the Fund, Organizational Structure, and Governance:

Before outlining the proposed organizational structure, it is essential to emphasize the fund's necessity to operate independently. This independence is a crucial requirement for the fund to effectively contribute to the growth and development of the Iraqi economy. The fund should work based on market principles, rather than governmental or central bank principles, as it is essentially a profit-driven institution. Independence should not imply complete separation from governmental, financial, or political authorities. Instead, it means independence in the intermediate goals between the state, the fund, and the choice of tools, methods, and appropriate timing to achieve these goals without external influences on the fund. Moreover, it should strive to maintain a high level of alignment with financial and monetary authorities. The legal basis for establishing the fund is Article 60 (first) of the Iraqi Constitution. A draft law to establish the fund should be submitted to the Parliament through the executive authority,



Figure (6) Proposed Organizational Structure of the Iraqi Sovereign Wealth Fund for Investment



represented by the President of the Republic and the Council of Ministers. The fund should be managed by a seven-member board of directors, three of whom are appointed, including the chairman of the board and two Iraqi members with at least 20 years of experience in the economic field. These members should be appointed by the Prime Minister with the approval of the Parliament. Their terms should be eight years, could be renewed, and they can only be removed in cases of proven corruption, committing a crime, or physical or mental incapacity that hinders their work. Additionally, four members should be from the government and monetary authority, including the Minister of Finance, Minister of Oil, Minister of Planning, and the Governor of the Central Bank. The proposed organizational structure for the Iraqi Sovereign Wealth Fund is illustrated in Figure 6.

The Viability of Establishing the Iraqi General Investment Fund

Sovereign wealth funds have become crucial indicators of a nation's economic strength and stability in today's world. With their control over substantial financial assets, they exert significant influence in international markets and major corporations across various sectors. Over the past two decades, they have evolved from a luxury reserved for wealthy nations to a pressing necessity for economies worldwide. Today, they stand as one of the most pivotal pillars of global investment,



if not the most important. A testament to their importance is that out of the 13 member countries in the Organization of the Petroleum Exporting Countries (OPEC), 11 have already established 17 sovereign wealth funds. These funds serve to diversify income sources and shield economies from shocks in the oil market. Moreover, they contribute to social justice by distributing wealth equitably among current and future generations. Additionally, their participation in international financial markets aligns with economic and political strategic objectives.

Generally, all sovereign wealth funds share a primary goal of financial profit, but their specific objectives vary depending on each country's economic characteristics and resources. Hence, each fund worldwide has its unique objectives, justifying why some nations, such as the United States with 23 sovereign wealth funds, or China with 4, possess multiple funds.

In the case of Iraq, the proposed fund holds financial and political significance. It aims to rationalize operational spending, preventing misuse of public funds and budget surpluses as a political tool. Operational spending in Iraq skyrocketed from approximately 20 trillion dinars in 2004 to nearly 106 trillion dinars in 2019. Like all sovereign wealth funds,

its primary goal is financial profit. Furthermore, it will help Iraq enhance its foreign relations through investment and integration into global markets, positioning Iraq as a significant player in the world economy. Moreover, the establishment of an Iraqi investment fund is expected to boost investor and business confidence, attract savings into joint projects with the Iraqi Sovereign Fund, stimulate job growth, and increase the significance of Iraq's securities market. For these reasons, this fund will simultaneously promote sustainable development in both economic and political aspects for Iraq

Conclusions

- Iraq has not effectively invested its financial surpluses resulting from oil revenue in recent years, leading to a substantial increase in operational spending without a focus on sustainable growth.
- Sovereign wealth funds represent a pioneering global experience, and Iraq has the full capacity to establish such a fund, similar to other rentier economies.



- It is imperative to invest financial surpluses as a crucial necessity to preserve the country's resources and secure the rights of future generations.
- The fund must enjoy financial and administrative independence, with no influence on its operational mechanism or investment objectives by legislative or executive authorities while maintaining open communication with them.
- When drafting the legislation to establish the fund, both executive and legislative authorities should prioritize transparency. This includes disclosing the fund's capital, funding volume, investment scale, future objectives, and conducting regular international auditing to enhance government and public trust in the fund's operations. Additionally, it is advisable to study the Norwegian Government Pension Fund Global's experience for insights in this field.

References

- World Bank: April 2022 Report.
- World Bank: Comprehensive Overview of the Iraqi Economy.
- World Bank: Iraq Economic Outlook - Spring 2022.
- Iraqi Ministry of Finance: Overview of the Iraqi External Development Fund.

- Data compiled from various pages of the Annual Reports of the Organization of the Petroleum Exporting Countries (OPEC).
- Data compiled from the World Bank for all mentioned years.
- Iraqi Ministry of Finance - General Debt Department.
- White Paper.
- International Forum of Sovereign Wealth Funds (IFSWF) - January 2023 Update.
- Data compiled from various pages of IFSWF Annual Reports.
- International Forum of Sovereign Wealth Funds (IFSWF) - January 2023 Update.
- International Forum of Sovereign Wealth Funds (IFSWF) - Excerpts from Various Annual Reports.
- Excerpts from the Official Website of the Kuwait Investment Authority.
- Excerpts from the Official Website of the Norwegian Government Pension Fund
- Global.
- Strategic Studies Center at the University of Karbala: A Report on the 2021 Budget and Its Alignment with the White Paper by Researcher Dr. Adnan Hussein Al-Khayat.
- Iraqi News Agency, May 25, 2022.
- International Forum of Sovereign Wealth Funds (IFSWF) - January 2023 Update.
- The Center for Strategic Studies at the University of Karbala, a report on the 2021 budget by the researcher, Prof. Dr. Adnan Hussein Al-Khayyat.

مركز المنصة للتنمية المستدامة
Platform Center for Sustainable Development



YOUR JOURNEY IN POLICY WORK STARTS WITH US



ALI SABAH MAHDI

A fellow in the Iraq Policy Program (Third Cycle), holding a bachelor's degree in engineering. He works in the public sector and focuses his interests on sovereign wealth funds