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## Risks and Problems of Lower Oil Prices in Preparing the General Budget of Iraq and the Necessity of Activating Sources of Non- Oil Income

Latfe ALHUSSEINAWI\*, Ileana ASHRAFZADE, Zaid  
ALAJWADEE

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## Risks and Problems of Lower Oil Prices in Preparing the General Budget of Iraq and the Necessity of Activating Sources of Non-Oil Income

Latfe ALHUSSEINAWI<sup>1\*</sup>, Ileana ASHRAFZADE<sup>2</sup>,  
Zaid ALAJWADEE<sup>3</sup>

### *Abstract*

*The aim of the present study is to analyze the impact of the decrease in oil prices on the general budget of Iraq and to raise awareness over the importance of activating non-oil income sources in order to provide resources for the budget. The study reached several conclusions from which the most important was that the volatility of oil prices between 1921 and 2012 generated a lot of confusion regarding public budgets of Iraq, as well as real challenges, such as budget surplus or deficit. The research concludes that it is necessary to activate alternative sources of income, or non-oil resources, for financing the general budget in Iraq, especially taxes, in addition to the development of productive and service sectors.*

**Keywords:** *oil prices, general budget, sources of non-oil income.*

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<sup>1</sup> The Bucharest University of Economic Studies, Faculty of Accounting and Management Information Systems, Bucharest, Romania, origin country Iraq, [latfeej@yahoo.co](mailto:latfeej@yahoo.co)

<sup>2</sup> The Bucharest University of Economic Studies, Bucharest, Romania, [nisulescu\\_ileana@yahoo.com](mailto:nisulescu_ileana@yahoo.com).

<sup>3</sup> Thi-Qar University College of Administration and Economics Iraq, origin country Iraq, [Zaid90alajwadee@yahoo.com](mailto:Zaid90alajwadee@yahoo.com).

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Corresponding Author: Latfe ALHUSSEINAWI

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## 1. Introduction

The international oil market is unstable and oil prices fluctuations are due to many factors. Oil is an international commodity and has strategic importance to all countries of the world, whatever their level of progress, as oil-consuming countries, albeit to varying degrees, they meet a limited group of producing and exporting countries.

The rise in oil prices is in favour of the producing and exporting countries, the increase in oil revenues positively impacts the preparation of the budget. At the same time, this increase is not beneficial to consuming countries, as this increase has a negative financial impact, affecting the preparation of the general budget and generating risks and problems.

Therefore, all the countries of the world face a single risk called oil price risk. This risk has many dangers and problems in the preparation of public budgets or when making economic decisions of oil exporting countries, especially that recently fluctuations in oil prices have become a recurrent phenomenon and alarming at global level. This phenomenon affects most of the oil producing and exporting countries or the countries where oil is the main source of financial resources in foreign currency. Therefore, these countries search for non-oil budget sources to mitigate the risks and problems of the decline in global crude oil prices.

## 2. The Concept of Oil Price

A barrel of crude oil is measured based on the US measuring system and it consists of 42 gallons. The price of the crude oil is also expressed in US currency, for example \$ 100 / barrel [1]. This price faces ongoing fluctuations, because of the nature of the international oil market, which is characterized by dynamism and instability. This characteristic of the oil market is reflected on the oil prices, making them unstable and subject to constant variations. This fluctuation phenomenon has become alarming at global level since the early seventies of the last century and it still is a reality, especially after the large increases in the years 2006-2007. The peak was at more than \$ 147 / barrel and nearly to \$ 150 / barrel in the month of July 2008, but soon began to fall and had a sharp decline as it fell below \$ 40 / barrel at the end of the second half of the same year, especially in December, thus losing about \$ 110 / barrel. The steep decrease of the oil price was determined by the global financial crisis that hit the global economy, leaving negative effects on the oil economy this is clearly reflected on the international oil market, represented by the return of the oil price level [2].

With the aggravation of financial crisis and the start of successive collapses in financial markets and banking institutions in the month of August 2008, oil prices have fallen sharply, unprecedentedly and at very high rates.

### 3. Factors Affecting Crude Oil Prices

There are many factors affecting the price of crude oil and they preoccupy a lot of specialists. They consider that oil as a commodity is not only subject to market laws (supply and demand forces), where production is sometimes increased but the price remains constant, or the price increases but the demand remains constant.

The factors affecting the determination of oil prices are political factors, economic factors, production factors, environmental factors and financial factors.

All of these factors affect the fluctuations and paths of oil prices and often the most fluctuations are those related to political and economic factors. Perhaps the political factors have greater effects than any other factors and this has a significant impact on all political and economic decisions of oil-exporting countries, as it affects the decisions of oil-importing countries.

Thus, oil exporting countries are facing a very important risk, the risk of oil price, which results in specific difficulties and insecurities for countries depending entirely on oil related revenues.

The oil revenues of exporting countries are a function of oil prices and the number of barrels exported from crude oil

$$R = f(P, Q)$$

Where:

R= Oil Revenue

P= Crude Oil Prices

Q= Number of barrels exported from crude oil

And

$$R = P.Q$$

Oil revenues are increasing and decreasing according to the relationship between (P, Q) and Q, P are affected by many factors, thus it is normal that oil revenues are susceptible to fluctuations. The instability of oil revenues is affected by all economic and political decisions of the exporting country in general and in the decisions of the general budget in particular.

#### **4. The Concept of General Budget**

The state budget is defined as "an official document that contains the expenses and revenues of a government of a country, within a financial plan that enables the government to complete decisions on activating all policies implemented by the government towards the society it serves [3] . The budget is the main economic policy applied by the government. It refers to the way in which the government plans to use resources to achieve the objectives of economic policy. The state budget represents a statement of the financial policy which shows the nature and extent of the government's influence on the economy. The process of preparing the budget begins before the start of the financial year and it takes several months, so that it can be converted into law before the beginning of the fiscal year [4]. The budget is also defined as a dynamic process that reflects a permanent movement of the government sector and continues from year to year. Economic, social and developmental programs based on estimations built on practical and economic means and vision result in a time limited strategy aiming to achieve the goals set while focusing on the economic balance through the roles of intervention. These principles can be applied only after the implementation of the legislative authority [5]. In the light of the above concepts, the basic contents of the state budget are as follows:

It is a general law with specific objectives that reflect the size of the governmental sector, indicating the state's political and economic philosophy; it is one of the channels of state communication, both internal and external, reflecting the degree of political, economic and social development of the state, a reflection of the extent to which the state is able to achieve efficiency in the use of its available resources.

#### **5. The Concept of Oil Price Risk**

The risk output from rapid variations and sharp and unpredictable fluctuations in oil prices creates an imbalance in the general economic policy of the affected countries [6]. Its emergence in the early seventies of the last century led to the evolution of dimensions that had not existed before on political level becoming one of the most important means related to national security, international relations, political and military policies, which later developed into the globalization of oil and the globalization of energy and the invasion and occupation of oil producing countries. The oil price line runs in two main directions:

### ***5.1. Oil price risk on oil exporting countries (export risk)***

It is the risk of collapse in the general rates of oil prices below what is expected, which leads to a sudden drop in oil revenues of the oil producing and exporting countries, especially for the so-called oil countries whose income and national product depends on oil revenues, sometimes reaching 99% of their Gross National Product (GNP). This risk lies in its impact on public finances if this deterioration persists for a long time [7].

### ***5.2. Oil price risk on importing countries (import risk)***

For the importing countries, sudden, sharp and long-term spikes in global oil price rates lead to imbalances in the implementation of public spending plans and great deficits.

We conclude from the foregoing that the oil price risk is the sum of the two previous risks.

Oil price risk = Export risk + Import risk.

The risk on both sides affects public budgets of the exporting countries, as well as in oil-importing countries. Thus, both importing and exporting countries should build common strategies [8].

The risk of oil price at the level of any country has three dimensions: political risk, economic risk and financial risk. This risk is measured by purely statistical measures such as absolute and relative dispersion measures. There is a relationship between the risk of oil price and the risk that accompanies it in each country (Compounded diagonal risk).

Compound diagonal risk (S) = political risk + economic risk + financial risk.

The relative weight of political risk is 50% and both economic risk and financial risk have relative weights of 25% [9].

The compound oil risk of the State (S) = 50% + 25% + 25% = 100%

From all this, we conclude that the oil price risk has been and will remain as long as oil remains the main source of energy - the most influential factor in general economic policies and in private financial policies, with the highest relative weight in both revenues and public expenditures for exporting and importing countries alike. All these images have confused the general budget of all those countries (exporting and importing) and this applies to all countries in the world that suffer from the risks and problems of fluctuations in global crude oil prices.

## **6. Effects of low oil prices in the preparation of the general budget in Iraq:**

To illustrate these effects, the following aspects should be addressed:

### ***6.1 The strategic importance of oil in the Iraqi economy:***

Oil has a strategic importance in the Iraqi economy, since it was discovered commercially in the 1920s, in terms of its contributions. In gross domestic product, national income, total exports, general budget, and construction, oil revenues are the main source for transforming comprehensive development programs. Iraqi economy depends primarily on oil, as oil revenues feed the budget of the Iraqi government, representing a large part of its resources and contributing to the construction of the monetary reserve of the national economy. All these aspects show the importance of oil in the Iraqi economy. [10]

### ***6.2 Contribution of oil to GDP:***

The contribution of oil to gross domestic product in Iraq was 65% in 2008, which represents a high percentage. [11] As is well known, the relative importance of the oil sector in GDP is the degree of economic diversification. The increase in this relative importance reflects the low degree of economic diversification while at the same time means increasing the contribution of other sectors to GDP.

### ***6.3 The contribution of oil exports in the total exports:***

Oil exports have a high rate in total Iraqi exports, which indicates a decline in the degree of diversification in the structure of exports. Oil exports reached 99% in 2008 [11]. And this makes Iraq dependent on oil exports and on the provision of foreign currencies. This index results in economic problems, as the Iraqi economy relies on monetary income from a single source (oil).

### ***6.4 The ratio of oil revenues to total revenues:***

The proportion of the contribution of oil revenues in the general revenues of Iraq is very high reaching 97% in 2008, due to the aggravation of the problems experienced by other economic sectors, such as the industrial sector and the agricultural sector, which led to a decline in the proportion of contribution. The increase in Iraq's oil exports, which amounted to about 1.850 million barrels in the same year has had a

significant impact on the rise in relative importance in addition to the high oil prices since 2004, which led to an increase in Iraqi oil revenues.

### ***6.5 The role of oil in the budget:***

The general budget in Iraq depends entirely on oil revenues since the discovery of oil commercially in Iraq until the present, as can be seen from the general budget data for the year 2007 where the percentage of the contribution of oil revenues from the final revenues of the general budget was of 97.7% [12].

### ***6.6 The role of oil in funding for development:***

The process of funding development programs in Iraq at all stages relied almost entirely on the oil revenues and since 1931, which represents the issuance of urban works. Eight investment methods were issued during the period 1931-1949.[13]. The importance of oil has increased significantly after 1952, when the government began to implement economic development plans and the percentage of the contribution of oil revenues in the construction works and development plans reached 98.8%.

## **7. General issues that are taken into consideration when preparing the Iraqi general budget.**

The nature of the Iraqi oil economy required the decision-makers to take the following aspects into consideration when preparing the general budget:

Dependence on hypothetical prices. Decision-makers depend on global crude oil price projections in the year of budget implementation, which is often lower or higher than the actual oil price, posing challenges to the public budget.

Probability of deficit or surplus. There are differences between the price of oil approved to estimate revenues from oil imports and global prices. The persistence of imbalances in the public budget year after year is a natural result of the policy of quotas between influential political forces and their effects. The price of Iraqi crude oil is \$ 15, which is less than the world price due to differences in quality, distance and purity. The allocation of investment usually does not exceed 15% of planned investments and most of the revenues of the general budget are directed to the operational side.



## 8. Effects of low oil prices in the preparation of the general budget in Iraq

Thus, it became clear that oil is the main player in the process of preparing the general budget for Iraq as the main source in the realization of financial resources of foreign currency. Oil, as mentioned earlier, represented about 90% of the revenues of the general budget between 2003 and 2012.

This means that the allocation of the general budget in Iraq, like all other developing countries exporting oil depends on the following variables:

- Crude oil prices and their continuing fluctuations.
- Production capacity and volume of oil source.
- Oil revenues (price \* number of barrels exported)
- General Budget = General Revenue = Dollar (Crude Oil Price, Volume of Oil Source).

The deterioration of global oil prices and their impact on the preparation of the general budget in Iraq was obvious after the financial crisis that swept the world during 2008. The crisis has cast a shadow on the rates of global economic growth and therefore on global demand in general and demand for crude oil in particular during two years (2008-2009), which had a significant impact on the decline in oil revenues of oil producing countries as well as for Iraq. The year 2008 in the oil market in general had all the paradoxes and rapid dramatic fluctuations: during the first half of the year, the price of oil was very high, almost reaching the threshold \$ 150 / barrel, as mentioned, and soon began to fall in decline and rolled to below \$ 40 dollars / barrel at the end of the second half of the same year. Especially in December, the price lost about \$ 115 dollars per barrel. The reason for this phenomenon was the financial crisis that negatively impacted the global economy and clearly reflected on the oil market in the decline of oil prices. [2] The barrel of crude oil lost nearly 60% of its value in several months.

Thus, with the worsening financial crisis and the start of successive collapses in the financial markets and banking institutions by the month of August 2008 the oil prices fell sharply and at very high rates. The impact of the crisis on oil prices worsened during the second half of 2008, specifically after August [2].

It is noticeable that the deterioration of oil prices is very rapid and dramatic, while prices did not rise suddenly, but gradually when the price of oil increased from 40 dollars in May 2004 to 70 dollars in August 2005 to 100 dollars / barrel in January and to more than 147 dollars / barrel in the same year and then started to fall until reaching its lowest level at 32 dollars / barrel. In this situation, the attempts of OPEC to reduce the volume of oil

supply so that prices may rise again or reduce the deterioration had no effect due to the other productive forces outside OPEC, or even some OPEC countries which sometimes fail to comply with the organization's decision to set production quotas for its members. However, the rise in oil prices has returned during this period due to Hurricane Katrina in 2005, which destroyed refineries in the east coast of America. In addition, some investment institutions in oil institutions tried to speculate the situation for futures contracts, which had a contribution to the rise in international oil prices in August 2005, reaching \$ 73 / barrel and then falling again because of the decline in the value of the US dollar. This shows the rapid fluctuations in oil prices and the impact on the oil revenues of oil-exporting countries, which affect the public budgets.

## 9. The global financial crisis and its impact on the financial budgets of Iraq

The global financial crisis has serious repercussions on the Iraqi economy in general and on the banking and credit system, in particular because of the fact that oil is the main source of public money in Iraq. Iraq has no portfolios or sovereign or investment funds. The banking system in Iraq is not nested with the global banking system. Thus, the main impact was in the area of falling public revenues to the extent that posed significant challenges to the Ministry of Finance in the federal budget. Table (1) shows the contribution of crude oil revenues in the composition of the budget resources of Iraq during the period (2004-2009).

**Table 1:** Percentage of the contribution of crude oil revenues in the composition of the resources of the general budget of Iraq over the years (2004-2009)

Years	(1) Oil revenues	(2) Budget resources	(3) 2/1 %
2004	17456	22762	77
2005	23199	27516	84
2006	29708	33258	89
2007	37847	43093	88
2008	61884	67000	92
2009	50000	59000	85

*Source:* Central Bureau of Statistics 2009

Table (1) shows the fluctuation of the total oil revenues in the general budget in both sides operating and investment during the period 2004-2009. The share of oil revenues increased from 77% in 2004 to 92% in 2008, the year when oil prices reached \$ 148 / barrel. [2] The global crisis has led to the deterioration of oil prices dangerously until reaching the level of \$ 32 / barrel at the beginning of the year 2009. The decline has affected the budget for the year 2009 as Iraq's oil resources dropped from 67 billion dollars in 2008 to 59 billion dollars in 2009, that is, decreased by 12 billion dollars, which caused the amendments to the budget for the year 2009. This was preceded by another amendment to reduce the general budget from 80 billion dollars to 67 billion dollars and then to 59 billion dollars.

From the above, the impact of the global financial crisis on the price of crude oil is clear. It led to the total review of the general budget for 2009 assuming that the price of export of Iraqi crude oil was going to be \$ 62.5 / barrel instead of the price previously assumed of \$ 80 / barrel.

The impact of the global financial crisis on the general budget of Iraq has continued. The second reduction was to 67 billion dollars and the third reduction to about 59 billion dollars based on the price of 50 dollars per barrel at an export rate of 2 million barrels per day. Thus, the 2009 budget was reduced by 8 billion dollars for the general budget for the year 2008. [11]

The effects of oil price fluctuations on the preparation of the general budget in Iraq during the period 2008-2009, which affected the economic, financial and monetary policies of Iraq, led to Iraq's adoption of an expansionary fiscal policy in 2008 after the significant increase in oil revenues at that time, when public spending has increased by 86%, the spending capital has been increased by 140% and wages have increased significantly. With the decline in public revenues due to the fall in crude oil prices in 2009, Iraq has followed a contractionary fiscal policy of reducing public expenses by 44.3% as current spending declined [14].

The general budget of Iraq for the year 2010 prepared by the Department of the General Budget within the Ministry of Finance is based on the expectations to increase the volume of Iraqi exports of crude oil with the assumption of the price of \$ 60 dollars / barrel and the expectation of an increase in the volume of financial revenues from other sectors. The contribution of oil revenues in the budget for the year 2010 was 85%. [11]

The public budget witnessed a surplus of 13.3 billion dollars as a result of the oil prices being higher than forecasted during the preparation of the general budget. This surplus was used to cover the deficit that occurred in the general budget for 2011.

## 10. The strategic necessities to activate the sources of non-oil income in Iraq to face the risks and the problems of the fall in oil prices

From above analysis, it is clear that the low prices of crude oil have global risks and problems and pose a serious threat to the national economy of oil-exporting countries, whether the preparation of the budget, approval or the stage of implementation. In this case, the appropriate solution for these countries, including Iraq - the subject of the study - for facing these risks and problems, stands in the diversification of non-oil income sources.

### *10.1 Activating the sources of non-oil income in Iraq to face the risks and problems of low oil price:*

The activation of sources of non-oil income in Iraq has become a strategic imperative to face the risks and problems created by the effects of falling price of crude oil. Another aspect is that the proportion of non-oil revenues in the preparation of the budget in Iraq did not exceed 5% at best during the period 1921 to 2012.

Table (2) shows the evolution of non-oil revenues during the period 2003-2007, which ranged from 1.6% to 1.7%.

**Table 2.** Contribution of non-oil public revenues during 2003-2006  
(million dinar)

Year	Non-oil revenues	Non-oil revenues contribution ratio In public Budget resources	Contribution of revenues in public Budget resources
2003	257140	1.6	98.4
2004	395839	1.20	98.80
2005	987226	2.4	97.6
2006	2359096	4.7	95.3

*Source:* Ministry of Finance - General Budget Department 2007

From the above table the following conclusions can be drawn:

The contribution of non-oil revenues in Iraq in funding the general budget is quite weak. The general budget is based on oil revenues, which reflects the reality of the Iraqi economy as an economy dependent on oil resources. The most important aspect of the underdeveloped economy is the lack of balance of the productive structure. The contribution of non-oil

revenues in the general budget of Iraq is very low when compared with advanced countries.

This situation requires the activation of all government economic policies in order to initiate the sources of non-oil income. The most important of these policies are: saving policy, investment policy, price policy, fiscal policy, monetary policy and trade policy [15].

Using all the tools of the policies mentioned, since all these policies and instruments contribute effectively to the activation of non-oil sources of income, all ministries related to these policies are involved in the activation of other sources of income in order to achieve the goal of preparing a general budget with diversified income sources of Iraq. This will allow the implementation of a more secure and stable budget. In order to achieve the objectives of reducing the risks derived from oil price fluctuations, which confuse the budget and make it unstable and subject to uncertainties caused by oil price fluctuations. These ministries are: the Ministry of Planning, the Ministry of Finance, the Ministry of Oil, the Ministry of Agriculture, the Ministry of Industry, the Ministry of Tourism, the Ministry of Service and others. The government can build national strategies to divide the imbalance into two parties of the budget and focus on non-oil sources.

### ***10.2 Activate the role of taxes:***

In the current stage, the process of activating the role of taxes in Iraq is the first task and has precedence in activating sources of non-oil income to support the preparation of the general budget and diversification of the sources of its resources. This sector generates tax revenues, which consist of ten forms [11]. Iraq's reconstruction fee, corporate income tax, employee income tax, interest income, corporate and general institutions tax, services wages, contribution of pension deductions, max tax, taxes and fees, income tax. Based on the analysis of the public budget and the extent of the contribution of tax revenues, the taxes in Iraq have been characterized by weak impact in the financing of the budget which can be attributed to the following reasons:

The current tax system of Iraq was designed for an internal national economy that was centrally controlled; tax legislation did not receive any attention from the society or institutions; lack of financial laws that draws unclear tax administration legislation; complex tax accounting procedures; reluctance of taxpayers and their attempts to evade taxes; weak tax awareness among the members of society towards understanding the role of tax in achieving economic and social goals.

The aforementioned reasons led to the fact that the rate of tax revenues is very low in the budget preparation. In order to deal with this situation, the following requirements must be met: the need for the Iraqi government to make real reforms in the tax system and to promote it to the level that ensures achievement of the required objectives, foremost of which is the funding target for the general budget; the activation of the role of taxes as a non-oil source in financing the state budget; carry out radical reforms in the tax system by revising tax laws; introducing new containers within the tax structure; raising the level of tax awareness and ensuring that taxation is an important financial, economic and social tool in the mind of citizens and their culture; manifesting interest in experiencing tax systems of advanced countries in order to benefit from them.

### ***10.3 Activating the role of productive and service sectors:***

The proportion of non-oil revenues contribution to the composition of gross national product and national income needs to be increased in Iraq. These are considered as strategic imperatives in the current phase in order to build a more secure and more stable economic future. Iraq needs to concentrate all the potential that can contribute to the impulse and to accelerate the achievement of this objective. Iraq is rich in natural resources that are rarely available in a country with an area close to the size of Iraq, in addition to the geographical diversification of terrain and climate. These are the necessary inputs to develop these sectors and move them from their specific and very precise role to a dynamic ratio that grows continuously.

### ***10.4 Natural resources include the following resources.***

Hydrocarbon resources (oil and natural gas) which are estimated to 115 billion barrels of proven oil reserve and 215 barrels of reserves with economic and technical advantages. There were also 110 trillion cubic feet of natural gas. Iraq's production of gas in the year 2002 was about 486 billion cubic feet but it is regrettable that most of the gas associated with oil is burned in the air and limited amounts are used for the purposes of generating electricity and re-drilling wells to facilitate the extraction of oil. [10]

### ***10.5 Mineral wealth:***

In addition to the hydrocarbon wealth, there are different minerals, especially sulfur, which is found in huge amounts in the Mashraq region. Sulfur was produced on a large scale before 2003, in addition to phosphate in Akashat and red mercury in Maysan province, as well as other minerals.

### ***10.6 Agriculture:***

Iraq has all the basic requirements for the advancement of the agricultural sector. The land of Iraq has been known throughout the history as the black land. Agriculture is characterized by its variety and quality. The most important products are palm trees, wood, oak, grains, vegetables and fruits. Besides agriculture, there are livestock (fish, birds and livestock). All these possibilities can be a source of income and a diversification base of GDP, especially as some of them can be exported abroad and in order to generate foreign currencies.

### ***10.7 Financial resource:***

In Iraq, there are many financial resources derived from oil imports, such as financial surpluses as a result of high oil prices and increased production capacity in addition to other resources that must be developed. Their contribution to national income must be activated and then to the resources of the general budget.

### ***10.8 Human Resources:***

Iraq is one of the countries that is characterized by high population growth compared to neighboring countries, confirmed by population data - the annual population growth rate ranges between 2.68% - 3%. Population forecast in the last years of the twentieth century indicated population 28 million and up to 8 million in 2030 [16]. The utilization of available economic resources mentioned above would speed up the process of economic development of sectors in order to activate their role in increasing their contributions of non-oil sources to the preparation of the general budget for Iraq Sources. All these require full governmental intervention in accordance with the national strategy of comprehensive development in Iraq.

## **11. Conclusions**

Oil is the main source of national income for the Iraqi economy and therefore it relies on the general budget. It is the oil revenues that determine whether the public budget will achieve surplus or deficit. The risks and problems of fluctuations in oil prices during the period 1921 to 2012 greatly confused the general budget, produced serious repercussions and posed real challenges to the public budget. All budgets of Iraq were only a function of oil prices and the volume of exported quantities and here lies the need and



fragility of the Iraqi economy, which suffers from the imbalance of production structure and unilateral public revenue. The evolution of non-oil public revenues constitute only a weak percentage ranging from 1.6% -4.7% at best, namely the contribution of tax revenues, which was characterized by weak impact in financing the public budget. One of the most important challenges facing the preparation of the budget and approval by the Parliament is political instability and the control of quotas and political consensus between the major blocs. Iraq has many economic resources (natural, human and financial); if exploited efficiently, they can contribute to the activation of sources of non-oil revenue that will help the diversification of the components of the gross national product, reduce the risk of oil price and contribute to finding means to ensure that the Iraqi budget is safer, more stable and independence from the dominance of unilateral resources of the general budget.

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