HM TREASURY INVOLVEMENT IN IRAQ

Witness statement
Sir Nicholas Macpherson, Permanent Secretary, HM Treasury

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The Committee wishes to explore the Treasury's involvement in UK Government activity on Iraq over the period 2001-2010.

The Treasury had two principal roles. As an economics ministry, it had a role in ensuring that potential impacts from the intervention on the world economy had been taken into account in economic forecasting and policy making; helping other parts of Government plan for economic reconstruction in Iraq after the conflict; and providing economic expertise to support the UK's post-conflict reconstruction efforts on the ground.

Stephen Pickford has already covered this area in his evidence to the Inquiry on 17 December. This statement will not go over that ground other than to answer the Committee's specific follow-up questions about HMT contributions of personnel to post-conflict activity.

This statement concentrates on the Treasury's second role as a finance ministry, which was to ensure that an appropriate level of resource was provided to achieve the Government's objectives in Iraq and ensure that this resource was being deployed in a cost effective way.

I set out below the funding mechanisms through which UK activity in Iraq was resourced, together with the processes by which expenditure in each of these streams was forecast and managed. As requested Tables 1 and 2 below give the figures for actual outturn spend on Iraq from UK Government funds through each of these mechanisms. Further details are available from published Departmental accounts and Annual Reports.

Funding mechanisms

There were three main funding streams for the UK's involvement in the Iraq war.

The additional costs of Iraq-related diplomatic and reconstruction activity were funded through the baseline spending settlements for the relevant Departments - FCO and DfID - supplemented through the joint Conflict Pool.

The additional costs of military operations were funded through the Treasury Reserve, supplemented by the Special Reserve which was created specifically for this purpose in 2002.

Departmental settlements

The Treasury sets the budgets for each department as part of the spending review process. Departmental settlements were the main source of funding for FCO activity in

Iraq including our diplomatic presence in Baghdad and Basra; and for DFID's contribution to the humanitarian and reconstruction effort. Prior to the invasion the Treasury worked with departments to produce estimates of the potential cost of intervention and to ensure that where appropriate sufficient funding had been set aside within their budgets.

The Conflict pools

As activity developed, some funding for stabilisation and reconstruction activity was also drawn from the Global Conflict Prevention Pool.

The Global Conflict Prevention Pool (now called the Conflict Pool) was a pooled resource managed jointly by FCO, DFID and MOD bringing together spending on conflict prevention and stabilisation.

The Treasury worked with DFID, MOD and FCO officials and Ministers to identify how we could reprioritise within the Pool to supplement departmental funding for activity in Iraq. Decisions on allocations were taken collectively by the three departments as managers of the Pool.

The Reserve

Finally, funding was also drawn from the Treasury-managed central Reserve. The Reserve is intended for genuinely unforeseen contingencies which departments cannot manage from their own resources. Against those criteria small claims were accepted by the Treasury from DFID and FCO in respect of items that could not be met from their own resources or the Conflict Pool.

However, the main call on the Reserve was paying for the additional costs of military operations. By longstanding convention, MOD's spending review settlement pays for MOD to be 'ready' for military operations, but the net additional costs of those operations themselves are met from the Reserve.

Reserve funding covers the net running costs of operations such as operational allowances, consumption of munitions, supplies and so on. It also meets the costs of any UORs.

UORs are Urgent Operational Requirements for equipment enhancements that have arisen due to the particular demands in a specific operational theatre. To qualify as a UOR a piece of equipment must be specific to a theatre of operations, should be in addition to generic capability financed out of the core funds and must be deliverable within 12 months (18 months by exception).

Decisions on how much of a Reserve to set aside and on claims against that Reserve are the prerogative of Treasury Ministers. Prior to the invasion the Treasury with MOD produced estimates of the potential cost of military intervention. These included a central case of £3 billion. Based on these estimates the Treasury assessed that its existing Reserve would not be sufficient to cover other Government contingencies while paying for the costs of Iraq. At the Pre-Budget Report in 2002 a Special Reserve

of £1 billion was therefore established for “the UK’s defence and overseas needs in the fight against global terrorism”.

Budget 2003 announced that these resources had allowed the military to prepare for a possible conflict in Iraq. The 2003 Budget also increased the Special Reserve to £3 billion “to cover the full cost of the UK’s military obligations.” This was in line with MoD estimates at the time of the initial invasion costs. £1 billion of the 2002-03 reserve was allocated to the MoD. The 2003 PBR carried forward the remainder to 2003-04, and added a further £0.5 billion to the Special Reserve in 2003-04. The Special Reserve was intended to ensure the Government could meet not only all costs of commitments in Iraq but also elsewhere in the war against terrorism.

Forecasts for the overall net additional costs of military operations, as well as estimates for UOR expenditure, were produced by the Ministry of Defence in consultation with the Treasury. The estimates were based on historical data coupled with assumptions on the anticipated operational tempo, activity and conditions for the forthcoming 12 months. Parliamentary approval for Reserve funding was provided through MOD's Parliamentary Estimates, with changes to MOD's in-year forecasts for the net additional costs of operations reflected in the Winter and Spring Supplementary Estimates.

For the Pre-Budget Report in 2003, only Iraq-related Reserve claims were scored to the Special Reserve but subsequently other military costs (e.g. Afghanistan) and domestic counter-terrorism costs were also scored against it. In PBR 2004, £520 million was added to the Special Reserve for 2004-2005 “as a prudent allowance against continuing commitments on the military conflicts in Afghanistan and Iraq and other international obligations.”

Budget 2005 provided a further £340 million for the Special Reserve in 2004-05 and £400 million for the Special Reserve in 2005-06 for “military operations in Iraq and the UK’s other international obligations”. The 2005 Pre-Budget Report made an additional allocation to the Special Reserve in 2005-06 of £580 million. Budget 2006 made an £800 million provision for the Special Reserve in 2006-07, set aside from within existing public spending plans. Budget 2007 added £400 million to the Special Reserve in 2007-08. The 2007 Pre-Budget Report added a further £400 million to the Special Reserve in 2007-08.

Managing spend against the Reserve

In managing claims against the Reserve for the costs of operations the Treasury aims to strike a proper balance between safeguarding the taxpayer’s interest by scrutinising claims appropriately without interfering in the proper running of the campaign or to second-guess the military judgement of commanders on the ground.

All small claims below £10 million are approved by MOD without reference to Treasury. Larger items are scrutinised but with a light touch, recognising that operational tempo will often require very swift approval.

To date the Treasury has never turned down a request for an Urgent Operational Requirement for the Iraq theatre that has met the criteria. UORs have been funded from the Reserve with in excess of £2 billion being spent in Iraq since the commencement of operations. The majority of Iraq (Operation TELIC) UORs relate to force protection, some of which have subsequently been transferred to Afghanistan.

Non-UK sources of funding

As well as providing direct UK financial support for the effort in Iraq, it was UK policy to maximise Iraq's own contribution from oil revenues, ensure that Iraq's revenues were not wholly diverted to paying debts and compensation, and to maximise contributions from International Financial Institutions and donor funding from other countries, the EC and United Nations.

In the event, the financing for Iraq did include some of all of these elements; major pledges from donors and the international financial institutions at the Madrid Donors' Conference in October 2003, and maximising oil revenues. The Development Fund for Iraq was established which was funded by released frozen assets as well as all Iraqi hydrocarbons revenue and continues to operate in this way today. A debt moratorium was agreed in the aftermath of the conflict and a major debt restructuring through the Paris Club was agreed in November 2004, cancelling 80% of Iraq's debts.

As noted above the Madrid Donors' Conference of 23-24 October 2003 was probably the key milestone in financing the reconstruction effort. This galvanised international support for reconstruction, with pledges of $33 billion secured from close to 40 donors, including significant pledges form the IMF and World Bank. The UK pledge was for £544 million over the years 2003-4, 2004-5 and 2005-6, making the UK the third largest bilateral donor. The pledge was met and spent in full. The Treasury worked with Departments to ensure a significant pledge was possible. The Government has made subsequent pledges for reconstruction in Iraq totalling a further £200 million to be provided up to 2012.

Outturn costs of UK involvement in Iraq

Outturn spend from UK departmental budgets and the conflicts pools and the Reserve is outlined in Table 1 below. There was also some spending by the security and intelligence agencies. For security reasons in an unclassified document it is not possible to break out these numbers from the Single Intelligence Account. This spending is therefore not shown in the totals below.

Table 1 – Funding for Iraq by Department (£m)

Year / Area of expenditure	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10	TOTAL
DfID[1]	18.9	220.3	60.1	92.9	63.6	48.6	32.8	n/a	**537.2**
MoD									**7,858**
Resource	629	1,051	747	798	787	1,055	1,124	n/a	6,191
Capital	218	260	163	160	169	402	257	n/a	1,629
Quick Impact Projects	-	-	30	5	3				38
FCO									
Costs of diplomatic mission	0.4	5.5	45.5	54.7	88.6	49.7	38.75	N/a	
Support to CPA	-	29	10	-	-	-	-	-	39
Global conflict prevention pool	-	5	18	14	25	29	-	-	129
Peace keeping conflict pool	-	-	11	15	12		-	-	
Stabilisation Aid Fund	-	-	-	-	-	-	18	-	18
TOTAL	866.3	1570.8	1084.6	1139.6	1148.2	1584.3	1470.55		

[1] **Total DFID Bilateral Expenditure plus UK imputed Multilateral Share *Statistics on International Development,* DfID.**

Spend from the Reserve is set out in Table 2 below.

Table 2 – Total net additional costs of operations in Iraq funded from the Reserve and special reserve

	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09
Total Reserve (£m)	**2,600**	**4,100**	**3,300**	**3,600**	**3,000**	**3,600**	**4,200**
Total Reserve funding for net additional costs of operations in Iraq (£m)	**847**	**1,456**	**910**	**958**	**962.5**	**1,458**	**1,381**
Total spend on Iraq as % of total Reserve (%)	**33**	**35.5**	**28**	**27**	**32**	**41**	**33**
Memo: Special Reserve (inc. in Total Reserve above) (£m)	**1,000**	**2,500**	**1,200**	**1,000**	**1,100**	**800**	

HMT's contributions of personnel to post-conflict activity in Iraq

As noted above, post-conflict work in Iraq was not just about exchequer funds but also about technical assistance, maximising donor aid and delivering debt relief. Treasury sent expert staff to Iraq, was involved in the Madrid Donors' Conference and led work to secure a significant debt deal for Iraq (achieved in November 2004).

Treasury secondees during the Coalition Provisional Authority (CPA)

The Treasury sent secondees to Baghdad to work for the CPA in 2003 and 2004. In the summer of 2003 there were four UK secondees working for the Ministry of Finance in Baghdad. However, as it became clear that the post-conflict period would involve a phase as an occupying power, the role of the secondees changed and they became part of the CPA with powers and responsibilities over the Iraqi budget. The secondees were carefully selected on the basis of their skills and experience. Looking at the task in hand and our objective to put in place the building blocks for a stable economy, the Treasury needed people with experience of budget planning, macroeconomic and fiscal policy and currency exchange. In total the Treasury sent 6 secondees and one from the Bank of England, but these were not all in Iraq at the same time. The secondees worked in the CPA on a variety of issues; development of a new currency and the currency exchange, on which one secondee had a leading role, macroeconomic policy, budget issues, reform of state-owned banks, expenditure policy, preparing for engaging with the IMF and transfer of cash from Iraqis overseas into Iraq.

Secondees initially went to Iraq in April and May 2003. After the Hotel Rasheed bombing in October 2003, in which one of the Treasury secondees was injured, the Treasury withdrew all secondees until more secure accommodation could be obtained. This was in place by January 2004 when some Treasury staff returned.

In addition to staff sent to Iraq, the Treasury also seconded a policy analyst to the FCO Iraq Policy Unit whose role was to ensure that the emerging post conflict process was informed by economic and financing issues.

Although HMT secondees were not in place until early summer of 2003, their skills enabled them to make a very positive and immediate impact on their arrival in Iraq. They worked well with US and other international colleagues and were able to challenge successfully some proposed policies that were not thought to be the right course of action – notably negotiating a wind down on the policy of mass privatisation of Iraqi state assets.

Treasury secondees after the CPA

The CPA handed over power to the interim Government of Iraq in June 2004 and HMT secondees returned to the UK. The Treasury did not second any further staff to Iraq after that although two members of staff took unpaid leave to return to Iraq working as consultants for DfID. During this time however they did not report to Treasury.

In London there were still a number of Treasury staff working on Iraq on spending issues, debt and economic policy, across the department as had been the case since

2003. These staff met on a weekly basis to ensure a joined-up approach and to consider the cost implications of UK involvement in Iraq.

Once transition had taken place, the Treasury took a step back and reverted to the usual system of the FCO and DfID leading the UK's involvement in Iraq.

In 2006 the Treasury was involved in the drafting of the Compact with Iraq and was keen that the Compact should support economic reform. The Treasury worked closely with Whitehall colleagues (FCO was the lead department) and with the US on this. The Treasury worked to ensure the process had the buy in of the UN and was oriented towards encouraging the Iraqis to agree their own priorities for spending. A common UK/US position was developed ahead of the launch in May 2007.

Other direct Treasury involvement in the reconstruction effort

In terms of determining strategy for Iraq, the Treasury had an interest in the economic framework emerging for Iraq and were heavily involved in this, primarily through the cross-Whitehall Iraq economics group, which gave policy direction to our secondees in the early phases, and also through our work with International Financial Institutions, the European Union and international colleagues. The World Bank and IMF left Iraq after the bombing of the UN building in August 2003 and the IMF did not return. And so after that point, the Treasury needed to engage with them elsewhere, for example through our presence in Washington, where the UK Delegation to the IMF liaising with Treasury officials increased IMF engagement with Iraq including through the use of programming, as well as securing IFI approval for economic policy and legislation during the CPA period, such as the introduction of a new currency. The Treasury also led on providing Paris Club debt relief for Iraq, as well as continued engagement regarding the settlement of commercial and non-Paris Club sovereign debt and UN immunities around the Development Fund for Iraq.

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HM Treasury
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