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BUILDING A SUSTAINABLE INVESTMENT CLIMATE IN IRAQ

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**Finance, Private Sector and Infrastructure Department
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US\$1 = NID 1,460

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ABBREVIATIONS AND ACRONYMS

ADR	Alternate Dispute Resolutions
BDS	Business Development Services
FDI	Foreign Direct Investment
GoI	Government of Iraq
IPCC	Iraq Property Claims Commission
NID	New Iraqi Dinar
QIZ	Qualified Industrial Zones
SEZ	Special Economic Zones
SME	Small and Medium Enterprises
SOE	State Owned Enterprises
WTO	World Trade Organization

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REPUBLIC OF IRAQ
BUILDING A SUSTAINABLE INVESTMENT CLIMATE IN IRAQ

TABLE OF CONTENTS

PREFACE	i
Executive Summary	i
I. INTRODUCTION	1
II. INVESTMENT CLIMATE, JOB CREATION, AND TRADE FACILITATION IN IRAQ TODAY	3
III. INVESTMENT CLIMATE IN IRAQ	6
<i>A. Strategy to Build a Competitive Investment Climate</i>	<i>6</i>
<i>B. Private Foreign Direct Investment and Job Creation</i>	<i>7</i>
<i>C. Sources of Investment Markets</i>	<i>9</i>
<i>D. Legal and Regulatory Framework</i>	<i>11</i>
IV. Building and Strengthening Institutions	13
<i>A. Building Public Sector Institutions</i>	<i>13</i>
<i>B. Trade Ministry Role</i>	<i>14</i>
<i>C. Strengthening Private Sector Institutions</i>	<i>15</i>
V. Trade and Economic Zones	18
<i>A. Improving Trade Facilitation and Addressing Key Bottlenecks</i>	<i>18</i>
<i>B. Potential Role of Economic Zones</i>	<i>19</i>
VI. The Way Ahead: Resolving Issues	22
Annex: Proposed Next Steps – Investment Climate, Trade Facilitation and Economic Zones	23

PREFACE

To provide guidance and information on the many economic challenges that Iraq faces, the Bank is preparing a series of notes dealing with three broad clusters: Economic Reform and Transition, Poverty Safety Net and Social Development, and Public Sector Management. Fitting in the Economic Reform and Transition cluster, this note on the Investment Climate will be revised if necessary when the other notes are produced. Four sub-tasks are planned under this cluster:

Incentive Framework for a Market Economy—focusing on the transition strategy overall and the choices and policy options in domestic and external price liberalization;

Oil and Gas Sector Reform—focusing on critical energy issues and options for pricing and institutional reform in managing oil resources’

Investment Climate, Financial and State-Owned Enterprise Reforms—focusing on key institutional issues in private-sector development and the supporting financial framework and on reform options for state-owned enterprises; and

Agricultural and Rural policy and institutional framework—focusing on key issues in agriculture and rural development.

This note, which builds on the Needs Assessments presented at the Madrid donors’ conference in October 2003, synthesizes the findings of consultations between the World Bank and the Iraqi Investment Climate delegation at two sets of capacity-building workshops held in Amman, Jordan in February and May 2004 on the subject of “Building a Sustainable Investment Climate in Iraq,” with lessons from regional and international best practices in developing a competitive investment climate regime. These workshops, together with prior and subsequent formal and informal discussions between both sides, have resulted in the emergence of an Iraqi-owned strategy together with a set of detailed priority actions. The workshops and discussions were highly interactive and included study tours, general debates, case studies, and specific relevant best-practices presentations from experts familiar with the region.

The workshops were informed by the presence of many leading private business executives working in the region, who participated in discussions with the Iraqi delegation on the operating conditions necessary to enter Iraq and commence operations.

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EXECUTIVE SUMMARY

One part of an ongoing economic sector work program to provide timely discussion of critical issues facing Iraq, this note seeks to guide and inform the Iraqi authorities, the Bank and the international community in the continuing development of support strategies and, in particular, efforts to nurture a healthy climate for future investment in Iraq. Responding to questions that have arisen in the ongoing dialogue with the Iraqi authorities, the note examines and emphasizes the need for private investment from both Iraqi and foreign services to generate growing and sustained employment. Further, assessing Iraq's significant institutional and capacity shortcomings in the private sector, the note details a strategy, based on the Bank's global experience, for laying the necessary institutional foundations for a strong and growing private sector.

Acknowledging the obvious – the paralyzing impact of continuing internal violence on the development of either investor confidence – the note looks ahead to measures that can be undertaken once security is restored and to preparatory steps that can be initiated in the interim. It identifies some areas where immediate support can take place that will encourage job creation, an urgent task of enormous dimensions.

The challenge is huge. Reasonable estimates put employment and underemployment in Iraq as high as 50%. No job-creation program (and no long-term strategy to stimulate private investment) in the world has been able to solve a problem of this magnitude overnight. *It is therefore essential to develop a strong package of social safety-net interventions in parallel to work on improving conditions for investors and investments.* These interventions, which should be as non-distortionary as possible, could include a strong emphasis on micro-finance and job-creation schemes through public works financed by the reconstruction.

Public Awareness is Critical

There is no debate that Iraq needs a strong and growing private sector if it is to meet the twin challenges of:

- Job generation for now and the future, and
- Economic diversification and sustainability

However, a strongly held view believes that public investment will suffice and sees foreign investment as a major challenge to sovereignty.¹ This philosophy is driven in part by its past history as well as its perceptions of neighbors. It is undercut by the reality that the country's huge reconstruction needs will clearly absorb the majority of public investment funds available. ***The first key recommendation, accordingly, is to mount an extensive public awareness campaign on the need for private-led investment with a wide range of stakeholders in Iraq.***

¹ A recent survey of Iraqis by the State Department showed that 90% of Iraqis expected the public sector to generate the necessary jobs

Institutions are Fundamental

Investment will drive private-sector growth, but only when investors gain the confidence to invest and the investment climate becomes attractive. Even in the best of circumstances this will take time, and current circumstances in Iraq are particularly challenging:

- The security situation makes it virtually impossible to conceive of any significant private-sector investment taking place now, and
- The large, oil-based economy, because of its impact on internal competitiveness, will make it difficult to follow a traditional export manufacturing approach.

On the positive side huge reconstruction flows present an enormous opportunity to develop the private sector. For the Iraqi private sector to benefit fully from them, however, efforts will be needed to foster business skills, entrepreneurial development, and business associations. Bureaucracies will also need training in administering public investment and conducting regulatory oversight. The greatest possible Iraqi participation in the allocation and use of these reconstruction funds is essential to insure that they not only serve genuine needs but are seen to do so.

Analysis of the investment climate shows the obvious that many critical areas – infrastructure, the financial system and security are very weak. As these issues are being addressed very seriously in other studies, they are not covered here. What is less obvious is that necessary institutional underpinnings for a strong private sector either do not exist or are very weak. Unfortunately recent survey evidence suggests that this situation on the institutional front is deteriorating rather than improving. Indeed the Bank has identified institutions -- along with sound and stable, social and macroeconomic structures -- as the critical success factor for private-sector growth.

Therefore the second key recommendation is the need to focus now on creating—in some cases, strengthening -- some critical institutional building blocks. This priority reflects investors' various needs. They need to know their property rights will be respected. They need competitive costs of business so they can make a profit. And whether Iraqis believe it now or not, the private sector will benefit from competition. This theme of institutions is important particularly in post-conflict or transition situations. Experience has shown that where perceived risks are high, initial investors may not be particularly professional, a deformity that can be very hard to change later. Moreover this is an area where it is possible to work now. As the experience in West Bank Gaza shows, institutional reform can be initiated and continue even in the most hostile of environments.

The building blocks of a competitive investment climate will include the following institutional components:

- The creation of a commercial legal and regulatory structure,
- Building the institutional capacity of the public sector,
- Strengthening the private sector's institutional capacity,
- Building the capacity to access various markets for trade and investment,
- Developing the framework for regional economic development institutions, and
- Revitalizing the trade facilitation infrastructure by addressing key bottlenecks, e.g. a working customs administration

In virtually every case a multi-phased approach is required initially. The first phase would support specific priority areas with the following type of support: (i) a business plan for the institution which deals with strategy and direction, organizational issues, resource and training needs and sustainability questions; (ii) guidance and training on operating processes; (iii) support for feasibility studies on initiatives; (iv) seed financing for initial initiatives and (v) draft enabling regulations. The priority areas include:

- A self-standing Investment Promotion Agency that will need to bring together a number of disparate investment initiatives.
- Strengthening export promotion capabilities.
- Developing an Alternative Disputes Resolution System. This is a way to provide for property rights uncertainty without waiting for more fundamental reforms of the Commercial Court system
- Creating a local economic development capability in a small number of pilot cities, recognizing that economic development tends to happen at the municipal and sub-regional level where it is often easier to identify opportunities and resolve constraints to doing business, and
- Supporting on a pilot basis public private partnerships that provide financial and technical resources. This should link with the reconstruction flow, export and the services sector.

The second phase would apply the lessons learned from the first phase to a much wider array of institutions, (competition authorities, customs, private sector NGOs industry associations and the like). This follow-on would also provide a second round of support to the first-phase activities.

Opportunities for Growth Exist Now

While this work will lay the foundation for growth in the private sector, it will do little to kick-start activity. Three, somewhat interrelated areas of opportunity, however, offer potential for stimulating job creation and investment:

- Ensuring reconstruction flows that benefit the Iraqi private sector as much as possible
- Encouraging economic zones that can provide enhanced security, good quality infrastructure and protection from regulatory interference
- Supporting the private sector, efforts to obtain access to technology, know-how and markets for, export markets and reconstruction flows.

Given the potential for productive activity in these areas, the third recommendation is to investigate the feasibility of these measures in detail.

A considerable amount of effort already seeks to encourage Iraqi private-sector involvement in reconstruction flows. Nevertheless more could be done, particularly in regards to the flows that the Government itself will be managing. The needed is to build a strong procurement system for both internally developed and internationally provided flows so as to encourages Iraqi private-sector participation.

The economic development zones that are proposed do not rely on any tax or customs advantage for their justification. They are a response to the need to maintain security, control red tape and provide infrastructure. In an environment where these problems are insurmountable from a countrywide perspective development zones will encourage focused resolution of these issues.

The private sector in Iraq consists of very few large companies, a significant number of SMEs and a very large number of micro enterprises. Therefore any support strategy will, of necessity, have a SME and micro enterprise focus. The immediate challenge is to improve their productivity and find markets for them. Reconstruction programs open one obvious area, with exports as the other. In the latter area Iraq has strong artisanal manufacturing traditions and a number of SMEs that -- while not exporting -- have the capability to do so if provided with missing technology and market know-how. Measures to provide these elements should be strongly encouraged.

Implementation Capacity is Required

The three key recommendations proposed will require significant effort to implement, including – as an essential matter -- close attention from the senior leadership of Iraq. Further many of the agenda items will require cross-ministerial coordination. The final recommendation therefore is the establishment of an inter-ministerial working group on the investment climate. This committee should coordinate with other aspects of economic reform and act as a bridge to the infrastructure and financial sectors.

Investment climate reforms are a fundamental ingredient of economic growth. Whether in post –conflict or post-transition situations or in the experience of the OECD countries, such reforms have been crucial. Indeed, “[o]ne of the main lessons of Bosnia and Herzegovina’s experience is the need to press for investment-related policy reforms as early as feasible. Donors are now fully aware of this, and are supporting rapid reform accordingly. Opinions differ on the extent to which it might have been possible to accelerate reforms at an earlier stage. It might have been difficult politically. However, there is no doubt that earlier reform would have been desirable, and this is one of the most important lessons for other post-conflict environments.”²

That lesson is one Iraqis must take to heart. If they shirk the path of reform and the effort needed to make their country attractive to investment by its own citizens and by foreigners, private sector jobs will not be generated at the pace needed, and the public sector will be saddled with an overwhelming burden.

²[http://lnweb18.worldbank.org/ESSD/sdvext.nsf/67ByDocName/MIGAsExperienceinConflict-AffectedCountriesTheCaseofBosniaandHerzegovina/\\$FILE/WP13_Web.pdf](http://lnweb18.worldbank.org/ESSD/sdvext.nsf/67ByDocName/MIGAsExperienceinConflict-AffectedCountriesTheCaseofBosniaandHerzegovina/$FILE/WP13_Web.pdf)

I. INTRODUCTION

1. Quickly laying the foundation for private investment in Iraq is critical for progress on the government's goal of creating jobs and jump-starting economic activity. Although this objective – the creation of a climate that fosters competition and enterprise -- seems straightforward, the answers to basic policy questions are not obvious. Indeed, there is considerable debate in Iraqi society about the role of private investment and real concerns that “foreigners will steal” all the country's assets. Further, the issue of a fair balance between public- and private-sector investment remains open, and the structural and psychological legacy of decades of government domination of the economy remains strong. The purpose of this note is to define the elements needed to build a competitive setting for investment and at the same time to make the case for private-sector investment, both foreign and particularly local. In most developing countries, it is worth noting, local private investment is typically 8-10 times larger than foreign investment.

2. Four fundamental challenges currently affect the investment climate in Iraq:

- (i) The security situation makes it virtually impossible to conceive of any significant private sector investment taking place now.
- (ii) Huge reconstruction flows will provide attractive investment opportunities and therefore dominate the short and medium-term investment agenda.
- (iii) The large oil-based economy -- because of its impact on internal competitiveness -- will tend to lead the economy away from export manufacturing and toward an emphasis on services
- (iv) A philosophy, driven in part by past history as well as perceptions of neighbors, which pictures an Iraqi economy driven largely by public-sector investment.³

3. Security is an obvious precondition for investment, local and, in particular, foreign. Without security, investment will be no more than minimal and limited in all probability to the oil sector –if there. All evidence from such recent conflicts as those in Palestine, Ireland, Afghanistan and Kosovo indicates that insecure conditions cut off all but minimal, non-oil-related investment. For example in the case of Palestine, local and foreign investment, which had grown significantly after the first Intifada ended, collapsed again after the start of the second Intifada. Notably in the case of Palestine, during the worst years of the Intifida, development work to improve and streamline systems, procedures and institutions (both public and private sector) has proceeded apace with the assistance of the international donor community, and much of this work has been successful. The current Palestinian Authority programs on civil service reform across a number of ministries have demonstrated that progress can be made on institutional development during conflict situations.

³ A recent survey of Iraqis by the State Department showed that 90% of Iraqis expected the public sector to generate the necessary jobs

4. After security considerations, the institutional agenda is fundamental. Virtually every study of the investment climate highlights this area -- the effective combination of regulatory, legal, and policy frameworks with organizations that convert them into reality -- as the key to investment and growth. Sound institutions provide investors with certainty and are the focus of the note along with suggestions for a number of measures that can accelerate the program. Immediate measures that could encourage investment include economic zones that can both meet basic infrastructure needs and deal in part with the security concerns. These zones are discussed later in the note.

5. Except in passing, the note does not address such core issues as public-sector reforms, general SOE reform, infrastructure, and the financial sector. Nor does it deal with short-term job creation, a concern related to the social safety net. Papers addressing actions to be undertaken in these areas are being prepared and will be coordinated with this one. Although sustainable jobs will only emerge in the private sector when investors have the confidence to risk working and investment capital, some potential job creation can come from (i) public works employment programs particularly in construction, (ii) micro-finance initiatives and, (iii) matching grant schemes that support key aspects of SMEs. All these areas have the potential to support the general investment climate initiatives discussed below.

II. INVESTMENT CLIMATE, JOB CREATION, AND TRADE FACILITATION IN IRAQ TODAY

6. Current unemployment in Iraq stands at about 28% with an additional 22% estimated as underemployed in a labor force of about 6.8 million and a population of about 25 million. This would imply that the effective labor force participation in Iraq is less than 15%, surely among the lowest in the world. The exceptionally high unemployment rate reflects both an atrophying GDP since the US-led invasion in 2003 and, despite great oil wealth, extremely poor growth since the Iran-Iraq War in the 1980's and the United Nations-endorsed sanctions imposed after Iraq's 1991 invasion of Kuwait. To achieve *both* growth *and* job creation, private investment will have to be stimulated in the non-oil sector at roughly the same pace as in the oil sector, since the latter -- while already producing at pre-war levels of 2 million barrels a day -- is capital intensive and cannot absorb the large numbers of unemployed Iraqis.

7. Positive steps taken to better the investment climate include: (i) creating a stable macro economic framework, (ii) enacting investment friendly laws, and (iii) beginning the work of removing fundamental distortions in agricultural and energy.

8. Of these steps, the macroeconomic measures tally with the Bank's experience in its global work on investment climate where such stability is seen as critical. Iraq has also made good progress on exchange-rate policy and a working trade regime, with further work required to address domestic pricing. A 2004 budget has been put in place together with a systematic budget process. There is now a stable monetary authority with appropriate intervention mechanisms that allow the central bank to retain the purchasing power of the New Iraqi Dinar (NID). The current fiscal and monetary regime has brought stability at least to financial markets and the government. From the perspective of the investment climate, it is important to insure these institutions remain and appear to remain intact in the future. A further critical challenge is managing Dutch disease (see Box 1 below) issues arising from reconstruction and oil windfalls.

Box 1. What is the Dutch Disease?

"Dutch Disease" was named for the problems experienced by the Netherlands following the discovery and initial exploitation of vast domestic reserves of natural gas. The rapid growth in petroleum exports led to an appreciation of the exchange rate and put upward pressure on the costs and prices of non-traded domestic goods and services, diminishing their competitiveness and eroding the diversity and balance of the domestic economy. Similar symptoms have been subsequently identified in almost all countries where petroleum exports play a major economic role, Nigeria, for example. The arrival of oil devastated all three of Nigeria's traditional agricultural export industries. Cocoa exports dropped by 30 percent over the last five years; ground nuts exports by 95 percent; and palm oil exports, once a major earner, have disappeared.⁴

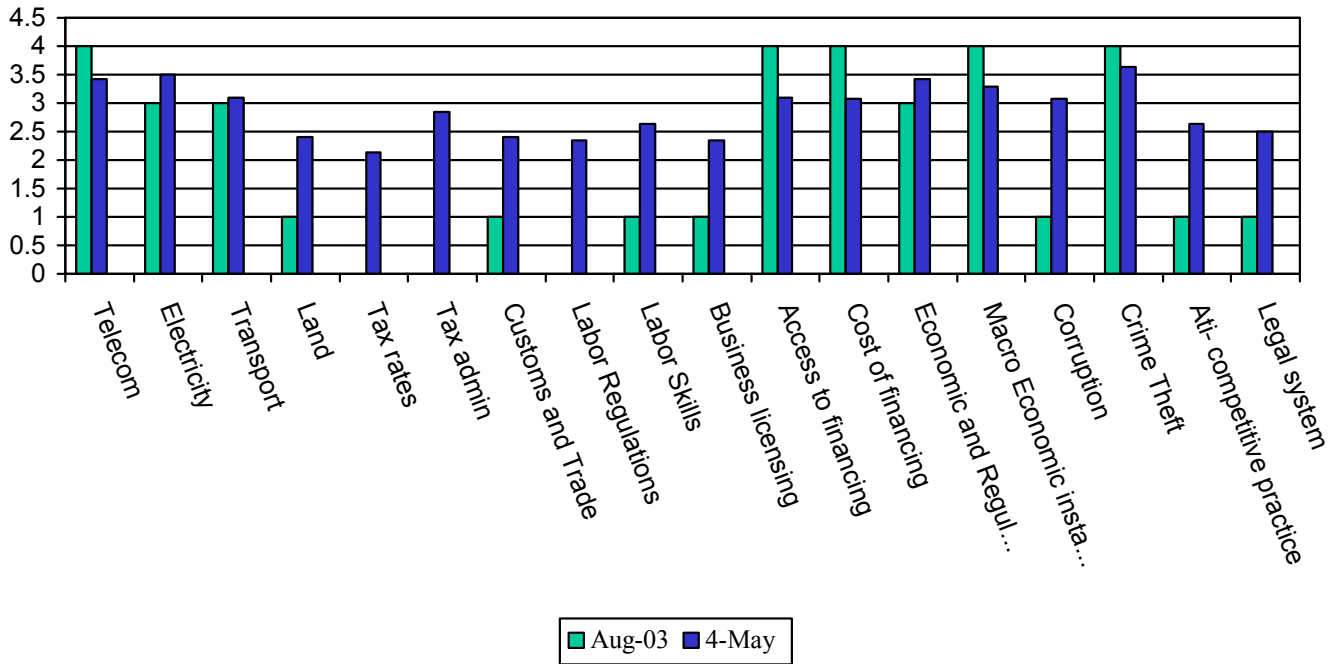
⁴ Charles P. McPherson, Oil, Gas and Chemicals, The World Bank, Petroleum Revenue Management in Developing Countries

9. In addition, over the last 18 months, Iraq has introduced a comprehensive set of laws that describe a reasonably balanced legal and regulatory environment for investment. These measures -- all standard for a normal business climate -- include laws on foreign investment, bankruptcy, labor, competition, consumer protection, securities, property rights, and a company law. Initial review suggests that most of these laws are in line with international best practice. The challenge is to put in place the institutions to implement these laws and regulations to support an investor-friendly environment. In the process, it is important that the Government signal from the outset some key principles. These include: (i) no retroactivity with respect to this legislation and (ii) a clear signal to the market that investors' interests will be protected.

10. Despite this progress significant problems remain. The legal and regulatory aspects of the investment regime require some very serious review. A recent survey of investors, Iraqi government officials, and Iraqi consultants identified several areas where the investment climate has worsened since last year. In particular, perceptions pointed to significantly increased regulatory and corruption problems. While still a serious problem, infrastructure is not the overwhelming constraint it was in August 2003. Although these impressions come from an ad hoc sampling, their logic and match up with general anecdotal evidence are remarkable. Figure 1 below shows the ranking of the issues on a scale of 0-4 --4 being highly constrained.

11. Some of the issues mentioned in May 2004 such as taxation and tax administration simply did not exist in August. However, what is of note is that customs and trade regulation, labor regulation, business licensing, and land registration have all significantly increased as perceived constraints since August last year. The good sign is that the macroeconomic environment has improved, as has access to finance (reflecting the liberalization of financial markets by the Central Bank of Iraq in March 2004). Infrastructure issues were either similar to last year or improved.

Figure 1: The Investment Climate in Iraq



III. INVESTMENT CLIMATE IN IRAQ

A. STRATEGY TO BUILD A COMPETITIVE INVESTMENT CLIMATE

12. For Iraq to make its investment climate competitive will require:

- (i) The creation of a commercial legal and regulatory structure;
- (ii) Building the institutional capacity of the public sector;
- (iii) Strengthening the private sector's institutional capacity;
- (iv) Building the capacity to access various markets for trade and investment;
- (v) Developing the framework for regional economic development institutions;
- (vi) Revitalizing the trade facilitation infrastructure by addressing key bottlenecks; and
- (vii) Investigating the use of special economic zones to kick start job creation.

13. Additionally, progress in improving Iraq's investment climate will benefit from the development of a support program to SMEs to enhance competitiveness and productivity and sector-specific studies to identify particular barriers to productivity. Such studies would follow three tracks; (i) market-seeking services (construction, tourism, finance etc), (ii) resource-seeking agriculture and energy, and (iii) efficiency-seeking export-oriented manufacturing based on Iraq's proud industrial and artisanal past. Detailed strategy options for each of these approaches are discussed in the sections below, and Annex 2 presents a comprehensive and sequential listing of all recommended priority actions for consideration by the recommended Investment Climate Working Group.

14. Sequencing the interventions to put the fundamental elements of a support strategy in place will be critical, and this sequencing will be largely determined by the security situation. It can be reasonably assumed that creation of private local investment and inflows of private foreign direct investment in the non-oil sector will largely depend on the security situation. Even with security risks abated, investment will lag, allowing an interim period for initial work to improve and streamline systems, procedures, and institutions (both public and private sector) and, as far as possible, to put in place the investment-supportive architecture that can rapidly respond once security reaches a satisfactory level.

15. Since these policies, by themselves, will not lead to substantial immediate job creation, it is clear that a parallel social safety net based short-term job program is necessary. This should be as non-distortionary as possible and oriented to build skills and capital that will be of future use. Micro-enterprise programs have particular attraction in this regard. In terms of accelerating the program the following are proposed interventions:

- (i) Strengthening SME capacity is a critical element addressed in more detail in a separate paper;
- (ii) Taking full advantage of the reconstruction flows;
- (iii) Industrial-estate-type initiatives can simultaneously deal with security concerns, resolve land ownership uncertainties and provide the necessary infrastructure;
- (iv) Sectoral efforts to resolve constraints, build know-how and exploit opportunities (agro-industry, services, export ready manufacturing); and
- (v) Local economic development efforts.

B. PRIVATE FOREIGN DIRECT INVESTMENT AND JOB CREATION

16. For a secure Iraq to succeed in attracting foreign investment, it will need not only the legal and regulatory underpinnings that bolster investor confidence, but also vigorous investment-promotion policies, institutions, and programs that can aggressively pursue the very mobile foreign investment dollar within the region and beyond it. It is clear that the private-sector-led growth of SMEs will be Iraq's primary engine of job creation in the non-oil sector. What is also likely from the experience of post-conflict, emerging economies and the newly industrialized countries of South East Asia (and other examples such as Ireland and Mauritius) is that foreign direct investment is critical to such job creation, not only in directly and indirectly generating jobs, but also in the very important areas of technology transfer, work methods and procedures, access to existing and established international marketing channels, and in critical backward linkages⁵ to local indigenous suppliers.

17. These backward linkages create an incubator effect that allows local micro and SMEs to grow and create jobs. Research (such as that of Mucchielli and Jabbour on Spanish manufacturing industry) and empirical evidence from such programs as the BUILD program in Thailand and the National Linkage Program in Ireland confirm the direct technology transfer benefits to local SMEs from the presence of foreign direct investment.

18. The recent emergence of Ireland as the "Celtic Tiger" has been primarily driven by its policies to encourage private local and foreign investment. FDI has played a pivotal role in the Irish success story -- 8% annual growth in the 1990s. The key elements behind Ireland's achievement were: (i) a consistent investment policy for 40 years, (ii) a gradual abandonment of the attempt to protect declining industries, (iii) a market-driven, export-led and FDI approach, (iv) major investment in labor (skills and education) as part of labor market flexibility policies, (v) major capital investment in telecommunications, (vi) appropriate macroeconomic policies, and (vii) facilitation of geographical clustering supported by relevant infrastructural investment. Regarding fiscal incentives for investment formation, the automatic low corporate tax rate (for productive companies the tax rate is 12.5%) was guaranteed out to 2010 and complemented by flexible grants designed to promote investment and influence company location.

⁵ Technology Transfer through Backward Linkages: The Case of the Spanish Manufacturing Industry by Jean – Louis Mucchielli and Liza Jabbour <http://www.etsg.org/ETSG2003/papers/jabbour.pdf>

19. Ireland's surge in foreign direct investment spurred local entrepreneurs to leave the multinationals and, on a large scale, to establish various competitor or supplier industries. The government introduced a successful National Linkage Program (aimed at information technology, in particular) that created thousands of highly skilled jobs⁶. Finally, the Irish experience shows that efficient state promotional agencies such as IDA Ireland (to promote foreign inward investment) and the Irish Export Board (to promote indigenous firm exports) were also critical, alongside the attractive fiscal and general policy regime.

20. Similarly the case of Mauritius is instructive in showing the link between private foreign direct investment and general economic and job growth⁷. The economy sustained 6% annual growth for two decades, first driven by sugar, then textiles and clothing, and tourism, and most recently by financial services. What was once only another commodity producer today is the leading manufacturing exporter in sub-Saharan Africa. Private FDI has played a crucial role in Mauritius. In 1970, the government passed the Export Processing Zone Act which attracted Asian investors to locate textile and garment manufacturing plants there to take advantage of Mauritius' preferential access to the U.S. and European markets.

21. The Middle East has lagged behind other areas of the globe in the race to attract FDI in the non-oil sectors, largely because of the perceived lack of regional political and economic security and the rise in the 1990's and early 21st century of more attractive locations with huge indigenous markets such as China. Notwithstanding this relative lack of general regional success, Jordan and Dubai⁸ offer very instructive examples of success in attracting FDI to the Middle East¹⁰

22. The greatest success story of non-oil FDI in the region is that of Dubai, which has transformed itself into a regional business, tourism and services hub through the use of a very attractive fiscal regime together with efficient, investor-friendly marketing institutions, and finally, the existence of the huge Jebel Ali Free Zone. Jordan has recently had moderate success in attracting foreign investment owing to two artificial regulatory mechanisms that enhanced its attractiveness to investors. First is the Qualified Industrial Zone (QIZ) regime that is applied to approved public- and private-sector industrial estates and zones. This QIZ status requires that as long as a specified (minor) amount of the value-added content of the manufactured goods is Israeli, those goods then gain duty- and quota-free access to US market. This measure has resulted in a huge leap in exports of textile and other light manufactured goods (such as luggage)

⁶ "An Analysis of Backward Linkages in the Irish Electronics Sector". Economic and Social Review, Vol 16, No 3, 2000

⁷ Investment Policy Review: Mauritius by UNCTAD, publication 2001

⁸ The Jebel Ali Free Zone (JAFZ) in Dubai opened in 1985 with 30 occupant firms. By April 2004 the JAFZ has grown to 3,000 occupant firms. Over the years the range of industry has grown from distribution to include the whole spectrum of manufacturing, trading and services. Presentation by Abdul Salam Al Jassmi, Manager International Relations, Jebel Ali Free Zone Authority to Presentation to the World Bank, Iraq Trade and Investment Conference, Amman Jordan May 4, 2004.

¹⁰ The Jebel Ali Free Zone (JAFZ) in Dubai opened in 1985 with 30 occupant firms. By April 2004 the number had grown to 3,000. Over the years the range of industry has grown from distribution to include the whole spectrum of manufacturing, trading and services. Presentation by Abdul Salam Al Jassmi, Manager International Relations, Jebel Ali Free Zone Authority to the World Bank, Iraq Trade and Investment Conference, Amman Jordan May 4, 2004.

and in job creation in the rural areas outside Amman.¹¹ Second, the creation of the Aqaba Special Economic Zone -- an aggressive pro-business regime and red-tape-free environment -- in the port city of Aqaba has delivered for Jordan over a billion dollars of FDI in manufacturing and tourism, including investments by major, US-based corporations.

C. SOURCES OF INVESTMENT MARKETS

23. **Foreign:** Regarding FDI, a correct analysis of national comparative and competitive advantage is of critical importance to Iraq's success in targeting the appropriate potential foreign investor target groups. Along with the development of appropriate policies and institutions, Iraqis need to be consider the level of potential foreign and local firms they aim to attract and support as well as the kinds of investment driven specifically by the reconstructions flows. Current global investment patterns (that have seen China and India dominate in recent years) are largely driven by comparative and competitive advantage with firms tending to place their production facilities in locations whose relative comparative endowments most closely match their technical requirements in terms of factor-cost inputs, infrastructure, physical facilities, and the like.¹²

24. Another major factor in predicting the direction and pattern of direct investment is the end-user market to be served. The degree of export orientation of the investment greatly influences the relative importance of comparative versus competitive advantages as a determinant of direct investment types and patterns. Investors engaged in processes mostly for export (such as light assembly industries, food processing, etc.) tend to be driven primarily by cost and comparative advantage considerations. Enterprises looking to sell production to the domestic market tend to be motivated principally by competitive issues such as market growth, demographic trends, industry characteristics, and other localized advantages.

25. A future Iraqi national investment promotion agency will need to gauge such considerations in preparing its investment marketing activities sometime after conflict ends. The emphasis on massive job creation dictates a strenuous investment promotion drive, with particular emphasis on agro-related sectors and services. Outside of the oil sector, the agriculture sector is likely to be an area where Iraq will enjoy considerable comparative advantage.

26. **Diaspora :** The diaspora deserves special attention. In many post-conflict countries, this group has led the way with foreign investment. The experience of West Bank Gaza has demonstrated the willingness of non-resident Palestinians to invest when many others haven't. Indeed experience from a review of post-conflict and current, low-level-conflict economies is that abrupt increased flows of diaspora remittances are usually the first foreign investment to occur after a normalization of security in the former case, and a scaled reduction allowing a moderate revival of economic activity in the latter case. Iraq is fortunate that it has a large and

¹¹ Since 1998 when the QIZ first started in Jordan, over 62 factories employing 30,000 people have set up in Jordan in a record 5 years. Exports of goods from Jordan to the US in 1998 were around 15 million US\$, in 2002 they exceeded 400 million US\$ (primarily of garments and jewelry)

¹² Michael E. Porter The Competitive Advantage of Nations 1990.

active diaspora. Activities that encourage this source of investment should be an immediate priority, and significant anecdotal evidence suggests that diaspora investment is already reaching Iraq, albeit in a quite informal way.

27. **Local:** If other countries are a guide, local investment will be the engine of private sector investment and will be concentrated by and large be on SMEs, since Iraq has very few large private enterprises. Summarizing the findings of a separate paper that deals in particular with this issue, SMEs face critical challenges including barriers to entry, access to financing and access to information and business services. Supporting MEs and SMEs in Iraq will emphasize their special needs including institutional capacity building, promoting innovative approaches in the delivery of business services, creating the necessary business environment, and developing the capacity of the financial sector to meet ME and SME demands. Programs and facilities to provide these firms with Business Development Services (BDS)¹³ need to be in place throughout Iraq, in addition to necessary loan and grant measures.

28. **Reconstruction:** Reconstruction, for which potential flows are enormous, is another activity that can encourage investment. For the Iraqi private sector to benefit fully from these funds, investments will be needed in private-sector capacity, especially in fostering business associations, business skills, and entrepreneurial development. Bureaucracies will need to be trained as well in the administration of public investment, not least with a view to getting the most positive impact on the private sector from reconstruction funding that will go largely to and through the public sector. Establishing the greatest possible Iraqi participation in the use of reconstruction funds is essential and should start with the enactment of appropriate legislation and implementing regulations that produce, among other things, documented forms for procurement in the spending of these monies.

29. A reconstruction agenda should emphasize the following:

- Transparency;
- Procurement processes designed to encourage Iraqi participation as both prime contractors and subcontractors;
- Incentives to encourage Iraqi private contractors; and
- Support mechanisms such as the linkage program discussed above

Transparency is an essential precondition to building a competitive environment in Iraq. This means bidding processes that are fair and open, that stand up to outside scrutiny. Incentives to involve Iraqis can range from off-set arrangements, to mandatory inclusion to establishing favorable bid evaluation criteria. Linkages between small and medium-sized enterprises and large companies¹⁴ would generate benefits for both the SMEs and the large companies by allowing the large firms to concentrate on the core business activities they can do most efficiently while relying on supplier SMEs for raw materials and intermediate inputs as well as for services ranging from housekeeping to data processing. SMEs' concentration on specific activities that they can perform most efficiently would result in a production network that is more competitive than if the large companies were to integrate vertically and horizontally, creating enterprises too cumbersome to manage effectively. A diagnostic study to assess the

¹³ BDS provide support to SMEs

¹⁴ Most large enterprises in Iraq are in the SOE or mixed – part public and private sectors

situation would be a first step, followed by the preparation of a program of action to address specific issues

30. The public sector will also need technical assistance on how to generate and use procurement guidelines, while the private sector will require training in how to compete properly under those rules as well as in the ethical utilization of public funds.

31. Reconstruction efforts will also bring into being new, local firms of various sizes to handle services and tasks previously handled by SOEs or previously unneeded. These new SMEs could be entirely the product of the private sector or could be units from SOEs undergoing reform transferred to the private sector.

32. Whether investment is foreign or local or the outgrowth of reconstruction, new competent authorities will have specially tailor programs for investment promotion, indigenous job creation, and the like. It is urgent, therefore, to build capacity into the current public institutions in Iraq and eventually prepare for new institutions modeled on international best practice.

D. LEGAL AND REGULATORY FRAMEWORK

33. Crucial to investor confidence is the credibility of the transitional and new governments' approach to the existing legal framework and the predictability of their basic policies. Such sustainability will require achieving adequate consensus at various levels on an underlying economic strategy. For continuity, the sovereign Iraqi government will need to confirm its broad support for legislation issued by the Coalition Provisional Authority and clearly signal that pending administrative regulations critical to the implementation of fundamental legal provisions will be developed and implemented. Recent reforms often presuppose the existence of competent institutions. In practice, relevant institutions – public sector organizations and private sector bodies – should be established and/or strengthened to the point where they are capable of playing their appropriate roles.

34. Impeding the development of a modern market economy in Iraq are important weaknesses in dispute resolution and in enforcement of contracts and property rights. Independence of the judiciary needs to be assured, not only in writing but also in practice. Efficiency, predictability, and fairness of the judicial process demand a climate of security. Training programs for judges and other legal staff are needed, and the judicial infrastructure needs to be improved. Enforcement of judgments will depend critically on the empowerment of the Offices of Juristic Execution.

35. Local arbitration is a useful but a very rare practice in Iraq today because of deficiencies in present laws. The introduction of adequate alternate dispute resolutions (ADR) systems would address some of the principal problems confronting the judiciary as well as provide the private sector with needed expertise in commercial disputes. A pilot mediation program for commercial cases should be considered.

36. Restrictions on the enforcement of foreign judicial and arbitration awards obviously harm the confidence of potential foreign investors and render inapplicable crucial provisions of recent reforms. Changes in the legal framework, a more efficient court system, improved training in the legal profession, and participation in the relevant international agreements are steps required to improve foreign investor confidence.

37. The unsatisfactory situation of immovable-property registrars gives rise to serious concerns, with grave consequences for the clarity of both public and private property rights. Property claims caused by the previous regime's confiscation practices are being dealt with initially through the Iraq Property Claims Commission (IPCC), but recent illegal seizures of immovable property remain unresolved.

38. Overlapping legal regimes may result in confusion and inefficiency. The goal in the medium term should be to unify and develop both existing and reformed regimes to ensure clarity and consistency in the application of the law.

39. Iraq should become a member of international treaties and agreements critical to commercial activity. Observer status in the WTO has already been approved, but no steps have been taken on such other, crucial, multinational agreements and institutions as the New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards of 1958, the Strasbourg Agreement concerning International Patent Classification or the Convention on the Settlement of International Disputes between States and Nationals of Other States (ICSID, Washington 1996).

IV. BUILDING AND STRENGTHENING INSTITUTIONS

A. BUILDING PUBLIC SECTOR INSTITUTIONS

40. In three areas critical to a healthy investment climate, Iraq's currently weak institutional capacity needs support and eventual transformation. First, effective policies, institutions, and programs are needed for investment promotion, leading in time to a specialized institutional architecture (most likely a quasi-governmental organization¹⁵) capable of aggressively implementing marketing programs aimed at international corporations interested in the Middle East as a location for manufacturing, assembling, regional hub office location, etc. Current, fledgling investment promotion efforts need to be supported, and enhanced institutional capacity needs to be built so that, once security is restored, such efforts can bring results in the medium and long term,.

41. Second, export-promotion support should complement SME job-creation development programs being planned and implemented by donors. Based on the experience of other countries, many Iraqi SMEs should already have export-ready products and services, and planned SME support programs should help many more firms join their ranks. Current export development efforts need to be supported, and enhanced institutional capacity needs to be built to guide these SMEs through the web of issues relating to the export of products (standards, packaging, labeling, etc.) and to administrative (customs, freight forwarders, freight, etc.) and financial (duty drawback, duties, taxes, export rebates, etc.) considerations. Many tailored programs developed to assess company readiness to export¹⁶ should be integrated into any program of support.

42. Third, local economic development and job creation efforts need to be coordinated through effective institutions at the local level. Typically, good examples of such institutions work with local stakeholders to put in place forward-looking economic development plans that establish priority investment in infrastructure and formulate strategies for both export promotion and SME development. Such good examples typically act as the link between the national investment and export-promotion institutions (which tend to be focused on working outside the national territory) and local beneficiary firms.

43. One approach to building such locally based institutional capacity in all major cities to coordinate export promotion by local SMEs, the facilitation of foreign investment, or other related activities would be to establish city cluster development plans for 3 cities on a pilot basis.

¹⁵ "Our research findings build a strong case for the location of a government's promotion program in a quasi-government organization" Marketing a Country: Promotion as a Tool for Attracting Foreign Direct Investment (Revised Edition 2000) by Louis T. Wells, Jr. and Alvin G. Wint, Foreign Investment Advisory Service of the World Bank Group.

¹⁶ The CORE Program, (Company Readiness to Export) developed by Michigan State University, now a Windows application, is an example of a managerial tool for self-assessment of organizational readiness to export. Managers can use CORE to identify company strengths and weaknesses in the context of exporting.

These plans could consider the establishment of a new local economic development coordination institutional capacity, the development of special economic zones to address trade facilitation and infrastructure bottlenecks, SME business support centers and mechanisms to grow university linkages to local SMEs.

B. TRADE MINISTRY ROLE

44. In the area of investment promotion, the Private Sector Development Directorate of the Ministry of Trade currently has the central responsibility -- with other ministries also having some capacity and responsibilities -- for promoting foreign investment and facilitating the work of investors once they enter the country. The directorate is working to implement a new company registration system that will be in compliance with the amended Company Law and aligned with the corporate taxpayer identification system and the Central Statistics Office. Additionally, the directorate is seeking to establish a real capacity to assist foreign companies invest in Iraq. With that undertaking in its infancy, a first step toward a best-practices promotion capacity would be to provide technical guidance to the existing unit at the Ministry of Trade to upgrade its servicing capacity for a transition period (probably a year), and from there to move on to propose a two-year program to put in place a parastatal National Investment Promotion Agency, operating outside the civil service, and with both public and private sector stakeholders. In this scenario the Ministry of Trade, which has a key role to play in transforming Iraq into an entrepreneurial, diversified, globally integrated market-based economy, would most likely retain policy oversight over day-to-day investment promotion, both local (SME development) and foreign.

45. In the area of export promotion, the same unit in the Ministry of Trade has responsibility for promoting non-oil exports, which are, at present, practically non-existent. Nonetheless, review of the present SME base, and the experience of other MENA countries suggests there will be a number of enterprises that have export potential. As security returns, the promotion of non-oil exports by export-ready SMEs in agriculture and services will be a key component of a job-creation strategy for Iraq. Accordingly, it should be productive to build on the current work of the Ministry of Trade with technical guidance on export promotion, looking toward a transition that after one year into a two-year program to establish a robust best practices export promotion capacity, most likely separate from the ministry. A critical lesson from the international experience is that export promotion efforts work best when they are market led. Therefore an independent export promotion capability with private sector participation can be very helpful in ensuring promotion efforts are relevant.

46. Related to export promotion is the Export Promotion Fund,¹⁷ established in 1969 and revived by the Ministry of Trade, which favors using it to channel grants and donations to assist SMEs and micro enterprises to export. Consideration should be given to the use of this or another related mechanism to administer an export grants fund. The World Bank, for example, has had extensive experience worldwide with matching grants schemes (at varying levels), and this option should be considered. In particular, Tunisia's successful experience in export

¹⁷ Law No. 6 of 1969 established the Export Support Fund. This fund was financed by levies in imports and exports and has remained dormant since the end of the first Gulf war.

promotion (Export Market Access Fund) can show how public/private partnership has helped firms overcome difficulties in accessing export markets. The performance indicator for this in Tunisia is the emergence of more than 500 new exporters in 4 years.

47. Government grant assistance can be justified in principle when barriers exist, such as market knowledge and technology, so as to enable Iraqi private companies to diversify products and markets. International experience suggests that such programs are most effective in promoting exports and jobs when they have the following attributes:

- Focused on individual firms (as most of the existing programs in Jordan and Tunisia do);
- Temporary and designed to help enterprises overcome psychological and economic barriers to export;
- Consistent with WTO and other multilateral and bilateral agreements;
- Demand-based, whereby beneficiaries cover part of the costs (up to 50% on average);
- Performance-based on measurable criteria; and
- Develop local capacity to assist emerging exporters.

C. STRENGTHENING PRIVATE SECTOR INSTITUTIONS

48. For Iraq's private sector to grow rapidly and create jobs, chambers of commerce and industrial, professional and service associations need to play active roles in both policy advocacy to government and in member services. Advocacy to government on behalf of members on a wide range of trade, investment, fiscal, and monetary policies is the daily fare of most business associations in the developed world, and most of these organizations have developed an in-house policy advocacy capacity that gives them weight with government decision-makers. In emerging economies where donor assistance is present, advisory projects on strengthening private-sector business associations are common. The majority of these projects are structured to help the organizations act effectively as advocates for policies favorable to their members and improve their ability to provide relevant services directly to their members so as to help them grow, expand, and create jobs. In Iraq, an affiliate of the U.S. Chamber of Commerce has already made a start in providing advisory services to business associations.¹⁸

49. In both Morocco and Jordan much work has been done to improve the capacity of private-sector business associations. In Jordan, groups that were ineffective and isolated have modernized their operations and managerial practices and are now providing quality services to members.¹⁹ Additionally, many associations in Jordan have started working together, with better coordination and therefore a stronger advocacy voice. There is a large established network of these organizations in Iraq led by the Baghdad Chamber of Commerce, with at least 250,000

¹⁸ An affiliate of the U.S. Chamber of Commerce, the Center for International Private Enterprise (CIPE), has already started two programs in Iraq funded by the National Endowment for Democracy (NED).

¹⁹ "Building Capacity into Jordanian Business Associations: A Case Study". Presentation by Dr. Zaki Ayoubi, former Head of Business Association Strengthening component of the USAID AMIR project in Jordan to the World Bank, Iraq Trade and Investment Conference, Amman, Jordan May 4, 2004.

members from all over the country. Traditionally, the Baghdad Chamber has played the role as the leading association addressing issues of coordination.

50. There is, however, little history in Iraq of sustained and successful policy advocacy, and lobbying and communications abilities are weak. The methodologies and systems for this activity will be a focus area among investment climate priority actions, with a corollary emphasis on developing the capacity of these associations to provide training and advisory services for their members. Finally, support to associations that reach out to women and to micro-enterprises will be encouraged.

51. As a first step, an audit and needs assessment of the current private sector business associations could provide the base information regarding the range of governance structures, of advocacy skills, and of member services. It is important that all major cities be covered in such an audit. It is reasonable to expect that such an accounting will show that all the major chambers of commerce and industrial professional and service associations require basic capacity-building and advisory services in such areas as internal systems, policy advocacy, and member services.

52. As a matter of their credibility and sustainability, it is critical that the internal governance structures of all private associations be transparent and democratic. At issue could be the structures of boards, the voting systems for the formation of boards, the organization structures of the associations, the quality of the internal management information systems (if any) and the remuneration structures and scales for employees. In this regard, two concepts that have been successfully implemented to support business associations in the Middle East, e.g. Jordan and Morocco, have been twinning programs and accreditation programs. The former usually link nascent private business associations, such as those in Iraq, with large established associations in Europe or North America with a similar membership or in a similar industry, if possible. Although the extent of the capacity building and training in these twinning arrangements varies, they have proved to be a useful tool and could be of value in Iraq.

53. Those associations that are the most advanced in their systems could take the step of engaging in an accreditation program such as the U.S. Chamber of Commerce's Association Accreditation Program. This particular program covers over 50 management topics such as governance training, web-based management training, membership recruitment, policy advocacy, market research and linkages, communications, fundraising and financial management, and value-added membership services.

54. In the area of policy advocacy, there is a definite need to build economic-policy skills within the associations to enable them to understand the effects on their members of various policies being considered by government and civil society generally. Each association needs the skills and personnel to formulate and put forward its own position on policy issues. In addition to the actual formulation of a position that benefits the membership, the process of lobbying and communication skills could also be an area where capacity building is required.

55. In regard to member services, the first step would most likely involve assisting existing associations to design and implement business management workshops for their members. The assistance could be focused on market-driven training (dealing with specific issues for exporting,

importing, use of freight forwarders, etc.), quality trainers and materials, cost recovery, target audiences, and outreach outside Baghdad.

56. Consideration could be given to establishing a central training center – operating initially in Baghdad --under the auspices of such a body as the Federation of Iraqi Chambers of Commerce. Such a facility would act as the focal point for all capacity-building activity for private business associations in Iraq, and given what is believed to be a large need for assistance among all associations, it may be an efficient delivery vehicle.

57. The development of the entire array of business training programs for members of various business associations, primarily SMEs, is a huge task, for which it is critical to mobilize universities to participate and in many cases to lead such programs with some guidance from outside experts, if necessary. Participants in workshops and consultations generally agreed to the inclusion of the universities in programming and in the listing of priority actions. Programs to upgrade the capacity of the management faculties of selected universities (to provide these management courses) could be considered as part of the overall undertaking.

58. Finally, the program to build and strengthen business associations could assist in developing the kind of public-private consultations that work effectively in advancing reforms. These consultative efforts can lead to public-private agreement on common goals, recognition of the complementary public and private roles in promoting economic development, and greater transparency in decision-making. The example of the Jordan Vision 2020²⁰ process could give guidance to similar efforts for Iraq. 28 private business associations, the government, and the Economic Consultative Council to his Majesty King Abdullah II combined to develop a blueprint for private-sector led growth in that economy, and the process has spawned other such initiatives.

59. Lessons from these examples have been incorporated into the strategies and priority actions recommended for building a sustainable investment climate in Iraq. Among these best-practice lessons is the need for public dialogue to nurture within civil society and among the private and public sector stakeholders involved with any incoming investment acceptance of the proposition that the investment represents a positive economic and social influence for the society in general and for job creation in particular. Cultural values are particularly difficult to change, and Iraqis will need to build consensus (through a mechanism of public dialogue) in favor of FDI's role in advancing economic change, sustainable job creation, and technology transfer.

²⁰ The "Jordan Vision 2020" initiative brought together top businesspersons and representatives of Jordan's various business associations for a series of four meetings under the auspices of the Young Entrepreneur Association to produce a unified private-sector strategy document that will guide Jordan's development and growth over the current century.

V. TRADE AND ECONOMIC ZONES

A. IMPROVING TRADE FACILITATION AND ADDRESSING KEY BOTTLENECKS

60. Regarding the facilitation of non-oil trade – imports, at least in the very short term -- the current constraints in Iraq²¹ fall into two main categories. First is the lack of a coherent trade policy regime and the rules and regulations to implement it, including institutional capacity for their enforcement. Second is the unavailability of the key transport, logistics, and banking infrastructure required to facilitate the movement of goods and services. In addition to the critical need for a modern, smoothly functioning customs service, limited and run-down production capacity for non-oil related goods and services at international standards severely limits the market. Further, management skills and technology are lacking in both the private and public sectors, and there has been little or no investment in production capacity in the non-oil or value-added petroleum sectors.

61. The lack of an integrated functioning customs and tariff regime and of a functioning system of internal tax administration that will provide a predictable and level playing field for domestic activity has a marked negative impact on both trade and investment. Phyto-sanitary controls are not operational, and the means to enforce standards are not available. Intellectual property protection does not exist. Similarly banking institutions are not equipped to support trade and related activities, and the lack of financial and business regulation has eroded market discipline. Few or no conventional trade instruments are available in the banking system, and specialized funds for this purpose have been idle for the past decade because of sanctions.. The Government bureaucracy is not experienced in modern trade-related administration techniques, and such procedures as exist are outdated and overshadowed by security concerns.

62. In addition, international treaties have been largely sidelined by the recent conflict and its consequences, hampering market access for potential exporters. Iraq now looks to WTO membership to provide it with the international trading context needed for serious trade growth and to provide comfort to potential trading partners and investors. The accession process is a complex negotiation that will focus not only on trade issues but will review many core investment-climate issues, such as administrative barriers to investment and subsidies supporting local industries.

63. Policies of nationalization and privatization under the previous administration and the isolation resulting from the sanctions have resulted in a severely weakened private sector with poor production capacity, obsolete capital equipment, and little recent and relevant experience of

²¹ This overview of constraints to trade facilitation was informed by a presentation by Mr. Burhan Ramadan, World Bank consultant, to the World Bank, Iraq Trade and Investment Conference, Amman Jordan May 4, 2004.

modern trading practices except in the oil sector. The existing and upcoming reconstruction activities represent an as-yet untapped opportunity to increase trade.

64. The expected uni-directional flow of trade (apart from oil) brings with it challenges for the logistics networks in the country. The lack of return cargoes increases the cost of haulage. The transport sector is dominated by trucking, with 85% of the transport in-country and only 15% crossing the border. The trucking industry, more than 80% private, is dominated by local investors. International trucking firms are absent. Recent liberalization of trucking resulted in a period of unsettled market activity exacerbated by security concerns. In terms of further infrastructural initiatives, three Free Zones exist in the country – Khor Al-Zubair in Basra Governorate, Filaifil Zone in Ninawa Governorate, and Al-Quaim Zone in Anbaa Governorate - but these have not been home to any serious activity in the past and are awaiting reactivation.

65. Overall the constraints to trade are many, starting with the lack of basic security and systems needed before international producers, traders and service providers will enter the market. Non-oil goods to trade do not exist in quantity and quality, and financial services do not exist to facilitate the purchase and sale of traded goods. The physical infrastructure, while presenting a challenge, is not the major obstacle to trade.

B. POTENTIAL ROLE OF ECONOMIC ZONES

66. Economic zones are a designated geographic areas within a country that receive special attention from both the public and private sector usually due to their immediate potential for rapid development. The rationale for economic zones in Iraq is that they can deal with three critical issues: (i) providing a focus for areas of great developmental potential -- they can make things happen, (ii) ensuring needed infrastructure is provided – it is easier to deal with infrastructure requirements when the needs are tightly defined, and (iii) providing enhanced security protection. In the Iraq case the argument is not about tariff or tax freedoms. Iraq needs to demonstrate to investors that investment is possible. As mentioned previously, the idea of economic zones was already enacted in Iraq in the past, but to little positive effect.

67. Economic zones have become an increasingly important innovation over the past 25 years as developing countries seek to attract foreign investment by reducing administrative barriers and lowering the cost of doing business. Duties are deferred on imports destined for re-export, and concessions offered on income and other taxes. A large number of free zones have been put into effect throughout the world to attract foreign investment, boost exports and foreign exchange earnings, thus creating job opportunities and improving the host country's standard of living. Not all economic zones, however, have been successful. The critical success factors include: (i) private-sector involvement in management, (ii) sensible locations that are market-relevant, and (iii) an effective enabling environment in terms of regulations and infrastructure.

68. The desire to create employment opportunities and promote labor skills figured heavily in the decisions by Egypt, Jordan, Syria, and other Middle East countries to create economic zones. They hoped to use the zones to introduce new technology and skills to the labor force. In relatively simple industries such as footwear and garments, technology transfer has occurred. At present there are at least 30 free zones in operation or under construction in the region.

69. Investors in most of the Middle East economic zones benefit from the so-called "five freedoms," including exemptions or incentives relating to corporate income tax, import duties, import quotas, property taxes and excise taxes. Most zones offer a tax-exemption period of 5-10 years. The duty-free import concession is of almost unlimited duration, being the pillar of the zone. Financial incentives include freedom from foreign exchange controls and guarantees concerning the repatriation of capital invested and the unrestricted remittance of profits (Egypt, Syria, Jordan, Morocco, and Dubai). Preferential rates for electricity and water, the lease of land and rent of standard factory buildings are further incentives granted in most zones.

70. The trend towards economic liberalization and developments internationally with organizations such as the WTO, have led to an increasing interest in establishing economic zones. As tax rates and tariffs harmonize, competition is driven by economies of scale and the operational efficiency that zones can offer. This market dynamic has long been recognized by the Free Trade Zone regime in the US, where the logistical and tax deferral advantages in the zones have attracted most automobile manufacturers. From a public policy perspective, a key issue in the success of these zones is the extent to which they create links with the rest of the domestic economy for long-term benefit. Construction, electricity, transportation and other infrastructure development are the types of links that can benefit in the long term.

71. Other important factors in establishing free zones are the country's political stability, its commitment to a suitable exchange rate and other free trade policies, and a legal regulatory environment favorable to business. Free zones also must be located close to major international markets. For example Dubai's strategic location at the crossroads between East and West has made it the leading hub between Europe and the Far East. Dubai's traditional links with nearby Gulf States, the Red Sea, East Africa, and the Indian subcontinent have enhanced its success. Free Zones are also often found at land border locations where they take advantage of labor or markets on the other side.

72. Experience in the Middle East and among oil-rich nations has demonstrated that the availability of abundant but eventually exhaustible natural resources can be used to promote economic diversification both by sector and geographically. The development of a significant trading and tourism hub at Dubai in UAE is an example of wealth generated by the oil and gas sector being marshaled for diversification purposes. Dubai's growth was financed not only by its own modest oil sector but also by Abu Dhabi. Similarly in the Kingdom of Saudi Arabia, special commissions were set up for the cities of Jubail and Yanbo, resulting in significant employment opportunities through the development of downstream oil and gas activities. In all of these and similar examples, investors in the activities there will cite "the ability to do business" as one of their top criteria in deciding to locate in a specific place.

73. At Jebel Ali Free Zone in Dubai, total exports increased from \$60 million in 1985 to \$1.6 billion in 1995, indicating a clear capacity to increase exports. Imports grew proportionally as a result of the increasing number of firms operating in the zones. Aluminum articles, petroleum, foodstuffs and chemicals were the major items exported, and petroleum and foodstuffs were the major imports. Most of the exports went first to the Far East and South East Asia and secondly to Middle East countries. The free zone also penetrated western markets including Europe and the United States.

74. Three main issues arise with respect to using economic zones in the current situation in Iraq:

- Where should the zones be located, if any?
- What form should they take (from the fully autonomous zone such as Aqaba Special Economic Zone in Jordan or the SEZs in China to the narrowly defined, port-authority-licensed Free Trade zones in the US)?
- How do the zones fit into the overall economy without causing unwelcome distortionary effects?

75. These issues are similar to those facing any country making a decision about an economic-zone regime. However some useful lessons can be learned from experiences elsewhere. Zones that succeed generally have the following characteristics:

76. They build upon existing infrastructure and unrealized potential. Greenfield sites are not preferred since they usually involve a large investment in up-front infrastructure. An exception to this is the Jebel Ali Free Zone in Dubai, but it was essentially a part of a national policy to develop UAE as an entire low-tax zone.

They incorporate private-sector development wherever possible through public-private partnerships, outsourcing and deregulation of the real estate and infrastructure markets.

They form autonomous and self-sufficient development bodies that can make fast and market-responsive decisions without the normal bureaucratic hurdles;

They are market-led and address identified and specific needs. This characteristic requires a high degree of strategic planning and a long-term vision that remains in place for sufficient time to allow the longer-term benefits to accrue.

They receive the maximum possible and prudent delegated authority over the business environment from the national and local agencies normally responsible.

77. Among zones that have failed to deliver on their objectives, they have almost always been developed and operated by the public sector, often in poor locations selected for political purposes. The failures usually show as the use of the zones by marginal activities that are propped up by subsidized infrastructure and lack of financial sustainability. Some relevant examples include the industrial estates regime in the Kingdom of Saudi Arabia, Syria, the Aden Free Zone and some of the Free Zones in Egypt.

78. In the case of Iraq the zone regime should aim to provide foci of development where infrastructure and an efficient and secure business environment meet. Using the characteristics for success above, several key locations should be identified for scrutiny as potential economic zones. It should be noted that already several private-sector-led initiatives have been discussed with respect to developing economic zones in the country. Several leading businessmen in Iraq have already approached leading regional free zone developers with the view to developing a business model for economic zones in Iraq. This interest points to an appetite for economic zones in Iraq, a positive step towards the establishment of a solid zone regime.

VI. THE WAY AHEAD: RESOLVING ISSUES

79. The elements needed to develop an appropriate investment climate in Iraq have been laid out above. These building blocks have been derived from a rich combination of international best practice, regional experiences and realities, and importantly, from the meetings and workshops held between the Iraqi public- and private-sector representatives (under the auspices of the Ministry of Planning) and World Bank staff and practitioners in the areas of investment climate. In addition, the attached annex suggests a draft work program of priority actions.

80. The key to moving ahead, resolving outstanding issues, and reaching consensus on the sequencing of these recommended actions is to create the Investment Climate Working Group in Iraq as soon as practically possible. The creation of this mechanism was agreed at the recent workshop in Amman, Jordan in May 2004 and the concept was thereafter presented to the Ministry of Planning. This working group will need to be supported by technical experts experienced in the investment-climate issues presented above. The World Bank will also liaise with other multilateral and bilateral donors currently in Iraq to ensure program coordination. Of critical concern will be the security climate, and on that will depend the sequencing of specific actions. However, it is clear that much of the program work can commence in the interim between the current situation and the complete securing of the country.

81. In the workshops in Amman the following priority actions were agreed with the Iraqi authorities:

- Review the regulatory environment for investment-climate issues and recommend measures for improvement of particular areas;
- Assess trade and investment administrative and procedural bottlenecks;
- Conduct City Cluster Development plans for three pilot cities, which may include initiatives such as special economic zones, business support centers, and university linkage programs to local industry;
- Support existing foreign-investment promotion and export-development efforts and build new institutional capacity;
- Build public awareness on the benefits of both foreign and domestic private-sector investment; and
- Assess the needs of small and medium enterprise (SME) support in all governorates.

ANNEX: PROPOSED NEXT STEPS – INVESTMENT CLIMATE, TRADE FACILITATION AND ECONOMIC ZONES

Recommendation	Main Implementing Donor Agency	Other Potential Implementing Agencies	Timeline
Form an Investment Climate working Group (Steering Committee) that includes identified line Ministries, private sector and academia	WB and other donors to provide guidance and TA. However, Implementation steps should be taken by MoP&DC and other line ministries	N/A	Need to form immediately.
Start dialogue with the Working Group and the GOI on developing the road map for the creation of an investment-promotion agency, PPP, etc.	The World Bank	FIAS/MIGA/IFC	Start as soon as the ICWG is formed, first meeting by end of September 2004. Continues through out the process.
Develop a public awareness campaign to promote private investment including foreign investment	DFID	WB	As soon as possible
Strengthen legal and regulatory environment to address the obstacles facing local and foreign investors such as property rights, contracts, transfer of profits, etc.	The World Bank / MIGA	EU / USAID	Start as soon as possible and continue through the process as needed
Building capacity at the Ministry of Trade to handle investment requests through the PSD and provide on-going TA	USAID	WB / EU	Capacity building could start immediately. TA to start as soon as the foundations are formed and agreed upon between the ICWG and the donor agencies.

Recommendation	Main Implementing Donor Agency	Other Potential Implementing Agencies	Timeline
Assist the GoI in managing the reconstruction effort by providing procurement training for government agencies and devising methods to encourage local private-sector participation while promoting transparency	USAID	WB	Already started – WB delivered training in procurement for Iraqi ministries early 2004. Should continue as appropriate.
Assess the progress of the recently created Business Centers and how they can become an effective tool to promote private and foreign investment	USAID		As soon as possible
Assess the current situation of trade, customs and regulatory regime pertaining to trade	The World Bank	USAID	Review what has been done to date and then start as soon as possible
Start dialogue with the Ministry of Trade and other stakeholders to develop the foundations for the creation of an export-promotion agency	The World Bank	IFC/ USAID	Start by 2004
Conduct a feasibility study of the transportation sector especially trucking and its role and impact on trade	USAID		2004-2005
Start dialogue with the GoI to develop and install a modern customs systems to facilitate trade	The World Bank	USAID / Bilateral donors	After the review and needs assessments are complete, but no later than mid 2005
Strengthen the legal and regulatory systems by building capacity in the Ministry of Trade, trade agencies, customs, port control, etc.	The World Bank / USAID	DFID / UNCTAD	
Conduct a full feasibility study of potential economic-development zones in Iraq	The World Bank	USAID / UNIDO	

Recommendation	Main Implementing Donor Agency	Other Potential Implementing Agencies	Timeline
Creating a database of the SME sector and conducting a needs-assessment study	DFID	The World Bank / USAID	Start as soon as possible
Strengthening the legal and regulatory environment to address the obstacles facing the SME sector such as barriers to entry, red tape, and taxes	The World Bank / MIGA	EU / USAID	Start as soon as possible and continue through the process as needed
Strengthening business, industrial and trade associations by building capacity, providing necessary equipment and training to enable them to provide the necessary services and training to their members	The World Bank through SMExchange Program in addition to other programs	USAID / EU / Bilateral Donors	Start as soon as possible to create the foundations for the SME sector and PSD
Increase productivity in the SME sector by encouraging entrepreneurs' investments in new technologies, upgrading current systems, and training employees	IFC - Lending through its facility	USAID / EU	
Encourage commercial banks and other lending institutions to provide credit to SMEs based on international best practices by providing TA and build capacity	IFC	USAID	Already begun, however, need to move forward to include more commercial banks
Business services and firm-level assistance - Provide training for entrepreneurs on basic modern business techniques such as preparing feasibility studies to qualify for loans, accounting, marketing, strategic planning, business correspondence, and English language	USAID	IFC through PEP-ME, UNIDO for industrial sector SMEs	FY 05-FY 08
Create business incubators for SMEs in research, IT, medical and pharmaceutical sector with the objective of graduating sustainable enterprises	USAID	The World Bank / DFID	FY 05 - FY 08
Ease the process of doing business in Iraq for	The World Bank	USAID	

Recommendation	Main Implementing Donor Agency	Other Potential Implementing Agencies	Timeline
local and international investors by supporting public institutions in adopting modern practices such as company registering, licensing, inspections, etc.			