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REBUILDING IRAQ: ECONOMIC REFORM AND TRANSITION

Executive Summary

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GLOSSARY OF ABBREVIATIONS

Btu	British thermal units	IT	Information Technology
CBI	Central Bank of Iraq	kWh	kilowatt-hour
CoE	Commission of Electricity	Mbpd	million barrels per day
CPA	Coalition Provisional Authority	MENA	Middle East and North Africa
DFI	Development Fund for Iraq	MOA	Ministry of Agriculture
DFID	Department for International Development (U.K.)	MOE	Ministry of Electricity
FDI	foreign direct investment	MOF	Ministry of Finance
FTA	free trade agreement	MOLSA	Ministry of Labor and Social Affairs
GCC	Gulf Cooperation Council	MOPDC	Ministry of Planning and Development Cooperation
GDP	gross domestic product	Mt	million tons
GWt	Gigawatt	OFFP	U.N. Oil for Food Program
HFO	heavy fuel oil	NDS	National Development Strategy
HR	human resources	PCS	public service commission
IAMB	International Audit and Monitoring Board	PDS	Public distribution system
IBRD	International Bank for Reconstruction and Development (The World Bank)	PFM	Public Finance Management
IQD	Iraqi Dinar	SBA	Supreme Audit Board
IDA	International Development Association	SMEs	small and medium enterprises
IDP	internally displaced person	SOEs	state-owned enterprises
IG	Inspector General	SPS	State Pension System
IGFR	intergovernmental fiscal relations	SSS	Social Security System
IIG	Interim Iraqi Government (2004-2005)	TAL	Transition Administration Law
IMF	International Monetary Fund	TIG	Transitional Iraqi Government
		VAT	value added tax

CURRENCY EQUIVALENTS

Iraqi Dinars (IQD) per one U.S Dollar (US\$)

Average exchange rates for the period

2001 official rate	0.3109
2001 market rate	1929
2002 official rate	0.3109
2002 market rate	1957
2003 official rate	0.3109
2003 market rate	1957
2004	1460
2005 H1	1465

ABSTRACT

This report focuses on the main cross-cutting issues of Iraq's transition and aims to support the Iraqi Government in strengthening its policymaking capacity by laying out the policy options available and discussing tradeoffs under each option. The key themes of the report are reconstruction and job creation; reform of the pricing system; managing oil revenues; and strengthening safety nets. Underpinning this complex agenda are the overarching issues in public sector governance.

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EXECUTIVE SUMMARY

Iraq has a rich and diverse resource base— third largest oil reserves in the world, abundant water, and a national labor force of more than 7 million people—much larger than any member country of the Gulf Cooperation Council (GCC). In one decade this combination of resources could help the country regain the middle-income status it enjoyed earlier. To do this, Iraq will need to make three transitions: from conflict to post-conflict rehabilitation, from a closed, state-dominated economy to a growth-oriented, market-driven economy, and from extreme dependence on oil to a diversified economy. The report lays out some of the policy options to accomplish this transformation.

Recent developments and reforms to date

Oil production and exports have yet to reach the prewar levels, and non-oil sectors remain sluggish. High unemployment, poverty, and weak social protection systems are dominant in people's minds, threatening the fragile democracy. Violence and crime have increased substantially since late 2003, hampering reconstruction and undermining public sector governance. Losses to social capital have been massive. Success in recovery will depend on how quickly a social consensus emerges on reform priorities and tradeoffs. That consensus is essential. Cross-country analysis shows that countries developing a cohesive and consistent reform strategy outperform in terms of GDP per capita those unable to develop such a consensus by about 50 percent within the first post-conflict decade.

The incidence of absolute poverty is estimated at 8–10 percent, and a further 12–15 percent of the population is vulnerable to falling into absolute poverty. Both monetary and non-monetary aspects of poverty have worsened dramatically in recent decades. Several population groups are especially vulnerable: unemployed youth, demobilized soldiers and militia, war victims with disabilities, and internally displaced persons, refugees, and returnees.

There was some early progress on policy and institutional reforms in public finance, trade, the business climate, and the financial system in 2003–04. Reforms sought to remove price distortions, increase competitiveness, and enhance economic efficiency. Iraq is also reintegrating into the international financial system: in 2004 it adopted an IMF-supported stabilization program, negotiated a highly concessional debt rescheduling, gained access to IDA resources, and submitted a request for full WTO membership.

However, severe problems remain. Social indicators are at levels of low income countries. Access to infrastructure services is high—almost universal connection to the national electricity grid and 81 percent access to improved water sources—but the quality of these services had declined sharply in the past decade. In 2004, only 15 percent of households had a stable electricity supply, and a mere 20 percent had safe and stable drinking water.

In October 2004 the Government announced its National Development Strategy (NDS) for reconstruction and reform. The NDS was welcomed by the international donor

community, but it needs more specific sectoral strategies and it needs to be further developed into an actionable agenda.

Key Challenges Ahead

Iraq's first need is speedy progress in addressing the most critical condition for economic recovery: security. Beyond security, Iraq's reconstruction strategy is shaped by three main objectives: (a) creating enough productive jobs; (b) rebuilding public services accountable and responsive to citizens' needs such as power, water, roads, schools, and hospitals; and (c) ensuring that vulnerable social groups have access to vital services.

Realizing this vision calls for three main policy instruments: (a) reforming incentive systems to support faster, more efficient growth in private sector jobs; (b) establishing strong formal safety nets, protecting the poor and the vulnerable as prices are freed; and (c) installing accountable and transparent management of oil and other public resources.

Jobs and Reconstruction

Iraq's labor force is growing rapidly (at 2.4 percent a year) and will continue to do so in the medium term. Iraq has one of the highest unemployment rates in the region—close to 30 percent, almost twice the MENA average. More than half of young urban males are unemployed. Iraq also has very high underemployment (over 23 percent), while its female labor participation is a mere 19 percent—low even by MENA standards. Reconstruction should expand the demand for labor substantially.

Iraqi policymakers face a choice on the relative roles of the public and private sector in job creation. A simulation analysis conducted for this report suggests that a strategy reliant on public sector reconstruction without enabling the private sector will run out of steam on jobs and growth within 5–8 years. This simulation demonstrates clearly that there exists urgency to a private sector development strategy now.

Women's labor force participation has been shown to positively contribute to development. Research from other MENA countries show that while the public sector has been the key employer of female labor, in the private sector, women face higher barriers to employment than men. Labor market strategies should also seek to eliminate these barriers.

Strong job creation requires simultaneous improvement of institutions underlying the markets for capital (investment climate) and labor (active labor market policies).

Strengthening the Investment Climate

Private sector job creation is driven primarily by investment. This will require a two pronged approach. The first will build the institutional underpinnings (the overall market economy, the laws and regulations together with their monitoring, implementation and enforcement capabilities) for a strong investment climate. The second will develop a creative and targeted set of programs aimed at focused investment that leads to substantial job creation. Iraq will have to deal with two additional challenges: (a) managing public investment and restructuring state-owned enterprises (SOEs); and in the longer term (b) diversifying the economy through a strong competitive industrial sector.

Managing public investment is critical. The Government will be an important provider of

employment in Iraq during recovery. But because the Government will not be able to create jobs for everyone, it needs to change from primary employer to partner in creating and sustaining the opportunities for employment. The Government should finalize its SOE diagnosis and proceed with restructuring public enterprises. Many of the SOEs in the tradable sector have the potential to regain profitability, even in a very open economy with substantial foreign direct investment (FDI) inflows and low import duties.

In the longer term, strong job creation can be assured only by economic diversification, particularly in services, efficient import-substitution and export industries, since Iraq's petroleum sector does not generate the jobs commensurate with its role in the economy. Iraq faces a dilemma typical for all oil exporters: as oil revenues flow into the country, they push up the real exchange rate and the prices of non-tradables, including labor. This weakens the ability of domestic producers of traded goods to compete against imports (the "Dutch disease"). Many Iraqi entrepreneurs already complain about the flood of cheap imports. A temptation thus arises to rebuild the highly protectionist trade system, and to shield inefficient SOEs. The tradeoff is that these SOEs and protected private sector enterprises will reduce economic efficiency. A better approach would be to diversify while maintaining an open trade regime, low price distortions, and a competitive exchange rate. Expanding export product variety requires overhauling viable SOEs and encouraging new Iraqi exporters. That will take substantial time and resources, but in the long run will bring more stable job creation and growth than Iraq's protectionist model of the 1970's. Integration into the global economy through the WTO and FTAs can give an additional impetus to economic diversification.

Improving Labor Markets

An analysis of labor markets in Iraq, undertaken with limited data that are available, suggests that most private sector jobs are informal and have very low productivity. With more high-paying public sector jobs, private labor markets lost attractiveness, while queuing for public sector jobs had risen sharply. The Government needs to address this by: (1) stimulating private sector activity; (2) contracting out more reconstruction tasks to private sector; and (3) moderating wage expectations in the public sector.

Active labor market programs can tackle labor market dislocations in Iraq, but they need to be carefully targeted and monitored due to the potentially high fiscal costs. To cushion workers during SOE restructuring, urgent measures are required, such as severance payments, retraining programs, and assistance with job market reentry via employment agencies and public works programs. Women have a harder time integrating into private sector work, and when considering the more male-dominated supply of private sector jobs that will be initially available in Iraq, such as construction, it is likely that they will find less opportunities than men. Thus, safety nets would need to have a gender mainstreamed focus.

In the short term, steps are needed to expand the supply of reconstruction jobs. Iraq's capital investment in the budget averaged 27 percent of GDP in 2004–2005. Most of this investment is capital- and import- intensive. The labor content of reconstruction could be improved by designing employment-intensive programs, by scaling down the size of contracts to make them feasible for local execution, and by building up the capacity of

local contractors. Increasing local content of purchases and encouraging growth of sectors with strong links to the domestic economy (housing) would also help. Local development strategies should focus on job creation and income generation.

Reform of the Pricing System

In 2003–04 Iraq made significant progress in price liberalization. Most key prices in the economy are free. At the macroeconomic level, exchange rate policies have sought to stabilize the foreign exchange market, and it will be prudent to continue managing it well so that domestic production in the non-oil sectors remains competitive. Financial markets are still nascent, and interest rates will need to remain free as well. Most sectoral output prices are free. But the subsidies on several key prices—food, fuel, electricity, and other utilities—are very large, adding up to possibly more than 50 percent of GDP.

Iraq faces crucial choices in dealing with these untargeted subsidies, which result in large fiscal costs and serious disincentives in the economy while leaving massive demand for public services unmet. Carefully planned price reforms are needed to: (a) reduce the deadweight loss to the economy¹; (b) improve incentives to private sector producers; and (c) save fiscal resources for the production of vital public goods. Simulations using a simplified computable general equilibrium model (CGE) of the Iraqi economy, confirm all three points.

- *Domestic fuel prices* in Iraq are among the lowest in the world. This leads to a rampant black market and fuel smuggling out of the country; inadequate maintenance let alone modernization or expansion of the production, transport, and distribution facilities; and waste and over-consumption. The budget is directly hit, since state-owned refineries cover less than half the domestic demand, and the Government has to import the rest. Black market prices are 10–40 times above the official ones. Raising prices is the most efficient way to address these distortions. Econometric simulations indicate that a six-fold increase in fuel prices would lead to a 16 percent decline in fuel imports and a 30 percent decline in black market sales. Government savings would amount to about \$1.73 billion, allowing for additional investment and/or compensation transfers to households.

The Government certainly has grounds to be concerned about the pace of price rises. The welfare impact of price rises on the poor can be substantial, and compensation options are under consideration. International experience suggests that designing effective targeted compensation for liquid fuels is very difficult. Without a mechanism for targeted subsidies already in place, the cost of administering an effective targeted fuel price subsidy program could far exceed its benefits. Ideally, the policy focus should not necessarily be on the fuel sector per se but on consideration of how policies across different sectors (food, water, electricity, fuels, education, and health) are affecting the poor in aggregate and how to assist them with direct income transfers to help them purchase the basket of goods they consume. Finally, because fuels are inputs in almost all sectors of the economy, fuel price increases need to be coordinated with policies in other

¹ Deadweight loss is the cost to society created by market inefficiency, resulting from Government actions (taxes, price controls) or market failures (externalities, market control).

sectors, especially the fuel-intensive ones, such as transport, power, and cement.

- *Electricity tariffs* in Iraq are also among the lowest in the world (a fraction of one cent per kWh). Collections in 2004-2005 were very low—30 percent or less of the billed amounts--as distributing companies were awaiting security to strengthen billing and collection procedures. The negative effects of the electricity subsidy are similar to those for fuels. The national grid is currently unable to satisfy the demand, and Iraqis buy electricity from small, privately operated diesel generators, at a high price, necessary to cover the cost of operating these relatively inefficient sources of electricity.

How fast and to what level should the tariffs be increased are not the only policy tradeoffs the Government faces. Iraqis enjoy wide access to the electricity grid, and this should be preserved. Low-income groups connected to the grid may need subsidized access for a given period. This could take the form of a cross-subsidy built in the electricity tariff, where larger consumers are proportionately charged more than lower consumers. There is an urgent need to improve metering, billing, and revenue collection. Service reliability must improve for the tariff hikes to become acceptable. Furthermore, to enable adequate investment allocations and optimal deployment of capital across the industry, it needs to revert to its earlier structure of autonomous companies, away from the direct control of the Ministry of Electricity.

- *The Public Distribution System (PDS)* prevented a humanitarian crisis in Iraq during over a decade of sanctions. Today, however, the PDS poses a difficult dilemma for policy makers. The PDS is very effective in reaching the poor and guaranteeing a minimum standard of living, but it accomplishes this goal in a very costly and inefficient way -- absorbing 21 percent of government revenue and costing about US\$ 6.30 to transfer US\$ 1 worth of food to a poor person. The dilemma is further complicated by the fact that there are no other large-scale safety nets functioning in Iraq which could take over the role of the PDS. Three aspects of inefficiency are particularly noteworthy: (i) Because the PDS is available to all households -- not only poor households -- the cost is considerably higher than for a targeted safety net. (ii) As a result of rudimentary accounting, communication and tracking systems, the PDS is highly vulnerable to waste, theft and corruption. (iii) Because of its magnitude and non-competitive procurement practices, the PDS has crowded out and reduced the efficiency in many parts of the food supply chain. Unfortunately, an appropriate policy response is not easy to design: eroded private sector capacity in food markets, absence of a functioning banking system and lack of data that can be used for actively targeting the poor, restricts the options for rapid reform of the PDS. Nevertheless, there are a number of concrete steps the government can take, including: (i) gradually introducing targeting; (ii) reducing the number of products in the ration basket; (iii) increasing the role and capacity of the private sector in the PDS, and in food markets in general; and (iv) improving the procurement and financial management of the PDS.

The trade regime

An open trade regime is the key element of Iraq's pricing system reform. In 2003–04 the Government took steps to liberalize its trade policy. Border restrictions to merchandize trade were removed. A uniform reconstruction levy (tax) of 5 percent was instituted, and foreign exchange markets were liberalized. Maintaining this open regime will realize trade's beneficial impacts on job creation and growth. These effects can be direct and indirect: trade in services can generate substantial demand for labor; open trade for goods helps keep the prices of inputs and capital goods low for domestic Iraqi producers and thus stimulate the growth of production. To minimize "Dutch Disease" problems and to rebuild a diversified economy, it is necessary to ensure that the non-oil traded sector remains lightly taxed and has easy access to capital goods and key inputs. The effects of open trade will be maximized if it is combined with a friendly regime for FDI. This would encourage both foreign and domestic investment in the non-oil sector and significantly increase the demand for labor.

In defining its longer term trade policy Iraq faces a choice between a zero tariff and an optimal tariff,² which can support broader policy objectives. A modest degree of protection (not exceeding 10 percent) from international competition can be advisable, at least for the initial period. International experience suggests that a uniform moderate rate will contribute to efficiency in the economy while providing support for domestic value added. This is preferable to having multiple rates for individual products, which invite corruption and create unnecessary distortions. A modest uniform tariff across all goods and all importers will also be a welcome sign for all investors. It will reduce the cost of capital and intermediate goods, provide access to modern technologies, simplify customs clearance and valuation procedures, and put Iraq's trade regime close to that of its most open neighbors.

The service sector, including trade in services, is likely to be the largest source of employment in Iraq. Efficient provision of "backbone" services (power, telecommunications, transportation and logistics, and finance) is crucial to productivity and international competitiveness. Stimulating competition in the service sector and providing access to state-of-the-art technologies and management practices—by allowing investors' access to the domestic market for services—should be a central thrust of Iraq's development strategy. A liberal FDI regime is also essential to promoting Iraq's integration in global markets for manufacturing, agriculture, and food processing.

The much-needed but technically difficult regulatory reforms in services can be supported by WTO accession. Iraq's application for WTO membership in 2004 sent an important signal to investors that Iraq is willing to commit to transparent, rules-based, and liberal trade policies. WTO compatibility for domestic regulations and policies does not in itself create a high-quality institutional environment, but WTO commitments can be used to leverage domestic reforms and to integrate Iraq's economy into global markets, with wide-ranging beneficial consequences for growth and job creation.

Iraq's short-term priority is rehabilitating the Customs Authority and maintaining standards and food safety. Iraq's success in agricultural and manufacturing exports hinges on enhancing the quality of domestic products. Institutional capacity of the State

² Optimal tariff maximizes a country's welfare, which can be approximated by real national income. In a non-distorted small open economy, the optimal tariff is zero.

Standardization and Metrology Agency will be central to success. There also may be scope for near-term initiatives directed at selected industries or commodity sub-sectors that have some export track record yet are likely to face market access problems due to nonconforming product quality, safety, or certification.

Managing Oil Revenues

Iraq faces a choice between redistributing its oil revenue directly to the people and managing it well through the central budget for overall development impact. In the short-term, oil production and exports remain heavily constrained by rundown facilities and sabotage. Over the medium to long-term, however, Iraq's oil export revenues can rise dramatically—provided that oil production recovers strongly.

The economic performance of oil exporters is often inferior to that of resource-poor countries. This is often explained by the influence of oil wealth on governance and by the harmful real exchange rate effects on the non-oil sector (the Dutch disease). Volatility of oil export revenues may hamper the prospects of Iraq's reconstruction program, since volatility increases uncertainty, leads to wasteful public investment in times of boom and depresses investment when oil prices are low. These effects may combine to undermine economic diversification and growth.

Expenditure smoothing is the key to avoiding the transmission of oil price volatility to the economy. Investment levels should fluctuate substantially less than the price of oil. The Government needs to determine a sustainable level of capital and current spending based on whether the higher revenue flow is temporary or permanent and whether the expected (financial and social) returns justify the expenditure. Given poverty and high unemployment, the Iraqi Government will find it hard to withstand the pressures to spend and invest. Fiscal policy and institutions can help the government maintain a more stable investment strategy. The quality of investment matters as much as the quantity: oil windfalls have often produced huge inefficient projects - "white elephants".

To address volatility, a number of oil-exporting countries have combined mechanisms to accumulate foreign reserves during periods of high revenues with *fiscal rules* for spending these funds. Others have introduced *state oil funds* from which an annual transfer is made to meet the needs of the non-oil deficit in the budget. It is important to distinguish between (a) savings funds, which ensure that future generations benefit from the oil wealth even after the oil deposits are depleted; and (b) stabilization funds, achieve expenditure smoothing as discussed earlier. In Iraq, the benefits of a savings fund or a fiscal rule appear to be limited, since the rates of return on investment in the depleted physical and human capital are likely to be vastly superior to returns realized from the stock of financial assets that such a fund could hold overseas. Stabilization, on the other hand, is a legitimate concern; it can be most effectively achieved if pursued within a unified budget framework. Hence a stabilization fund can be virtual, and primarily ensure that each investment project, once started, can be completed.

Given the importance of oil revenues in the Iraqi economy, good governance in their management is crucial. Transparency is needed in the flow of budgetary funds, as well as for the accounts of the Development Fund for Iraq and for the national oil company once it is created. Minimal standards include transparency of the oil sector finances, independent, credible, and transparent audits, and the involvement of civil society.

Reducing Poverty and Vulnerability

Iraq faces a choice between considerably broadening and strengthening its formal safety nets or continuing reliance on untargeted subsidy schemes and subsidized services. The choice is imminent since large segments of Iraq's population face unprecedented social and economic risks.

A first priority is to undertake comprehensive household expenditure surveys to identify the Iraqi poor; these surveys are starting. The next step is to design formal safety nets and finance them in a sustainable fashion.

Apart from the universal food safety net (PDS), social protection consists of a collection of program interventions and providers, including direct assistance from families, private and charity assistance, and government programs. Private and non-governmental safety nets (zakat, waqf) likely account for the majority of social protection. The government-sponsored system has been weakened by wars and sanctions, and the cash benefits currently paid are modest, reaching fewer than 15 percent of the needy. None of these transfers is based on a consistent definition of need, and leakages to the less needy are highly possible. State-sponsored disability care institutions have been severely damaged and have inadequate supplies, while the number of their beneficiaries is small.

Simulations conducted for this study suggest that the Iraqi pension system is financially unsustainable despite the fact that it covers a small share of the population. It is also inefficient and inequitable. Only part of these problems stems from the emergency pension policy put in place in 2003. To a large extent the problems are structural and must be addressed under any circumstances:

- The dual structure of the Iraqi pension system leads to inequality and excessive administrative cost and restrains the efficient allocation of labor.
- The system is unaffordable due to very high benefits—close to 100 percent of the last salary for the average full-career worker.
- Benefit formulas and eligibility conditions distort labor supply and savings decisions and generate adverse distributional transfers (i.e., from low to high income workers).
- Current financing mechanisms can impose large costs on employers and discourage job creation.

These structural problems reduce incentives to diversify the sources of savings for retirement, particularly among middle- and high-income workers. In addition, they limit the coverage in the private sector, which is already unacceptably low. Employers systematically underreport the number of employees to remain below the minimum at which pension enrollment becomes mandatory. Finally, the governance structure and administrative capacity of the pension system are a cause of concern. The pension system staff needs skills to design and implement necessary reforms, and then to properly manage the reformed pension fund. Modernization is also called for with regards to information and payment systems.

Strengthening Governance and Public Management

Issues of public management and governance are at the forefront of Iraq's reform agenda for many years. The most immediate challenge is to build a legitimate state and ensure the security and the basic rights and freedoms of Iraqi citizens. Equally pressing is to determine the size and scope of the Government and the appropriate division of responsibilities between ministries and different levels of government. Other pressing questions: How should financial and human resources be organized and optimally deployed? And how can Iraq ensure public sector integrity? The new Iraqi constitution is likely to address many of these issues.

The main fiscal policy issue appears to be strengthening the budgetary framework and anchoring it in a medium-term context. In light of Iraq's large reconstruction needs and uncertain environment, a flexible medium term fiscal framework is the optimal way to manage oil revenues.

Twenty years ago, the *budget system* in Iraq was fairly efficient and robust. Elements of this system remain, but are hampered by poor security, difficulties in communication, and nontransparent recording of subsidies. In certain areas, for example reporting of fiscal data, the system appears to have deteriorated further since the war. This has degraded the Government's ability to allocate resources effectively and to track spending and outcomes. Urgent reforms are needed to address the fragmentation of the budget, inadequate reporting of revenues and expenditures, and weak accountability. The new Financial Management Law (2004) established principles for strengthening the budget process. However, the law does not itself provide a complete picture of the fiscal architecture required to rebuild the budget as the primary policy instrument; this requires further political and administrative decisions on the appropriate roles for various institutions.

A fundamental problem is budget fragmentation. There are several parallel spending plans but virtually no coordination in their preparation or execution. Improving the coverage of the budget so that it incorporates all significant government revenues and expenditures, and improving its transparency, are critical. It is also important to ensure that all donor aid is brought within the budget. The roles of the Ministry of Finance and Ministry of Planning in preparing the budgets for capital and recurrent expenditures need to be unified within a medium-term expenditure framework. Institutions need to be strengthened in all areas of the budget cycle and in some cases (e.g. internal audit and the parliamentary budget and finance committee) new institutions need to be developed from a rudimentary base. New skills are needed, ranging from treasury operations to debt management to financial auditing. Clearly such reforms will take many years to design and implement though a useful start has been made in some of the key areas.

Public procurement is a closely related area in which reform is urgently needed. The process of reforming the public procurement environment will be challenging, because long-established procedures in the ministries and state-owned enterprises are likely to generate inertia and resistance to change. A major training effort and supporting leadership will be critical. The lack of adequate procurement audit practices, the absence of a code of ethics for procurement officers, and the widespread culture of bribe-taking constitute additional challenges. Strengthening records management requirements and practices for procurement is badly needed. The most urgent action needed from Government is to clarify the legal framework for public procurement and enact the

needed legal and regulatory instruments, either by deciding to enforce the new Public Procurement Law through issuance of adequate regulations, or to prepare and enact an entirely new law and suitable regulations. The establishment of an adequately staffed procurement policy body, to be primarily endowed with formulating the regulations and preparing the standard documents which are so badly needed is therefore a very high priority.

Rebuilding Iraq's *civil service* hinges on making changes in how its employees are organized, including: (1) the statutory basis under which civil servants function; (2) the scope and comprehensiveness of the civil service; (3) its management; (4) the composition of categories and grades; (5) salary structure and benefits; (6) recruitment and promotion; (7) disciplinary procedures and termination; and (8) the boundary between the political and administrative spheres. These issues call for an early attention; also, the gender differences in all these areas should be addressed.

Several CPA directives addressed various aspects of civil service reform, but the record of implementation was uneven. One of the most urgent steps is to create two units with responsibility for human resource management throughout the civil service: one within the executive branch, focusing on human resource management and policy issue; the other with some degree of constitutional independence, overseeing compliance with human resource guidelines and providing an appeals function. In the near term it is of paramount importance that robust payroll and human resource controls be put in place to provide an accurate picture of the civil service and to avoid the pilferage of government resources. New human resource laws and regulations are needed, to enhance meritocracy and protect workers from harassment and discrimination. Modern human resource practices are needed, as well as stronger capacity of line ministries and departments to manage their staff. Eventually, issues of organizational structure and appropriate staffing levels will require attention.

Intergovernmental fiscal relations require careful consideration as Iraq prepares its Constitution. As with most MENA countries, Iraq is a unitary country with a dominant central government and weak local governments. Three northern governorates are run by the Kurdish regional government and are de facto autonomous. The other 15 governorates are administrative units with no control over revenues and expenditures. The CPA efforts to strengthen local governments in order to prepare the ground for a democratic federation did not build on the existing governance structures and therefore did not live up to expectations. Newly created local councils often lacked basic skills and have found it difficult to exercise authority over departments of central government ministries, which remain in control of service delivery. A confusing patchwork of legislation and practice emerged.

There are no technical answers to the question of how Iraq will proceed with decentralization: this is typically determined by political imperatives. Decentralized governance can accommodate diverse populations and maintain national unity; empower people to support democratization; and improve the efficiency of service delivery. The new Iraqi constitution will need to address three vital questions: Should Iraq be a federal or unitary country? Should decentralization be symmetrical or asymmetrical (equal autonomy for all subnational units or greater autonomy to certain areas)? And how will national revenues be shared?

A second layer of questions revolves around the assignment of responsibilities for each level of government. The guiding principle would be to give responsibilities for public services to the level of government that can discharge them most effectively. The determination of appropriate budget transfer mechanisms and local tax bases would follow. Given the predominance of oil revenue, intergovernmental transfers will remain the main source of financing for local governments. If they are responsible for delivering public services, they must be able to finance them. Finally, institutional arrangements developed, to define accountability and incentive frameworks for each level of government.

Corruption is widely perceived to be significant in Iraq. To combat it, the Government launched several initiatives: the independent Inspector Generals within individual Iraqi ministries, the new Commission on Public Integrity, and the revival of an existing Supreme Board of Audit (SBA). The Inspector Generals were authorized to perform a variety of functions, including auditing all records and activities of the ministry; conducting administrative investigations against any ministry official, including the minister; auditing the economy, efficiency, and effectiveness of the ministry's operations; and reviewing any ministry systems for measuring performance. The Commission on Public Integrity was charged with the criminal investigation of corruption cases and violations of the code of conduct. However, these new institutions have not yet taken root, and their impact is uncertain at this stage. To succeed in anticorruption efforts, Iraq must: (a) strengthen its legal and regulatory framework; (b) develop strong accountability institutions; (c) support prevention within individual agencies; and (d) enhance public opinion and awareness.