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CONSIDERING THE FUTURE OF THE IRAQI PUBLIC DISTRIBUTION SYSTEM

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EXECUTIVE SUMMARY

During the sanctions period, the Public Distribution System (PDS) played a crucial role: by making transfers to households and by injecting food into local markets, the PDS helped Iraq avoid a humanitarian crisis. Today, the situation in Iraq has changed and the Government is developing a new vision for the future, articulated through the National Development Strategy. In this context, it is necessary to reassess the function currently being played by the PDS and to make choices about its future.

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. The dilemma is further complicated by the fact that there are no other large-scale safety nets functioning in Iraq which could accomplish this goal if the PDS were eliminated.

What, then, should policy makers do about the PDS? A variety of specific proposals have been put forth since the end of the 2003 war, most notably: a rapid elimination of the PDS; replacement of the PDS with universal cash transfers (available to all Iraqis); and replacement of the PDS with means-tested cash transfers. This report examines the existing functioning of the PDS and private sector food markets, considers advantages and disadvantages of each of the three proposals, and recommends an action plan. Specifically, the report recommends a four-part program 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) immediate improvements in procurement and financial management.

Dilemma for Policy Makers: The PDS is effective but costly and inefficient

The PDS is effective in reaching the poorest in Iraq and increasing their purchasing power by up to 50 percent.¹ Although there is no data on income or consumption poverty in Iraq, the World Food Programme estimates that about 25 percent of the population is highly dependent on the PDS with a further 35 percent partially dependent on it. And, even if the security situation improves, transitory unemployment and poverty typical of transition economies is likely to continue over the medium term.

While the PDS undoubtedly serves an important function, it consumes a very large share of government resources. The 2005 budget allocates more than US\$ 4 billion to the PDS, equivalent to US\$ 150 per capita annually. Currently, the PDS allocation is 21 percent of government revenue. However, if oil prices fell to 2002 levels, maintaining the PDS

¹ The PDS reaches the poor as well as the non-poor. Indeed, more than 95 percent of Iraqi households receive rations. For the average Iraqi, the PDS increases purchasing power by about a third. For some groups – including groups commonly considered to be poor, such as agricultural laborers – the increase in purchasing power is as high as 50 percent.

would require over 30 percent of government revenue. Moreover, the opportunity costs of the PDS are high: the same quantity of resources currently spent on the PDS could alternatively be used to double operating expenditures on both education and health.

Although the PDS is an effective safety net, this goal is accomplished in a highly inefficient manner, costing about US\$ 6.30 to transfer US\$ 1 worth of food to a poor person – quite high by international standards. 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 is typical for a targeted safety net. Indeed, the actual role of the PDS goes far beyond providing a safety net for the poor. Whether or not it was intended as such, after 15 years of receiving rations, many better-off Iraqis see the system as a general entitlement and a mechanism to transfer natural resource revenue directly to citizens. (ii) Despite efforts by Ministry of Trade officials, accounting, communication and tracking systems for the PDS are rudimentary and generally dysfunctional, making it difficult to know if prices charged are appropriate, if contracts are fulfilled, if duplicate payments are made, and if appropriate quantities of goods are where they are supposed to be. As a result, the system is highly vulnerable to waste, theft and corruption. (iii) The MOT implements the PDS through a combination of Iraqi private companies and State-Owned-Enterprises.² In those areas that are contracted to the Iraqi private sector, non-competitive procurement reduces competition and the efficiency it can bring. In those areas of the PDS that are implemented by State-Owned-Enterprises (and in markets that compete with ration products), the Iraqi private sector is crowded out and has not had the experience necessary to build its capacity. The PDS's heavy reliance on imports and the artificially low prices caused by large injections of food into the Iraqi market have exacerbated the crowding out problem.

Iraqi Food Markets and the Iraqi Public Distribution System

Iraq became a net importer of food 40 years ago and currently imports about 70 percent of its food supply. Cereals, especially wheat, form the basis of the Iraqi diet. Domestic wheat production averages 1 million tons per year, with an additional 3 million tons of imports meeting the remainder of demand.

The Iraqi Public Distribution System (PDS) is the largest public food program operating in the world today and is perhaps the most visible program of the Iraqi government – absorbing 21 percent of government revenue.

The entire population of Iraq is eligible to receive the food ration for a nominal fee (equivalent to US\$ 0.16 per person per month). Adult rations consist of a basket of 10 products, including everything from wheat flour and salt to detergent, providing 100 percent of the minimum daily calorie requirement.

The size of the program is so large that it necessarily has a strong influence on food markets. Although the government does not directly set retail prices of any food

² Wheat processing, transportation and retailing activities are predominately contracted out to the Iraqi private sector, while importing, rice processing and warehousing functions are largely performed by State-Owned-Enterprises.

products, the PDS depresses open market prices considerably below border prices by injecting large quantities of food into the market.

The PDS started as a program to distribute domestically-produced food when sanctions were imposed in 1990. In 1996, the United Nations agreed to allow food imports under the Oil for Food Programme, thereby permitting the size of the rations to more than double.

Managed by the Ministry of Trade, the PDS is implemented through a combination of State-Owned-Enterprises and private sector companies: while importing, rice processing and warehousing functions are largely performed by State-Owned-Enterprises, wheat processing, transportation and retailing activities are predominately contracted out to the Iraqi private sector.

During the years of economic sanctions, all PDS ration goods were produced abroad and imported by the Ministry of Trade. In the past year, efforts have been made to use locally produced goods (especially Iraqi wheat) and to use Iraqi import companies. These efforts have had mixed success due to problems of low product quality and insufficient capacity of the import companies.

Consideration of three specific proposals for PDS reform

The report considers three specific proposals for the future of the PDS that have been put forward since the end of the 2003 war: rapid elimination; replacing the PDS with universal cash transfers; and replacing the PDS with means-tested cash transfers. Clearly, other alternatives can be envisioned as well, including various permutations on the basic three that we consider. We focus on these three and examine them separately in order to most clearly describe the proposals that have been put forward and to highlight the policy choices that need to be made.

Although in some ways the three specific proposals appear in principle to be very promising, all have practical difficulties in the current environment of Iraq.

Rapid elimination of the PDS. Because private sector capacity has eroded and an environment conducive to business is lacking, the supply response to rapid elimination of the PDS is likely to be muted. As a result, a large decrease in food supply and corresponding food price increases are likely. There is no doubt the private sector can eventually take the lead role in food markets. However, 15 years of crowding out by the PDS, artificially suppressed retail prices, lack of investment, lack of access to credit, and a largely non-competitive business environment have limited capacity in parts of the food supply chain, which will take time and effort to ameliorate.

Removal of PDS transfers and corresponding price increases would have a devastating impact on the poor, who lack any alternative safety net. While wealthier households would be able to maintain an adequate level of food consumption, the political ramifications could be destabilizing.

Universal cash transfers. The principle advantage of cash transfers over food transfers is that cash transfers do not distort market prices. To realize this advantage, therefore,

requires elimination of the government's role in food supply. As with the rapid elimination proposal, we would expect the private sector supply response to be limited in the short term.

There are two important considerations regarding the impact of monetization on households: the size of the cash transfer and the feasibility of making cash transfers in Iraq's current conditions. (i) The general consensus has been that cash benefits should leave households as well off as they are today – that is, the cash transfer should be sufficient to permit households to continue to purchase the ration basket. However, the frequently proposed cash benefit (of about \$5.50 per person per month) is inconsistent with this goal. In order to maintain purchasing power cash benefits must be calculated on the basis of future (undistorted) prices rather than today's suppressed prices. In any case, cash transfers will not protect households from inflation or price fluctuations which are common in transition countries and are evident in Iraq. (ii) Proponents of cash transfers argue that the logistics of cash transfers are simpler – and therefore less costly – than the logistics of food transfers. However, this is unlikely to be true in Iraq for two reasons. First, the Iraqi banking system is inadequate to handle a system of universal cash transfers, given that there is little communication between bank branches and many parts of the country are inaccessible to any branch. Second, security concerns in Iraq today make transport of cash – either between bank branches or directly to households.

Monetization of the PDS would not result in any budget savings if households are fully compensated. Moreover, Iraq has many public goods (e.g. reconstruction of infrastructure and the education and health systems) which need to be addressed before consideration can be given to use of government revenue to finance private consumption for better off Iraqis. Only when Iraq is much richer in terms of natural resource revenue and access to public goods and services can it consider Alaska-type oil dividends.

Means testing for targeting PDS rations. Rigorous means testing is not possible because incomes cannot be verified for the majority of the population. Further, active targeting based on household characteristics (generally accomplished by statistical identification of characteristics which are highly correlated with poverty status) will not be feasible until household expenditure data is available in mid-2006. Moreover, many in society view the PDS as a universal entitlement and withdrawal of benefits from the middle class could be politically destabilizing.

Recommended action plan

Although all of the three specific proposals considered above are problematic, there are a number of concrete steps the GOI can take immediately to move toward the vision articulated in the NDS. This vision includes a government which operates in the most efficient, accountable and transparent means possible, developing a comprehensive safety net to protect vulnerable groups, and removing from the food ration system segments of the population who are not identified as food insecure. The recommended action plan includes introducing the concept of targeting, reducing the number of products in the

ration basket, increasing the role and capacity of the private sector both within and outside of the PDS, and improving procurement and financial management practices.

- *Introducing the concept of targeting.* A proposal was made by Iraqi policy makers to withdraw benefits from the highest paid government employees. If well-publicized, this step could help establish in the public mind the notion that the PDS is a safety net for the poor. Because this is a small group, there would be limited impact on the budget.

A variety of “self-targeting” approaches may be useful as well. One approach requires households to reregister for the ration card, certifying that they are poor. When combined with publicity campaigns explaining the opportunity costs of the PDS budget, can result in wealthier households voluntarily opting out of the system out of pride and patriotism. Other approaches to self-targeting involve focusing the ration on products which are consumed disproportionately by the poor, making the ration products less attractive or convenient through packaging,³ or making the ration conditional on a work requirement (i.e. converting the PDS into a food-for-work program).

Once household expenditure data becomes available (starting in mid-2006), it should be analyzed in order to develop an understanding of the geographic location and typical characteristics of poor households. On the basis of this analysis, active approaches to targeting (e.g. proxy-means testing) or more refined approaches to self-targeting can be developed.

Self-targeting approaches can provide significant budget savings with very minimal administrative costs: for example, spending on the food program in Tunisia was cut in half as a result of self-targeting efforts. Nevertheless, the most important benefit of initial efforts at targeting may be a gradual acceptance by the general public that while spending on safety nets for the poor is justified, universal entitlements for private consumption may not be a good use of resources.

- *Reducing the number of products in the ration basket.* Currently, the ration basket includes ten products. Reducing the number of products would simplify the MOT’s work in terms of contracting for purchases and tracking spending and movement of inventory – tasks which are quite challenging given existing procedures. A reduced number of products would also make it easier to analyze the impacts of the ration on households.⁴

³ Ideally, household expenditure data would be used to design a self-targeting program. Until such data is available, other surveys such as those conducted with the support of the World Food Programme and DFID could be used.

⁴ Very little is currently known about household use of ration products (i.e. the extent to which households consume, sell or give away their rations) and the extent of benefit they receive in terms of purchasing power. Further, because the PDS distributes a wide range of products together in one basket, it is not possible to calculate the subsidy rates for individual products.

Reducing the number of products in the ration basket is useful even if there is no savings to the PDS budget. Indeed, it may be desirable to simultaneously increase the quantity of other ration products, so that households are not made worse off.

Further consideration would be needed in order to determine which specific products should be eliminated. Good candidates for elimination would be products that are inexpensive (i.e. would not drastically reduce households' purchasing power), and products that are not essential for good nutrition.

- *Increasing the role and capacity of the private sector both within and outside of the PDS.* Since the restrictions associated with sanctions and the Oil For Food Programme ended, the MOT has taken steps to increase the role of the Iraqi private sector in the PDS. Specifically, the MOT has signed contracts with Iraqi entrepreneurs to handle a portion of PDS imports and the MOT now purchases domestic wheat, mixing it with imported wheat at a ratio of 40/60. Although there have been some problems due to insufficient private sector capacity to handle large import contracts and due to problems of quality of domestic wheat, these initial steps are laudable. Careful assessment of these experiments is necessary so the problems can be rectified. And, analysis of areas in which private sector capacity is strong is necessary to identify scope for expansion of the initial efforts.

Some parts of the PDS supply chain may be entirely handed over to the private sector, possibly including privatization of public assets. For example, transportation for the PDS has always been dominated by contracts with the private sector: it may be possible for the government to move out of direct transportation entirely. As the PDS supply chain is increasingly handed over to the private sector, the goal of increasing efficiency through greater competition should be kept in mind. In areas where there are large economies of scale, a natural monopoly in the hands of the public sector might be as good as one in the hands of the private sector – especially in post-conflict environment. Of course, whatever public contracting there is, should be as efficient and transparent as possible. In order to avoid conflicts of interest, progress should be monitored by a competent third party.

Even more important, the private sector's capacity to operate independently of the PDS needs attention. A variety of efforts are required. (i) In agriculture, improved quantity and quality of production could be encouraged by increased access to inputs. This includes access to credit and adjusting banking laws so long term leases of government land can be used as collateral. (ii) Efforts to build the private sector should be coordinated with existing efforts by others to develop the banking sector, increase access to credit, and removing barriers to entry. (iii) Food safety regulations are needed to protect consumers. (iv) Insurance products are needed to serve the private sector's risk management needs. (v) And market information such as governorate level wholesale and retail prices is needed by the private sector and should be made widely available through newspapers or radio.

- *Improving procurement and financial management practices.* Important steps could be taken immediately to improve the procurement and financial management of the PDS. A variety of improvements can be made, particularly to improve the documentation and reporting of transactions. (i) Procurement practices can be improved by use of more specific and clear bidding and contract documents as well as public bid opening. (ii) Inventory control systems could be automated and linked to track the location of PDS products at all points from entry at port, to warehouses, to transport and retail outlets. Such a control system would help ensure timely deliveries of rations to the public and to identify the extent of losses to waste and theft. (iii) Beneficiary lists can be updated and automated, creating a national list in order to begin to enforce eligibility (i.e. preventing households from receiving rations on behalf of Iraqis living outside of the country). (iv) A modern financial management system could be put in place allowing accurate assessment of the cost of the PDS and avoiding incorrect payments. (v) Annual auditing and reporting could be instituted, including random checks of inventory.

Improved procurement and financial management practices, such as those suggested above, could begin immediately leading to significant budget savings in the short term.

In addition to the four-part action plan described above, there is a need for on-going data collection and analysis to permit adjustment of the plan as Iraqi food markets develop. Such data collection and analysis would include monitoring the extent and nature of private sector imports and domestic production, monitoring food prices at a sub-governorate level, and the development of knowledge about the causes and characteristics of poverty. Some of this data is already being collected by GOI COSIT and by WFP: this data should be made readily available for analysis. Other parts, such as the household expenditure survey and poverty assessment are in the planning stage. Additional efforts will be needed as well, particularly as related to the private sector.

In each of the four parts of the recommended action plan, steps can be taken immediately and built upon over the medium term. In addition to the national level steps, there may be scope for accelerated advancement in some parts of the country. For example, the greater experience of the private sector and better security situation in the Kurdish Region may permit more rapid expansion of targeting efforts, reductions in the number of products or enlargements in the role of the private sector.

In the longer term, the GOI may wish to transform the PDS into a cash-based safety net. This type of reform has several prerequisites including the data and institutional ability to actively target program beneficiaries, a developed and widely-used banking system, and efficient private sector food markets. Realizing these prerequisites will take some time – though there is no question that Iraq has the key ingredients necessary to make this possible.

The action plan recommended above could generate considerable savings in the PDS budget. In short term, significant gains could be made by improving procurement and financial management practices, thereby reducing losses due to waste, theft and corruption. In the medium term, budgetary gains will come from improved targeting and enhanced efficiency resulting from more extensive reliance on the private sector.