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REBUILDING IRAQ:
ECONOMIC REFORM AND TRANSITION

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CURRENCY EQUIVALENTS

Average exchange rates, 2001–05

Date and type	*Iraq dinars per U.S. dollar*
2001	
Official rate	0.3109
Market rate	1,929
2002	
Official rate	0.3109
Market rate	1,957
2003	
Official rate	0.3109
Market rate	1,957
2004	1,455
2005	1,467

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 and discussing tradeoffs under each option. The key themes of the report are generating growth and employment, protecting the poor and vulnerable, and improving public management and accountability. Specific recommendations cover reconstruction of public services, job creation; reform of prices and incentives; targeting and sustainability of social safety nets; public management of oil revenues; and strengthening of governance for public finance, intergovernmental relations, human resource management, and transparent public management.

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Contents

Boxes

Preface

This report focuses on the cross-cutting issues at the heart of Iraq's transition, including the immediate challenges of reviving the economy and creating jobs, rebuilding public services responsive to citizens' needs, and strengthening safety nets to protect the poor and vulnerable. It also addresses some overarching issues in public sector governance, particularly the management of oil revenues, the realignment of economic incentives and prices, the reform of human resource management, and the implementation of anticorruption efforts. The report begins by surveying recent developments and reforms to date. Each chapter concludes with specific recommendations for the future.

The report is intended for three audiences: Iraqi policymakers, the international donor community, and World Bank staff. For the Iraqi audience, the most important of the three, the report analyzes what worked and what did not in other countries, including those in the Middle East and North Africa, and strives to support the Iraqi government in strengthening its policymaking capacity in the context of the National Development Strategy. Instead of prescribing policies, the report lays out the options available to the Iraqi authorities and discusses tradeoffs under each option. For the international donor community, the report may help to refine approaches to reconstruction assistance and improve the efficiency of cooperation with Iraqi counterparts. Finally, for World Bank staff, the report aims to provide an integrative analytical platform for the Bank's Interim Strategy for Iraq.

Drawing on sectoral studies of the Iraqi economy and policy discussions held in 2003–05 with senior Iraqi counterparts from a wide cross-section of agencies, the report builds on extensive data collection and analytical work undertaken by Iraqi government agencies and independent experts, as well as by many international institutions involved in reconstruction assistance. Surveys organized and funded by the U.N. Development Programme, the World Food Program, and the International Labour Organisation and implemented by Iraq's Central Organization for Statistics and Information Technology (COSIT) provided valuable information on social development standards in Iraq. Project and advisory work undertaken by U.N. agencies and bilateral donors, such as the U. K. Department for International Development (DFID), the U. S. Agency for International Development (USAID), and many others supplied further information. Iraqi and international experts provided very helpful comments on earlier versions of this report.

A word of caution is needed about the quality of data underpinning the analysis in this report. Although data has improved and several wide-ranging surveys have been undertaken since 2003, substantial gaps remain. Further data collection and research are needed to deepen the understanding of challenges facing Iraq.

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Executive summary

Iraq has a rich and diverse resource base—the 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. This combination of resources is expected to enable the country to regain in only a decade the middle-income status it enjoyed earlier. To do so, however, Iraq will need to make three transitions: from conflict to rehabilitation, from state domination to market orientation, and from oil dependence to diversification. The report lays out some of the policy options to accomplish these transformations.

Recent developments

Iraqi reconstruction is being stalled by the lack of security. Oil production and exports have yet to reach prewar levels, and nonoil sectors remain sluggish. High unemployment, poverty, and weak social protection systems dominate public concerns and threaten the fragile democracy. Violence and crime, which have increased substantially since late 2003, hamper reconstruction and undermine governance efforts. Increased violence also limits people's access to much-needed public services and thus stifles progress in human development, particularly for the growing number of the poor and the vulnerable. Thirty years ago, Iraq led the Middle East and North Africa region in social development indicators, such as maternal and child mortality, nutrition, literacy, and secondary school enrollment. Since then, as a result of decades of conflict, sanctions, and underinvestment, living conditions have declined. Many of these indicators have fallen to the levels typical for low-income countries.

Violence in Iraq remains much worse than in other conflict-ridden countries at a comparable point after the end of open warfare. The incidence of conflict in Iraq in the past two decades has been three times as high as in the Middle East and North Africa region as a whole, which itself has one of the highest incidences of conflict in the world. Losses to social capital have been massive. Success in reconstruction and recovery will depend on how quickly a social consensus emerges on reform priorities and tradeoffs. That consensus is essential: a comparative analysis of trends in GDP per capita in the decade following conflicts shows that countries developing a cohesive and consistent reform strategy outperform those unable to develop such a consensus by about 50 percent.

About 8–10 percent of the Iraqi population is now estimated to be living in absolute poverty, and a further 12–15 percent is vulnerable to falling into absolute poverty. Both monetary and nonmonetary aspects of poverty have worsened dramatically in recent decades. Several population groups are especially at risk: unemployed youth, demobilized soldiers and militia, war victims with disabilities, and internally displaced persons, refugees, and returnees. Iraq's volatile security is likely to have continuing consequences for poverty and vulnerability.

Some early progress was made in 2003–04 on policy and institutional reforms in public finance, trade, the business climate, and the financial system. 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 a stabilization program supported by the International Monetary Fund, negotiated a highly concessional debt rescheduling, gained access to concessionary resources from the International Development Association, and submitted a request for full membership in the World Trade Organization.

Nonetheless, severe problems remain. By many measures of social development, Iraq has fallen below most other countries in the region and middle-income countries around the world (see “Iraq at a glance” tables in the annex). Access to utilities is high—almost universal connection to the national electricity grid and 81 percent access to improved water sources—but the quality of these services has declined sharply in the past decade. In 2004, only 20 percent had safe and stable drinking water, and a mere 15 percent of households had a stable electricity supply.

In October 2004 the government announced its National Development Strategy, which outlines long-term priorities for reconstruction and reform. The strategy offers a vision of economic revival driven by private enterprise and supported by a strong and transparent public sector. It was welcomed by the international donor community, but it needs more specific sectoral strategies to become an actionable agenda. It needs to be further developed by the incoming Iraqi Government.

Challenges ahead

Iraq has made less speedy progress than expected in addressing the most critical condition for the economic recovery: reversing violence and insecurity. Building up law enforcement and strengthening a representative form of government would allow conflicts to be resolved through political means, rather than through violent confrontation. Restoring law and order, engaging all important stakeholders, and reintegrating combatants into civil society are thus the highest priorities for Iraq.

Beyond the need to credibly establish security, Iraq’s reconstruction strategy should also be designed to create productive jobs that will engage Iraq’s burgeoning labor force, to improve the well-being of the most vulnerable groups, and to rebuild public services in ways that are accountable and responsive to citizens’ needs. Experience from other successful postconflict transitions indicates that all of these objectives need to be met simultaneously, guaranteeing that all citizens share in a vision of a just and prosperous Iraq.

Realizing this vision calls for three main policy approaches: (a) generating growth and employment in the private sector by rebuilding needed services and reforming incentive systems; (b) protecting the poor and the vulnerable as prices are freed by establishing strong formal safety nets and sustainable pensions; and (c) improving public management and accountability, especially for oil revenues and other public resources, by strengthening governance, reforming public finance and human resource management, and increasing anticorruption efforts.

In Iraq, as in all countries, there are choices for the role of the state. The Iraqi state remains central to the reconstruction task, but its role will likely evolve. In the initial postconflict years, it will continue to create jobs, rebuild human and physical capital, and restore vital services. But it should scale back its direct involvement in economic activities to concentrate its human and financial resources on the provision of vital public goods—such as law and order, a sound trade and investment regime, and strong social safety nets.

The pacing of reforms should incorporate goals targeting women's development and employment, since gender-neutral pacing may not protect most women. Some pricing reforms should proceed faster than others to realize quick gains while protecting the vulnerable groups.

All three areas of reform are interconnected, and care is needed in their pace and sequence. Reform of the subsidy system needs to generate fiscal savings for reconstruction and job creation. Effective public resource management remains central to the success of transition.

Generating growth and employment

Iraq’s labor force is growing rapidly (at 2.4 percent a year) and will continue to do so in the medium term. The current demand for labor cannot absorb large numbers of unemployed and new entrants to the labor market. As a result, Iraq has one of the highest unemployment rates in the region—close to 30 percent, almost twice the average in the Middle East and North Africa region. 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 Middle Eastern standards.

Once security concerns are addressed, the situation may improve. Reconstruction should expand the demand for labor substantially, given Iraq’s enormous needs for basic services. Although the vast majority of the population has access to the national electricity grid and improved water sources, the quality of these services had declined sharply in the past decade. In 2004, only one-fifth of the population had safe and stable drinking water, and less than one-sixth had a stable electricity supply. Many new jobs will be in the public sector, since reconstruction programs will be initiated by the state, funded from its oil revenues.

Creating jobs and rebuilding services

Iraqi policymakers face a choice on the relative roles of the public and private sector in job creation. Other labor-abundant countries show that job creation is most effective when the public and private sectors are strengthened simultaneously. During early stages of transition, the public sector may indeed be the chief job engine. However, where the state dominates investment and service delivery and crowds out the private sector, efficiency eventually declines, and unemployment remains stubbornly high. Where the state moves early to facilitate private enterprise and concentrates on the provision of key public goods, private enterprise flourishes and strongly expands the demand for labor. A vibrant private sector in Iraq would deliver not just ample jobs, but more productive jobs as well.

A simulation analysis conducted for this report suggests that a strategy that relies on public-sector reconstruction without enabling the private sector will run out of steam to generate jobs and growth within five to eight years. This simulation demonstrates the urgency of promoting private-sector development immediately.

Women's labor force participation contributes significantly to development. Research from other Middle East and North Africa countries shows that, while the public sector has been the main employer of female labor, in the private sector women face higher barriers to employment than men. Labor market strategies should seek to eliminate these barriers.

Increasing investment

Private-sector job creation is driven primarily by investment. To improve the climate for investment, Iraq needs to strengthen the institutional underpinnings (such as the laws and regulations together with their monitoring, implementation, and enforcement capabilities) and develop a creative and targeted set of programs to focus investment on substantial job creation. Indeed, job creation should be the key metric by which economic development programs are gauged. This strategy will require close attention from the top leadership and efficient cross-ministerial coordination. In delivering on this agenda Iraq will have to deal with two additional challenges: (a) managing public investment and restructuring state-owned enterprises and (b) in the longer term diversifying the economy through a strong competitive industrial sector.

For the private sector to become the prime job generator in Iraq, critical steps to improve the investment climate include establishing clear property rights, stable regulatory frameworks, and low entry and exit barriers for businesses. Barriers to entry (time and cost of administrative approvals for setting up a private company) are high, and access to finance is still limited. Regulations do not facilitate the restructuring of viable businesses or permit failing firms to close expediently, thus raising the social and economic costs of bankruptcy. The judicial system is slow, and enforcement unpredictable. Infrastructure is weak and impedes business activity. Corruption drives many private firms into the grey economy and discourages possibly even a greater number of entrepreneurs, especially women, from launching their own businesses. In all of these areas Iraq has made important first steps, but much remains to be done.

Much more can also be done to increase what the Iraqi private sector does in reconstruction. Stronger and more transparent procurement systems are needed, as are appropriate mechanisms to resolve critical market failures that hamper private-sector enterprises (such as market access, information, technical knowledge, and finance). To deal with security and infrastructure needs, economic development zones can be established.

Managing public investment is critical. Even under the private-sector development model and beyond the early reconstruction years, 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 also finalize its diagnosis for state-owned enterprises and proceed with restructuring public enterprises. Many of the state-owned enterprises in the tradable sector have the potential to regain profitability, even in a very open economy with substantial foreign direct investment inflows and low import duties.

In the longer term, strong job creation can be ensured only by economic diversification (particularly in services such as tourism), 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 nontradables, including labor. This weakens the ability of domestic producers of traded goods to compete against imports (the so-called Dutch disease). Many Iraqi entrepreneurs already complain about the flood of cheap imports. A temptation thus arises to rebuild a highly protectionist trade system and to shield inefficient state-owned enterprises. The tradeoff is that these state-owned enterprises and protected private-sector enterprises would 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 the variety of export products requires overhauling viable state-owned enterprises 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 1970s. Integration into the global economy through the World Trade Organization and free trade agreements can give an additional impetus to economic diversification.

Improving labor markets

Iraq faces a choice in strengthening the performance of labor markets: one option is to continue with large public-sector interventions; the other is to strengthen private markets to generate more jobs. An analysis of labor markets in Iraq, undertaken with the 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 have lost attractiveness, while queuing for public-sector jobs has risen sharply. The government needs to address this by: (a) stimulating private-sector activity; (b) contracting out more reconstruction tasks to the private sector; and (c) 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 because of their potentially high fiscal costs. To cushion workers during the restructuring of state-owned enterprises, urgent measures are required, such as severance payments, retraining programs, and assistance from employment agencies and public works programs to help displaced workers reenter the job market. Women generally have a harder time than men integrating into private-sector work, and given the supply of private-sector jobs that will be initially available in Iraq—mostly male-dominated work in construction—it is likely that women will find fewer opportunities than men. Thus, safety nets would need to recognize gender differences in determining need.

In the short term, steps are needed to expand the supply of reconstruction jobs. Iraq's capital spending in the budget averaged 23 percent of GDP in 2004–05. 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 the local content of purchases and encouraging growth of sectors with strong links to the domestic economy (such as housing) would also help. Local development strategies should focus on job creation and income generation.

Reforming 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 nonoil 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—especially food, fuel, and electricity—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 cost to society resulting from market inefficiencies caused by government actions or market failures (so-called deadweight loss); (b) improve incentives for private-sector producers; and (c) save fiscal resources for the production of vital public goods. Simulations using a simplified computable general equilibrium model of the Iraqi economy confirm all three points.

Food prices. The Public Distribution System prevented a humanitarian crisis in Iraq during more than a decade of sanctions. Today, however, the system poses a difficult dilemma for policymakers. It is 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 $6.30 to transfer $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 that could take over the role of the Public Distribution System. Three aspects of inefficiency are particularly noteworthy. First, because the system is available to all households—not only poor households—the cost is considerably higher than for a targeted safety net. Second, as a result of rudimentary accounting, communication, and tracking systems, the Public Distribution System is highly vulnerable to waste, theft, and corruption. Over 2004–05 the system's reliability worsened significantly: many items in the food basket are now delivered with long delays, if at all. Third, because of its magnitude and noncompetitive procurement practices, the system has crowded out and reduced 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 all restrict the options for rapid reform of the system. Nevertheless, there are a number of concrete steps the government can take, including: gradually introducing targeting, reducing the number of products in the ration basket, increasing the role and capacity of the private sector in the Public Distribution System and in food markets generally, and improving the procurement and financial management of the system.

Fuel prices. 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 overconsumption. 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 to 40 times above the official ones. Raising prices is the most efficient way to address these distortions. Econometric simulations indicate that a sixfold 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 or compensation transfers to households.

The government certainly has grounds to be concerned about the pace of price rises. The welfare impact of price increases 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 be on the fuel sector alone but on how policies across different sectors (food, water, electricity, fuels, education, and health) are affecting the poor and how to assist them with direct income transfers to help them purchase the 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 sectors, especially the fuel-intensive ones, such as transport, power, and cement.

Electricity prices in Iraq are also among the lowest in the world (a fraction of a cent per kilowatt hour). Collection rates in 2004–05 were low—30 percent or less of the billed amounts—as distributing companies were awaiting improved 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 the tariffs should be increased are critical policy issues, but not the only ones 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 into 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, electricity service needs to revert to its earlier structure of autonomous companies, away from the direct control of the Ministry of Electricity.

Maintaining an open 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 on merchandise 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 stimulates the growth of production. To minimize Dutch disease problems and to rebuild a diversified economy, it is necessary to ensure that the nonoil 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 foreign direct investment. This would encourage both foreign and domestic investment in the nonoil sector and significantly increase the demand for labor.

In defining its long-term trade policy, Iraq faces a choice between a zero tariff and an optimal tariff, which can support broader policy objectives. An optimal tariff maximizes a country's welfare, which can be approximated by its real national income. In a nondistorted, small open economy, the optimal tariff is zero. 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, a trade regime that invites corruption and creates unnecessary distortions. A modest uniform tariff across all goods and all importers will also be a welcome sign for 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 regime for foreign direct investment 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 accession to the World Trade Organization (WTO). Iraq's application for WTO membership in 2004 sent an important signal to investors that Iraq is willing to commit to transparent, rule-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 priorities for its trade regime are rehabilitating the customs authority, maintaining product standards, and ensuring food safety. Iraq's success in agricultural and manufacturing exports hinges on enhancing the quality of domestic products. Building the institutional capacity of the State Standardization and Metrology Agency will be central to success. There also may be scope for near-term initiatives to bolster selected industries or commodity subsectors that have some export track record yet are likely to face difficulties gaining access to markets because of nonconforming product quality, safety, or certification.

Protecting the poor and the vulnerable

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. About one in every ten Iraqis is now living in absolute poverty (according to best available estimates), and another one in every seven or eight is at risk of falling into absolute poverty. Those most vulnerable include (a) the unemployed, who make up about 30 percent of the labor force and more than 50 percent of urban youths, (b) the legions of demobilized soldiers and ex-militia, (c) war victims, who have suffered disabilities or lost household providers, and (d) the refugees, displaced persons, and returnees who are resettling after conflict. Recent assessments confirm the importance of developing social protection mechanisms that mitigate the pains of economic transition.

Strengthening safety nets

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 (the Public Distribution System), social protection consists of a collection of program interventions and providers, including direct family assistance, private and charity aid, and government programs. Private and nongovernmental safety nets probably account for most of the current 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 institutions for disability care have been severely damaged and have inadequate supplies, and the number of their beneficiaries is small.

Reforming the pension system

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 because it pays 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 causes of concern. The pension system staff needs skills to design and implement necessary reforms, and then to properly manage the reformed pension fund. Modernization of information and payment systems is also needed.

Improving public management and accountability

The need for more accountable and transparent public management is at the forefront of Iraq's reform agenda. The most immediate challenge is to build a legitimate state and ensure the security, 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 decentralized authorities. Other basic questions that must be resolved include, How should oil revenues be distributed? How should financial and human resources be organized and optimally deployed? And how can Iraq ensure public-sector integrity? The new Iraqi constitution should address many of these issues.

Managing oil revenues

Iraq faces a choice between redistributing its oil revenue directly to the people and managing it 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 may be explained by the negative impact of oil export revenues on real exchange rates in the nonoil sector (the Dutch disease) and oil wealth on governance issues through rent-seeking behavior. The volatility of oil export revenues may hamper the prospects of Iraq's reconstruction program, since volatility increases uncertainty, leads to wasteful public investment in boom times, and depresses investment when oil prices are low. These effects may combine to undermine economic diversification and growth.

Smoothing expenditures is the key to avoiding any adverse economic impact from oil price volatility. 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 current revenue flow is temporary or permanent and whether the expected financial and social returns justify the expenditure. Given Iraq's poverty and high unemployment, the government will find it hard to withstand the pressures to spend and invest. Sound fiscal policy and financial 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 developed both mechanisms to accumulate foreign reserves during periods of high revenues and 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 nonoil 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, which are intended to achieve expenditure smoothing. 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, in contrast, is a legitimate concern; it can be most effectively achieved if pursued within a unified budget framework. Hence, a stabilization fund can be virtual, intended primarily to 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 in the accounts of the Development Fund for Iraq[1] and the national oil company, once it is created. Transparency and good governance help to foster a democratic debate, increase accountability, improve macroeconomic management, and enhance access to finance. Minimal standards include transparency of the oil-sector finances; independent, credible, and transparent audits; and the involvement of civil society. The sustainability of any major political solution in Iraq critically depends on transparent management of the national oil wealth.

Strengthening governance and public management

Strengthening the budgetary framework and anchoring it in a medium-term context is the main fiscal issue now facing Iraq. 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.

The budget system. Twenty years ago, Iraq's budget system 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, such as the 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, to report revenues and expenditures adequately, and to ensure 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; getting the complete picture would require 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. Critical reforms include improving the transparency and the coverage of the budget, so that it incorporates all significant government revenues and expenditures. 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 areas (e. g., internal auditing and the parliamentary budget and finance committee) new institutions need to be developed from a rudimentary base. New skills are needed for treasury operations, debt management, financial auditing, and many other budget activities. Clearly such reforms

[1] The Development Fund for Iraq (DFI) was established pursuant to United Nations Security Council Resolution 1483 and holds the proceeds of petroleum export sales from Iraq, as well as remaining balances from the UN Oil-for-Food Program and other frozen Iraqi funds. Disbursements from the DFI must be used for the benefit of the Iraqi people. It is directed by the Iraqi interim administration. See www.iamb.info.

will take many years to design and implement, although a useful start has been made in some important areas.

Public procurement. Reforming the public procurement environment is also urgently needed, but the process will be challenging, because long-established procedures in the ministries and state-owned enterprises are likely to generate inertia and resistance to change. Success will require a major training effort and supporting leadership. The lack of adequate procurement audit practices, the absence of a code of ethics for procurement officers, and the widespread culture of bribery constitute additional challenges. Strengthening records management requirements and standardizing practices for procurement are also badly needed. The most urgent action needed from government is to clarify the legal framework for public procurement and enact the legal and regulatory instruments needed to support it, either by deciding to enforce the new Public Procurement Law and issuing adequate regulations or by preparing and enacting an entirely new law and suitable regulations. The establishment of an adequately staffed procurement policy body, to be primarily entrusted with formulating the regulations and preparing the standard documents that are so badly needed, is therefore a very high priority.

Civil service. Rebuilding Iraq's civil service hinges on making changes in how its employees are organized, including (a) the statutory basis under which civil servants function; (b) the scope and comprehensiveness of the civil service; (c) the management of the civil service system; (d) the composition of categories and grades; (e) the salary structure and benefits; (f) the process of recruitment and promotion; (g) the procedures for disciplinary action and termination; and (h) the boundary between the political and administrative spheres. These issues call for early attention. In addition, the gender differences in all these areas should be addressed.

Several directives from the Coalition Provisional Authority 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 issues; 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, including measures to strengthen the 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. As with most countries in the Middle East and North Africa region, Iraq has a dominant central government and weak local governments. Three northern governorates are run by the Kurdish regional government and are autonomous in effect. The other 15 governorates are administrative units with no control over revenues and expenditures. The efforts of the Coalition Provisional Authority to strengthen local governments, which were intended 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 have 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 has 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; 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 should national revenues be shared? Other key concerns are how to ensure public safety and how to promulgate the rule of law.

A second layer of questions about decentralization concerns the assignment of responsibilities to 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 need to be developed to define accountability and incentive frameworks for each level of government.

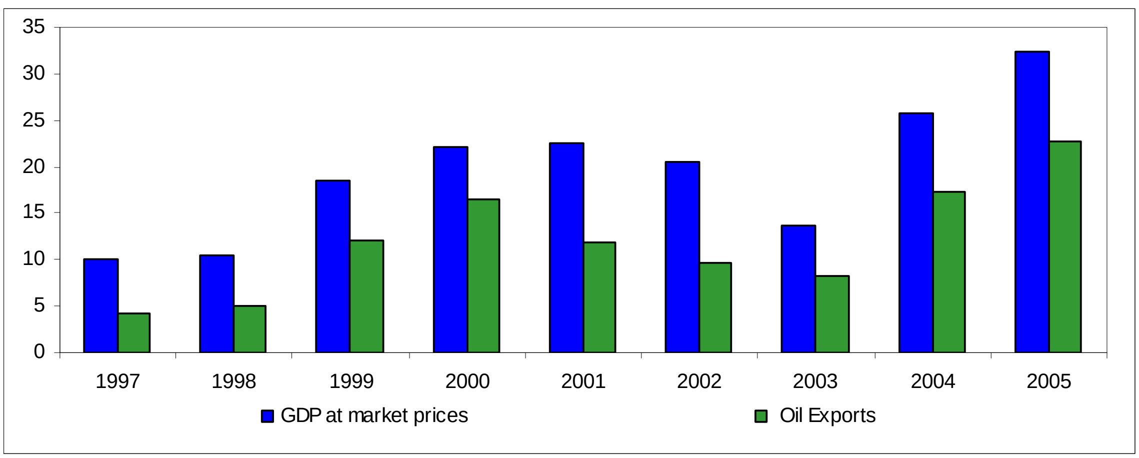
Corruption. Corruption is widely perceived to be significant in Iraq. To combat it, the government launched several initiatives: the independent inspectors general within individual Iraqi ministries, the new Commission on Public Integrity, and the revival of an existing Supreme Board of Audit. The inspectors general 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.

Chapter 1. Recent developments and challenges ahead

Iraqi recovery and reconstruction is progressing at a much slower pace than expected. The economy imploded in the 2003 conflict, with nominal gross domestic product (GDP) hitting a low of $12 billion. In 2004, GDP recovered to an estimated $25.7 billion, and income per capita rose to about $948 (figure 1.1 and table 1.1). Almost all growth has been in the oil sector, propped up by unusually strong world oil prices. Oil production, however, has not risen above prewar levels, and other basic services, such as electricity, remain too disrupted to support strong economic growth (figure 1.2). Although the nonoil sector surged in late 2003 and early 2004, it has slowed sharply since then. GDP per capita remains less than a third of what Iraq enjoyed 25 years ago, before the economy began its decline. Recovery has generated few jobs; unemployment and underemployment are pervasive.

Figure 1.1. Iraq's gross domestic product and value of oil exports, 1997–2006

Oil exports are recovering and driving GDP growth.
(US$, billion)

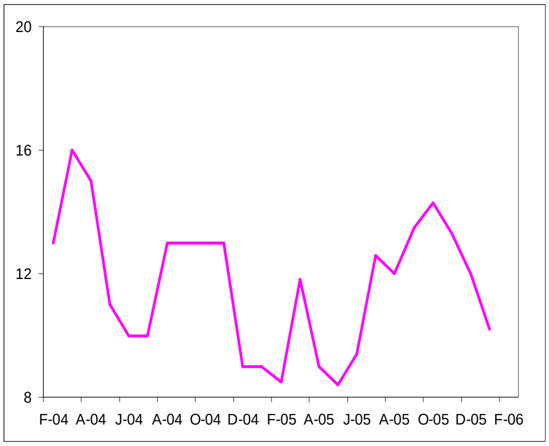


Note: Data for 2004–05 are preliminary estimates. GDP estimates are prone to significant errors, because of the multiple exchange rates and pricing regimes that existed prior to 2004.
Source: World Bank and IMF staff estimates; International Energy Agency 1999.

Figure 1.2. Vulnerability of the oil and electricity sectors in Iraq

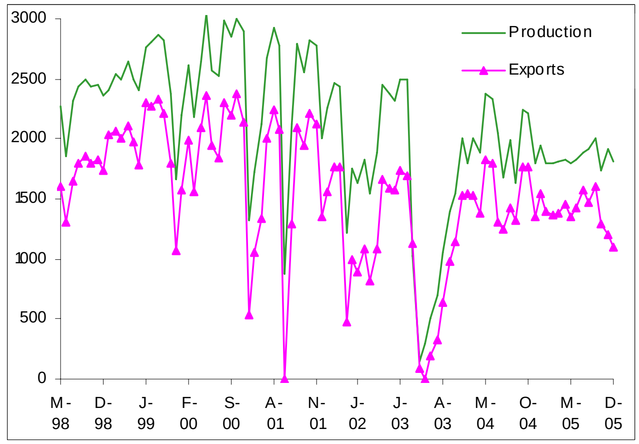
Electricity supply is inadequate…

Hours of electricity available daily



…while oil output remains below prewar levels

Thousands of barrels a day



Source: Brookings Institution, various dates; International Energy Agency 1999; World Bank staff estimates.

The state-controlled oil and gas sector dominates the Iraqi economy, accounting for about two-thirds of GDP and almost all of exports and budget receipts (excluding grants). Its recovery from the total halt in mid-2003 remains weaker than initially expected. Oil production and exports in 2004 and 2005 were at about 2 million and 1.4 million barrels per day, respectively, still below the 2000–01 levels, which themselves were about a quarter below the peak levels reached in late 1970s. Oil revenues in 2004–05 exceeded the projected levels only because of very strong world oil prices. Rundown facilities, which were starved of investment for 30 years; extensive looting in the wake of the 2003 invasion; and persistent sabotage have all hindered productivity. The short-term outlook for significant rise in oil production and exports is very uncertain. Maintaining even the current levels of production would require annual investments of $1 billion to $1.5 billion; boosting production further calls for much larger investment.

Table 1.1. Selected economic indicators for Iraq, 2002–05

	2002	2003	2004e	2005e
Economic growth and prices				
Nominal GDP (US$ million)	18,970	12,602	25,724	33,182
Of which non-oil GDP (% of GDP)	33.4	33.1	32.5	38.0
Real GDP (% change)	-7.8	-41.4	46.5	2.6
Of which non-oil GDP (% change)	0.2	-40.2	14.9	8.0
GDP per capita (US dollars)	743	479	948	1189
Oil production (million bpd)	2.01	1.29	1.84	2.20
Oil exports (million bpd)	1.29	0.90	1.38	1.70
Consumer price index (% change)	19.3	34.0	31.7	32.8
National accounts	*(percent of GDP)*			
Gross domestic investment	–	–	26.5	29.1
Of which public	–	–	22.3	25.6
Gross domestic consumption	–	–	97.1	95.4
Of which general government	–	–	56.3	59.6
Gross national savings	–	–	-10.2	14.7
Of which public	–	–	-39.1	14.6
Fiscal and oil sector accounts	*(percent of GDP)*			
Revenues and grants	–	–	80.0	93.6
Of which oil revenues	50.3	69.6	69.6	67.8
Of which foreign grants	0	0	9.2	23.2
Expenditures	–	–	120.6	104.5
Operating expenditures	–	–	98.3	78.9
Of which Public Distribution System	–	–	18.6	8.4
Of which salaries and pensions	–	–	12.1	17.7
Capital expenditures	–	–	22.3	25.6
Overall fiscal balance (including grants)	–	–	-40.5	-10.9
Overall fiscal balance (excluding grants)	–	–	-49.8	-34.1
Balance of payments	*(percent of GDP)*			
Current account balance	–	–	-36.8	-14.4
Trade balance	-0.6	0.2	-7.0	-4.9
Merchandise exports	51.2	80.0	69.1	68.7
Of which oil	50.9	67.1	67.4	66.8
Merchandise imports	51.8	79.8	76.2	73.6
Of which OFFP	–	–	13.6	5.8
Of which refined oil products	–	–	10.3	10.3
Income and services (net)	–	–	37.5	30.8
Transfers	–	–	7.8	21.4
Financial account	–	–	42.1	18.6
Foreign direct investment	–	–	0.8	0.9
Other capital (net)	–	–	41.4	17.7
Overall external balance	–	–	6.1	4.7
Financing	–	–	-25.3	-4.2
Central Bank reserves (increase -)	–	–	-24.6	-4.2
Net change in arrears (decrease -)	–	–	-135.9	-84.3
Debt forgiveness	–	–	135.2	84.3
External public debt[1]				
Estimated debt stock (US$ billion)	–	125.0	78.2	51.2
In percent of GDP	–	*992*	*304*	*154*
In percent of exports	–	*1240*	*440*	*225*

Memorandum items				
Population (millions, mid-year)	25.5	26.3	27.1	27.9
Oil prices (US$ per barrel)[2]	20.5	26	31.6	43.1
Gross reserves in months of imports	–	1.3	3.2	3.1
Exchange rate, ID per US$1 (period average)	1957	1957	1455	1467

Notes: 2004-05 data are preliminary estimates; – is not available.

1. Debt data assume full application of the first (2004) and second (2005) tranches of the Paris Club debt rescheduling agreement by the dates stipulated by the Paris Club, and of comparable treatment by other creditors, but not the third tranche of debt relief.

2. Iraqi oil blends (Basra light, Kirkuk) are traded at a discount which reflects their lower quality and frequent supply interruptions.

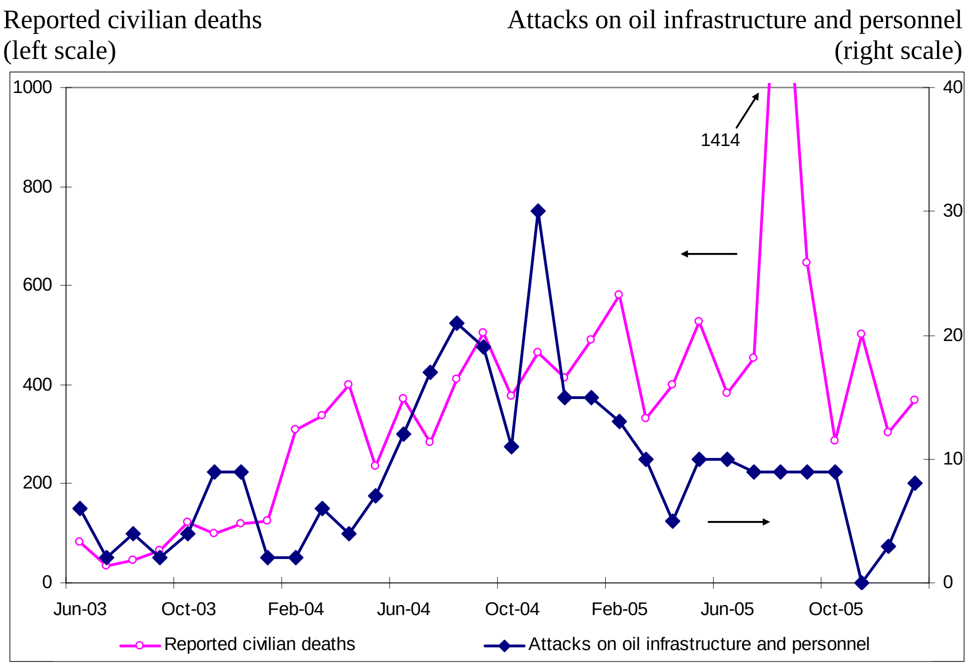
Sources: IMF and World Bank staff estimates, COSIT. Trade: UN Comtrade reported by partner countries. Oil: International Energy Agency.

Security and recovery

Rising violence continues to weigh heavily on socioeconomic revival. The incidence of conflict in Iraq in the past two decades has been three times as high as in the Middle East and North Africa region as a whole, which itself has one of the highest incidence of conflict in the world. As a result, Iraq incurred enormous losses to its social and physical capital. While formal war stopped fairly quickly, the incidence of violence has increased since late 2003 and is not abating (figure 1.3). Criminal activities (kidnappings, robberies, murders, etc.) are rampant as well. Baghdad, for example, records an average of 90 crime-related murders per 100,000 residents every month—three times higher than in most major cities in the world. Many aid organizations and private companies continue to work out of neighboring countries. While the insurgency is most intense in the centre of Iraq, attacks occur in all major cities, indicating that no part of the country is beyond the reach of hostile elements. The level of violence in Iraq remains much worse than that in postwar Afghanistan or Bosnia and Herzegovina. In Afghanistan, civilian deaths were very few after the end of the war, and cumulative foreign troop fatalities were about one-tenth of those in Iraq. Bosnia and Herzegovina saw almost no violence following the Dayton Peace Accord in December 1995 and the deployment of international peacekeepers.

Figure 1.3. Iraq's security situation, 2003–05

Violence has continued.



Source: Iraq Pipeline Watch, Iraq Body Count; and Brookings Institution, various dates.

Studies of other conflict situations indicate a strong inverse relationship between violence and economic recovery (Putnam 2000; Keefer and Knack 2001). In Bosnia and Herzegovina annual GDP growth averaged some 62 percent in the early postwar period (1996–97). GDP per capita more than doubled from $546 in 1995 to about $1,300 in 1997, and social services and school enrollment improved sharply. In Afghanistan, three years after the cessation of war, annual real GDP growth averaged about 20 percent, and per capita GDP nearly doubled (from $123 to $200). In Iraq, in contrast, oil has propelled real GDP growth to 47 percent in 2004, but in 2005 real growth slumped to less than 3 percent. Economic activity in the nonoil sectors remains weak. Violence and corruption severely disrupt trade and investment flows and eat into reconstruction spending. Donor agencies and contractors report security and insurance outlays at 25–40 percent of the total cost of works. Since early 2004, there has been an exodus of wealthy Iraqis and their capital abroad.[2] Foreign banks that had secured licenses to operate in Iraq have yet to enter the country.

Regional obstacles to recovery. Regional disparities in security affect the strength of recovery. While the Kurdish North has also seen violence in the past two years, its levels were lower than in rest of the country, and much lower than in the Central region. Not

[2] Friedrich Ebert Stiftung (2005) estimates that $2 billion of Iraqi capital entered Jordan in 2003–04; over the first eight months of 2005, another $2 billion entered Jordan. Iraqis accounted for over half of all Amman property purchases by nonresidents in 2003–05. As a result of this demand, Amman property values more than doubled over two years.

surprisingly, nonoil economic activity was consistently stronger in the three Northern governorates (Arbil, Dohuk, and Sulaimaniya) than in the rest of Iraq. As a result, median incomes in the three Northern governorates were estimated in 2004 to be 20–25 percent higher than in the rest of the country. A substantial labor migration from the Central region to the North is reported, driven by better security and higher private-sector wages.

Iraq's social fabric remains very fragile. High unemployment, widespread poverty, and weak social protection systems are some of the problems confronting the society. Although reliable data on poverty incidence and other socioeconomic trends are spotty or absent (box 1.1), surveys undertaken in 2003–04 suggest that the incidence of absolute poverty in Iraq may be as high as 10 percent.[3] Both monetary and nonmonetary aspects of poverty have increased dramatically in Iraq. As a result, over the past 20 years Iraq has moved away from the targets specified in the Millennium Development Goals (box 1.2). The number of widows and orphans, war wounded, and disabled grows by the day, the social exclusion of these large vulnerable threatens the fragile democracy and the reconstruction process. Apart from the universal Public Distribution System, formal safety nets cover less than 15 percent of the population and face an imminent funding crisis. The employment situation is precarious, with more than 2 million unemployed—almost 30 percent of the workforce (ILO 2004; COSIT 2003). Unemployment among young urban males is twice as high, and women's labor participation is low even by regional standards.

Box 1.1. Data quality issues in Iraq

Evaluating Iraq's socioeconomic trends remains complicated by the lack of data. The Center of Statistics and Information Technology (COSIT) in the Ministry of Planning and Development Cooperation is the leading government agency responsible for the production of nationwide data. COSIT has been working closely with the United Nations and other international agencies to meet the data needs of the government and the donor community. Elsewhere in the government, statistical capacity remains sparse.

Even basic data such as population is wanting in reliability and timeliness. The most recent census was held in 1997; population trends for later years are estimates. Recent surveys produced population estimates that differ by as much as 5 percent of the total. It is particularly hard to estimate the numbers of refugees, internally displaced persons, returning exiles, and other vulnerable groups. This paucity of data affects the estimation of development indicators and the Millennium Development Goals.

Information on household incomes and poverty is also scarce. Price and monetary data are reported regularly, but balance-of-payments and fiscal data remain incomplete. The coverage of COSIT's price indexes is unclear, as information from regions other than Baghdad is very unreliable. Very little information is available about the nonoil sector. Because communication with many parts of the country is very difficult, information on local economic trends is problematic.

International assistance for recovery. The international donor community mobilized to support the rebuilding of Iraq. UN Security Council Resolution 1483 (May 22, 2003) called for the international donor community to assist the people of Iraq in reconstruction. A conference of donors, meeting in Madrid in October 2003, pledged about $32 billion in

[3] Using the international poverty line of $1 per day. Iraq has neither a national poverty line nor a national report on the Millennium Development Goals. The estimates of poverty in Iraq are preliminary, as collection of poverty data is just beginning.

grants and soft loans to Iraq reconstruction. This amount included bilateral assistance programs and the donor governments' contributions to the International Reconstruction Fund Facility for Iraq (IRFFI), designed by the World Bank and the UN Development Group. IRFFI, funded in the amount of about $1 billion, not only helps donors channel their resources, but also assists the coordination of national donor programs. IRFFI encompasses two trust funds: the Iraq Trust Fund, administered by the World Bank, and the UN Development Group Iraq Trust Fund (UNDG Trust Fund), administered by the United Nations. IRFFI is reviewed every six months at the Donor Committee meetings, the most recent of which was hosted by the government of Jordan in July 2005. Reconstruction projects are identified and approved by an interministerial body, the Iraqi Strategic Review Board.

In December 2004, Iraq formally requested funding from the World Bank's International Development Association (IDA). Following detailed discussions between the Iraqi authorities and the World Bank, a strategy was developed to define the uses of an exceptional IDA allocation of $500 million. The strategy also provides the framework for additional funds channeled through the World Bank Iraq Trust Fund. The Board of Directors of the World Bank approved the strategy on September 15, 2005, and by end-2005 the first IDA project was approved. A similar strategy governs the use of the UNDG Trust Fund in 2005–07. Actual aid disbursements and their reconstruction impact have been much lower than expected, because of the extreme security risks. Security costs consume 25–30 percent of the total of reconstruction assistance.

Box 1.2. Iraq and the Millennium Development Goals

Economic dislocation has led to major deterioration in Iraq's human development indicators, many of which were superior to averages in the Middle East and North Africa region just two decades ago. No official review of Millennium Development Goals has been issued in Iraq, but the country's ability to attain most of these goals appears highly uncertain at this time.

Goal 1: Eradicate extreme poverty and hunger. Reliable data on poverty are unavailable, but estimates based on recent surveys suggest that the incidence of absolute poverty can be over 10 percent, with a further 12–15 percent of the population close to the international absolute poverty line of $1 per day. Up to 60 percent of the population is dependent on the food ration system.

Goal 2. Achieve universal primary education. By 1980, Iraq had achieved near universal primary school enrollment. Gross enrollment in primary school remains high at 102 percent. (Gross enrolment can exceed 100 percent because some children begin school early or repeat grades.) Secondary school gross enrollment, however, dropped from 47 percent to 36 percent. The attendance rate remains high at 93 percent, but is lower for girls in rural areas (86 percent). By mid-2003, some 12,000 schools were in need of repair; so far, some 3,000 schools have been rehabilitated, with repairs under way in another 1,500.

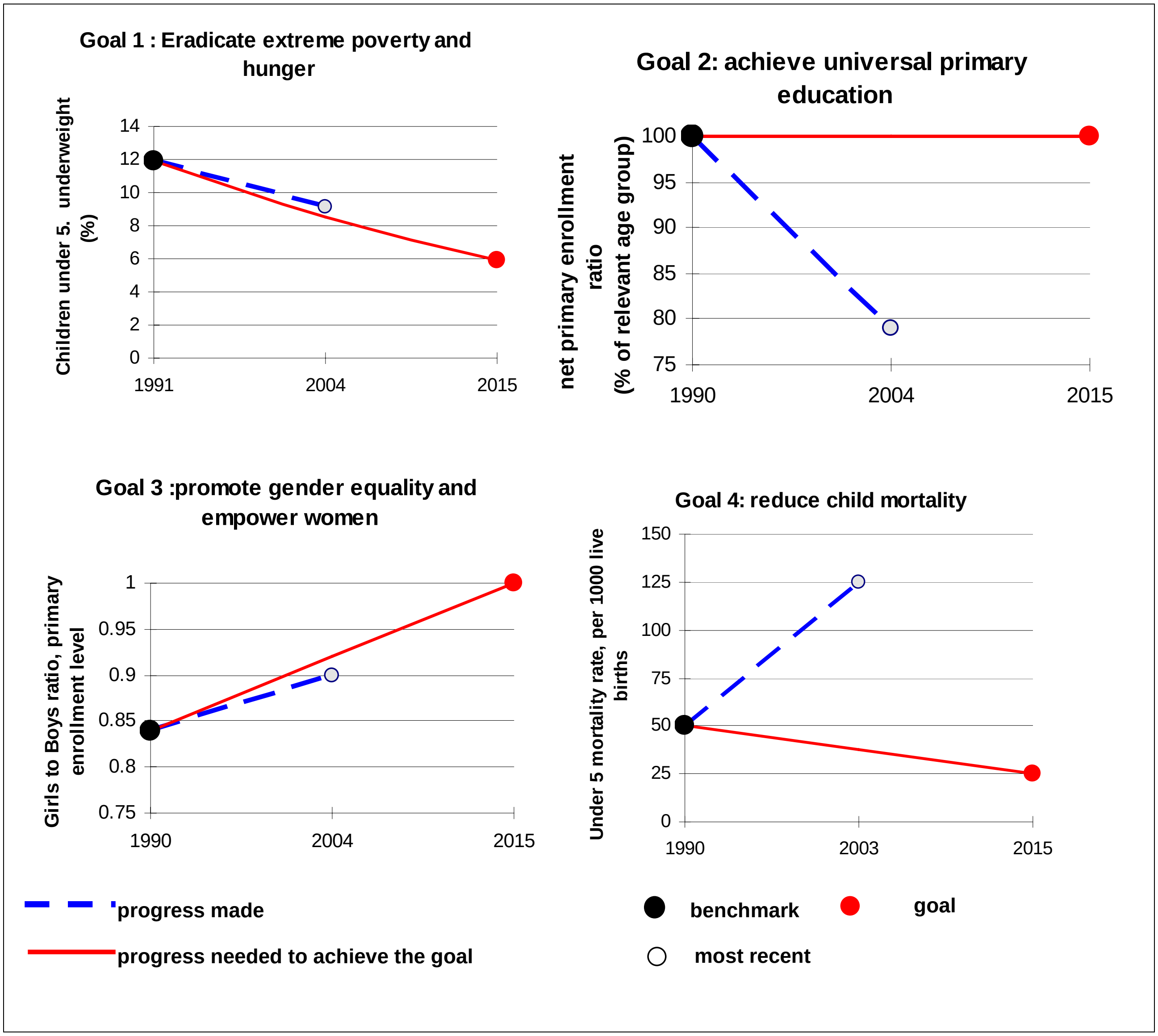
Goal 3: Promote gender equality and empower women. In 1985, Iraq's ratio of girls to boys in primary and secondary education was comparable to the Middle East and North Africa regional average of 72 percent. While the regional ratio improved steadily to reach 95 percent in 2000, Iraq's ratio only increased to 76 percent (in 1999). The ratio of young literate females (ages 15–24) to males is 50.1 percent, compared with 60 percent in Yemen, and 100.3 percent in Jordan. The gender distortion is worse in rural areas.

Goal 4: Reduce child mortality. During the 1970s and1980s, key health indicators steadily improved; since 1990, however, they have deteriorated sharply again. Mortality of children under five years old reached 115 per thousand in 2003 (33 in Jordan, 107 in Yemen) and is twice as high in the South and Central regions of the country as it is in the North. Infant mortality has increased by 2002 to 102 per thousand live births (105 in Sub-Saharan Africa). It is believed that the majority of infant deaths are due to diarrhea as a result of poor water and sewerage quality and overcrowding. The incidence of the most important vaccine-preventable disease, measles, has declined since vaccine coverage improved in the 1990s, but in the North the disease is still the third most common cause of death among children five and younger.

Goal 5: Improve maternal health. Maternal mortality is extremely high at about 300 per 100,000 live births (compared with 41 in Jordan and 350 in Yemen). The share of births delivered without trained assistance in 2000 was about 28 percent nationwide and close to 40 percent in rural areas.

Goal 6: Combat HIV/AIDS, malaria, and other diseases. Typhoid, cholera, and malaria are endemic. In the center and south of the country the situation remains critical, with 20 percent of the population at risk from lack of access to safe water and sanitation. The reported incidence of tuberculosis (at 132 per 100,000 of population) is markedly higher than in neighboring countries. Iraq is categorized as highly vulnerable to HIV/AIDS, but no reliable data are available to support this rating. The registered number of cases of HIV/AIDS is low (about 250); however, risk factors are present for increased rates of transmission.

Goal 7. Ensure environmental sustainability. Destruction and deterioration of key ecosystems and habitats, including waterways, forests, and marshlands, are widespread. Access to improved drinking water sources has declined over the past two decades and stands at 81 percent—below the regional average of 88 percent. Emissions from the rapidly growing and often obsolete vehicle fleet and open burning of solid waste cause major air pollution. Attacks on the oil infrastructure lead to oil fires and serious air pollution over vast areas. Untreated hazardous and municipal waste accumulates as a result of fighting, while no appropriate sanitary landfills exist.



Progress on policy and institutional reform

Early on, the authorities made progress on a variety of policy and institutional reforms. Most reforms undertaken in 2003–04 were concerned with new legislation and institutional changes: establishing a modern central bank; enacting commercial banking and anti–money laundering laws; liberalizing trade; promulgating laws on public finance, audit, and procurement; liberalizing bankruptcy and company laws; and establishing interministerial commissions on reconstruction, privatization, oil, and economic reform.

Fiscal and monetary policies. Upholding its independence under the 2004 law, the Central Bank of Iraq did not provide any new lending to the government. The Central Bank also successfully introduced the new Iraqi dinar in early 2004. Since then, and in line with its policy of securing exchange-rate stability, auctions were used in effect to peg the dinar's exchange rate to the U.S. dollar. Since then and until late 2005 the exchange rate premiums between the street market and the auction rates remained low. Base money grew by 117 percent in 2004, reflecting rapid remonetization of the economy. This growth, however, was largely mirrored by the accumulation of foreign exchange reserves, which were equivalent to 3.2 months of merchandise imports by end-2004. Although fiscal and monetary policies have generally been prudent, pressures on the exchange rate emerged in Spring 2005, as the daily demand for currency more than doubled, probably as a result of private-sector capital flight. The accumulation of reserves has slowed significantly.

Trade policies. Important steps have been taken to liberalize Iraq's external trade. Restrictions on trade were cancelled, and imports were subsequently subjected to a uniform reconstruction levy of 5 percent, with broad exemptions granted to imports of many humanitarian items. A national committee has been established to design a rules-based, transparent, and stable foreign trade regime that meets requirements of the World Trade Organization. These measures are intended to remove price distortions, increase competitiveness, and enhance the efficiency of the Iraqi economy. Iraq has gained an observer status in the World Trade Organization, and in December 2004 submitted a request for full membership.

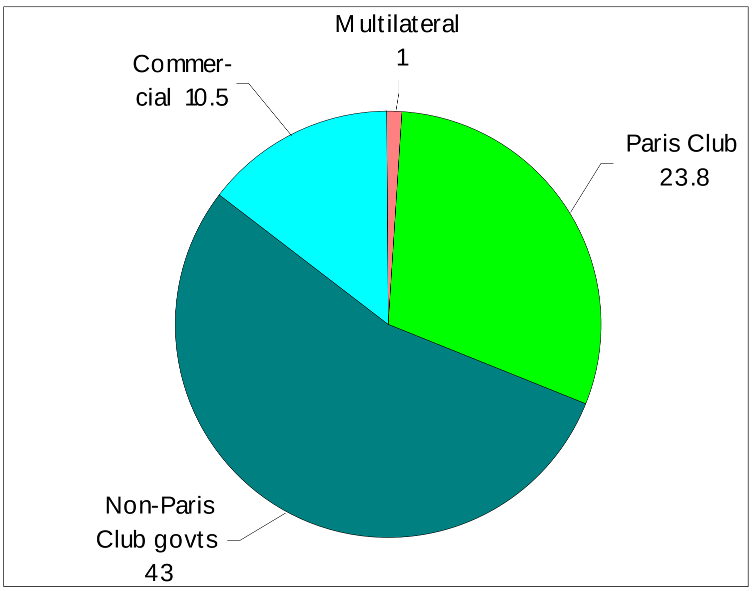
International finance and debt. Iraq is reintegrating into the international financial system. The International Monetary Fund and the World Bank determined in July 2004 that they could work with the interim Iraqi government (2004–05) as the legal government of Iraq. The Iraqi authorities moved promptly to adopt their first IMF-supported stabilization framework, the Emergency Post Conflict Assistance Program, which opened the way to the normalization of external public debt. The outlook for debt sustainability was much improved by the highly concessional debt rescheduling granted by the Paris Club in November 2004. It envisaged the write-off of 80 percent of sovereign debt in three phases: (a) an immediate cancellation of 30 percent of the debt stock; (b) a further 30 percent reduction upon approval by the IMF of a Stand-by Arrangement, which took place on December 23, 2005; and (c) a final tranche of 20 percent upon completion of the IMF Board review of the third year of the Stand-By Arrangement, expected no later than December 31, 2008. The remaining debt stock is being rescheduled over 23 years, with a 6-year grace period. By end-2005 Iraq has already signed implementation agreements with most individual Paris Club countries. It also seeks comparable treatment[4] of its debt owed to other external public and private creditors (figure 1.4). Several non–Paris Club countries have granted debt relief on terms comparable to Paris Club countries. However, progress has been very slow on renegotiating debt with GCC countries. Assessments indicate that debt sustainability would be achievable only if all three tranches of debt relief were provided in full and if

[4] This does not reflect comparable treatment of non–Paris Club debt in the first tranche of debt relief, which is conditional. If the first tranche of debt relief were applied to all bilateral and commercial debt, the end-2004 debt ratio would have declined to 306 percent. The Paris Club Agreed Minutes include a clause of "comparability of treatment," which aims to ensure a balanced treatment among all external creditors of the debtor country. According to this clause, the debtor country commits itself to seek from nonmultilateral creditors, notably other official bilateral creditor countries that are not members of the Paris Club and private creditors (mainly banks, bondholders, and suppliers), a rescheduling on comparable terms to those negotiated within the Agreed Minutes.

other creditor groups granted comparable treatment. Under an optimistic scenario for oil prices and production, Iraq's debt-to-GDP ratio will fall below 84 percent of GDP by 2010, while the ratio of debt service to exports will decline to a manageable 6–8 percent by the end of the current decade. However, should oil production plateau at 3 million barrels per day and/or oil prices weaken, the debt-to-GDP ratio will remain above 100 percent until 2010. Debt-service payments are projected to remain low—under 1 percent of GDP until 2010.

Figure 1.4. Iraq's external public debt at the end of 2004

Governments outside the Paris Club hold about half of Iraq's debt.



Note: Amounts outstanding reflect the first tranche of debt relief granted by the Paris Club in 2004 and full comparable treatment.
Source: World Bank and IMF staff estimates.

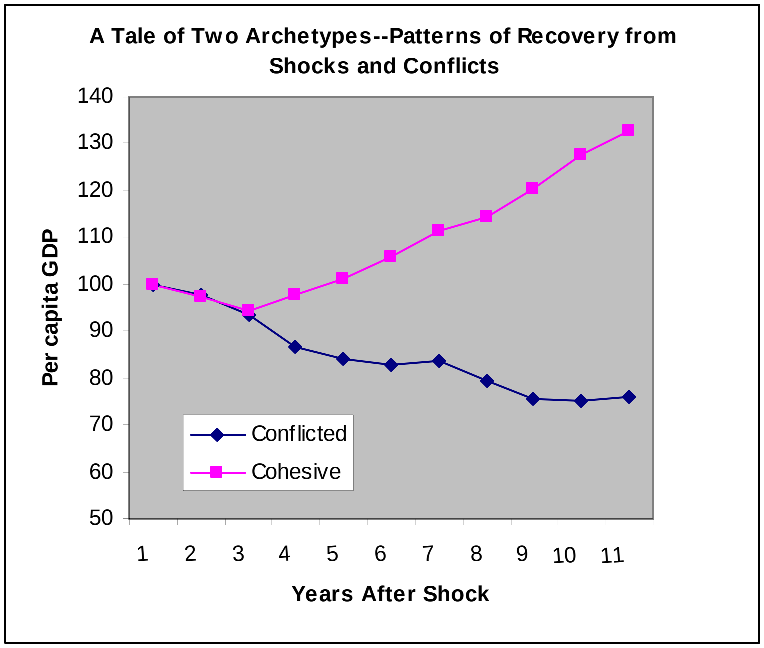
Development strategy. In October 2004 the Iraqi government presented to the donors its first National Development Strategy, which outlined long-term priorities for reconstruction and reform. The strategy document was further updated by the transitional Iraqi government in July 2005. The strategy document offers a vision of economic revival driven by private enterprise and guaranteed by a strong and transparent public sector. The strategy recognizes that the Iraqi economy could not function well if price incentives were distorted, and charts a reform of the subsidy system, supported by strong formal social safety nets to protect the poor and the vulnerable. The strategy seeks to establish a strong governance system in Iraq to foster fair and accountable institutions, with a particular focus on integrated budgets, strong public financial management, and a degree of fiscal decentralization. With regard to private enterprise, the strategy calls for an enabling investment climate, which will lower entry and exit barriers, and a strong legal and judicial system. The financial system is to be reformed to offer equitable access to finance for all businesses, public and private. The state will lead the rehabilitation of social services and infrastructure to ensure the supply of skilled labor and vital services. The strategy also discusses a course toward diversification, with decreasing dependence on oil exports. The National Development Strategy was welcomed by the international donor community, but has not gone far enough in offering meaningful sector strategies or reconstruction priorities.

Foundations of security and cohesion

Learning from other recoveries. One of the most important lessons from other postconflict episodes is that recovery hinges on the degree of cooperation and cohesion reached by the different sociopolitical groups. An analysis of the postconflict recovery paths in ten countries conducted for this study suggests that success in reconstruction depends on the degree to which social consensus emerges on the priorities and tradeoffs of the reform process (figure 1.5). The analysis identified two archetypes of postconflict evolution: (a) countries that manage to achieve reasonable cohesion and cooperation through domestic and external political bargaining, which produces sustained economic and social progress and (b) countries that remain mired in deep divisions and are thus unable to make headway for extended periods of time. Over the first postconflict decade, countries that develop a cohesive reform strategy outperform those that are unable to develop such a consensus by about 50 percent in terms of GDP per capita.

Figure 1.5. Patterns of recovery from shocks and conflicts

Countries with a cohesive postconflict strategy outperform those unable to develop consensus.



Note: Trends are based on the experience of ten countries: Algeria, Angola, Bangladesh, Bosnia and Herzegovina, Bulgaria, Hungary, Korea, Indonesia, Iran, and Jordan.
Source: World Bank staff estimates.

Rodrik (1999) arrives at a more generalized conclusion from the examination of growth experience in a larger sample of countries during 1960–89. His study suggests that many parts of the world, especially in Latin America, the Middle East, and Sub-Saharan Africa, have suffered large collapses in long-term growth when faced with shocks or conflicts, because they lacked internal institutions or settings to resolve the distributional conflicts that such shocks gave rise to. He suggests that "when social divisions run deep and institutions of conflict management are weak, the economic costs [of shocks from conflict-] are magnified by the distributional costs that are triggered"(p. 385). There is little doubt that such risks are currently high in Iraq. Yet, many countries with cleavages along lines of wealth, ethnic identity, geographic region, and other divisions have done very well in post-conflict situations—a trend most clearly evident earlier in East Asia (Indonesia, Korea, Malaysia, Singapore) and in more recent settings elsewhere in South Asia (Sri Lanka), Latin America (El Salvador, Guatemala), and Eastern Europe (Bosnia-Herzegovina). Two main lessons emerge. First, citizens, groups, and their political representatives can make a striking difference to their welfare and those of their children by showing a greater willingness to work out a cohesive approach to the future. Second, this effort of cohesion needs to be reinforced by clear objectives and a supporting framework of government policies. Both lessons are eminently feasible to implement and will deliver rapid recovery in economic and social conditions. Much will depend on the ability of the Iraqis themselves to fashion such a prospect.

Restoring law and order. In any conflict situation, the most critical condition for economic recovery is the end of violence and insecurity. In the case of Iraq, the two main strategies for ending violence and insecurity are: (a) building up the internal security and law enforcement institutions, so that the government is able to uphold law and order and (b) strengthening a representative form of government, so that differences are resolved through debate, representation, and contest in the political sphere, rather than in violent political conflict and confrontation. In both of these respects, progress is being achieved, with the enlargement and training of the Iraqi national security forces and with two rounds of national elections and the constitutional referendum in 2005. The immediate and critical task is to reintegrate combatants into the civil society. Successful postconflict experiences (Bosnia and Herzegovina, El Salvador, Guatemala) indicate that essential steps include providing ample civilian jobs, training, and social and economic opportunities for former combatants (as well as disarming them). The development consequences of these actions can be enormously positive, but they are expensive to design and implement. Finding the mechanisms to stop the violence in the specific circumstances of Iraq is a difficult challenge, but one that needs to be met.

A representative political system that gives a voice to all stakeholders in the society allows grievances to be resolved through negotiations and contestable elections. This task acquires particular importance in resource-rich economies, where the potential or actual flows of revenue from abundant natural resources can transform the political process into a competition for access to that revenue. In countries as diverse as Angola, Colombia, Indonesia, Nigeria, and Venezuela, natural wealth was the most powerful driver of conflict. Working out a political solution and ensuring the restoration of law and order are thus the highest priorities. Without achieving these markers of social cohesion, reconstruction and development will not happen. Sustainable political solutions demand the transparent management of national wealth. Corruption and the lack of accountability will fracture political stability and doom reconstruction.

The three main challenges ahead

Assuming that the process of reversing the violence gains credibility and restores the basic functions of representative government, the reconstruction of Iraq is likely to be shaped by three main challenges:

- *Generating growth and employment.* Key objectives for the recovery are reconstructing war-ravaged infrastructure, laying the economic foundations to generate faster and more efficient economic growth in all sectors, and giving Iraqi citizens access to an increasing number of productive jobs. Specific reforms to meet these objectives include improving the price and incentive systems, liberalizing trade, and strengthening labor market policies. The goal is to achieve an economic transformation from state domination to private entrepreneurship, from a closed to open economy, and from oil dependence to diversification.

- *Protecting the poor and the vulnerable.* Another major objective for the recovery is ensuring that poor and vulnerable social groups have access to vital services and to gainful employment opportunities. Specific reforms include shifting from universal and untargeted subsidies to strong formal safety nets, thus ensuring social safety for the poor and vulnerable and dealing with the costs of economic transition as prices are freed. Many victims of conflicts and postconflict tensions will not regain full productivity and will crucially depend on some form of social support. Opening up the economy is already hurting the poor and needs to be mitigated by efficient and targeted safety nets, as well as reform of old pension system.

- *Improving public management and accountability.* The recovery also depends critically on building more accountable institutions and transparent management of public resources, especially oil. These reforms will amount to a transition from closed to open and accountable public finances. Another important aspect of improving public management focuses on delivering public services more efficiently and responsively. These reforms signify a transition from top-down to more decentralized and participatory public services delivery and institutions.

All three challenges need to be met simultaneously to ensure that an increasing majority of citizens share in a vision of a just and prosperous Iraq and to permit the government to undertake an ambitious transition program that lies ahead.

Redefining the role of the state

Meeting each of these three challenges requires a departure from previous role of the state in Iraq. The government will remain central to the reconstruction task, but substantively its role is likely to be very different from what is was in the past or from what is traditional for many Middle Eastern and North African countries. In the first postconflict stage the state plays the crucial role in creating jobs, rebuilding the human and physical capital of the country, and restoring population's access to vital services. In the long term, however, the state-led model cannot provide sufficient economic dynamism and job creation. In economies as diverse as Chile, China, India, and Russia, the state's role has evolved over the past 20 years to providing only essential public goods (of which law and security are the key ones), fostering a transparent and predictable business climate, and stamping out corruption. In postconflict environments as diverse as South Korea in the 1950s, Vietnam in the 1980s, and Bosnia and Herzegovina in late 1990s, most of the new jobs were created by private entrepreneurs.

The rest of this report discusses actions that Iraqi authorities may wish to consider in addressing the three reconstruction challenges. Chapters 2 and 3 propose ways to generate growth and employment. Chapter 2 discusses the immediate challenge of reviving the economy and creating more jobs, and chapter 3 considers the realignment of economic incentives and the pricing system. In examining how to best protect the poor and the vulnerable during recovery, chapter 4 addresses the issues of strengthening formal social protection and reforming the pension system. Then chapters 5 and 6 investigate options for improving public management and accountability. Chapter 5 discusses the investment regime and oil revenue management. Chapter 6 examines overarching public governance concerns, including public finance and human resource management, intergovernmental fiscal relations, and anticorruption efforts.

The pace and sequence of reform actions will need to be considered carefully. All postconflict societies are by definition fragile, and achieving social consensus in support of the reform program is essential for its success. Incentive reforms to change prices need to be expertly calibrated: some reforms are likely to proceed faster than others, so as to achieve quick returns while not hurting the socially vulnerable groups before adequate safety nets have been established. Actions to strengthen safety nets must take into account their short- and long-term costs, so as to maintain fiscal sustainability—a particularly vital concern for the high-debt situation Iraq finds itself in today. Effective public resource management is also central to delivering and prioritizing key social and infrastructural services. The menu of actions will obviously need to be tailored carefully to Iraq's unique situation and circumstances.

Part I. Generating growth and employment

Chapter 2. Creating jobs and rebuilding services

Iraq's reconstruction needs are enormous and are likely to generate massive labor demand. Reconstruction is driven by the need to rebuild the country's depleted physical and social capital. Thirty years ago, Iraq led the Middle East and North Africa region in social development indicators; since then many of these indicators have declined to the levels characteristic for the low-income countries. Access to infrastructure services is nominally high (e. g., almost universal connection to the national electricity grid; 83 percent access to an improved water source), but the quality of these services has declined dramatically in the past decade. In 2004, 85 percent of households had unstable electricity supply—the national grid supplies 3–6 hours of electricity daily. A mere 20 percent of households have safe and stable drinking water.

While reconstruction and associated public-sector jobs are important in the initial phase of Iraq's recovery, they will not create a sufficient number of jobs to meet the population's needs in the long term, even if recovery is on a massive scale. The private-sector job engine must be engaged to meet the demand, and it needs equal prominence from the beginning. Many countries in Middle East and North Africa region and elsewhere in the world tried to create jobs by applying a statist industrial strategy. This was the case of Iraq in the 1970s. In the long run, the experiences have been disappointing. Instead, a successful growth model must equally rely on the entrepreneurial talents of the nation and on the state as the provider of key public goods, such as the rule of law, the appropriate regime for trade and investment, and the safeguards of strong social safety nets.

Labor market conditions and outlook

Iraq has a high population growth rate, a very young population, and a substantial growth rate for its labor force—2.4 percent per year. Every year, 170,000 new workers enter the labor market (ILO 2004).[5] The outlook is for continued rapid growth of labor supply: population growth will remain high, as declines in fertility are likely to be offset by the much-awaited improvements in maternal and children's health. In this respect, some of the features of Iraq's labor market are similar to other labor-abundant Middle East and North Africa countries, such as Algeria, Iran, and Syria. Some lessons learned by these countries could apply to Iraq.

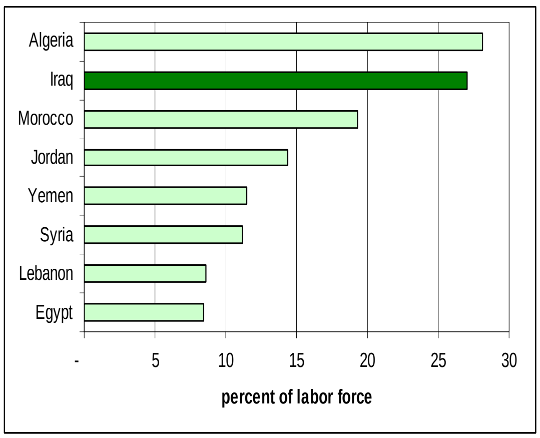
The demand for labor is currently too low to absorb all new entrants and the existing unemployed. Conflicts and economic decline have destroyed vast number of jobs in both formal and informal sectors.[6] Already before the 2003 invasion, employment in large and

[5] These numbers appear low, given the estimated annual population growth of 2.8 percent. If the population growth rate is correct, the number of new jobseekers could be closer to 200,000 a year.
[6] The formal sector is characterized by a formal relationship between the employer and employee, typified by the latter's access to social insurance (pensions, unemployment insurance, severance schemes). The informal sector comprises vast number of jobs in which workers do not have access to social insurance and

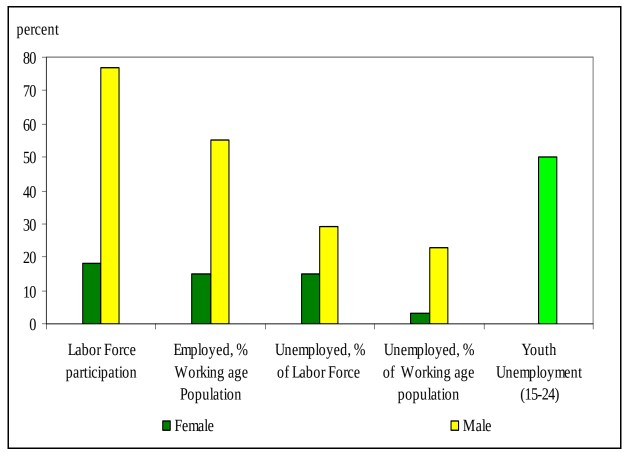
medium enterprises was about one-third less than in 1985–89. As for the small (family-based) enterprises, the Iraqi Federation of Industries, which unites small artisan-type family firms, reported in 2004–05 that out of some 30,000 members barely 4,000 were active. As a result, Iraq has one of the highest unemployment rates in the region—close to 30 percent (figure 2.1). Among the urban youth, more than half are unemployed. Iraq also has very high underemployment (over 23 percent); its female labor participation rate (13 percent) is low even by Middle East and North Africa standards.

Figure 2.1. Unemployment in Iraq, 2004

Iraq's unemployment is among the highest in the region…



…and Iraqi youth is the most vulnerable to it.



Source: ILO (2004); World Bank staff estimates.

Analysis of other episodes of conflict indicates a very strong reciprocal relationship between the lack of security and high unemployment (World Bank 1998 and 2003b). Although 25 years of conflict and isolation have greatly exacerbated Iraq's labor problems, their roots lie deeper, and are similar to Middle East and North Africa countries unaffected by conflict. These problems are captured by three contrasts: (a) between the oil sector and the rest of the economy; (b) between the private and public sectors; and (c) between job opportunities for men and women.

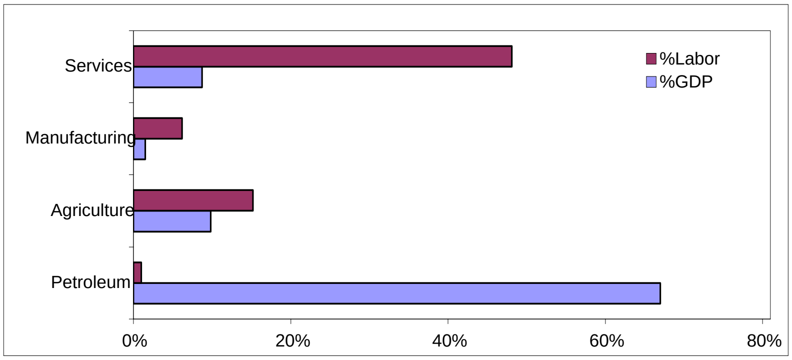
The oil sector versus the rest of the economy

Oil generates less than 1 percent of demand for labor in Iraq (figure 2.2). Like any petroleum-based economy, Iraq faces the challenge of using its oil wealth to foster growth and job creation in downstream sectors. In the 1970s and 1980s Iraq's state-led diversification was well advanced, but most downstream enterprises could function only by relying on massive input subsidies, artificially high output prices, and hyper-protectionist barriers. In the 1990s, even this artificial diversification waned: currently, the petroleum sector accounts for about two-thirds of GDP.

are in temporary or unstable relationships with employers, which are often small or medium enterprises. Many non-OECD economies have much larger informal than formal employment sectors.

Figure 2.2. Iraq's labor market, 2004

Employment by sector and structure of GDP by sector.
(percent)



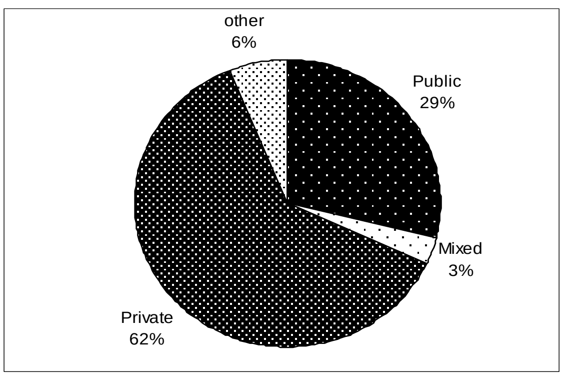
Source: Ministry of Planning and Development Cooperation/UNDP 2005; and World Bank and IMF staff estimates.

The public sector versus the private sector

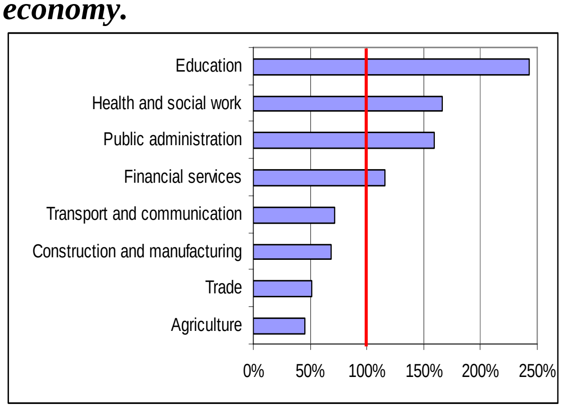
The current state of the labor market documents the difficulties of reconstruction stifled by insecurity and institutional weaknesses (figure 2.3). Security costs have eaten into the government investment budget.[7] Foreign aid moved much slower than originally expected. Private enterprise is also hampered by conflict, and most of its demand for jobs lies in the informal sector. These jobs are very low-paid and carry no social protection (box 2.1).

Figure 2.3. Iraq's employment and hourly wages, 2004

Most jobs are created in the private sector…



…but its wages are the lowest in the economy.



Percentage of median hourly wage

[7] Reports indicate that actual investment spending in 2004–05 was well below the budgeted levels in many sectors. However, this needs to be validated, as the quality of budgetary reports is weak.

Note: Breakdown of wages by firm ownership is not available. It is approximated by sectoral distribution: public administration and social services are in the public sector; agriculture, trade, construction, and manufacturing are of either private or mixed ownership. "Other" is unspecified.
Source: Ministry of Planning and Development Cooperation/UNDP 2005

Box 2.1. The informal sector in Iraq

Since late 1980s, Iraqi households had increasingly relied on the informal sector to cope with economic hardships caused by the Iran-Iraq war, the first Gulf War, and economic sanctions. The number of Iraqis seeking additional income from informal economic activities grew so quickly that in 1989 the Iraqi Council of Ministers convened three times to discuss the issue of state employees working "outside the official working hours."

Today, the economic condition of households has improved, and public sector salaries have risen dramatically compared to the pre-2003 period, benefiting about 1 million employees and their families and increasing consumption spending. However, unemployment remains very high. Security concerns continue to stifle private investment, both domestic and foreign, and prevent market mechanisms from playing their anticipated role. Slow job creation in the public sector, and the inability of the formal private sector to absorb all surplus labor combined with rapid population growth produce a pool of workers who can find employment only in the country's expanding informal economy.
A World Bank study of the informal economy in 110 countries (Schneider 2002) found that the average size of the informal economy as a share of official GNI in 2000 was 41 percent. Such estimates are arrived at by measuring inconsistencies in the national accounts (for example, the difference between actual and expected currency holdings; or using electricity consumption as a proxy for actual GDP level). Data gaps in Iraq are massive (see box 1.1) and do not even allow the approximate evaluation of the size of the informal sector. In assessing the current state of the informal economy in Iraq, we can rely only on anecdotal evidence.

Iraq's current economic difficulties are typical for conflict-torn countries. Economic agents pursue multiple strategies to cope with hardship and diversify their sources of income. Schneider and Enste (2002) show that the informal economy encompasses a number of activities with different degrees of sophistication and criminality. The informal sector offers both legitimate and illegitimate income opportunities. Legitimate ones are derived from pursuing economic activities similar to those in the formal sector, such as flea markets, street selling of small quantity goods, small scale food production, transport, and repair and recovery services. Illegitimate activities comprise smuggling, corruption, kidnapping for ransom, extortion, and larceny. Present-day Iraq is rife with both types of activities.

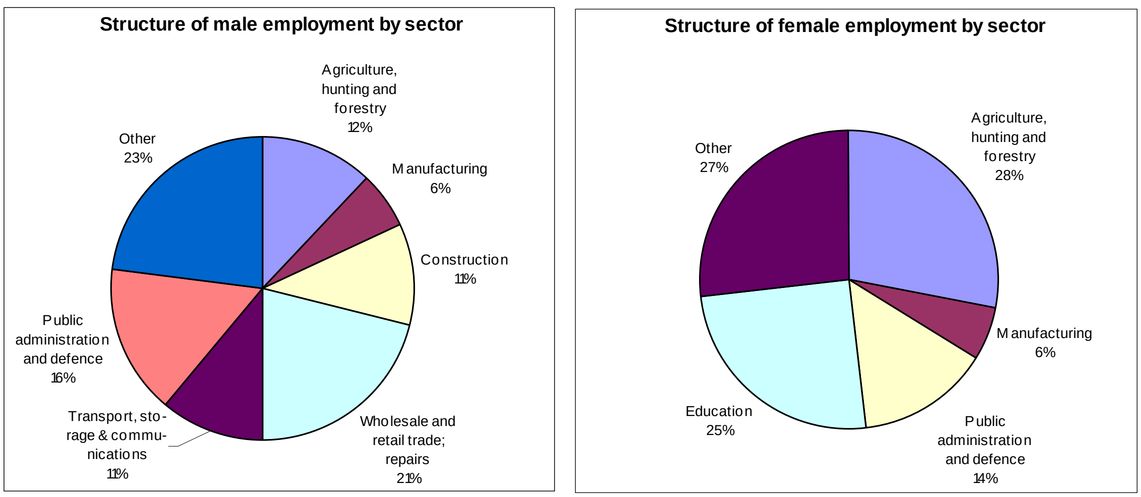
Given typically high risk levels, informal economic activities are not necessarily rewarding and may actually deepen the poverty trap (Morrisson 1991). Nevertheless, the informal economy remains a major job engine in Iraq, and for many Iraqis, it is the only chance for survival. Informal activities provide the vulnerable with at least some income opportunities where formal mechanisms remain paralyzed by conflict.

Once the security improves and more jobs are created in construction, services, and public administration, the public sector's demand for labor will likely grow. Simultaneously, reconstruction will fuel job creation in the private sector, first in construction and services, and then in broader range of sectors, including downstream industries. Long-term efficiency considerations require that industrial restructuring remains compatible with the pricing system reforms and open trade regime that now exists in Iraq. Long-term development prospects will suffer if attempts are made to revive the industrial behemoths of the past that could function only behind the hyper-protectionist barriers.

Men's jobs versus women's jobs

Another contrast in the Iraqi job market is its gender gap. The pool of female jobs is much smaller and less diverse than jobs available to men. Two features that stand out are the prevalence of female workers in education and a large share of female jobs in agriculture. In education women predominate in absolute terms, filling 60 percent of all positions. In only three other sectors is women's share above the 17 percent average—agriculture, health, and social and financial intermediation (32–38 percent of the total). Of these three sectors, only agriculture is a fairly large employer of women (figure 2.4).

Figure 2.4. Employment by sector and gender, 2004



Source: Ministry of Planning and Development Cooperation/UNDP 2005.

Prospects for employment growth

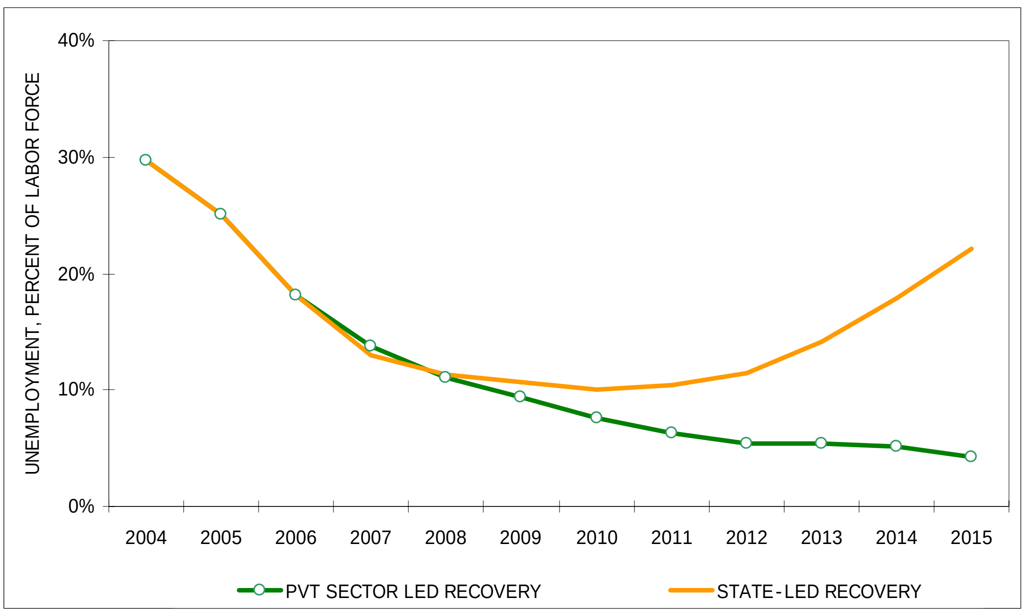
The outlook for the Iraqi labor market depends on the growth paradigm it follows. The short-term prospects are clearer: once the reconstruction process gets under way, demand will surge for both skilled and unskilled labor for rebuilding infrastructure, social services, and the like. Much of what needs to be done in these first years will have to be initiated by the state. Experience of other countries demonstrates, however, that beyond the first five to eight years, labor-market outcomes are likely to diverge:

- Some labor-abundant countries choose to maintain the leading role of the state in investment and service delivery (e. g., Egypt, Venezuela). Almost all of them face decelerating growth outcomes and stubborn unemployment problems. Large public sectors provide quality employment for the lucky few; but they also crowd out private investment. In some cases (such as Bosnia and Herzegovina), privatization progressed, but the state was less successful in addressing efficiency and accountability concerns, which stifled the private-sector response.

- Other countries used the early reconstruction years to establish a facilitating regime for private enterprise and then moved to gradually reduce the state's role in the productive sectors, relying increasingly on public-private partnerships (e. g., Chile, Indonesia). In these countries private businesses proliferated and pulled into the labor force large numbers of unemployed and part-time workers.

Analytical scenarios for the Iraqi labor market were formulated for this study. The findings of this analysis are summarized in figure 2.5. The first reconstruction years (2005–08) are similar under either scenario, as large public resources are channeled into public goods provision. In the later years, however, the state-led model is likely to encounter the problem of declining efficiency. In contrast, if the government supplements large public works program with early action to create a credible, transparent, and supportive environment for its private entrepreneurs, the private sector's demand for labor will grow very fast and absorb large numbers of unemployed.

Figure 2.5. Unemployment scenarios for private-sector and state-led recoveries



Source: World Bank staff estimates.

Jobs, investment, and diversification

Job creation is primarily driven by investment—typically by a mix of public and private investment. In Iraq, this presents four challenges:

- The need to strengthen public-sector investment, particularly to avoid the "resource curse"—distortions that often accompany public investment and that were so typical for Iraq in the past
- The need to address the problems of the state-owned enterprise sector
- The need to develop quickly significant levels of private investment

- The need over the long term to encourage investment and diversification through a strong and competitive industrial sector.

Strengthening public-sector investment

Efficient management of public-sector investment is critical in promoting economic growth and employment (box 2.2). An examination of other Middle East and North Africa counties, which were spared by conflicts, but embraced the same state-led development model, reveals problems similar to those of Iraq: declining productivity, massive hidden unemployment, rising workers' insecurity, and undermined public finances. For example, in the 1990s Iraqi enterprises were shut off from their export markets and were shedding labor. Even the remaining employment rolls were overstaffed significantly,[8] while the public-sector productivity was eroding fast. Such overstaffing is not unique to Iraq—public sectors of most Middle East and North Africa countries face the same problem. Recent estimates put labor redundancies in public enterprises at about 35 percent in Egypt and nearly 40 percent in Jordan (Ruppert Bulmer 2002). All of these problems were typical for the socialist model as well, which had much in common with Iraq's development path. Even in Western Europe labor encountered a similar dilemma: policies intended to provide economic security for organized labor, to enhance human capital, and to promote socially responsible development have eventually become a source of economic insecurity.

Even under the private–sector–led development model and beyond the reconstruction years, government will remain an important provider of formal-sector employment in Iraq. However, the government's role in the economy needs to be redefined from being the primary employer to a partner in creating and sustaining opportunities for employment. A vital state role in improving social services—especially health, education, and social security—is essential to establishing the conditions that will permit workers to thrive and economies to grow at competitive rates.

Box 2.2. The resource curse

All oil-exporting countries use mineral wealth to spur growth and job creation in the nonoil sector. The state captures most oil revenues and typically plays a central role in this process. In the Middle East and North Africa region, this state-led development model was embraced by many resource-poor countries as well. The model, which is defined in a recent World Bank study as "interventionist–redistributive" (World Bank 2004d), can be characterized by (a) a preference for redistribution and equity in economic and social policy; (b) a preference for states over markets in managing national economies and in providing welfare and social services; and (c) the adoption of import-substitution industrialization and the protection of local markets from global competition. During the 1980s, this Middle East and North Africa development model delivered some of the highest growth rates in the world (3.7 percent per capita a year), low-income inequality, and dramatic improvements in human development indicators. Iraq was at the forefront of these gains, leading the region in many human development indicators.

The collapse of oil prices in the mid-1980s has made the interventionist development model unaffordable. In the late 1980s, a growing number of Middle East and North Africa states recognized that it was not

[8] Recent state-owned enterprise appraisals suggest that a large number of their staff positions are redundant (DFID 2004).

performing and opted for restructuring. Iraq, however, moved in the opposite direction: wars and international isolation provided the former regime with a justification to tighten the interventionist grip further. It came at a price of rapid increases in public debt and declining productivity in most sectors of the economy.

Reducing wage (and benefits) premiums in the public sector will help to improve the competitiveness of the private sector for skilled labor. It would be more efficient if wages in the public sector are set in line with productivity and not merely according to education credentials and years of service. Recruitment to public-sector jobs must also be based on an appraisal of future performance. Better conditions of work in small and medium enterprises, side by side with their growth, are needed in order to create more formal-sector employment and thus give more balance to the labor market.

Reforming state-owned enterprises

Iraq faces specific challenges with regard to jobs in its state-owned enterprises. With over 500,000 workers on the payroll, state-owned enterprises are a major source of employment. Yet, appraisals undertaken in 2004 suggest that many of these enterprises are grossly overstaffed (DFID 2004). The challenge for state-owned enterprises is to find their way to being profitable in a liberalized Iraqi economy, which welcomes foreign investment and imposes a very low level of import duties. The outlook will differ for the two big groups of state-owned enterprises. The utilities, which produce nontradable goods and services, are more difficult to restructure, because of their critical role in supporting the rest of the economy and the welfare of households. The state-owned enterprises involved in tradable goods, however, cannot be immune from competition and will need to be restructured soon. Protecting them by reviving the previous protectionist regime would only hamper long-term growth prospects. A number of state-owned enterprises, for example in the petrochemical sector, can, with sufficient financing for rehabilitation, potentially be profitable even with inputs priced at world market levels. Chapter 3 provides more detailed analysis of a trade policy regime that could ensure optimal growth outcomes.

Promoting private-sector investment

The National Development Strategy envisages the private sector becoming the prime job generator in Iraq. A shift from the public to the private sector as the main engine of growth and employment requires more than the realignment of price incentives. For private enterprise to be able to offer a sufficient number of jobs for the Iraqi population, it must generate investment through a strong enabling investment climate. To create more jobs, private-sector employers need clear property rights, a regulatory framework, and low entry and exit barriers. Strong public-sector governance is essential: corruption drives many private firms into the grey economy and discourages possibly even a greater number of entrepreneurs from launching their own business. Private entrepreneurs also need access to finance: at present, Iraqi state-owned banks are stalled, while small local private banks do not have sufficient capital to handle the risks of lending to the emerging private sector.

A number of Middle East and North Africa countries have tried, with a varying degree of success, to facilitate the development of national enterprise. In most cases the share of value added in the private sector increased only marginally in the 1990s, with the same unfortunate pattern characterizing the share of the private sector in total investment. This disappointing outcome is explained by the limited progress in making the investment climate more accommodative. Barriers to entry, in the time and cost of administrative approvals, remain quite high. Access to finance is still very limited. Regulations do not facilitate the restructuring of businesses that are still viable, whereas nonviable firms are not permitted to close operations expeditiously, thereby raising the social and economic costs of bankruptcy. The judicial system is slow, and enforcement is unpredictable.
Businesses also suffer from weaknesses in the financial system and in the administration of licensing, regulations, taxes, and import duties. Furthermore, weaknesses in telecommunications and transport infrastructure greatly impede business activity and investment. In all of these areas, Iraq has made important first steps, primarily in adopting business-friendly legislation. But much remains to be done.

Reconstruction flows present an enormous opportunity to develop the private sector. For the Iraqi entrepreneurs to benefit fully from the reconstruction drive, efforts are needed to foster business skills, entrepreneurial development, and business associations. Bureaucracies will 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 ensure that they not only serve genuine needs, but are seen to do so. A focus on institution building would reflect investors' various needs. They need to know their property rights are 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 institution building is important particularly in postconflict 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, work can begin in this area now. As the experience in West Bank and Gaza shows, institutional reform can be initiated and continue even in the most hostile environments.

Another promising area now is the potential of small and medium enterprises to generate jobs. Assistance with moving the unemployed into self-employment can be very effective. Help can be given in setting up business plans and in securing credit. In addition, industrial estates can be set up to provide infrastructure and other facilities to small enterprises. Much of what constitutes support to small enterprises dovetails with encouraging competition in product and financial markets. Labor legislation (minimum wage, health, and safety regulations and other regulations on business registration, zoning, etc.) must be applied intelligently to small enterprises, neither forcing firms out of business nor condoning hazardous or underpaid employment.[9]

The UN-World Bank Joint Needs Assessment noted the existence of micro lending programs in southern Iraq that could be expanded, and the assessment proposed the

[9] The new Iraqi Labor Code raises the possibility of slightly different legislative approaches for companies with fewer than 15 regular employees.

establishment of a credit facility for small and medium enterprises. This could be particularly effective in major cities. As an example, it might aim to support subcontracting between larger and smaller enterprises, especially in diversifying oil-related activities and in raising value added in agricultural processing. An immediate possibility would be to link credit programs for small business explicitly to new job creation. Much can be done to assist small businesses by encouraging them to associate freely and express their common concerns, by supplying information on market trends, or by liberalizing markets and thus making such trends transparent.

The key priority is to strengthen critical institutions that support the private sector. At present the authorities' attention is drawn to business constraints, such as the weak infrastructure, financial system, and security. What is less obvious is that the necessary institutional underpinnings for a strong private sector are also very weak. The building blocks of a competitive investment framework include:

- Creating a commercial legal and regulatory regime.
- Building the institutional capacity of the public sector.
- Strengthening the private sector's institutional capacity.
- Increasing the capacity of businesses to access markets for trade and investment.
- Developing the framework for regional economic development institutions.
- Revitalizing the infrastructure to facilitate trade by addressing key bottlenecks, such as customs administration.

A multiphased approach is required. The first phase would support specific priority areas with the following type of support: (a) a business plan for the institution, which deals with strategy and direction, organizational issues, resource and training needs, and sustainability questions; (b) guidance and training on operating processes; (c) support for feasibility studies on initiatives; (d) seed financing for initial initiatives; and (e) draft enabling regulations. The second phase would apply the lessons learned from the first phase to a much wider array of institutions (competition authorities, customs administrations, nongovernmental organizations, industry associations, and the like). This follow up would also provide a second round of support for the first-phase activities.

A considerable amount of effort already seeks to encourage Iraqi private-sector involvement in reconstruction. Nevertheless, more could be done, particularly in regard to the flows that the government is managing itself. What's needed is to build a strong procurement system for both internally developed and internationally provided flows, so as to encourage Iraqi private-sector participation. The proposed economic development zones 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 on a countrywide scale, development zones will encourage focused resolution of these issues.

Iraq needs a public awareness campaign on the benefits of a strong private sector in meeting the challenges of generating jobs, diversifying the economy, and sustaining growth. In Iraq, a strongly held philosophy, shared with some Middle East and North

Africa neighbors, views public investment as sufficient to meet these challenges and sees foreign investment as a major challenge to sovereignty. Iraq's huge reconstruction needs will clearly absorb all the public investment funds available; broader growth and job creation can be ensured only if private enterprise is engaged fully.

Finally, implementation capacity is required. Energizing the private sector will require a significant effort, including—as an essential matter—close attention from the senior leadership of Iraq. Many of the agenda items will require coordination across ministries. The final recommendation therefore is the establishment of an interministerial working group on the investment climate, to coordinate with other aspects of economic reform and act as a bridge to the infrastructure and financial sectors.

Encouraging investment and diversification

Openness to trade and export diversification is critical for enhancing the efficiency of investment in an oil-exporting country. Otherwise, there is a risk that high public spending to expand infrastructure and employment will recreate a closed economy riddled with high inflation and exchange-rate distortions. Under this scenario, the existing polarities in the Iraqi economy and labor market will only become sharper. A small group of mineral–resource–based industries will integrate successfully into the global economy, providing quality jobs to the privileged few, while the majority of the nation will remain in the informal sector, with low skills and low pay (Taylor 2002).

Iraq has a new foundation on which it can recreate a diversified economy. The challenge, however, is to do it on a firm basis, by investing in vital social services and infrastructure; improving the quality of human capital; and maintaining a regime supportive of private investment and foreign direct investment. The losses from recreating a rent-seeking environment with massively distorted prices, which existed under the previous regime, could be massive.

Integration into the global economy through the World Trade Organization and open regional trade agreements can give a strong impetus to export diversification. Evidence for other developing regions suggests that trade agreements can have a positive and significant impact on export variety in sectors such as textiles and garments, wood and paper, machinery, and transport. Chapter 3 discusses these issues in greater detail.

Foreign investors can be a source of developing export potential and value added in oil-exporting countries. In Mexico, foreign companies generate nearly two thirds of manufactured exports (UNCTAD 2002). In addition to capital, technology, and managerial know how, transnational corporations also provide enhanced access to global, regional, and national markets. Value added is increasingly being created as multinational corporations build long-term direct supply relationships with locally owned producers, rather than extracting local resources into foreign-owned production, transport, and distribution facilities. Local firms also gain from the presence of export-oriented affiliates by copying their operations, employing staff trained by foreign companies, and benefiting from improvements in infrastructure.

Policies to promote the benefits of foreign investment are particularly important for oil-dependent economies and are essentially policies to strengthen the investment climate. The introduction of a flat, uniform tax for corporate and personal income and a value-added tax, together with elimination of customs duties and speeding up of customs procedures, can greatly enhance the benefits to firms for becoming involved in international trade. The investment climate also improves by removing restrictions and approval requirements for foreign investors and relying on domestic legislation to govern all investment, without distinguishing between foreign and domestic investors. Avoiding the targeting of certain industries through subsidies or investment incentives will mitigate problems of distorted investment decisions, bureaucratic discretion, and corruption.

Expanding export product variety at the firm level will require overhauling viable state-owned enterprises and encouraging entry by new exporters. Evidence from other developing countries suggests that both of these initiatives require substantial resources. Many of Iraq's industrial firms have a legacy of narrow product lines, weak management and information systems, poor product quality, and overly centralized structures. The experience of transition economies suggests that upgrading the export potential of existing state-owned enterprises that are considered viable can require substantial time and resources. Nonetheless, upgrading is worthwhile because it enhances f export potential while maintaining employment. A restructuring plan for product-constrained firms, such as textile companies in Poland, for example, included the following steps:

- *Financial restructuring.* Steps include extending the maturity of existing loans, converting government debt into equity, enhancing access to working capital, and providing long-term loans to finance capital investment and restructuring.
- *Product restructuring.* Steps include introducing new products, optimizing certain existing products to act as "cash cows" in the short term, and marketing products more effectively.
- *Product rationalization and consolidation*. Measures may include closing certain plants, subcontracting specific tasks, retrofitting machinery, and investing in selected new equipment.
- *Management restructuring*. Steps involve introducing quality controls, accounting, information management, and other control systems (Taylor 1994).

The restructuring requires good coordination among many institutions, public and private, with a focus on the long-term profitability of the company in question.

Labor market policies

A variety of labor market institutions, regulations, and programs can broadly improve working conditions and the functioning of the labor market in Iraq. In addition, specific measures can help to mitigate the effects of conflict and industrial restructuring on the labor force. The broad institutional interventions could focus on the following labor market policies:[10]

- *Legislation*. As the private sector gains prominence, modern labor legislation is needed that determines terms of hiring and firing and employment conditions. Draft legislation is under consideration and needs to be codified soon.

- *Industrial relations*. A good record of negotiation between capable workers' and employers' associations is a sign of industrial democracy in action. Both parties to the collective bargaining process should be representative and independent. The rules of the negotiating process should be set by labor regulations, and the rules for dismissing labor should be transparent and designed to prevent arbitrary decisions. The new Iraqi Labor Code (currently in draft) lays down the conditions under which a workers' association must be recognized for bargaining purposes. Through an active bargaining process, social partners can expect to play a constructive role in the formulation of state policy on employment and related safety and health standards.

- *Labor-intensive public works.* Such public projects provide temporary income and employment by providing immediately needed services with low start-up and overhead costs (such as security guard duties, cleaning and painting, reconstruction of buildings, and irrigation works). Such activities could create thousands of jobs.

- *Training and skills development*. The National Development Strategy calls for a strategy for sustainable job opportunities, especially for vulnerable groups. Rehabilitation of vocational training centers operated by the Ministry of Labor and Social Affairs would help to upgrade the skills of the unemployed and to prepare the labor force to use new technologies necessary to compete in a global economy. There is an urgent need to develop a training system reflecting the demand for labor arising from the private sector. The ministry has the key role in monitoring the quality of training. School leavers are likely to require most of this training, and there will be a need to include vocational training in secondary schools as well. To be most useful, such initial training needs to prepare young workers for learning a variety of skills in later life. State-provided training outside the education system needs credibility in the eyes of employers.

- *Microfinance programs.* These programs help vulnerable groups to meet their emergency needs and to build assets. Microfinance programs should be designed to generate as many jobs as possible and could be specifically targeted to assist returning refugees and internally displaced persons.

- *Employment support programs.* Focusing on generating jobs at the local level, these programs are run by local councils and civic and nongovernmental organizations.

- *Job-matching services.* Such services reduce periods of unemployment and raise productivity by facilitating the connection between employers and jobseekers. They

[10] This section draws on ILO (2004a).

require the collection and dissemination of labor market information. In 2003 the Ministry of Labor and Social Affairs initiated a nationwide job-matching service; by end-2004, the ministry had registered more than 0.6 million active jobseekers.

Active labor market policies also extend to helping particular groups in the labor market in the aftermath of conflict or industrial restructuring. Policies can help to reintegrate demobilized army personnel and retrain displaced state-owned enterprise workers, as discussed below. In other postconflict countries, incentives to employers in the form of wage subsidies or social security payment credits have been efficient in assisting such disadvantaged groups.

Mitigating the effects of conflict

Iraq's reconstruction efforts provide an opportunity not only to restore infrastructure and services interrupted or damaged by conflict, but also to reintegrate former soldiers into the postconflict workplace (box 2.3). The scale of the proposed reconstruction is substantial and could support a variety of goals. Iraq's budgeted capital spending averaged 24 percent of GDP in 2004–05, and donors have also undertaken additional large capital spending outside of the budget framework. Yet, given the existing security risks, the actual levels of investment have been lower than anticipated, and in any case most of the investment taking place is capital- and import-intensive. The International Labour Organization estimates that the employment impact of the Madrid package of financial assistance is likely to be insufficient to significantly affect overall employment, perhaps providing temporary jobs to only 10 percent of the unemployed in a year.

Box 2.3. Jobs and reintegration for demobilized soldiers

To help former soldiers and militia members to find civilian jobs and better reintegrate into society, international evidence indicates that it is important to develop a new sense of identity, one not linked to the conflict. A healthy civilian identity can be encouraged through remunerative employment, vocational training, and constructive work that contributes to individual and community well being. Training and work activities of ex-soldiers and militia members can contribute to the reestablishment of values, behaviors, and norms.

There are very few examples of successful reintegration programs among postconflict societies. However, several interventions may be considered to cater for ex-soldiers and to give them access to the postwar restoration and reconstruction of infrastructure. Well-targeted demand-driven skills enhancement can help ex-combatants to enter the labor market or to become entrepreneurs. Microcredit and small business development support can assist the most entrepreneurial clients, and labor-intensive public works foster temporary employment opportunities. In addition, employment-specific and psychosocial support services frequently feature as essential ingredients of any comprehensive reintegration program.

Source: World Bank 2004a; United Nations and World Bank 2003b.

Mitigating the effects of industrial restructuring

As recovery and industrial restructuring proceeds, designing measures to cushion workers from the effects of enterprise reform is a matter of priority. These social safety-net measures will likely include:

- Generous redundancy or severance payments
- Retraining programs to impart or upgrade needed skills
- Programs to assist workers to reenter the job market, such as the establishment of employment agencies
- Public works programs.

These measures may take a variety of forms. Egypt has successfully transformed a number of state-owned enterprises, making use of a generous compensation scheme. The government redundancy scheme may provide a lump-sum payoff or offer a monthly payment for a set period. Vouchers can be used to pay for retraining, which could also kick-start private-sector training institutions (with quality control by the Ministry of Labor and Social Affairs). Above all, redundancy is to be handled in a transparent manner, according to principles in the new Iraqi Labor Code. Negotiation with workers and their representatives can make the criteria used in the redundancy process more acceptable. Managing redundancy in a fair and acceptable manner will also be the first stage in establishing an appropriate industrial relations climate within functioning state-owned enterprises and will contribute to good labor practices even in those units that are subsequently privatized.

It is important to be open and honest about the short-term negative employment impacts of enterprise reform and to introduce these safety-net measures so that laid-off employees can benefit from them whenever and wherever necessary and in parallel to the reform of state-owned enterprises. Difficult though these problems are, Iraqis can take heart from the many other countries that have successfully tackled major overemployment in state-owned enterprises.

More broadly, the experience of other Middle East and North African countries suggests that well-designed labor market programs can help tackle a variety of labor-market dislocations. However, the experience also suggests that, despite their political appeal and contribution to poverty alleviation, such policies do little to remedy structural problems in labor markets or to reduce high unemployment. Only a small share of the labor force is likely to be covered by these programs. Furthermore, active labor market policies need to be carefully targeted and monitored, as such programs may have high fiscal costs.

Summary of recommendations

To immediately improve the labor content of the reconstruction effort, the Iraqi government could undertake these measures:

- Divert resources to more employment-intensive programs and use more employment-intensive techniques for approved projects.
- Scale down the size of projects to make them feasible for local execution.
- Exercise the technical supervision needed to use more unskilled labor and still meet proper standards.
- Build up the capacity of municipalities and local bodies to supervise and

implement small-scale construction.

- Build up the capacity of local contractors to undertake labor-intensive construction projects.
- Increase the local raw material content of purchases of inputs and encourage their production by small-scale enterprises.
- Encourage the growth of sectors, such as housing, with strong linkages to the domestic economy. Given the big housing deficit with apparently 1.5 million units to be constructed or repaired, housing programs are likely to stimulate activity in many other industries as well.
- Improve the access of low-income groups to productive infrastructure and basic social services.
- Design local development strategies that focus on job creation and income generation and incorporate elements of basic social protection and social dialogue at the local level.

To generate economic growth and productive employment in the short term, the government may wish to consider the following steps:

- Strengthen implementation and coordination across ministries to improve the investment climate, possibly by establishing an interministerial working group.
- Conduct a public-awareness campaign on the benefits of a strong private sector in meeting the challenges of job generation and economic diversification.
- Strengthen critical institutions, including the commercial, legal, and regulatory codes; the rules of access to various markets for trade and investment; the frameworks for regional economic development; and the infrastructure to facilitate trade.
- Create a supportive environment for private entrepreneurs by establishing clear property rights and regulatory frameworks, low entry and exit barriers for businesses, access to finance and infrastructure, and strong public-sector governance.
- Provide training to government staff in administering public investment efficiently and conducting regulatory oversight.
- Reduce public-sector wage and benefit premiums to improve the private sector's competitiveness for skilled labor. Set public-sector wages to reflect productivity.
- Implement measures to cushion workers from the effects of enterprise restructuring, including generous redundancy payments, retraining and reentry programs, and employment opportunities through public works.

In the longer term, the government may wish to consider the following steps to build labor-market institutions and improve working conditions:

- Maintain efficient management of public-sector investment, proceed with the restructuring state-owned enterprises that produce tradable goods, and decide what to do with those that produce nontradables. Formulate an action plan for upgrading the export potential of state-owned enterprises, including financial, product, and management restructuring. Improve conditions of work in small and medium enterprises to create more formal-sector employment and thus give more balance to the labor market.

- Encourage Iraqi private-sector involvement in reconstruction. Build an efficient procurement system for both internally developed and internationally provided flows. Support economic development zones to offer security and infrastructure services and to minimize red tape.
- Foster private-sector business skills, entrepreneurial development, and business associations.
- Improve social services to establish the conditions that will permit workers to thrive and economies to grow at competitive rates.
- Enhance the potential of small and medium enterprises to generate jobs by helping with business plans and credit and by providing infrastructure facilities by setting up industrial estates. Consider establishing a credit facility for small and medium enterprises and link its availability to new job creation. Apply labor legislation (e. g., minimum wage, health, and safety regulations) intelligently to small and medium enterprises, neither forcing firms out of business nor condoning substandard employment.
- Use the requirements of the World Trade Organization and open regional trade agreements as tools of economic diversification.
- Encourage foreign investors by removing restrictions and streamlining approval requirements.
- Avoid granting investment incentives to selected industries, to mitigate problems of distorted investment decisions, bureaucratic discretion, and corruption.

Chapter 3. Fixing prices and incentives for growth

Most key economic prices in Iraq are now free—evidence of significant liberalization in the postwar period. Still, the remaining price distortions are exceptional by any measure. Iraq maintains the largest untargeted food subsidy program in the world: the cost of the Public Distribution System (PDS) amounts to 12–14 percent of its gross domestic product, compared with 1–3 percent of GDP for food subsidy schemes in other Middle East and North Africa countries. Domestic fuel prices, electricity, and water tariffs are among the lowest in the world. Subsidies add up to more than 50 percent of GDP and are already squeezing the budget, notwithstanding the currently high oil prices. Iraq faces crucial choices on whether to accelerate price reforms or to continue these untargeted subsidies, which have large fiscal costs and produce serious disincentives in the economy while vast demands for public goods and services remain unmet.

The overall message of this chapter is that carefully planned price reforms can enhance public welfare, since such reforms will: (a) reduce the deadweight losses[11] that result from inefficiency in the economy; (b) improve incentives to private-sector producers; and (c) save fiscal resources for the production of vital public goods and services.

Pricing reforms

In 2003–04, Iraq made progress on a number of pricing reforms:

- For decades Iraq operated a system of multiple exchange rates. The gap between the dinar's official parity of about ID 1/$3.2 and its black market rate was growing ever wider; by 2002 the latter was over ID 2,000/$1/ID. In early 2004, the new dinar was introduced, and old banknotes were exchanged at the prevailing street rate for new ones. Since then, the market has determined the dinar exchange rate. After a short initial period of volatility, the dinar stabilized at around ID 1,465/$1. The daily foreign exchange auctions are open to all competitive bidders. Premiums between the auction rate and the street rates remain under 1 percent. The central bank uses the auction system to maintain exchange-rate stability, which is one of its declared policy goals.
- For prices of goods, the most important development has been trade liberalization. All border tariffs and controls disappeared with the collapse of customs in 2003. Private-sector imports grew twentyfold over 2002–04, quickly saturating the pent-up demand for consumer goods. Most prices on domestic outputs are now free.
- In the past decade, the purchasing power of Iraqi wages waned as the dinar declined. Monthly wages of $10–15 were not uncommon by 2002. The resumption of the flow of oil revenues since mid-2003 allowed the government to begin raising public-sector salaries. The 2005–06 budgets brought further wage hikes, with an average civil service salary exceeding $200 a month. More recently salaries of workers in state-owned enterprises and the private sector began catching up as well.

[11] Deadweight loss is the costs to society created by market inefficiency. It can result from government actions (taxes, price controls) or from market failures (externalities, market control).

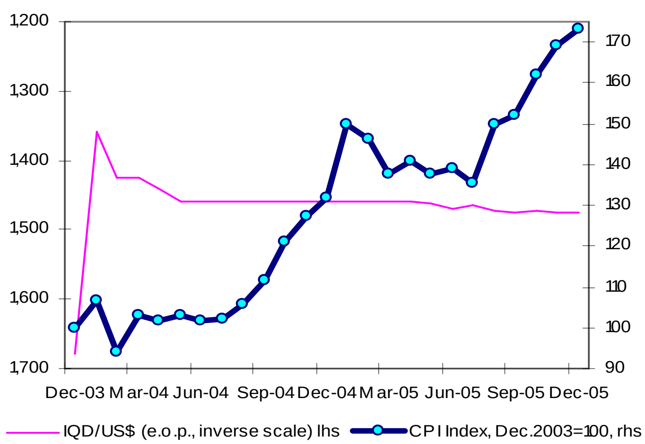
- Iraq liberalized the interest rates in March 2004—an important step toward creating a modern financial sector and enabling lenders and borrowers to make their own decisions guided by efficiency and profitability considerations. Very little credit is being issued, however, and the interest rates do not yet play a visible role in the allocation of capital. Real interest rates are negative (figure 3.1).

These early pricing reforms have shifted the structure of household consumption. Under the previous regime, consumption was maintained primarily by rations through the Public Distribution System (PDS) and by other subsidies (taken together, these accounted for an estimated 80 percent of total private consumption). The rest was coming from monetary incomes—wages and pensions, which by early 2000s were not buying much. As a result of early pricing reforms and several rounds of salary increases, the share of monetary incomes had risen significantly, but the subsidies continue to account for at least half of consumption (and a higher share in poor households that rely heavily on the PDS).

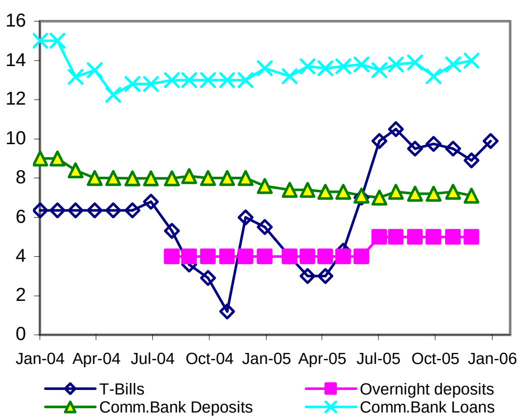
Rapidly rising monetary incomes of households and security-related disruptions of the supply chains were possibly among the key drivers of inflation in 2004–05. Vital needs of households are still met by subsidized goods and services; hence, the families could focus their higher purchasing power on the previously unavailable consumer goods. Until mid-2004 the consumer price index was relatively stable.[12] However, moving goods in the domestic market was becoming increasingly risky, and security costs and insurance premiums (both formal and informal) shot up. Administrative measures taken in early 2005 to normalize the situation in some key markets (in particular, fuel) had their effect, and the consumer price index declined for two months in a row.

Figure 3.1. Exchange rates, consumer prices, and interest rates in Iraq, 2003–05

Prices accelerated since mid-2004…



…while real interest rates remain negative.



Note: lhs is left-hand scale; rhs is right-hand scale.
Source: CBI 2004; World Bank and IMF staff estimates.

[12] The introduction of the new dinar in early 2004 produced a short-lived decline in prices

The share of monetary incomes in total household consumption is much higher now, but the subsidies are still pervasive (table 3.1). Some subsidy schemes are on budget, like the PDS, while others are off budget (e. g., the electricity tariff). These subsidies are untargeted and nontransparent. The rest of the chapter suggests that significant efficiency gains are possible from the reform of the subsidy system. Experience of price reforms in 2003 suggests that gains in growth from further reform of the subsidy system can be large.

The Iraqi subsidy system is not unique in the Middle East and North Africa region or among the resource-rich developing countries. Most of them use budgetary subsidies to redistribute oil wealth to the nation and to stimulate growth in the nonoil sector; some use subsidies to foster the private sector. Many governments in the Middle East and North Africa make less than full cost recovery for a variety of public services, such as energy, water, housing, public transportation, and postal service.

Table 3.1. Subsidies in Iraq

Sector	*Type of subsidy*	*Recipients*	*Form of subsidy*	*Estimated volume (% of 2005 GDP)*	*Implications*
Food	Imports of foodstuffs explicitly budgeted	Households	In-kind (ration card)	12–14	Maintains a vital safety net for all the population, but undermines domestic agriculture, distorts domestic food markets, and fuels corruption and smuggling
Fuels (gasoline, kerosene, diesel, LNG)	Only import costs are explicitly budgeted	Households and producers	Official prices at the pump are below operating costs	25–30	Encourages smuggling; black–market dealings, and corruption; anti-poor; reduces ability of refineries to self-finance rehabilitation; results in major quality problems
Electricity	Implicit	Households and producers	Fuel for generators is below opportunity cost; depreciation for equipment is not accounted in pricing; charges to consumers are below the cost of delivery	5–8	Creates major quality problems (cuts, voltage fluctuations); amounts due cannot be collected; the national grid is unable to self-finance rehabilitation
Utilities and urban services	Only partly explicit through budgetary transfers to municipalities	Households and producers	Charges to consumers are symbolic, well below cost of delivery	3–5	Lowers service quality; providers are unable to self-finance rehabilitation
Agriculture	Only a fraction is explicitly budgeted as farmers' support	Farmers	Seeds, fertilizers, fuel, power, and equipment are all at very low official prices; guaranteed purchase prices. Some subsidies are expected to be phased out soon.	8–10	Creates artificial profitability; functions as a major safety net for rural households; anti-poor
Inputs to	Implicit	Downstream		Data not	Causes operating losses for input

state-owned enterprises		industries (petrochemical, construction materials, etc.)		available—most state-owned enterprises are idle	providers (oil, gas, refining, and electricity sectors); low efficiency and overstaffing in recipient state-owned enterprises

Not all subsidies are damaging to the economy. A case can be made for subsidizing public goods that increase the human capital of the nation (primary education, primary health care) or support social overhead capital (roads, bridges). If used wisely, such subsidies enhance economic growth and social welfare. To some degree, even liberalized economies subsidize selected public goods, but every country must use care to keep the subsidy programs fiscally sustainable. Experience shows that, in every country that uses subsidies, they tend to become progressively wasteful and pervasive. Subsidies on marketable goods, such as food, fuel, and power, are particularly risky, because they can be a serious barrier to efficient markets. Subsidies crowd out private investment and distort production incentives, leading private producers to supply insufficient quantities or poor quality of goods. Subsidies also adversely impact income distribution, as their incidence is typically proportional to purchases (greater benefits are captured by the rich). If the government is concerned that the poor cannot afford even basic levels of consumption of food, fuel, and power, alternative supports can be explored. Such mechanisms are considered in the following three sections.

Food security

Food security remains the Iraqi government's focus of attention. A survey by the World Food Program in 2004 (WFP 2004) found that food insecurity is persistent, and is an important dimension of poverty in Iraq. A significant part of the population—about 11 percent, or 2.6 million people—faces real difficulties in accessing adequate food, despite the Public Distribution System, while many others—about 25 percent, or some 6 million people—are vulnerable because they depend heavily on the PDS. The nutritional status of the population continues to be a significant problem, with chronic malnutrition rising after the 2003 war as a result of insufficient nutrients and poor infrastructure and services, including, for example, health care, water, and sanitation. Among children under 5 years old, 4.4 percent suffered from acute malnutrition; 11.5 percent were underweight, and 27.6 showed signs of chronic malnutrition or stunting.

The extremely poor lack the income needed to purchase sufficient food for their households. Low purchasing power is associated with high rates of unemployment, underemployment, and illiteracy, particularly in rural areas. In the short term, Iraq's poorest households will continue to need the PDS. For this group, the PDS ration represents by far the single most important food source in the diet. Supply shortfalls thus affect them disproportionately, given their higher dependency rates than other households. Social protection mechanisms targeting these groups must be carefully considered in the context of possible PDS reform.

Box 3.1. Iraq's Public Distribution System

Iraq became a net importer of food 40 years ago and currently imports about 70 percent of its food supply. 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, costing more than 20 percent of government revenue. The PDS provides all Iraqi households with 100 percent of the minimum daily calorie requirement and more than 60 percent of the food consumed in Iraq.

The food basket provided today remains very similar to the ration distributed under the United Nation's Oil for Food Program in 1997–2003. The monthly basket of rationed goods currently includes 9 kg of wheat flour, 3 kg of rice, 2 kg of sugar, 0.2 kg of tea, 1.5 liter of vegetable oil, 1 kg of powder milk, 1.5 kg of dried beans, 0.15 kg of iodized salt, 0.25 kg of soap, and 0.5 kg of detergents. Infants less than a year old get baby care products and formula. Consumers pay ID 250 per ration (ID 50 for flour and ID 200 for the remaining products). The ration's resale market value is estimated at about ID 6,000. In 2000–02 this difference was slightly bigger in terms of Iraqi dinars, but not in terms of U. S. dollars because the Iraqi currency appreciated since 2003. Until 2004, most of the deliveries were imports organized under the Oil for Food Program, and the cost of subsidization was not reflected in the state budget. After the transition in 2004, the PDS is fully included in the 2005 budget.

The PDS is managed by the Ministry of Trade and implemented by 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 imported directly 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 because of problems of low product quality and insufficient capacity of the import companies.

Source: Razzaz 2005.

The Public Distribution System has successfully prevented humanitarian crises in Iraq for more than a decade. The 1990 Gulf War and the imposition of sanctions resulted in dramatic declines in the health status of the Iraqi population (see "Iraq at a glance" tables in the annex). Rising poverty and declining access to food imports were a significant part of this deterioration. In response, the government of Iraq in 1991 introduced the PDS, which provided approximately 50 percent of caloric needs. When the Oil for Food Program began in 1997, government revenue and the ability to import food increased, and the PDS rations increased as well (box 3.1). Throughout this period, the PDS has effectively reached the vast majority of the population, dramatically increasing household incomes and insulating households against food shortages and price fluctuations. Although the ration does not provide sufficient micronutrients and malnutrition remains high, the situation would be considerably worse without this food safety net for the Iraqi people. If the PDS were discontinued abruptly, many lower-income households would not be able to meet their food requirements.

What is wrong with the Public Distribution System?

The financial cost of the PDS is extremely high—approximately $4 billion in 2005—implying a transfer from the government of $150 per person per year to each of the 27 million people in Iraq. The program is expensive for two reasons: (a) it provides generous transfers to each beneficiary and (b) even the wealthiest Iraqis receive benefits. Still, the high financial cost is not necessarily unsustainable. To be sustainable, the expenditures of the government of Iraq must be in line with the revenues generated from oil sales and tax collection. The specific programs on which the revenues are spent, however, depend on the priorities of the Iraqi government and public. What the large financial cost of the PDS tells us is that the continuation of such a generous, untargeted program would come at the expense of other services, such as education, health, and infrastructure.

Distortions occur in any market in which government actions impact prices. Distortions occur on the supply side of the food markets—that is, the incentives of private-sector food producers are affected. Distortions also occur on the demand side of food markets—that is, the incentives of consumers are affected:

- *Producers' incentives*. The dominant role played by the PDS in food markets has massively distorted the incentives faced by Iraqi farmers and private enterprises. Because the PDS is a government in-kind transfer of food, the distortions are even greater than they would be in the case of input subsidies paid to the farmers and occur throughout the supply chain. One of the largest distortions created by the PDS is not because of rationing itself, but because the food supplied through the system is imported. This large injection of imported food pushes domestic food prices below international prices, thereby reducing the incentive for domestic production. Artificially low domestic prices of rationed goods create incentives for smuggling goods outside of Iraq, where they can be sold at a higher price.

- *Consumers' incentives*. By providing large transfers to households and changing the relative price of consumer goods, the PDS may distort labor supply and consumption patterns. Consider first the impact of the transfer on the household supply of labor. As with any unearned income, the transfer of resources through the PDS may reduce the incentive to work. Indeed, with the PDS transfer approximately doubling household income, the negative impact on labor supply would be expected to be large. In the current situation, however, the PDS does not appear to be a determining factor for employment rates: labor supply remains significantly greater than demand, as indicated by high unemployment. In terms of consumption patterns, there is little evidence that low prices on rationed foods are causing households to overconsume food, though there is some evidence to suggest that households are consuming too little of the more expensive nonrationed foods, such as fresh produce and animal protein.

Options for reforming the Public Distribution System

The Iraqi National Development Strategy discusses long-term reform of the Public Distribution System, moving away from a universal food ration toward an efficient, targeted safety-net system. Such reform will indeed happen only over the medium –to long term. At this point it is also useful to think of short-term reforms, which can improve the situation incrementally even though they may not solve the problems entirely. A number of ideas have been floated recently about modifying the PDS, which take incremental steps toward long-term reform, but can be implemented in the near term.

In designing the permanent safety-net system, two issues need to be considered. First is the form of the transfer. Cash transfers and food stamps, instead of in-kind transfers, are among the common program types that are being discussed now in the Iraqi context. Each of these program types has different benefits and costs. Second is the issue of targeting. Although most people agree that some targeting is desirable, there is no consensus yet on how narrowly to target—that is, what proportion of the Iraqi public should be eligible—or what targeting mechanism to use. A wide variety of targeting mechanisms have been successfully used in other countries. The question is, what is the most appropriate mechanism for the Iraqi context?

In addition to designing an appropriate permanent safety-net system, the timing and sequencing of reform must be carefully considered. There is a clear need to begin reforms—even if incremental—as soon as possible. Several ideas recently proposed include: (a) removing high-income civil servants from the PDS ration lists as a first step toward targeting; (b) giving households the option of either receiving their regular food ration or a cash transfer worth more than the ration; and (c) increasing the role of domestic food producers and the private sector within the existing PDS. Timing and sequencing issues have to be considered carefully in a broader context, beyond the economic benefits, to ensure that reforms do not trigger humanitarian or political crises.

Implementation

The advantages of cash transfers over the current in-kind rations are clear, since cash transfers do not substantially distort the prices in the economy. If a cash transfer system were implemented, food prices would likely be higher than they are now, thereby increasing the incentives for domestic farmers and food producers. Although food prices may not be a major concern in the long run, they are an important consideration in the medium term. Large fluctuations in prices are likely as the country transitions to a market-based economic model and as security problems may continue to interrupt the availability of commodities. Cash transfers would fail to buffer households from price fluctuations, which are a major form of food insecurity.

Another major question about cash transfers is whether they could be implemented in the current environment. Three concerns need to be studied in detail:

- Iraq's banking system is not sufficiently developed to handle the huge number of transactions required under the PDS. Rather, cash would have to be physically distributed throughout the country.
- Cash would be vulnerable to theft, particularly in the current security environment. The cost would be enormous to provide reasonable security measures for the transport and distribution of large sums of money.
- If a cash transfer system were adopted, short- to medium-term measures would need to be taken to prevent interruptions in food supplies and extreme price volatility.

> Although there is little doubt that the Iraqi private sector could eventually provide an efficient supply of food, the government would need to ensure that access to food remains adequate while the private sector adjusts to freer markets.

Food stamps have most of the same problems as cash transfers, though to a lesser extent. Where food stamps are widely distributed, they tend to become a form of currency.

Targeting issues. Many different mechanisms can be used to target safety-net programs to the poor. Options include means testing, proxy–means testing, categorical targeting, and self-targeting. The most appropriate mechanisms must be chosen on the basis of the specific situation of Iraq. Means testing is not yet possible, because data on income and assets are not widely available and are not easily verifiable. Proxy–means testing and categorical mechanisms are useful only if clear associations can be made between easily observable household characteristics (such as the sex of the household head or the district of residence) and need, usually based on a high-quality household survey. This may not be possible to accomplish with existing data, although in the longer term it may be feasible. Proxy–means testing and categorical mechanisms can also be politically contentious if there is any debate over the association of need with certain geographic regions and ultimately the religious and ethnic groups that live there.

Self-targeting can be an extremely useful mechanism and has been implemented successfully in a number of countries, though the program must be carefully designed to avoid creating any unintended incentive effects. Public works projects and food-for-work projects are common examples of self-targeted safety nets. These programs tend to work well if the needy are unemployed. However, if the program benefits are overly generous, the programs may draw individuals out of existing, possibly more productive jobs.

Financial issues. It would be a mistake to think that all reform options would be financially less costly than the PDS. For each option that is considered, it is important to identify whether it will be cheaper than the PDS, and if so, where the cost savings will come from. Two issues are particularly important:

- Targeting is expensive. Data must be collected and verified to identify whether particular households are eligible. Targeted cash and food stamp programs often spend 10 percent of their budget on targeting. While a targeted program may be less expensive than a universal system, there is a tradeoff between the quality of targeting and the administrative costs of the program.
- Even if a food stamp or cash transfer program is adopted, the Iraqi government will need to continue to be involved in the physical distribution of food (at least until the private sector builds sufficient capacity to take over). During this interim period, there are not likely to be any financial savings. In fact, the costs of the program in the transitional period could be higher than at present.

Considerations before beginning reforms

How to start the targeting process? It is now widely recognized that full means-testing is not possible in the short term, because reliable income data are not available for the general population. Civil servants, however, are the one group for which reliable income data are at hand. The suggestion has therefore been made to eliminate all civil servants whose salaries are above some cutoff (possibly ID 1,000,000) from the ration lists. Two practical issues to consider are (a) how to link the data on government employment with the ration lists and to accurately determine the number of individuals dependent on the civil servant's salary and (b) how to determine the size of the group affected. To significantly lower the financial costs of the PDS, it must impact a reasonably large proportion of the population. Another, more important consideration is the likely reaction of the civil servants. They may have a strong negative reaction because they are singled out—denied eligibility while even more well-off households in the private sector are not affected. And (especially because of their position in the government) a disenfranchised civil service could launch an effective campaign against the reform.

How much choice to give households? The proposal to give households the choice between receiving their ration or a cash transfer is attractive because it could facilitate a gradual transition from the pure ration system to a cash transfer system. However, this proposal is likely to have an even higher financial cost than the existing PDS. To see why, consider the following. To prevent food shortages and extreme price increases, the government is likely to continue to purchase and transport to food agents sufficient food for the entire population. The government's cost to purchase and transport the food is approximately $10 per person per month, and the food itself has a resale value of approximately $4 per person per month. The proposal calls for offering a cash alternative greater than $4 to make it attractive to households. Say the value of the cash transfer is $6. To keep the cost per person per month from increasing to $16, the government would need to be reimbursed $6 by food agents for the food distributed to the households who take the cash option. Clearly food agents would not be willing to pay $6 for food that has a resale value of only $4. In fact, there is no price the food agents would be willing to pay that would not create an increase in the financial cost to the government. Another crucial argument against this proposal is the long-term expectations it creates. Because cash is desirable to all households (including the wealthiest), a cash transfer system could be even more difficult to remove than a food transfer. It could be very risky to convert to a cash transfer before implementing an effective targeting mechanism.

Domestic fuel subsidies

Fuel prices in Iraq rank among the lowest in the world. A survey of consumer prices of super gasoline and diesel conducted in 171 countries on November 17–20, 2004, indicated that only Turkmenistan had end-user prices as low as those in Iraq (GTZ 2005). Table 3.2 compares official domestic prices in Iraq with the free-on-board prices in the Gulf countries. The latter do not include the cost of transportation, storage, and distribution, but still are markedly higher than the end-user prices in Iraq.

Table 3.2. Fuel prices in Iraq and on international markets, 2005

	LPG	*Gasoline*		*Kerosene*	*Diesel*	*Fuel oil*	*Natural gas*
		Regular	*Premium*				
Unit	per 12 kg	per liter	per liter	per liter	per liter	per liter	per cubic meter
Domestic price, ID	250	20	50	5	10	10	1
Gulf 2004 average, $	4.18	–	0.28	0.28	0.27	0.16	n.a.
Gulf 2004 average, ID	6,054	–	402	408	391	236	n.a.

Note: – indicates not available; n.a. indicates not applicable; LPG indicates liquefied petroleum gas.

Source: Iraq prices as of January 2005, except for natural gas where the price is as of 2002. Gulf prices are free-on-board as reported in the *Platts Oilgram Price Report* for all the fuels, except for LPG where the price is Saudi Aramco's contract price for propane. Premium gasoline for Gulf is 95 research octane unleaded.

The extremely low consumer prices found in Iraq lead to a number of serious problems. These include an unsustainably large burden on the government budget; undersupply of the domestic market; smuggling of subsidized fuels out of the country; inadequate maintenance, let alone modernization or expansion, of physical infrastructure for production, transport, and distribution of subsidized fuels; lack of attention to fuel efficiency; waste; and overconsumption of fuels for nonessential purposes. In Iraq, all of these adverse effects are observed. Refineries in Iraq are in major need of modernization and incapable of producing adequate quantities of products with appropriate quality (for example, gasoline without lead additives). Despite Iraq's large natural gas reserves, little use is made of gas in the economy, and more gas is flared than consumed. Adverse effects can even extend to other natural resources. An example is the impact of the availability of cheap diesel on underground water in Yemen, where cheap diesel used by farmers has led to the depletion of underground water as a result of excessive pumping for irrigation.

Raising fuel prices to reflect the real cost to the economy is an important consideration in stimulating fuel efficiency, as well as in reducing nonessential fuel use. For example, a recent U.S. study showed that increasing the price of gasoline by raising the fuel tax, rather than tightening fuel efficiency standards, was by far the most cost-effective option for fuel conservation. Higher gasoline prices from higher fuel taxes were estimated to start reducing consumption immediately, and the market effect would gradually drive the transition to more fuel-efficient vehicles (*Automotive Environment Analyst* 2004).

Where trade is permitted and domestic prices are far below those on the world market, refineries have an artificial incentive to export as much product as possible. An example is the Russian Federation following the devaluation of the ruble in 1998, which brought domestic crude and refined product prices well below world levels. Exports surged, and in response to the dwindling supply of fuels on the domestic market, the Russian government in 1999 and 2000 took a series of steps to control the petroleum sector, such as putting quantitative restrictions on product exports and reintroducing export duties.

Because the consumer prices in Iran are closest to those in Iraq among its neighbors, it is informative to review recent developments in the Iranian government's fuel-pricing policy. As in Iraq, there is a serious shortage of gasoline in Iran. For the fiscal year ending on March 20, 2005, the government spent 30 trillion riyals (about $3.4 billion) on gasoline price subsidies, far in excess of the $1.5 billion allocated in the national budget. Iran's gasoline consumption has recently grown at an annual rate of 12 percent, partly because prices are kept artificially low. In January 2005, an Iranian government official reported that the estimated cost to the government of smuggled fuels was 10 trillion riyals annually. Iran's 2004–05 draft budget contained only a modest rise in gasoline prices from 650 riyals ($0.075) a liter to 800 riyals ($0.09). Under a five-year economic plan developed in 2004, fuel prices were to rise gradually to international levels, starting in March 2005, but in January 2005, the Iranian parliament voted to freeze fuel prices for the entire fiscal 2005–06. This setback notwithstanding, even the low officially controlled price of gasoline in Iran is several times higher than that in Iraq, providing ample incentive for fuel smuggling from Iraq to Iran and on to other countries.

Raising prices is the most efficient response to correct the distortions introduced in the economy by fuel subsidies. This raises several questions for the government: to what level, how fast, with what consequences, and are there adverse effects of price increases that would require government intervention?

Target price levels

Broadly, target price levels can be classified into three categories:

- *Cost recovery*. Cost-recovery prices entail no direct subsidy to end-users. Cost-recovery levels account for rehabilitation, modernization, and expansion of oil and gas fields, as well as associated physical infrastructure. Iraq currently imports light fuel products, and for these imported fuels, cost-recovery and economic opportunity costs are the same. Because prices below cost recovery entail direct subsidies and a claim on the government budget, raising prices to recover costs would be an immediate priority.
- *Border prices.* Prices in the countries bordering Iraq vary considerably, ranging from very high prices in Turkey to very low in Iran. Matching border prices would curtail smuggling to a considerable extent. Any reduction in smuggling is expected to affect cost-recovery prices by reducing the quantities of imported fuels.
- *Economic opportunity cost.* Domestically produced crude can be sold on the world market at international prices or to domestic refineries. If the price paid by domestic refineries were below what producers can get on the international market, then given free choice, producers would not sell crude on the domestic market. For refined products, the economic opportunity costs would be either import-parity or export-parity prices, depending on the trade balance. If Iraq were to become self-sufficient with no imports or exports of refined products, then the economic opportunity cost could be defined as the export-parity crude price plus processing and transportation costs, capped by import-parity product prices.

It is almost certain that consumer prices in Iraq will not be raised in one step to economic opportunity costs. It may therefore be helpful to use the first two prices as intermediate targets, while using economic opportunity cost as the benchmark price. Setting prices below the economic opportunity cost would mean a loss of revenue that could otherwise be used by the government for the creation and maintenance of social overhead (roads, bridges, railroads), human capital (education, training), and other vital public programs.
Once fuel price subsidies are phased out, consideration can be given to fuel taxation (e. g., a general consumption tax). Excise taxes are usually imposed on petroleum products, but they tend to be low in major oil-producing countries. That said, excise taxes on transport fuels serve as a means of collecting road-user charges. Many countries have poor road systems because maintenance is not adequately funded. A fuel tax may be the most obvious and acceptable proxy for direct charging. Because diesel-powered trucks cause most of the wear and tear on roads, a diesel tax might be an appropriate proxy for direct road maintenance charges.

Welfare impact

How would fuel price increases affect the welfare of the poor? Unfortunately, data on household spending in Iraq are not available to offer quantitative estimates. We do know, however, that such increases are often regressive: while the rich may pay more in absolute terms following price increases, the poor are adversely affected because the increases affect a greater share of their spending.

The consequences of price increases can be categorized into direct and indirect effects. Direct effects concern the impact arising from consuming the fuels in question. Indirect effects arise because goods purchased have fuels as inputs in their production or transportation. In Iraq, households use liquefied petroleum gas (LPG) and kerosene extensively for cooking and heating. Available data on seasonal variation in demand for kerosene suggest that kerosene is widely used as a heating fuel. Gasoline and diesel are used by vehicle owners, who are not typically among the poorest. Diesel, however, is used in goods transport and agriculture, so a diesel price increase will have an economy-wide impact.

In markets without price subsidies, expenditures on electricity tend to be the highest among the various forms of household energy consumption. Because heating could require considerable energy in a cold climate, expenditures on heating fuels can also be significant. For poor households in Iraq, the impact of large increases in the prices of kerosene, LPG, and electricity (arising from an increase in the input price of fuels at the power plant gate) will require attention from policymakers. Depending on how much public transport is used (usually a substantial amount for the poor, who generally do not own vehicles), the impact of higher public transport costs can also be important, because the fuel cost makes up a significant fraction of vehicle operating costs.

It is important to note that the welfare impact depends on the effective price increases, which differ from the official price increases. Estimating the effective price is complicated by the presence of a large black market with considerable price variation over time and place. No quantitative information is available on the volume-averaged effective prices paid by households for different fuels, but the actual prices paid have been known to be higher by an order of magnitude or more at certain times. For example, in January 2005, some residents in Baghdad were paying ID 300 (against the official price of ID 5) per liter of kerosene and ID 3,000 (against the official ID 250) per cylinder of LPG. The higher prices actually paid would clearly make the direct welfare impact of raising official prices smaller.

To examine the impact of raising the prices of natural gas, fuel oil, and diesel on the cost of power production, illustrative calculations are shown in table 3.3. The results show the incremental impact of raising the fuel price on the cost of power production. Natural gas and fuel oil are assumed to be burned at power plants for supplying grid electricity, and diesel in small generation sets.

Table 3.3. Impact of fuel price increases on electricity production cost

	Price per unit		*Cost per MMBtu*	*Cost per kWh*	
Fuel	*In dinars*	*In dollars*	*In dollars*	*In dollars*	*In dinars*
Natural gas (in cubic meters)	1.0	0.001	0.02	0.000	0
	13	0.009	0.25	0.003	4
	26	0.018	0.50	0.005	7
	38	0.026	0.75	0.008	11
	50	0.035	1.00	0.010	15
Fuel oil (in liters)	1.0	0.001	0.02	0.000	0
	5.0	0.003	0.09	0.001	1
	50.0	0.034	0.87	0.009	13
	100.0	0.069	1.74	0.018	25
	200.0	0.138	3.49	0.035	51
Diesel (in liters)	10	0.01	0.20	0.003	4
	50	0.03	1.00	0.014	20
	100	0.07	2.01	0.027	40
	200	0.14	4.02	0.055	80
	300	0.21	6.02	0.082	119
	500	0.34	10.04	0.137	199

Note: Power plant fuel efficiency of 34 percent for natural gas and fuel oil is assumed, which is currently considered appropriate for Iraqi power plants. Calorific value of natural gas assumed to be 1 MMBtu per 1000 cubic feet. Diesel generation sets are assumed to have 25 percent fuel efficiency

The fuel cost per kilowatt-hour (kWh) in the case of natural gas can be decreased by more than 30 percent if generation is done in a gas turbine with a combined cycle design and fuel efficiency of 50 percent. Cost-recovery prices of associated natural gas at the wellhead in Iraq may be on the order of $0.50–0.70 per million British thermal units (MMBtu). A gas price of $0.75–1.00 per MMBtu at the power plant gate, compared with the current ID 1 per cubic meter, adds another ID 11–15 per kWh to the cost of power production. At a thermal efficiency of 50 percent, rather than the assumed 34 percent, the additional fuel cost falls to ID 7–10 per kWh. In comparison, increasing the price of fuel oil to approach market prices adds considerably to the cost of power production. Even at

ID 100 per liter, which is equivalent to only $11 per barrel, the additional cost from the fuel price increase is about ID 25 per kWh. At 40 percent efficiency (the maximum achievable using fuel oil), the additional cost of power generation for ID 100 per liter is ID 22 per kWh.

Iraqi households are increasingly turning to diesel generation sets. Raising the price of diesel will raise the cost of electricity from this source further. The economic opportunity cost of diesel, which is imported, is much higher than those of natural gas and fuel oil. Unlike the prices of natural gas and fuel oil supplied to power plants, information on the actual prices paid for diesel for this use is limited, making it difficult to estimate the likely consequences on end-user prices. At ID 500 per liter, which is the import-parity price of diesel, the cost of fuel alone is equivalent to $0.14 per kWh.

Estimated effects of energy price increases in Iran

An examination of energy price subsidies in fiscal 2001–02 in Iran and of the impact of raising domestic energy prices to 10-year average border levels gives useful insights (World Bank 2003c). Domestic Iranian prices in 2001–02 were particularly low compared with border prices for fuel oil (7.8 times lower), kerosene (6.9), diesel (6.9), and natural gas (5.1). The annual average of the energy subsidies over the previous decade was about 11 percent of Iran’s GDP.

The subsidies were found to be inequitable and regressive. For some forms of energy, the price subsidies benefited the richest 10 percent of the population 12 times more than the bottom 10 percent. Energy inefficiencies in industry were large compared with other countries. Cement plants and iron and steel mills in Iran were estimated to consume about 40–60 percent more energy than those in Japan. Domestically manufactured refrigerators and cars were similarly much less efficient than the imported ones.

In aggregate, raising domestic prices to border prices prevailing in 2001–02 entailed a fourfold increase in volume-average prices. The impact on economy-wide price levels was calculated to be 30.5 percentage points above the baseline. This figure represents an upper bound because price and income elasticity effects were not taken into account in the calculation. In practice, an energy price adjustment of this magnitude would be expected to result in more rational or efficient consumption of energy, as well as a fall in demand, reducing the increase in the general price level. Aside from the energy sectors, 5 out of 43 sectors studied (goods transport, brick, gypsum, cement, and water) experienced price increases of more than 70 percent. The proportional loss in welfare arising from higher energy prices declined with increasing household expenditure in both urban and rural areas, but was felt more heavily among rural households. The impact on the poorest rural group (which spent 15 times more on kerosene purchase as a share of their total expenditures than the urban rich) was nearly twice that of the richest urban group. Therefore, in the absence of compensating action from the government, the envisaged energy price increases in Iraq would probably be strongly regressive.

A scenario for fuel price increases in Iraq

As a part of at his study, a standard computable general equilibrium model was developed for Iraq to simulate the impact of a reduction in subsidies to refined oil products (box 3.2). Complementing that modeling exercise, a more detailed analysis of fuel price rises is also useful. When price increases are as large as those in Iran in the preceding study and those envisaged in the model for Iraq, the impact on demand is expected to be significant. Furthermore, in Iraq a sizable fraction of "demand" is actually for fuel smuggling, which is sustained purely by large cross-border price differences. Although the extent of fuel smuggling is not known, estimates range as high as 30 percent of the volume of refined product imports. This not only creates a fuel shortage, raising black market prices inside the country, but also imposes a large drain on the budget by artificially inflating demand for imported fuels. Raising official prices significantly will have a marked and immediate impact on perceived demand by reducing incentives for smuggling.

Box 3.2. The impact of subsidy reforms on the imports of refined oil products

A standard small open economy computable general equilibrium model was developed for Iraq to simulate the impact of a reduction in subsidies to refined oil products. The exercise simulated a sixfold increase of prices of Iraqi refined oil products (ROP). Such an increase would significantly reduce the extent of smuggling and the domestic black market. It would also decrease government expenditures on subsidies to domestically produced refined oil products and imports.

The model includes four producing sectors, three oil sectors (crude oil, refined oil products, and the black market for refined products), and the rest of the economy. There are two factors of production—labor and capital; one household and one account each for government, investment-savings, and rest of the world Domestic production of refined oil products is held constant, reflecting current government policies and security-related supply bottlenecks.

Results indicate that a sixfold increase in domestic prices of refined oil products would lead to a fall of 39 percent in households' consumption of refined oil products, while imports of refined oil products would fall by 15.6 percent. Government savings would amount to ID 2.5 trillion ($1.7 billion), allowing for additional investment or transfers to households to compensate for higher prices. Higher domestic prices of refined oil products would reduce incentives for black market sales—their volume would decrease by 30 percent. As a result of increased spending stimulated by a more efficient use of available resources, production in the rest of the economy would increase by 2 percent.

	Domestic production (trillion ID)		Domestic supply price index		Imports (trillion ID)		HH consumption (trillion ID)	
	Bench-mark	Increase of ROP prices	Bench-mark	Increase of ROP prices	Bench-mark	Increase of ROP prices	Bench-mark	Increase of ROP prices
Crude oil	0.054	0.054	1	1	n.a.	n.a.	n.a.	n.a.
ROP	0.157	0.157	1	6	0.122	0.103	0.055	0.008
Black market	0.617	0.432	1	1.416	n.a.	n.a.	0.546	0.359
ROE	5.252	5.349	1	1.001	28.035	28.599	8.999	8.387

This version of the model is only illustrative. It is now being extended to (a) examine in detail the impact of a reduction of fuel subsidies on the nonoil sectors (agriculture, transport, construction, etc) and (b) incorporate linkages and cross-subsidization among the extraction of crude oil, refineries, and the power sector. A disaggregation of households into rural and urban reflecting their different income and consumption patterns will be undertaken as more data become available.

Note: The data sources used to construct the social accounting matrix (SAM) for this model include the Iraqi government budget data, national accounts statistics, the 1988 input-output table (provided by COSIT), World Bank and International Monetary Fund estimates, UN Comtrade data, International Energy Agency data, and U.S. Department of State data. The construction of the matrix has highlighted severe data problems. Some of the data compilation effort and adjustments have been based on assumptions. With respect to the black market, the simulation assumes that households and enterprises in the rest of the economy consume the same volume of fuel at the subsidized and the black market prices, with black market prices being ten times higher.

The impact of price increases on the demand for fuels by end-users is difficult to forecast even qualitatively. Two factors distort demand at present in ways that make forecasts difficult: wildly fluctuating and occasionally extremely high (even by international standards) black market prices that consumers pay, and serious fuel shortages that deny access to fuels even to those who are willing and able to pay very high black market prices. It is entirely possible that among certain population groups—gasoline purchasers in urban areas, for example—demand could even increase if official prices are raised and fuel shortages are eased. More quantitative data, especially on prices and volumes purchased by end-users, are needed to make a better assessment.

Table 3.4. Scenario for fuel price reform in Iraq

Variable	*LPG*[a]	*Gasoline* *Regular*	*Premium*	*Kerosene*	*Diesel*	*Fuel oil*	*Total*
Official price (ID per liter or cylinder, early 2005)	250	20	50	5	10	10	
Current consumption (millions of liters or cylinders)	127	5,000	1,200	3,700	5,900	3,100	
Current revenue (millions of dollars)	22	69	41	13	41	21	207
Revised price (ID per liter or cylinder)	1,500	120	150	70	80	50	
Percentage fall in consumption	10	15	5	10	15	0	
Future consumption (millions of liters or cylinders)	114	4,250	1,140	3,330	5,015	3,100	
Future revenue (millions of dollars)	118	352	118	161	277	107	1,132
Incremental revenue (millions of dollars)	96	283	77	148	236	86	925
Fall in imports (millions of liters or cylinders)	13	750	60	370	885		
Import price (dollars per liter or cylinder)	4.18	0.24	0.28	0.28	0.27		
Import savings (millions of dollars)	53	180	17	104	239		592
Net government revenue (millions of dollars)	149	463	93	252	475		1,517

Note: Consumption estimates are from the UK Treasury. Price elasticities are arbitrary. The breakdown of gasoline consumption into regular and premium is not known; an 80/20 split is assumed.
a. LPG price is for a 12 kg cylinder of liquefied petroleum gas, and consumption is in number of cylinders. Import prices are the Gulf prices found in table 3.2, except regular gasoline.

To give some idea of the budgetary impact of fuel price increases, a hypothetical scenario is sketched out in table 3.4. Reductions in consumption ranging from 0 to 15 percent are assumed. The budgetary impact is twofold: the government receives higher revenues from higher fuel prices (much of which is currently captured by the black market) and pays a lower bill for fuel imports (estimated in the 2005 budget to be $2.5 billion). For the four imported fuels, the new prices are in the vicinity of, or lower than, the black market prices quoted in the media.

The incremental government revenue from higher prices amounts to $925 million. A reduction in fuel imports gives savings of $592 million, giving the government net revenue of $1.5 billion. Although all the assumptions in this illustration can be questioned, this calculation gives an order-of-magnitude estimate of the budgetary impact of near-term fuel price increases in Iraq.

International experience on access of the poor to essential household energy

Gasoline prices in Iran, Iraq, and Turkmenistan notwithstanding, it is rare for a government to subsidize gasoline heavily. Gasoline is used almost exclusively as an automotive fuel and to a considerable extent in privately owned vehicles. Given the concentration of car ownership and use in the upper-income groups in developing countries and the weak systems for direct taxation, a high incidence of taxation on gasoline is a progressive tax, making it relatively easy to win political support for high fuel taxes. Most governments in developing countries therefore price gasoline higher, and sometimes much higher, than other fuels.

Diesel is used in goods and public passenger transport, agriculture, and industry. It is viewed as a "social fuel" in many countries, and its price is almost universally lower than that of gasoline through differential taxation. The large difference between gasoline and diesel prices has historically led to much greater consumption of diesel than gasoline as an automotive fuel, with adverse effects on air pollution and public health.

Kerosene has also been considered by many governments to be a social fuel. It can be more easily transported to rural areas than LPG and is used for lighting by those who are not connected to grid electricity. Kerosene has historically been subsidized in a number of countries, at least on paper. But if kerosene is much cheaper than gasoline and diesel, adulteration of gasoline with kerosene and large-scale diversion of kerosene to the automotive diesel sector become widespread. Replacing diesel with kerosene has virtually no impact on vehicle performance and is hence financially attractive. In India, as much as 50 percent of heavily subsidized kerosene intended solely for use by households has been estimated to be diverted to other sectors, costing the government close to $1 billion in 1999–2000 (ESMAP 2003). There is no example of an effective targeted kerosene price subsidy scheme, in large measure because of the nearly perfect substitutability between kerosene and diesel and the ease of transporting and selling kerosene.

LPG is used by households for cooking and heating, especially in areas without piped natural gas. It is also one of the cleanest commercial fuels. LPG price subsidies tend to benefit better-off urban households much more than the rest of the population, and as such are regressive. This also means that eliminating LPG price subsidies would have little welfare impact on the poor. In Iraq, because of the extremely low LPG price in the past, its historical use has reportedly been extensive and common even in remote rural areas. This would need to be verified. If true, the welfare impact of the LPG price subsidy phase-down could be more serious than in other developing countries.

Natural gas has the potential to become the cheapest household fuel in Iraq in the future. Electricity and natural gas, which are delivered through networks, have one advantage over liquid fuels: they are more difficult to divert. One possible approach for protecting the welfare of the poor is to have a rising block tariff structure, whereby a small first block at a subsidized tariff is made available to help the poor, cross-subsidized by higher tariffs for higher blocks. All benefit from the subsidy in the first block, but the rich, who consume more energy, pay more on average on a unit basis. Rising block tariffs are not without problems and are prone to political capture. One serious and commonly encountered problem is the political pressure to increase the size of the first block, a politically popular move that is extremely costly. Careful analysis of the market is needed before deciding whether and how to adopt such tariffs.

International experience amply demonstrates that it is difficult to design an effective targeted subsidy for liquid fuels. The most suitable approach, if administratively and technically feasible, is to shift the focus away from fuels, consider how policies across different sectors (food, water, electricity, fuels, education, health) are affecting the poor in aggregate, and assist them with a direct income transfer to help them purchase the basket of goods they consume. But absent an already existing mechanism, the cost of administration—from identifying beneficiaries to delivering direct cash payments—could far exceed the intended benefits. A direct income transfer is unlikely to be a feasible option in Iraq in the near term.

Because the official fuel prices are extremely low today, even increasing prices fivefold or tenfold to reach ID 100–200 per liter would yield prices that are still low by world standards. It would be best if any compensation in the initial stages of price adjustments were temporary. Over time, if and as fuel prices are raised toward economic-opportunity prices, a sustainable mechanism to enable the poor to meet their household energy requirements will need to be designed as part of a broader social safety-net package.

Integrating fuel price increases with policies in other sectors

Because fuels are inputs in almost all sectors of the economy, fuel price increases need to be coordinated with policies in other sectors, especially those that are fuel-intensive such as transport and power. At present, primary resource prices are set virtually at zero for some users. For example, the price of a barrel of oil sold to local refineries is ID 300 ($0.21). It is important to start raising primary resource prices at the point of origin, to the level sufficient to cover long-run development and operating costs. Raising prices at any point along the supply chain has immediate implications downstream. The input prices at refineries and power plants are likely to be increased at the same time, adding on transportation costs. The first goal is be to raise ex-refinery prices to allow for recovering the cost of maintenance and investing in upgrading processes. Installation of cracking units, which convert fuel oil to lighter products, would substantially reduce the need for product imports in Iraq. Electricity tariffs will need to reflect fuel cost increases. Allowing full cost recovery will not only help sustain current production levels, but will provide incentives for investment in new capacity to meet rising demand.

Electricity pricing and management autonomy

The Iraqi government recognizes that adjusting energy prices is one of the keys to rehabilitating the electricity sector. The adjustment of energy prices can improve cost recovery and help to ensure that the right investment choices are made in that critical sector. Even under a new price regime, however, the electricity sector will not be able to recover unless electricity utilities have greater management autonomy. This section discusses some of the possible approaches to electricity reform and their likely impact on households and the budget.

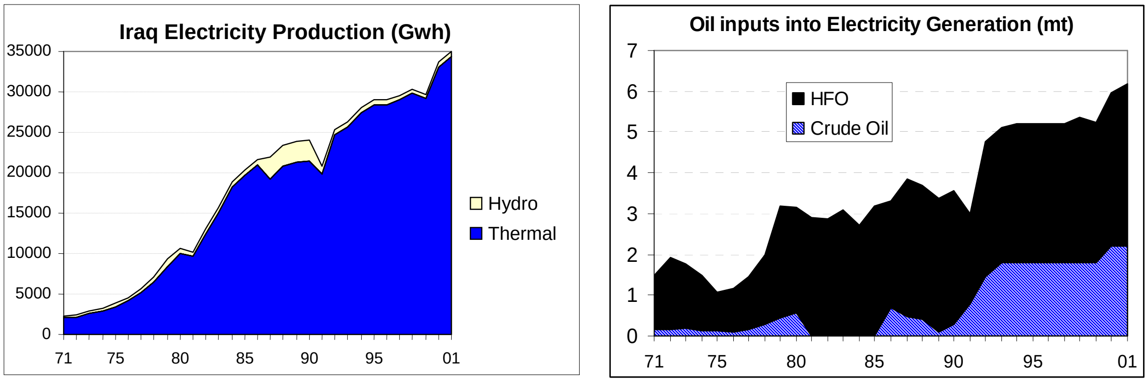
These considerations all bear upon the scope of reform in the electricity sector:

- Reforming electricity price subsidies ought to be part of a broad government effort to free more resources for investment and improve the targeting of the incentives across sectors. In particular, reducing subsidies for electricity needs to be coordinated with similar policies applied to other essential goods (such as food subsidies) to sequence their implementation in a way that reduces the potential political backlash.
- Electricity price reforms are acceptable only if the supply of electricity is reliable, a goal toward which the government is currently working.
- Electricity price reforms have to be conducted in parallel with efforts to improve the management and the use of oil revenues, since current electricity price subsidies (and direct fuel price subsidies) are one of the many ways through which Iraqi citizens perceive a benefit from oil production.

Rebuilding a deteriorated electricity supply

Electricity production has grown by nearly 10 percent per year over the past 30 years—albeit with noticeable bumps along the way—despite war, sanctions, depletion of capital stock, and other major difficulties (figure 3.2). Most of the generation has been fueled by heavy fuel oil, with a smaller contribution from hydropower. Since the Gulf War, a significant share of generation has been from burning crude oil, as the availability of natural gas associated with oil production has fallen. Roughly a fifth of generation was based on natural gas before 1991. After the recent conflict, as oil production fell off from prewar levels, little gas was put into pipelines, which resulted in too little pressure to fuel connected gas turbines. As power plants switched from gas to more crude oil and gas oil, the efficiency of generation has dropped significantly.

Figure 3.2. Iraq electricity production and oil inputs into electricity generation



Note: HFO indicates heavy fuel oil.
Source: World Bank staff estimates.

In 1990, the total installed generating capacity was 9,295MW, with a peak demand of about 5,100 MW. Approximately 87 percent of the population had access to electricity. In 2002, an estimated 2.6 million out of a total 3 million households were connected to the power grid. Households represented 80 percent of all customers and consumed 48 percent of all the power generated. Industry, with less than 1 percent of customers, consumed 20 percent, and much of the rest went to government (13 percent), commercial (6 percent), and agricultural (4 percent) uses. Industry and commercial enterprises also rely on their own standby generators, which could be in excess of 1,000 MW. About 40 percent of electricity is consumed in the Baghdad area. Per capita consumption had been suppressed at around 1,400 kWh from the 1991 Gulf War until the start of the 2003 conflict; recent consumption has been about half of that.

A combination of wars, lack of maintenance, sanctions, looting, and vandalism has severely affected the entire power infrastructure in Iraq. In 1991, the available generation capacity was reduced to 2,325MW, and power cuts of up to 15 hours or more a day were common. Repairs helped make available about 4,500MW of generating capacity in 2002, and about 5,300MW in mid-2004. After the most recent conflict, the situation has considerably deteriorated again. In spite of repairs, generating equipment is aging, fuel supplies are often interrupted, and fuel quality inadequate. As a result, generators frequently fail, and thermal efficiencies are extremely poor. Transmission and distribution systems remain highly unreliable, and total losses are currently about 30 percent. Power cuts have become more frequent. This is the case particularly during the summer, when demand is at its peak. Electricity is currently available only a few hours a day (8.5 hours per day on average throughout Iraq in the first week of January 2005).

Table 3.5. Electricity tariffs in Iraq

Price per kWh (in dollars)	Price per kWh (in dinars)	No. of kWh consumed
Household		
0.0007	1.000	1–1,500
0.0027	4.000	1,1501–2,100
0.0047	7.000	2,101–3,000
0.01	15.000	3,001–5,100
0.02	30.000	5,101 or more
Commercial		
0.0013	2.000	1–300
0.0027	4.000	301–600
0.0053	8.000	601–900
0.008	12.000	901–1,500
0.0013	20.000	1,501–3,000
0.0166	25.000	3,001 or more
Industrial		
0.0057	8.500	0.4 kv
0.002	3.000	11 kv
0.0017	2.500	33 kv
0.0013	2.000	132 kv
Governmental		
0.0013	2.000	1–10,000
0.017	2.500	10,001–20,000
0.002	3.000	20,001–40,000
0.0027	4.000	40,001–100,000
0.0033	5.000	100,001 or more
Agricultural		
0.0033	5.000	

Note: Black market exchange rates as of December each year for 1996 and 2001. These exchange rates fluctuated widely.
Source: Iraqi Ministry of Electricity, World Bank staff estimates.

To reconstruct the existing electricity infrastructure, the World Bank and United Nations have estimated that investments of $13 billion would be needed up to 2007 (United Nations and World Bank 2003a). This amount covers the costs of gradually bringing back the power system to a reliable and efficiently run system similar to the pre-1991 levels of total capacity and service access. The needs were estimated assuming a potential demand in the order of 6,500–7,000MW, to be matched by supply in 2007 with the addition of a little less than 4,000MW over 2005–07.

Getting electricity prices to reflect costs

Iraq has the advantage of being able to shift to natural gas-fired generation over time, which will improve the overall efficiency of operations and substantially reduce emissions. That shift requires significant investments, however. If the government plans to phase out subsidies and attract private capital (and management) into the electricity sector, the legal and regulatory framework will probably have to be updated to enable tariff setting above cost-recovery levels.

Electricity tariffs are now held at very low levels—among the lowest in the world. Although tariffs have increased in recent years, household tariffs, as measured by the black market exchange rate ranged from $0.002 per kWh from low consumption to $0.04 per kWh for high consumption in 2001. Given the features of Iraq's power system (fuel use, generation capacity, consumer density, etc.), tariffs in the range of $0.05–0.07 per kWh would probably better reflect actual cost. The extremely low cost of electricity to consumers provides no incentive to conserve energy, especially for households, and probably lead to wasteful consumption.

In principle, tariffs were set so that operating and maintenance costs would be covered at subsidized fuel prices, but that was barely the case. Total tariffs collected in 2002 were $44 million, compared with costs of about $1 billion, according to estimates made at international fuel prices for the Iraqi Commission of Electricity.

Indeed, the annual fuel bill of about $9 million at subsidized fuel prices would be on the order of $800 million at recent international prices. In the Commission of Electricity's 2002 budget, fuel costs represented only 6 percent of total expenditures, compared with about two-thirds in countries where energy prices are market-based.

At present very limited amounts of revenue are being collected, as distributing companies are awaiting security to improve billing and collection procedures. Yet, the capacity of consumers to pay is likely to be much higher than the existing tariff. In spite of the lack of security affecting economic activity, opening Iraq's borders in 2004 has generated a spurt in demand for electrical appliances. As a result, electricity demand has reportedly increased by about 30 percent, mainly from the household sector.

Since the existing centralized grid is currently unable to satisfy all electricity demand, Iraqis are increasingly resorting to producing their own electricity with small, often portable, stand-alone diesel power generators. In densely populated urban areas with sufficient income, private suppliers are providing power to clusters of households with a single generator, charging a flat rate for the connection. This is likely to be much higher than the prevailing electricity tariff. Reducing the subsidies on diesel prices and increasing the reliability of electricity supplied through the grid are likely to boost demand for grid electricity, possibly improving the profitability of the central power supply system. More important, the high price of electricity from stand-alone diesel generators could indicate a significant willingness to pay for electricity services.[13] Therefore, the Commission of Electricity has a significant margin of maneuver to raise electricity rates, increase revenue collection, and improve the financial health of the utilities.

Increasing tariffs is essential but not sufficient. Iraq used to benefit from a relatively wide

[13] The cost of distributed generation depends in part on the price paid by the generators for primary fuel. Further analysis would have to investigate the price of electricity from distributed generators to analyze the precise capacity of Iraqi consumers to pay. Worldwide, the average cost for household consumers of electricity production by such distributed-generation technologies is around $0.11–0.17 per kWh.

access of its population to electricity. This is well worth preserving. Low-income groups already connected to the grid will probably need some kind of subsidized access for awhile. This subsidy could take the form of a cross subsidy built in the electricity tariff, where larger consumers are charged proportionately more than smaller consumers (a block tariff). This type of tariff structure would imply a significant increase in electricity prices for larger consumers; hence the subsidized tariff for small consumers would need to be set for as low a level of consumption as possible, such as 50 kWh per month, and maintained at that level. If the assessed need for social support is expected to put a burden on larger consuming groups with a risk of political backlash, as a very last resort, a block tariff could be associated with a small direct electricity price subsidy, limited in time. Although the direct price subsidy is known to lead to poor targeting and considerable waste of expenditures, since a lot of the recipients are not necessarily the ones who need financial support, its administrative cost is limited, and it could be designed as part of the transition to prices reflecting economic opportunity costs. If chosen, such a system would need to permit monitoring of expenditures. Implementation of support mechanisms with an impact on the public budget would have to be coordinated with the improvement of safety nets (see chapter 4).

In conclusion, Iraq now urgently needs to mobilize efforts to improve the basic functions of electricity service: efficient generation, delivery, metering, billing, and revenue collection. Although raising tariffs is the key to improving service in the long term, the reliability of service needs to improve before consumers will accept price increases.

In parallel, there is a need for a detailed analysis of the use of electricity, the need for social protection, the appropriate tariff structure, and the options available to work out a transparent and well-targeted support mechanism. To work this out, detailed information on the cost of producing and distributing electricity need to be gathered.

Management autonomy of electricity utilities

In spite of its current problems, Iraq's electricity system has several advantages: a large transmission grid and a relatively expansive access to electricity, abundant primary energy resources of oil and gas, competent utility personnel, and an industry structure that has—in the past—experienced a relative autonomy from political interference. Yet, the challenges are huge: first, to rebuild the existing facilities and meet the existing demand and, second, to set the pace for reforming the utilities and providing them with sufficient autonomy to operate and fund their future expansion. For the electricity utilities to reintroduce more internal financial responsibility, better cost accounting, and eventually lower production costs, they will need more management autonomy.

The Ministry of Electricity is currently responsible for policymaking and electricity supply throughout the country. (The ministry is the successor of the Commission of Electricity.) The Commission of Electricity provided corporate services, operated the National Dispatch Center, and oversaw the operation of three regional generation and transmission companies (400kV and 132kV), four regional distribution companies, and four other companies responsible for construction, manufacturing of equipment, and information technology.

The Ministry of Electricity was recently reorganized into a number of directorates largely maintaining the Commission of Electricity structure, but power generation, transmission, and distribution operations are now reorganized into 18 geographically based directorates, which report to a senior deputy minister. Total staff is estimated at about 43,000. The two electricity departments in Kurdistan (Dohuk, Erbil, and Suleimania governorates), which are not connected with the main grid, report to another official in the Ministry of Electricity and have an estimated 7,300 employees.

Electricity supply will have to rapidly revert to its earlier structure of autonomous companies, away from the direct control of the Ministry of Electricity, to enable adequate investment allocations and rapid and optimal deployment of capital investments across the industry. Gradually, financial accountability of the managers at all level will need to be enforced, and three measures will have to be implemented:

- Prepare programs to reduce technical losses within each of the generation, transmission, and distribution entities.
- Set objectives and measures to improve metering, billing, and revenue collection in the four distribution entities.
- Expand financial accounts to assess the true cost of producing, transporting, and distributing electricity.
- Consider reorganizing generation, transmission, and distribution activities into corporate entities.

The Ministry of Electricity has to give careful consideration to moving away from direct management of the electricity utilities and instead playing the following roles:

- Formulating electricity policy on the timetable for switching to natural gas for power generation; the role of the private sector; the rules, monitoring, and regulation of competition; and the goals for electricity access.
- Protecting low-income consumers by defining the size and nature of possible cash supports to soften the negative impact of electricity price rises.
- Monitoring supply, demand, and reliability of electricity services and identifying gaps in generation investments.
- Creating a favorable investment climate and a clear regulatory framework for private and public enterprises to supply electricity to the grid.
- Determining and enforcing safety and environmental guidelines for electricity supply.

As Iraq moves toward reforming its pervasive system of subsidies on food, domestic fuels, and electricity, it may be able to draw lessons from other sectors of the economy, especially experiences in agriculture (box 3.3). By moving on all these fronts to bring domestic prices more in line with world market prices—and in doing so fostering growth and competition in the country’s private sector—Iraq would also be positioning its economy to take more advantage of trade and foreign investment opportunities.

Box 3.3. Impact of subsidy reforms on the agricultural sector

Agriculture in the national economy. Decades of war, sanctions, inadequate public resources, limited private investment, and heavy state intervention have degraded facilities and distorted incentives, resulting in low productivity and decreasing the contribution of agriculture to rural incomes. For more than two decades, agricultural production was determined by government intervention, with little regard to efficiency or comparative advantage, creating major disincentives for private initiative. The agricultural strategy of the previous government, aggravated by an embargo, promoted the production of strategic crops (wheat, maize, cotton, and sunflowers). For these crops, the government supplied farmers with inputs and equipment at subsidized prices, provided free extension services, acted as the main buyer of the crops at government-set prices, and arranged storage, marketing, and processing. The UN and World Bank Needs Assessment (United Nations and World Bank 2003a) estimated the total amount of subsidies for agriculture at $582 million for that year. About 45 percent of all subsidies were for fertilizers. Most prices, production, and agricultural commodity markets were controlled by the government. Export markets were lost when an embargo was imposed in 1991. In response, the government established a network of state enterprises for the provision of inputs, purchase of crops, and processing of strategic commodities. In 2003 this network broke down; some private entrepreneurs emerged to fill the void. Although the public facilities and their employees have remained in place, they are now largely inactive. The private sector has only slowly and insufficiently developed the capacity to provide the goods and services that were formerly provided by the government. Nonetheless, agriculture still provides 6–8 percent of Iraq’s GDP and absorbs about 20 percent of the Iraqi labor force, supporting a rural population of about 7 million people.

Effect of input subsidies and output price support. Input and output price interventions by the state have created market distortions leading to an inefficient allocation of resources. They created major disincentives for private investment, initiative, and innovation and dramatically reduced sectoral productivity and competitiveness. In addition, large-scale farmers benefited disproportionately from the subsidies, because they used larger amounts of subsidized inputs and outputs. However, price interventions and state procurement systems have generally offered predictable and stable incomes for producers of strategic agricultural products, providing some social safety net for part of the rural population.

Fertilizer production used to be exclusively in the hand of three state-owned factories with a capacity sufficient to meet domestic demand. During the war of 2003, fertilizer production was suspended, and the prewar capacity has never been reached again, primarily because of the lack of electricity. In the absence of governmental supplies, private traders have started to sell imported fertilizers at market prices. The government intends to restore fertilizer production, but gradually to phase out fertilizer subsidies by 2008. Farmers are facing two major issues: the timely availability of sufficient amounts of fertilizers at local markets and the gradual transition to market-based prices for inputs.

Cereal markets are strongly distorted by the Public Distribution System. Before the war, the Ministry of Agriculture used to announce producer prices for wheat and barley before each planting season. The farmers planted according to these prices and received strongly subsidized inputs. The Ministry of Trade’s State Company for Trading Grains procured the farmers' produce, stored it at government-operated silos, and fed it into the milling and distribution processes under the Public Distribution System. Although Iraq has begun its transition toward a market-oriented agricultural sector, the earlier system is still in place as well. Farmers are facing two major issues in this transition: they will need to orient their production toward the requirements of domestic and international markets, and they will need to organize the marketing of their products (in the absence of the guaranteed state procurement of agricultural outputs).

Government strategies for the agriculture sector. The objective of the National Development Strategy is to foster market-led growth. A variety of measures are being implemented, to increase agricultural productivity through input and output price liberalization, increased purchase of goods for the Public Distribution System from local farmers at international prices, improvements in input supplies and support services, investment for irrigation and critical rural infrastructure (e.g., storage); improved natural resource management; and the reform of state-owned enterprises. Related strategies on food security and regional development call for procuring more food from domestic suppliers, liberalizing food prices, maintaining an open trade regime, and reducing the disparities among governorates and between rural and urban areas.

Expected impact of price reforms. While a quantitative analysis of the net effect of these reforms has yet to be conducted, the elimination of subsidies and product price supports will change relative prices among agricultural products and between agricultural and nonagricultural products. Resources will move to agricultural products with higher net returns; some resources will shift between agriculture and other sectors. Evidence from other countries shows that the income effect of low producer prices is usually not compensated by input subsidies. The net income effect of eliminating price distortions is therefore expected to be positive. More efficient resource allocation and increased incentives for private investment are expected to lead to increased sectoral productivity and competitiveness, resulting in higher incomes for farmers, but leaving nonfarm rural families more vulnerable because of higher food prices. Policy reforms affecting agricultural input and output prices work best if coordinated with strengthening the social safety nets.

The extent to which the potential for higher productivity and competitiveness can be realized will depend on farmers' willingness and capacity to adapt their production in terms of output type, quantity and quality, intensity level, and long-term investment. Functioning input and output markets, financial services and risk management (crop insurance, floor prices, etc.), marketing and transportation infrastructure, and effective farmer training and information are critical in this transition.

Trade and investment

Trade has a potential to significantly boost the Iraqi reconstruction process. Already in the current tense security situation private trade has been growing rapidly, providing jobs for thousands. This job creation potential will grow manifold as soon as the security risks are addressed.

For trade to play this facilitating role, however, a trade regime must be designed that is transparent, open, and resistant to instability stemming from highly volatile oil markets. Trade reforms are part of a broader development and reconstruction strategy that will succeed only if harmonized with the domestic price liberalization and reform of Iraq's complex subsidy system. This section examines Iraq's trade structure and recent performance; key underlying issues in mainstreaming trade in Iraq's development strategy; components of a sound trade agenda; and short-term challenges.

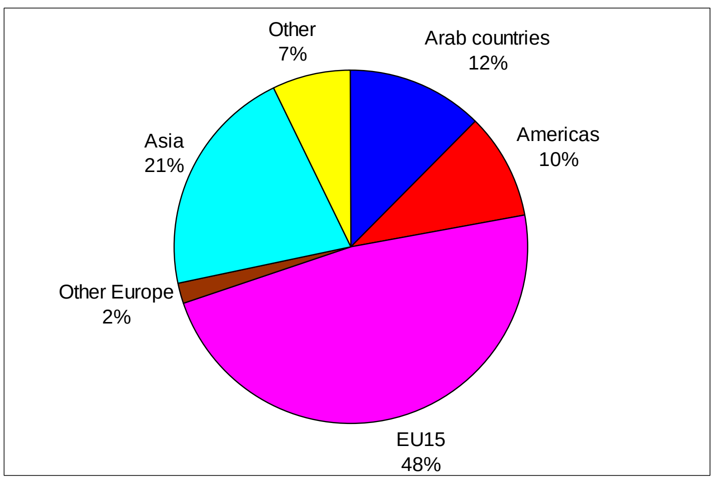
Iraq's trade structure and recent performance

It should not be surprising that Iraq's exports are currently highly concentrated in petroleum and other oil-related products (98 percent), given the recent history of conflict and sanctions. Such concentration was not always the case, however. By the mid 1970s, Iraq was well on its way toward developing a more diversified export structure, with over 90 partners and a wide range of export products. Trade expanded rapidly from the mid-1960s to the mid-1970s, with a 40 percent increase in the number of trade partners and nearly 20 percent increase in total export products. Total exports increased in value by over 700 percent between 1965 and 1975, decelerating a bit by the mid-1980s. In the mid-1970s, Iraq's trade partners spanned countries in the Middle East and North Africa, the Organisation for Economic Co-operation and Development, Latin America, and Asia, and reached to markets as distant as Iceland. Few of the export sectors were competitive on a global scale, with the exception of dried fruit, sulfur, and petroleum. Sanctions have cost these nonoil exporters their foreign markets. These producers have either disappeared completely or are currently idle. The only noticeable nonoil exports are now dates and other food products, amounting to 1 percent of total exports.

The export volume of oil and related products increased significantly in the late 1990s, reaching $16.5 billion in 2000, before following a declining trend ever since. Exports in 2003 were just about half of the level reached in 2000. Imports followed a similar trend. They increased gradually to reach a maximum of $10.5 billion in 2002, and then declined sharply in 2003. Iraqi imports are much more diversified than exports, with machinery, food, and a large number of other products imported. The collapse in imports of machinery, which dominated imports in 2001–02, drove the total decline in imports in 2003. At the same time, Iraq experienced a boom—almost a twentyfold rise since 2003—in private-sector imports. This has filled the Iraqi markets with a variety of previously unavailable goods. Overall, Iraq's trade surplus remains high at $4.5 billion in 2003.

Iraq's major partners for imports include Germany, Iran, Jordan, Turkey, United Kingdom, and United States. Iraq actively pursued bilateral regional trade arrangements with its Arab neighbors before the 2003 invasion. According to the Ministry of Trade, the government signed free trade agreements with 11 Arab countries. Most of these agreements were signed in 2001–02 as part of Iraq's efforts to skirt the UN international trade embargo (Kaminski 2004). As shown in figure 3.3, however, Arab countries accounted for only 12 percent of Iraq's imports in 2004.

Figure 3.3. Geographical distribution of Iraq's imports, 2004



Source: Central Bank of Iraq 2004.

Mainstreaming trade in Iraq's development

To integrate trade policy into Iraq's broader development and reconstruction strategy, three issues are worth considering:

Fiscal consolidation, restructuring, and diversification. While oil revenues will continue to be the mainstay of government revenue streams, it will be important to encourage development of a more diverse fiscal base, reflecting the underlying volatility of oil, the high demand for reconstruction, and the need to service debts in the short and medium term. Within such a diversified structure, sensibly chosen taxes on imports can play a modest but nonetheless important role, especially when world prices of oil are low. Tariff revenues will supplement oil royalties to fund government expenditure without resort to additional taxation, largely or wholly relieving the nonoil traded sector and the private service sector of other forms of direct and indirect taxations. Whatever the difficulties of creating customs administration and working tariff regimes, they are likely to be easier and more immediate to achieve, and easier to sustain, than introducing more broad-based domestic taxes (income tax, value-added tax, or sales tax) or export-supporting schemes, such as duty drawbacks.

Minimizing Dutch disease effects. Iraq is an oil-rich economy with tangible prospects for expansion of production. Income per capita is likely to increase significantly over the coming ten years. Higher income will boost consumption of nontraded goods and services, bidding up their prices, resulting in overvalued and uncompetitive exchange rates and reduced relative profitability of the nonoil traded goods sectors (agriculture and industry). These are the classic symptoms of Dutch disease. To minimize such problems and maintain a diversified economy, it is necessary to ensure that the nonoil traded sector remains lightly taxed, flexible exchange rate policy and labor legislation is in place, red tape is kept to a minimum, and capital goods and inputs are not subject to high tariffs.

Improving the investment climate. The success of trade reform will heavily rest on private investment response and job creation. Combined with policies friendly to foreign direct investment and other measures to improve the investment climate, this is likely to encourage both foreign and domestic investment in the nonoil sector and increase the likelihood of absorbing workers currently unemployed, as well as new entrants to the labor force. Changes in the trade and investment climate are critical complements in benefiting labor markets. Reinvigorating trade reforms, when combined with complementary actions to spur private investment, will likely lead to much faster employment growth in aggregate.

A proposed trade agenda

As Iraq reconfigures its agenda for trade, it should consider reforms to streamline the tariff structure, stimulate trade in the service sector, and, encourage foreign direct investment.

Tariff policy. In the prewar period most of Iraq's trade was through the U. N. Oil for Food Program, under which imports entered the country tariff free. Private-sector imports that took place outside the program were subject to tariffs in the 15–20 percent range, with tariff peaks of 100 to 200 percent on some products, including luxury cars.

In 2003–04, the Iraqi government took a number of trade policy measures. Border restrictions to merchandise trade were lifted, a uniform tax of 5 percent instituted, foreign exchange markets liberalized, and the decision was made to negotiate membership in the World Trade Organization. Iraq has started to unwind decades of state control, price distortions, and high protection. Over the longer term, the main task will be to put in place a tariff structure that can yield important benefits to the country's broader policy objectives. International experience suggests a few rules of thumb that could guide policymakers when designing a tariff structure:

- *Simpler is better.* A regime with a uniform moderate rate that injects efficiency in the economy while providing a degree of support for domestic value added is preferable to one with multiple levels and peaks on individual products. Multilevel and specific product tariffs can foster fraud, corruption, and economic distortions.
- *Lower is better.* A low uniform tariff (e. g., not exceeding 10 percent) provides domestic value added with a modest degree of protection, but also exposes the tradable sector to some international competition, which places an upper bound on the inefficiencies that can emerge in closed markets.
- *Broader is better*. Even simple structures can be hard to administer if there are countless ways to legally avoid paying duties, e. g., exemptions for the government, for nonprofits, or for specific expenditures and industries.

The proposed tariff structure—low uniform tariff across all goods and all importers—has many advantages. It would send a clear signal to investors, reduce the cost of much needed capital and intermediate goods, provide increased access to modern technologies, facilitate trade by simplifying customs clearance procedures and customs valuation, and put Iraq's trade regime close to that of the Gulf Cooperation Council with which Iraq may want to eventually affiliate. In addition to the free trade agreements signed with Arab countries, Iraq is likely to engage in an agreement with the United States and, possibly, with the European Union. The bulk of Iraq's trade may be governed by trade agreements in the medium run, and a low uniform tariff could help avoid costly trade distortions. To put Iraq's trade regime into perspective, it is worth noting that the simple average tariff in Middle East and North Africa is 16.5 percent—higher than any region except South Asia. About 16 percent of tariff lines are subject to at least one nontariff barrier in the Middle East and North Africa. Only Jordan, which has an average tariff of 16.2 percent, has done away completely with its nontariff barriers. Syria has high protection, with an average tariff of 21 percent, and Saudi Arabia also has moderate protection (12 percent average tariffs), as well as fairly prevalent nontariff barriers.

The proposed tariff reform should also be consistent with overall tax policy. If the objective is to introduce a value-added tax, such taxes would have to be collected at the border. If the same principles of simplicity and broadness are applied to the tax reform, then the efficiency of the tariff reform will be enhanced.

Trade in services. The service sector is likely to be the largest source of employment and, to a lesser degree, value added in Iraq. A vibrant service sector can also be a source of exports—for example, the United Arab Emirates have been moderately successful in developing tourism, re-export trade, shipping, telecommunications services, broadcasting and media, and financial services (World Bank 2003d). Efficient provision of so-called backbone services, including telecommunications, power, transportation, and finance, is crucial to economy-wide productivity and therefore to international competitiveness. These services also have a direct impact on living standards.

Stimulating competition in the service sector and providing access to state-of-the-art technologies and management practices, by allowing foreigners access to the domestic market for services, should be a central thrust of Iraq's development strategy. The benefits of this strategy are clearest in sectors that are normally the province of the private sector throughout the world, such as retailing and wholesaling, banking, even though many of these sectors are state-driven at present in Iraq.

The regime for foreign direct investment. Foreign direct investment—or foreign establishment—is by far the main vehicle through which the domestic service sector can be exposed to international competition. Other modes of international service provision identified in the General Agreement on Trade in Services include temporary movement of workers, remote provision (e. g., through the internet), and movement of consumers (e. g., tourism). Thus, a new regime for foreign direct investment is a crucial platform for facilitating trade in services and promoting efficiency across the Iraqi economy.

As in the case of services, a liberal foreign direct investment regime is also essential to promoting Iraq's trade integration in global markets for manufacturing, agriculture, and food processing by providing risk capital, technology, access to markets, and management know-how, as well as enabling Iraq to enter the international value chain in sectors where it has comparative advantage. Finally, foreign direct investment can be a crucial source of development finance during Iraq's reconstruction phase. Increased reliance on foreign direct investment may help to develop Iraq's still largely unexploited oil production potential and also contribute to the country's debt-reduction objective.

As Iraq undertakes these much-needed, but technically difficult regulatory reforms in services, it may wish to focus initially on services directly related to logistics and facilitating trade. These backbone services facilitate resource flows and economic transactions between countries. They are critical to attracting "production blocs" from abroad because they allow for production fragmentation. Without high-quality backbone services, Iraq's domestic and foreign investment will be hindered, with resulting loss in trade (Kaminski 2004)

Membership in the World Trade Organization. Iraq's application for World Trade Organization membership in 2004 sent an important signal to investors that Iraq is willing to commit to transparent, rule-based liberal trade policies. It also had a symbolic dimension, signaling to the world that Iraq wants to reintegrate into the broader world community after a long period of diplomatic isolation and war. The move will further help to ensure that products originating in Iraq would be subject to most favored treatment across the World Trade Organization membership. If Iraq binds its tariffs at a lower level (e. g., 10 percent), it would send a strong signal of stability to its partners.

Since the Uruguay Round in 1994, the accession process has been notably successful in helping countries shift toward stable, transparent, rule-based foreign trade regimes. Beyond traditional trade policies, there has been a tendency among current World Trade Organization members to insist that new entrants remove even a wide range of behind-the-border barriers, frequently compelling them to introduce far-reaching institutional reforms. In the case of Iraq, World Trade Organization members will likely push Iraq to reduce or eliminate certain discriminatory policies and laws, as well as discretionary import licensing, subsidies, monopolistic state-owned enterprises, and similar harmful practices. There are practical limits, however, in using World Trade Organization accession as a "lock-in" mechanism to meet demand for reforms in these areas and implement regulatory agreements that emerged from the Uruguay Round. Contrary to tariffs that have to be bound in the World Trade Organization, many of these reforms are not requirements of World Trade Organization members. The government has to choose to implement them.

Furthermore, simply promulgating domestic regulations and policies compatible with World Trade Organization standards does not in itself create a high-quality institutional environment. Nor does it ensure that rent-seeking will disappear. In the case of Kyrgyzstan, the World Trade Organization accession process itself had opened the door to domestic special-interest lobbying. That country started the accession process with a low, uniform tariff and ended it with 11 tariff bands and the maximum rate triple the level of the preaccession tariff. Accession means having to bargain with other World Trade Organization members over conditions for opening to competition from imports. For a particular country eager to join, the exchange of "concessions" may not necessarily add up to the best and most productive trade regime. There are many paths to the World Trade Organization, and most countries look at the process as one of mercantilist bargaining, treating liberalization and compliance with World Trade Organization rules as bargaining chips rather than as opportunities to improve overall economic welfare.

For these reasons, the key factor in reforming trade and institutions is likely to be the political will to modernize institutions. Using World Trade Organization commitments as a strategy to leverage domestic reforms and to integrate Iraq's economy into global markets could thus be effective if two conditions are met. First, the Iraqi government must genuinely commit itself to multilateral liberalization, with the accession process serving as a shield and driver of reforms. Second, accession must fit within a broader strategy of structural reforms. The primary objective is not compatibility with the World Trade Organization, but a high-quality institutional environment that ensures macroeconomic stability and a healthy climate for economic activity.

Short-term challenges

Priorities include the rehabilitation of the customs administration, the establishment of safety standards for imported and exported products, and need to link trade liberalization with domestic reform of price subsidies and state-owned enterprises

Customs administration. In the past year, important steps were made in this area. Customs were transferred back under the control of the Ministry of Finance, with a new director general and key staff appointed. Several points of entry were made operational, with the basic infrastructure rebuilt and basic information technology installed. Customs regulation and procedures were clarified and disseminated. Customs staff has made study tours to well functioning customs operations in the Arab world and elsewhere.

Still, there remain significant deficiencies: transport and communications equipment is often lacking, and many staff positions are vacant. Customs operations consist of sets of interlocking processes. To be efficient and effective, they need to be adapted to changing trade practices and modern management approaches, and they need to reflect the various objectives of the country. Simplified customs procedures will therefore need to be established with modern techniques of risk management and selectivity, and staff will need to be intensively trained in these procedures. While the present legislation is judged adequate for the time being, new simplified customs procedures and tariff classification need to be made available in Arabic to the business community and customs officers.

International experience shows that effective customs modernization processes generally start with good initial diagnostic work to identify the shortcomings of the existing system, to define a strategy for the reform, and to mobilize stakeholder support. It also requires a comprehensive approach, i. e., one that encompasses all aspects of a customs administration to address the issues identified, as well as an adequate sequencing of actions. Strategies need to be realistic and consider the country's capacity for implementation, the time that is required, and the level of stakeholder and political support that is needed. The overall modernization program would aim to assist the Iraqi customs to adhere to professional standards as close as possible to those provided in the Revised Kyoto Convention of the World Customs Organization.

Safety standards. The 2003–04 import boom experienced in many nonmachinery products has filled the Iraqi markets with a variety of previously unavailable goods. There have been many reported cases of imports of unsafe or adulterated products. The Iraqi government is moving to assess the current and prospective safety hazards associated with expanded private-sector imports. Then, it will strive to design an appropriate set of public actions, involving tighter and more systematic inspections (at border sites or in the distribution system)—either by government agencies or contracted third parties—recognition of product certification from accredited trade partner agencies, and other measures as necessary.

These steps are important for both imports and future nonoil exports. The ability of Iraq to expand exports of agricultural and manufacturing products will require measures to enhance the quality consciousness of producers, induce wider adoption of recognized good practices—which impart safety and quality—in agriculture and manufacturing and put in place product conformity systems which are recognized and accredited internationally. To identify current capabilities and weaknesses, as well as near-term priorities for technical assistance and capacity building, an assessment is needed of Iraq's system of standardization, accreditation, and quality certification, reflecting capacities in both the public and private sectors.

The development of organizational capacities—for example, the State Standardization and Metrology Agency, which is accredited to issue certificates on ISO 9000 standards on quality or IS 14000 series—would encourage improvements in the quality of domestically produced goods. The issuance of local "quality markings," certificates that Iraq meets international standards, and contests for the best-manufactured products would be a good investment. The best option would be to follow international practice by accepting standards and certificates from recognized international and national bodies. Iraq should take a first step—establishing a modern, market-based system of technical regulations, product standards, and certification. This requires a legal framework to ensure that there is an organizational split between accreditation or certification processes and privatizing laboratories.

While more general reforms and institutional strengthening are being planned, there may be scope for some near-term initiatives involving training, technical assistance, and other support directed at selected industries or commodity subsectors that have an established export track record, yet are likely to face market access problems because of nonconforming product quality, safety, or certification systems. Any such pilot initiatives will benefit from strong private-sector involvement, in both their design and implementation.

Domestic price liberalization and state-owned enterprise reforms. Iraq will remain a large net importer of food, and it will benefit from a liberal trade environment. However, the country has a complex system of controlled prices, and the establishment of the proposed uniform tariff for finished goods may be difficult in the face of continued domestic price controls. If the timing of trade policy reform and price liberalization is not worked out carefully, the response is likely to be a long list of exemptions. Furthermore, as long as food and other products are subsidized so heavily, some export controls will be necessary to avoid smuggling. Trade reforms will be more effective if closely linked to gradual food and energy price liberalization. At the same time, the food distribution system needs to be adapted to the new context, and adequate safety-net arrangements need to be put in place to protect the poor and vulnerable. Needless to say, moving forward on these reforms (price liberalization and privatization of the food distribution system) would need to be carefully timed, taking into account the current highly volatile security situation. Chapter 4 discusses some of the possible safety-net solutions.

Summary of recommendations

Price adjustments of the magnitude required in Iraq carry large and complex implications for the economy and society. Care is needed to evaluate the likely consequences and to formulate a coordinated approach. The following recommendations can be offered for the short term:

Food security

- Give careful consideration to the speed and sequencing of reforms before choosing a future direction for the Public Distribution System or its replacement system.

- Maintain the existing inefficient safety net (i. e., the PDS) until a more efficient safety net is in place.
- Prioritize collecting and analyzing data on poverty and assessing the institutional capacity of the government to implement safety-net programs.

Domestic fuel subsidies

- Raise prices at least to the level that eliminates or significantly reduces smuggling, as a first step toward reforming fuel subsidies. Given the very low fuel prices today, immediate price increases are warranted, in coordination with price adjustments in other affected sectors.
- To the extent possible, set prices of gasoline, kerosene, and diesel at comparable levels to minimize interfuel substitution.
- Minimize the use of fuel price subsidies, as these are not pro-poor. Include compensation for fuel price increases as a component of a broader social safety-net package.

Electricity pricing and management autonomy

- Launch a detailed analysis of energy use and costs of producing and distributing electricity to evaluate the precise need for social protection, to define the appropriate electricity tariff structure, and to determine the nature of a social support mechanism that is transparent in the public budget and well targeted.
- In coordination with end-user electricity price reforms, initiate a move toward pricing heavy fuel oil at international parity price levels for the power sector.
- In coordination with price subsidy reforms in other sectors (in particular, food), design a sequence to gradually bring back electricity prices to cost-recovery levels.
- Revert electricity supply to its earlier structure of autonomous companies, away from the direct control of the Ministry of Electricity, to enable adequate investment allocations and a better control of costs.

Trade and investment

- Maintain a low uniform tariff across all goods and all importers. This will reduce the cost of much-needed capital and intermediate goods, provide increased access to modern technologies, and facilitate trade by simplifying customs clearance procedures and customs valuation. It will also put Iraq’s trade regime close to that of the Gulf Cooperation Council, with which Iraq may want to eventually affiliate.
- Bind the tariff structure at a lower level (e.g., 10 percent) at the World Trade Organization, to send a strong signal of transparency and stability to Iraq’s partners.
- Seek coherence between the proposed tariff reform and overall tax policy. If a value-added tax is to be introduced, it is best implemented using the same principles of simplicity and broadness underlying the proposed tariff structure.
- Revise the foreign direct investment regime to allow greater foreign investment in Iraq. Foreign direct investment is by far the main means through which the domestic service sector can be exposed to international standards. World Trade Organization accession can be used to make “opening offers” in the services sector.

- Rehabilitate the customs administration by investing in new communications equipment and training staff. The present legislation is judged adequate for the time being, but new simplified customs procedures and tariff classifications need to be made available in Arabic to the business community and customs officers.
- Assess Iraq's system of standardization, accreditation, and quality certification, reflecting capacities within the public and private sectors, to identify current strengths and weaknesses, as well as near-term priorities for technical assistance and capacity building.
- Link very closely the timing of trade policy reform and price liberalization to avoid a long list of tariff exemptions. As long as food and other products are subsidized heavily, maintain some export controls to avoid smuggling.

Part II. Protecting the poor and vulnerable

Chapter 4. Reforming social safety nets and pensions

Iraq faces a choice between considerably broadening and strengthening its formal safety nets or continuing to rely on untargeted subsidy schemes and subsidized services. The choice is imminent because Iraq's social fabric remains very fragile, with large segments of the population facing unprecedented social and economic risks. The continuing conflict, high unemployment, widespread poverty, and so far limited economic response to reform are some of the problems that the society must confront. The incidence of absolute poverty is significant. Whether measured by monetary income or nonmonetary indicators such as health, nutrition, and life expectancy, poverty has worsened dramatically during the turbulent 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.

Iraq's volatile security is likely to have continuing consequences on poverty and vulnerability. The limited ability to manage these risks, coupled with the social exclusion of large vulnerable groups, threatens the nascent Iraqi democracy and the reconstruction process. Recent assessments confirm the importance of developing social protection programs that can help to mitigate the consequences of economic transition. The first priority would be to undertake comprehensive household expenditure surveys to identify the Iraqi poor. These surveys are starting. The next step would be to design formal safety nets and finance them in a sustainable fashion.

Poverty and vulnerability in Iraq

A systematic assessment of poverty has yet to be undertaken in Iraq, but available data suggest that the incidence of poverty is significant.[14] About 1 in 10 Iraqis lives in absolute poverty, and the same number are near the brink of the international poverty line of $1 a day (table 4.1).

At the same time, surveys register relatively low inequality. The ratio of median incomes of the lowest and the highest quintiles was relatively low in 2003 at 3.7. In 2004 conflict and economic transition exacerbated inequality and pushed this ratio up to 5.3. Similarly, poverty indicators other than income also reveal relatively low inequality (e. g., in child malnutrition). These outcomes suggest the impact of the state-led redistributive development model that Iraq followed for decades and, more recently, the success of the Public Distribution System in securing the nutritional standards of the Iraqi people.

[14] Income data should be interpreted with caution: recent income surveys may have been hampered by the security situation and a large role of informal sector (see box 1.1). Certain groups of the population were not covered, including recent returnees and internally displaced persons fleeing combat areas such as Falluja. More of these households are likely to fall into the lowest income category, and their exclusion could have artificially inflated income levels.

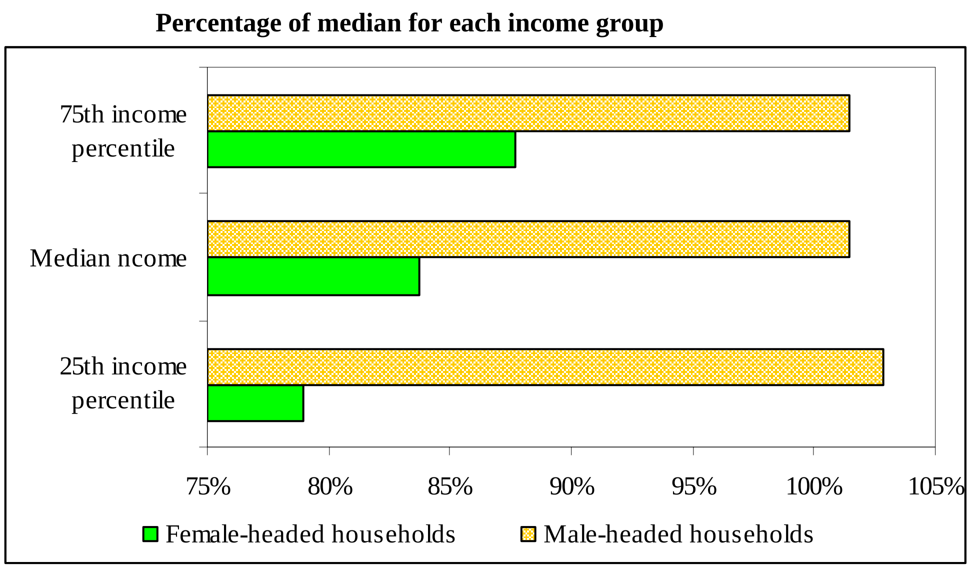
Table 4.2. Iraq's per capita household income by income quintiles, 2003 and 2004
(in U.S. dollars)

Year	*Income quintile*	*25th percentile within quintile*	*Median for quintile*	*75th percentile within quintile*
2003	Lowest income	427	585	780
	Low income	661	873	1,132
	Medium income	847	1,179	1,545
	High income	1,137	1,544	2,072
	Highest income	1,470	2,158	3,025
2004	Lowest income	555	809	1,104
	Low income	1,029	1,374	1,833
	Medium income	1,433	2,070	2,638
	High income	2,053	2,797	3,698
	Highest income	3,057	4,314	6,211

Source: Ministry of Planning and Development Cooperation/UNDP 2005.

An important aspect of Iraq's poverty is its concentration in female-headed households, whose median incomes are 15–25 percent below comparable male-headed households. The gender gap is particularly pronounced among the poorest (figure 4.1).

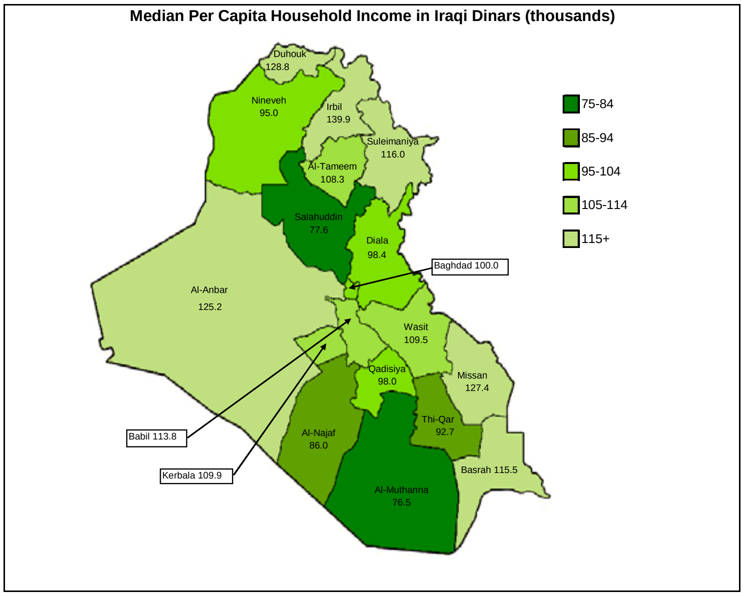
Figure 4.1. Gender and poverty by household income percentile, 2003



Source: Ministry of Planning and Development Cooperation/UNDP 2005.

Iraqi poverty has a distinct regional dimension (figure 4.2). The three Northern Kurdish governorates register consistently higher incomes than the rest of the country, while several Southern governorates, particularly Muthanna and centrally located Salah Al Din, report distinctly lower incomes. This poverty gap does not appear to be a rural-urban divide, at least not nationwide: the gap between median incomes of rural and urban households was less than 10 percent in 2003–04. Regional disparities are also pronounced in the nonmonetary poverty indicators, such as health and education conditions.

Figure 4.2. Regional patterns of poverty in Iraq



Source: Ministry of Planning and Development Cooperation/UNDP 2005.

Societies can have both chronic and transitory poor people. In Iraq, there are many groups that are especially vulnerable to poverty, social exclusion, and other social ills, given the current environment. These include, among others:

- *Unemployed youth*. The labor force participation rate among Iraqi youth is estimated at less than 30 percent, while for the economy as a whole it is over 40 percent (Ministry of Planning and Development Cooperation/UNDP 2005). Youth do not have the experience to compete in tight labor markets, and many also do not have the skills that employers need. Unemployment early in working life has been shown to increase the probability of future joblessness and lower future wages and can lead to alienation and social unrest (ILO 1998–99).
- *Former military, police, and ex-militia*. Many young people are among the former military and paramilitary forces that were disbanded following the fall of the old regime. While military forces are being reconstituted, it is expected that some 250,000 to 300,000 former members of the military, some with disabilities, and another 20,000 private militia members need civilian jobs. These large numbers make redeployment and reintegration a formidable challenge, particularly because many ex-soldiers are not oriented toward private-sector occupations. They are vulnerable to social and lifestyle adjustments; their alienation poses a risk to the formation of a stable Iraq. Already over 300,000 former military and militia and their families receive cash assistance under the government's reintegration program.
- *War victims with disabilities.* Exact statistics for the number of civilians injured in the conflict are difficult to come by. A standard assumption is that the number of

people injured in a war is at least three times the number of deaths. Estimates of the injured in Iraq, including combatants, range from between 20,000 up to 135,000, depending on the source and the methodology.[15] Children, too, often are affected long after a conflict stops. UNICEF has concluded that by July 2003 more than 1,000 children had been injured since the end of the war as a result of unexploded ordinance. That number continues to increase.

- *Internally displaced persons, refugees, and returnees*. These groups form a vulnerable population that has limited recourse to traditional risk-coping mechanisms, such as personal or family assets or faith-based support. Internally displaced persons include a prewar group displaced by the policies of the former regime (perhaps as many as 800,000 in the Northern governorates and up to 200,000 in the South, including Marsh Arabs and displaced Shi'a families).

Iraq's volatile security is likely to have continuing consequences on poverty and vulnerability. Lack of access to work and social services will cause temporary hardship for a large segment of the population. Long-term, chronic poverty will also result in households whose primary earners are killed or whose livelihood is destroyed, and for those whose education is cut short. Even in the optimistic scenario of a stable security and political situation, the Iraqi economy will be undergoing a major market-oriented transformation, which will create temporary unemployment as labor allocation moves to more productive areas. There will certainly be winners and losers in this transformation and changes in the distribution of income. The nature of these changes, however, is uncertain and, given the number of changes occurring simultaneously, the changes will be difficult to predict. In this context, efforts to monitor changes in the nature and extent of poverty and measures to provide reliable safety nets to the poor will be crucial.

Social protection

Social protection in Iraq consists of a collection of program interventions and providers, including direct support from families, assistance from private and charitable organizations, and programs administered by the government, as well as temporary interventions from donors and the international community. Altogether, the system is similar to other social protection arrangements in the Middle East and North Africa region and elsewhere. It has been profoundly weakened by the policies of the previous regime, coupled with the years of conflict and the resulting burden placed on the limited public assistance.

Subsidies

The Public Distribution System is the main publicly supported safety net available to the whole Iraqi population. Other subsidies are off budget and amount to transfers to households possibly in excess of 50 percent of GDP. These subsidies were analyzed in chapter 3.

[15] Various sources report a range between 20,000 and 135,000 deaths over 2003–04.

Cash and in-kind assistance

For families without adequate support, including the blind and disabled, as well as single-parent families and the elderly, the Ministry of Labor and Social Affairs provides a monthly cash transfer. This flat benefit is modest (less than 10 percent of the median income of the lowest quintile) and reaches only about 112,000 families, whereas conservative estimates have put the number of needy families at more than 850,000.[16] Small cash transfers are also provided to demobilized military personnel covered under the government demobilization and reintegration program. The 2005 budget allocates ID 375 million for the 300,000 demobilized personnel, implying an average benefit of about 10 percent of the median income of the lowest income quintile, similar to the Family Allowance.

Neither of these transfers is based on a consistent definition of need, nor takes adequate account of family size in determining benefits. It is likely that some benefits are spilling over to those less needy and that better targeting methods, such as individual or proxy means testing, would improve the equity and efficiency of payments.

The ministry also provides limited institutional care for the blind and disabled. It maintains approximately 130 facilities, including kindergartens, orphanages, institutes for the disabled, elderly homes, and cooperative society workshops. Many of these have been severely damaged and have inadequate supplies. The number of beneficiaries is quite small, numbering only about 6,300 in 2004. The facilities and in-kind services offered are not designed to promote independent living or integration into society.

Private and informal safety nets

The extent of nongovernmental mechanisms for social protection is unknown. It is likely that family and personal networks account for the majority of social protection and that charity and faith-based institutions provide significant assistance to the most vulnerable. Recent surveys suggest that more than 90 percent of households had more than one source of income in 2003, with nearly a quarter reporting three or more sources. Households are relying on multiple jobs and job holders within the family and possibly in some cases contributions from outside the family to survive.

Nongovernmental organizations (NGOs) could have a significant role in the provision of social safety nets. Currently, there is not enough information at hand to determine the level of assistance actually provided by NGOs. Official estimates put the number of registered NGOs at more than 2,500 at the end of 2004, following the adoption of statutes designed to encourage the formation of NGOs and community groups.

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[16] Data are for 2004. The Ministry of Labor and Social Affairs has recently increased the Family Care Allowance for a single person from ID 30,000 to ID 40,000 (about $28) and for families with more than one person to ID 50,000 ($35). The ministry also intends to expand the number of families covered to 300,000 in 2005, resources permitting (Ministry of Labor and Social Affairs data; United Nations and World Bank 2003a).

As in many majority Muslim countries, *zakat* and *waqf* are common forms of assistance from individuals, typically given to community charitable organizations or to mosques, which then direct the use of funds. The government, through the official Awqaf Divans, helps to coordinate the distribution of some of these resources.

Pension reform

Pensions are another kind of formal social protection mechanism. All public-sector workers and employees of private firms with five or more employees are entitled in principle to social insurance, including pensions, medical insurance, disability, sickness, and maternity leave benefits.

Having an insurance mechanism in place to protect against poverty in old age is an important element of the social contract for workers in Iraq. Formal pensions have existed in various forms since 1922. Unfortunately, the pension system covers a minority of workers, given the large informal-sector workforce, and it is very expensive. The system now faces critical problems of financial sustainability, equity, and efficiency. These problems stem in part from the implementation of a series of emergency policies put in place after the war without proper assessment of the financial implications. To a large extent, however, the problems of the pension system are structural and would have had to be addressed in any circumstance.

The Iraqi mandatory public pension system is composed of two separate funds: (a) the State Pension System, which covers civil servants, the military and security forces, and employees of state-owned enterprises and (b) the Social Security System, which covers private-sector workers. Both are defined-benefit schemes financed on a pay-as-you-go basis.

Excluding the military, the two systems together cover roughly 15 percent of the labor force—mostly public sector workers. Indeed, from a total of 1.1 million workers accruing pension rights with either system, 1 million are civil servants or employees in state-owned enterprises (table 4.2). Only around 76,000 workers in the private sector currently are enrolled in the Social Security System—a mere 1 percent of the labor force.

Table 4.2. Contributors and beneficiaries in the Iraqi pension system, 2004

	Military		Civil servants		Private sector	Total
Contributors		n.a.		1,733,686	76,200	n.a.
Share labor force (percent)		n.a.		17	1	n.a.
	Length of service					
	Less than 25 years	*More than 25 years*	*Less than 25 years*	*More than 25 years*		
Beneficiaries	322,164	156,685	320,510	235,538	14,125	1,072,791
Old-age	105,120	116,205	181,968	169,209	6,108	620,825
Survivor (one)	91,151	15,709	84,092	41,827	8,017	231,049
Survivor (more than one)	125,893	24,771	54,450	24,502		220,917
Total expenditures (ID million)	407,526	286,259	472,185	595,971	11,683	1,405,987
Share of GDP (percent)	1.09	0.76	1.26	1.59	0.03	3.74
Average monthly benefit (ID)	105,414	152,247	122,769	210,855	68,929	109,216

n.a. is not applicable.
Note: GDP in 2004 was ID 37,556 billion. Data are as of December 2004. Data regarding the demographic structure and the finances of the pension system remain very limited.
Sources: Ministry of Finance, Ministry of Labor and Social Affairs.

Implementation of emergency policies

After the termination of major military operations in Iraq, the Coalition Provisional Authority replaced regular pensions with emergency "flat" payments, which amounted to about 3.7 percent of GDP in 2004. These payments have been increased continuously and now range between ID 80,000 per month ($53) and ID 200,000 per month ($133). The motivation was to compensate pensioners whose payments had been significantly eroded by inflation. General civil service salaries were also increased. Together, these measures imply a larger government debt with the pension system. Costs are likely to increase further, given the need to design compensation and reintegration programs for military, security forces, and ex-members of the militia.

It is desirable to normalize pension payments as soon as possible, but going back to the previous pension formulas would be counterproductive. Indeed, as discussed in the next section, these formulas have several problems that compromise the financial sustainability of the pension system and are a source of inefficiencies and inequities. Current emergency "flat" pension payments could be preserved until the new pension system is ready. These payments would be financed out of the general budget, but they would be rationalized to control costs. Assuming that individuals continue to retire with emergency payments during the next 12 months, it is estimated that costs would peak at 7.6 percent of GDP in 2006 and then gradually decline.

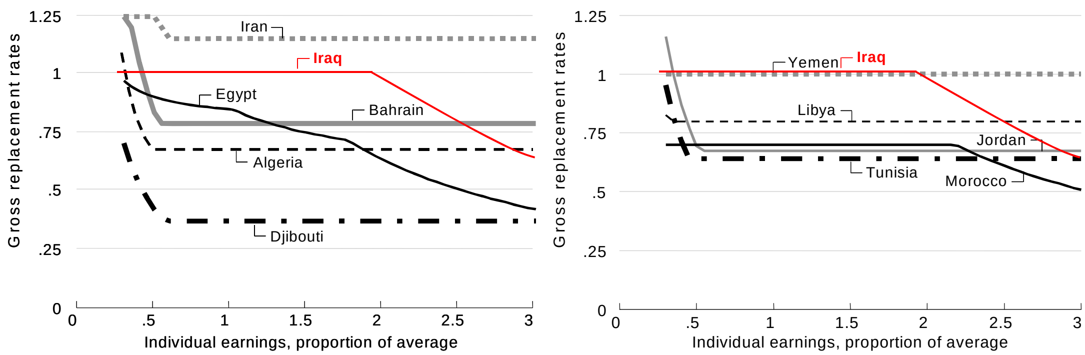
Structural issues

The pension system in Iraq, as in other Middle East and North Africa countries, faces structural problems that compromise its financial sustainability, reduce economic efficiency, and create intra- and intergenerational inequalities:

- A first problem is the dual structure of the pension system, which is a source of inequalities. Provisions differ between schemes, with civil servants receiving more generous benefits. Dualism also increases administrative costs and, more important, can restrain the movement of the labor force, thus precluding efficient allocation of labor. As the role of the private sector expands, a dual pension system would be a drag on the Iraqi economy.

- The second problem is related to the mandate of the pension system, which is unaffordable. Both schemes offer very high gross replacement rates, close to 100 percent of the last salary for the average full-career worker. These are among the highest replacement rates observed in the region (figure 4.3). This reduces incentives to diversify the sources of savings for retirement, particularly among middle- and high-income workers and thus limits alternative means of managing financial and longevity risks.

Figure 4.3. Income replacement patterns of pension systems in the Middle East and North Africa



Source: World Bank staff calculations.

The Iraqi pension system is accumulating unsustainable pension liabilities as a result of the misalignment between the contribution rates, the targeted replacement rates, and the retirement age. Accrued-to-date pension liabilities with current contributors—that is, excluding the liabilities with current retirees—are estimated at over 60 percent of GDP. This is due, in part, to recent salary increases for civil servants. The contribution rate necessary to equilibrate the old-age pension component (i. e., without taking into account disability and survivorship pensions) would need to be set at over 30 percent of the covered wage. This level of taxation can cause a severe loss in competitiveness, a reduction in the demand for labor, and the possible expansion of the informal sector. Moreover, as the demand for public resources continues to increase, pension payments would crowd out the production of other public goods and services potentially of higher social value (e. g., health and education).

The low coverage rate of the scheme for private-sector workers is another cause of concern. Only about 2.5 percent of private-sector workers are enrolled in the pension scheme. Managers report high levels of evasion. Employers systematically underreport the number of employees to remain below the minimum at which pension enrollment becomes mandatory.

A final concern is the governance structure and administrative capacity of the pension system. The current staff will need additional skills to properly manage a reformed pension fund and to design and implement necessary reforms. Information technologies will need to be updated, including record keeping and payment systems.

Summary of recommendations

The social protection system in Iraq faces enormous challenges. Unemployment, poverty, and other vulnerabilities are prevalent under current conditions, and the resources and capacity to assist the needy and help them manage risks effectively are limited. Yet, the difficult transition that Iraq is enduring presents an opportunity for strategic development of effective social protection for the future. Several recommendations emerge from the initial review of the system:

Improve information for policy design. To design and implement effective social programs, it is critical to have timely and reliable information on the poor and vulnerable in society. Data and information will need to be collected at two levels: the national population level and the program level. Improving the information base includes implementing comprehensive household surveys on income, expenditure, and use of services as soon as conditions permit, together with reestablishing administrative data sources at the program level.

Enhance institutional capacity and coordination. The capacity of many ministries and agencies with social protection mandates has been weakened in recent years, even before the current conflict. The infrastructure to collect and process data, the institutional ability to analyze data, and the administrative and technical capabilities to effectively run, monitor, and evaluate programs need to be improved. Coordination between agencies with overlapping mandates or beneficiaries must be improved as well. Government safety-net interventions, NGOs, and Islamic charities largely operate independently of one another at present.

Rationalize existing social safety nets. There is considerable scope for improving the targeting and efficiency of existing programs to reach more needy families while containing costs. An important element is the design of the interventions, which can benefit from moving toward more individual needs-based targeting criteria. The performance of the Public Distribution System, for example, can be improved by altering the set of commodities or developing income or asset-based tests of need. Alternatively, the subsidy may gradually be replaced by a targeted cash transfer that would reach more disadvantaged families while reducing administrative costs. It is advisable to reexamine in-kind services to ensure that they are helping beneficiaries to become more productive and independent, especially with respect to institutional care.

Develop new interventions to preserve human capital and respond to the needs of vulnerable groups. Appropriate analysis will be needed before considering new interventions, including a conditional cash transfer program to improve education and health outcomes among youth and programs for former combatants and displaced families.

Utilize community-based, informal, and private social protection mechanisms. Community and faith-based assistance is a vital component of an effective strategy to alleviate poverty and mitigate social risks. Religious charities and foundations appear to be among the most active providers of safety-net assistance, and NGOs have emerged as potential contributors as well, after having been suppressed for many years. Incorporating local capacities and strengths in the provision of services is also consistent with the federalist thinking of the interim government.

Improve the design of the pension system. Iraq has the unique opportunity to fundamentally revise the design of its pension system. The current scheme is financially unsustainable now and can be improved in terms of both equity and efficiency. The main components of a strategy may be summarized as follows:

- Within a period of one to two years, a new, integrated pension system would be designed and implemented. This new system would: (a) provide adequate and affordable pensions for plan members; (b) be financially self-sustainable; (c) allow for transparent and equitable redistribution; (d) minimize economic distortions; and (e) incorporate the best international practices in the scheme design and management.
- The current schemes would be closed to new entrants, and the current plan members along with the new entrants would start contributing and accruing rights in the new system.
- The rights accrued to date in the old system by current employees would be respected and the associated pension liabilities made explicit by the government. To improve transparency and the credibility of the fiscal framework, the implicit pension debt of the new system will be explicit. This can be done if all the surpluses of the pension fund are invested in government debt instruments.
- A new noncontributory scheme, financed out of general revenues, could be created to provide a basic pension to all individuals reaching a certain age (say, age 65). Individuals benefiting from the "flat" emergency payment scheme will not be eligible for this new basic pension.
- Any incentive package for military or ex-members of the militia who fall outside the rules of the new Pension Law, the new noncontributory scheme, or the "flat" pensions emergency payments, would require separate financing mechanisms and would not be managed by the new pension fund.
- It is very important that the fiscal impacts of any reform program are assessed. The key feature of the proposed design is that the surpluses of the new pension system would be reinvested in government debt, thus helping the government to finance the cost of the implicit pension debt.

Part III. Improving public management and accountability

Chapter 5. Managing oil revenues

Oil is central to the Iraqi economy and will remain so for the foreseeable future: its oil reserves can drive economic growth for decades to come. Even if it extracted 6 million barrels of crude oil a day—three times the current level of production—Iraq has more than 50 years' worth of oil left in its proven and developed reserves; more oil is likely to be discovered in areas that await exploration. But managing oil revenue well has challenged many producing countries, rich or poor. The economic performance of oil exporters is often inferior to that of resource-poor countries, an outcome often attributed to the harmful influence of oil wealth on governance and on the real exchange rate for the rest of the domestic economy (the Dutch disease).

Even with vast reserves, Iraq faces large uncertainties about its future revenues, because of the volatility in the volume and price of oil exports. In the short term, production and exports are heavily constrained by rundown facilities and sabotage (box 5.1). Over the medium term, however, revenues can rise dramatically, if oil production capacity recovers strongly and oil prices stay high. Even in the case of declining oil prices, Iraq may be able to maintain high export revenues by building up the volume of oil exports significantly. Alternatively, revenues may be considerably lower, if oil production stalls and prices decline. In 2004–05, oil export revenues ranged from $1.1 billion to $2.7 billion per month.

Whether rising or falling, revenues require production. In Iraq, substantial investment is needed to rehabilitate and expand the oil sector, which has long suffered from a lack of capital, deteriorating technology, and an aging workforce. Large investments are also required in the refining, petrochemical, and natural gas sectors. Without such investment, Iraq will have difficulty maintaining and expanding capacity.

Iraq faces an additional challenge of developing competitive, labor-generating nonoil traded sectors to diversify its economy. The National Development Strategy correctly calls for reducing oil dependency over the medium term by promoting market-based, private-sector development of nonoil traded sectors. Three main reasons underlie this strategy:

- *Preventing a rent-seeking society*. Oil revenues, or "rents," find their way into the economy through the government's fiscal system, which can create a dependency on the state. The government often becomes the largest employer and relies heavily on a very narrow tax base (the oil industry). The result is a "rent-seeking" society, i. e., an economy characterized by excessive, unproductive activities in exchange for government finance and support, which results in widespread corruption and stagnation.
- *Creating more jobs.* Despite its economic importance, the oil sector generates very little domestic employment. For the medium to long term, economic growth and jobs

will need to originate from more labor-intensive, traded goods sectors, focused on market-based private investment.

- *Reducing vulnerability and volatility*. Dependence on a single export makes an economy vulnerable: any deterioration in the terms of trade will hamper consumption, welfare, and stability. In Iraq, as in other oil economies, vulnerability is aggravated by the fiscal dependence on oil prices, which are notoriously volatile: price shocks inevitably lead to fiscal crises.

Beyond using the government budget to direct oil revenues to the needs of the nation, there exists an option of their direct distribution to people. Despite its apparent advantages, the direct distribution option is: (a) difficult to implement in Iraq's current circumstances; (b) prone to corruption and leakages; and most importantly, (c) at Iraq's current level of development and opportunities (unlike Norway or Alaska), the social rate of return to investment in public goods and targeted social spending is much greater and more equitable than the private rate of return on consumption by distributing oil revenues to all households. Redistribution of oil revenues to Iraq's provinces is becoming an equally serious problem, a part of an intergovernmental system design discussed in chapter 6.

Box 5.1. Generating oil revenues in Iraq

In addition to managing oil revenues, Iraq faces the challenge of generating export revenues from its massive oil reserves. Iraq's oil sector has long suffered from lack of investment—and more recently from looting and sabotage—and is in need of substantial investment to rehabilitate its oil fields and infrastructure and to increase its production capacity in the coming years. Many fields have been damaged by excessive injection of liquids to sustain output, and producing wells are badly in need of rehabilitation. The industry also has suffered from a lack of spare parts and equipment, a long reliance on outmoded technology, and a need to retrain and expand the workforce. The sector can absorb a lot of oil export revenues itself; it also needs technology and managerial and technical skills.

Iraq faces a range of options in financing its oil-sector development needs. This can be done by (a) using oil revenues to hire technical, managerial, and engineering skills the country might need to expand oil extraction; (b) funding these needs with additional borrowing; and (c) attracting equity capital from private investors. Attracting private investors into the oil sector can be valuable. Such investors, however, require appropriate legal, fiscal, and contractual frameworks—and this will take time.

The Dutch disease and oil price volatility

The Dutch disease, which got its name from the experience of Holland after the discovery of North Sea gas in the 1960s, describes the weakening of domestic industries in an economy that discovers and exploits an abundant natural resource, such as oil. An increase in net oil exports, irrespective of the exchange rate regime, typically leads to a real appreciation of the exchange rate. This reduces the competitiveness of domestic products in international markets, leading to a decline in nonoil exports, a rise in imports, and often some short-term hardship and adjustment in domestic industries. Although the fiscal authority that receives most of the oil rent could sterilize it entirely by accumulating only foreign assets, this is not a realistic option because then no benefits from oil exports would accrue to the nation. Hence, a portion of the rent will be spent domestically, some real exchange-rate appreciation will occur, and the nonoil traded goods sector to some extent will be harmed. As nonoil traded goods decline, employment is maintained by the expansion of nontraded goods and services, very often in the form of an expansion of the public sector.

Although Iraq shows some signs of Dutch disease, its challenge is not adjusting to an oil boom, but preventing oil dependence from stifling job generation. The effect of the real appreciation can, in time, be more than offset by increases in productivity, if the boom can finance technological progress and draw investment. Policies aimed at improving the investment climate in the nonoil economy are the key antidote for the Dutch disease. Stable fiscal policy to encourage a stable real exchange rate and a sustainable public investment program can be augmented by targeting investment and other government expenditure at productive public goods. Best-practice policies for the oil economies are no different from any other (nonoil) context, but the oil economies have greater need for fiscal prudence because of the extreme volatility of oil revenue.

When oil prices fluctuate widely, the government transmits that external shock to the rest of the economy, and through repeated boom-bust cycles volatile oil prices translate into a volatile real exchange rate. The increased uncertainty in the nonoil traded sector is likely to depress investment, long-run diversification, and growth.

Reducing the transmission of revenue volatility to the economy may be accomplished by expenditure smoothing. If budgetary expenditure is planned and implemented according to “permanent” rather than “transitory” prices, then destructive swings in public expenditure can be avoided, and this will help stabilize the real exchange rate. Otherwise, public expenditure pattern based on current (boom) prices will not be sustainable, because when prices fall expenditure is forced to contract. It is often public investment that contracts first and most, because politically and socially it is usually the easiest budget item for governments to cut. This stop-go public investment behavior has long-run negative consequences.

Just as expenditure smoothing is necessary for macrostability, smoothing public investment can enhance its efficiency. Fluctuations in infrastructure investment reduce the efficiency of the investment program. Building roads, schools, and other facilities requires relatively skilled workers, and when investment levels decline unexpectedly, workers are laid off and buildings are abandoned. Erratic, stop-go investment entails high adjustment costs and waste. Because it is costly to adjust to changes in the level of investment, the optimal rate of investment should fluctuate substantially less than the price of oil.

Subsidies, such as free education, free energy, and interest-free loans for housing or business, create economic activity through spending and lead to a lack of financial discipline in the budget and political instability when governments try to roll back commitments. In Algeria, Indonesia, Iran, Mexico, Nigeria, Trinidad, and Venezuela, subsidies in the 1980s rose twice as fast as nonoil GDP. During periods of oil price decline, capital projects were canceled, but subsidies, together with public wages and salaries, were politically difficult to roll back. Unsustainable spending commitments based on overly optimistic oil revenue forecasts should not be introduced in the first place.

Many oil-exporting governments find it difficult to strike the right balance between short-run needs and long-run growth and stability, and if they are also combating pervasive poverty and high unemployment, they will also find it difficult to withstand the pressures to spend. However, strong fiscal policies and institutions can help governments maintain a more stable investment strategy in an environment of highly volatile oil revenues. Oil price changes can be temporary or permanent; if they are likely to be permanent, governments would be wise to adjust the level of investment spending to the new sustainable level of future investment.

The quality of investment matters at least as much as the quantity, as oil windfalls have often produced huge, unproductive “white elephant” projects. Investment in heavy industry to promote diversification has generally contributed to huge, insolvent state-owned firms. Oil-exporting countries tend to experience periods of rapid expansion in investment and growth, followed by a collapse in growth that far outweighs the decline in investment.[17] From 1965 to 1998, per capita GNP among members of the Organization of Petroleum Exporting Countries decreased on average by 1.3 percent per year, with an average ratio of gross domestic fixed investment of 23 percent. The quality of investment is a key factor that separates resource-rich countries that have grown rapidly from those that have had less success (Gylafson and Zoega 2001).

Oil-based economies seem to be particularly susceptible to poor governance and corruption because the government is the direct recipient of the rents. Patronage politics play an important role in determining the use of oil revenues, when fiscal linkages are narrow and public scrutiny is weak. Developing mechanisms to enhance public oversight of expenditures can enhance transparency in managing oil revenues (box 5.2).

In Iraq, there is a premium on speed in allocating donor funds to rapidly disbursing reconstruction projects. Clearly, the priority is to address urgent needs of the population, but authorities are well advised to do so in ways that do not undermine the future fiscal and financial soundness of the Iraqi economy. Over the medium term, authorities would benefit by developing more capacity for independent evaluations. Such evaluations could include conducting cost-benefit analysis, projecting rates of return, analyzing risks and sensitivities, and evaluating client impact. An independent capacity to evaluate investments would significantly help to alleviate pressures for spending oil revenues hastily and help to improve the choice of projects.

[17] Rodriguez and Sachs (1999) show that overinvestment could explain the sluggish growth performance of resource-dependent economies.

Box 5.2. Transparency in managing oil revenues

Given their importance in the Iraqi economy, oil revenues must be managed with open and readily accessible policies and procedures. Such transparency can help foster a democratic debate, increase accountability, improve macroeconomic management, and enhance access to finance. Transparency is needed both in the flow of budgetary funds and in the accounts of the national oil company. The following characteristics are increasingly recognized as minimal standards in dealing with transparency in the oil sector:

- *An independent and credible audit* of revenues generated by the oil sector and financial flows between the producers and marketers of crude oil and refined oil products, including the national oil company and the government. It is advisable to extend the audit to all actors (national as well as international oil companies, if the latter are involved in the sector) and to physical production, sales, and costs. The results of the audit should be independently published and made available to the public.
- *The active involvement of civil society* is very desirable. The civil society, for example, can review and raise concerns about the terms of reference for the audit and the implications of its findings.
- *A financially sustainable plan for transparency* should be developed and implemented by the government. Complementary activities include institutional strengthening in tax administration, the central bank, and other institutions involved in receiving and managing oil revenues.

These principals would directly apply to the Development Fund for Iraq, owing to its central role in managing the oil revenue flow. The International Audit and Monitoring Board found systemic irregularities in the use of resources by the Development Fund for Iraq under the Coalition Provisional Authority, (www.iamb.info). The Iraqi government is considering measures to strengthen the accountability and transparency procedures for those funds. A joint IMF and World Bank public expenditure mission (February 2005) recommended setting up a committee to examine operations of the Development Fund for Iraq and to enhance the transparency of tracking Iraq's oil resources and other spending.

In the short to medium –term, it will be important to develop accounting concepts, rules, and procedures in the form of an accounting manual clearly specifying the accounting requirements, particularly those related to direct foreign investments, other bank accounts, oil assets, letters of credit, and other types of investments.

Enhancing fiscal discipline

A number of oil-exporting countries employ fiscal rules to help determine sustainable level of capital and current spending. While fiscal rules can help to break the link between current commodity prices and current expenditure levels, they also lessen the ability of fiscal policy to respond to severe, unforeseen shocks. In Iraq, this rigidity would be unwelcome, because of the country’s need for fiscal flexibility and massive reconstruction in the face of uncertainty. Furthermore, fiscal rules require strong fiscal institutions to support them, which is not yet the case in Iraq.

Some oil-producing countries have set up oil funds to help in the implementation of fiscal policy. While funds have taken various forms, the basic aim is to set aside some portion of government oil revenues for when these revenues decline. Two main types of funds exist: (a) stabilization funds seek to reduce the impact of volatile oil revenues on the government and the economy and (b) savings funds aim to create a store of wealth for future generations. In many cases, governments use these funds for both purposes.

Although oil funds generally focus on managing revenue, expenditure policies are really the primary consideration for fiscal management and saving for future generations. Oil funds do not guarantee fiscal stability (Devlin and Titman 2004). Well-designed oil funds can enhance the transparency of oil revenues and expenditures, but they are no substitute for fiscal policy and overall improvements in public resource accountability (Devlin and Lewin 2005). A well-designed oil fund should be integrated with the budget and have appropriate asset-management strategies and mechanisms to ensure full transparency and accountability (Davis and others 2001).

In Iraq, an oil fund might be worth exploring in the medium and long term as one of several measures to exert adequate fiscal discipline over volatile oil revenues. However, in the short run the benefits of an oil fund will be limited, as 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. In other words, the immediate benefits of an intergenerational transfer of wealth seem to be less relevant for Iraq, simply because the government has to give priority to the need for immediate investments over the potential for saving oil revenues. Yet, Iraq's large oil reserves provide a solid reason to explore how such a fund could be set up in the future. In the meantime, expenditure smoothing can possibly be more effective, if pursued within a unified budget framework with carefully designed fiscal rules.

Summary of recommendations

To maximize the long-term development impact of future oil export revenues, the Iraqi government may wish to consider the following steps:

In the near term
- Use oil revenues to address urgent needs of the population, but be careful not to embark on policies or programs that undermine long-term fiscal sustainability of the Iraqi economy.
- Develop transparent mechanisms to enhance public oversight of oil revenue expenditures, ensure accountability, and improve macroeconomic management.

In the medium to long term
- Minimize boom-bust cycles through expenditure and investment smoothing.
- Prevent development of a rent-seeking society dependent on government handouts from oil revenues, engaged in nonproductive economic activities, and susceptible to poor governance and corruption.
- Diversify away from oil and generate employment in nonoil traded sectors by creating an enabling regime for private investment.

Chapter 6. Strengthening governance

Regardless of the contours of the nation that emerges from Iraq's transition, any Iraqi governments will need to establish good governance and public administration. This chapter addresses four objectives that are most important for Iraq's long-term development: (a) strengthening budgeting and financial management, so that it can deliver key public services and facilitate private-sector growth; (b) determining the size and scope of government and the division of responsibilities between ministries and different levels of government, so that appropriate functions can be devolved to the provincial and municipal levels; (c) reforming human resource management policy and procedures, so that financial and human resources can be optimally deployed; and (d) combating corruption, so that the integrity of the public sector can be ensured. These issues will be at the forefront of Iraq's reform agenda for many years, as they have been in other countries following conflict (box 6.1).

Box 6.1. Strengthening governance after conflict

Strengthening governance is central to the successful recovery of countries that have endured conflict. Several lessons can be drawn from their experience:

- Building an efficient administration is a key task and is best achieved by focusing, especially in the immediate aftermath of conflict, on the basics of good administration—effective budgets, streamlined business processes, efficient civil service, and political and managerial accountability.
- One critical but often neglected priority is the creation of robust mechanisms for policy formulation and coordination at the center of government.
- Combating corruption is important, right from the beginning.
- There are often significant political pressures to increase public-sector employment to cope with challenges such as demobilization.
- Most postconflict societies will want to measure visible success in terms of the delivery of vital services—roads, power, water, sewerage, schools, and hospitals.

Fiscal policy and public finance

Iraq's systems for public financial management have been hampered by the poor security environment, the difficulties in communication, and the nontransparent recording of subsidies, which degrades the government's ability to allocate resources or to track overall spending. Urgent reforms are needed to address weaknesses in the budget and financial management systems.

The budget system

Before the Saddam regime, the budget system in Iraq was fairly efficient and robust. Elements of this system still remain, but have degraded substantially in the past 20 years. Controls and efficient reporting have largely broken down. Budget execution reports, for example, were formerly submitted on a timely basis; now there are substantial delays and no reconciliation between above- and below-the-line fiscal operations. This reflects difficulties of communication and gaps in reporting by governorates and decentralized agencies in Baghdad, as well as the absence of consolidated information on balances in government bank accounts (or even accurate knowledge on the number of bank accounts). Furthermore, information is lacking on the operations and activities of major bilateral donors. The lack of accurate, timely financial information makes it virtually impossible to hold managers accountable, and any Iraqi government will need to solve this reporting problem if it is to exercise adequate financial discipline over line departments.

This points to another fundamental problem within Iraq's budget practices—the extraordinary fragmentation in the budget. Currently, several parallel spending plans that include both recurrent and capital expenditures exist in Iraq. The official Iraqi budget is financed by tax and nontax revenues, of which oil-export sales constitute the lion's share. In previous years, other sources of finance included letters of credit issued under the Oil for Food Program managed by the United Nations. Other streams include expenditures financed through external assistance from donors (including both grants and loans) and spending in some autonomous government institutions. There is virtually no coordination in the preparation or execution of these various spending plans, which often takes place through separate mechanisms.

- There is inadequate recording and reporting in government accounts of goods purchased through letters of credit issued under the Oil for Food Program in previous years, though these goods could represent a substantial share of a ministry's recurrent and capital expenditure.
- Donor-financed expenditures are taking place outside of the budget process. In many instances, donors discuss assistance directly with the relevant departments in line ministries, without necessarily informing the Ministry of Finance or the Ministry of Planning and Development Cooperation. Often several donor agencies have projects in certain sectors, without coordinating with each other or the concerned ministry. In some instances, donors pay civil servants directly in cash. The Ministry of Finance does not receive any records on the execution of external assistance. Payments for the execution of these expenditures are mostly taken outside of Iraq or made directly in cash.
- Total revenues and expenditures of some noncommercial government agencies, such as the Election Commission, are not included in the budget.

Thus, critical elements of the government's budget reform program could be (a) improving the coverage of the budget, so that it incorporates all significant revenues and expenditures made by the government, and (b) improving its transparency in line with international classification and accounting standards. It is also important over the medium term to ensure that all projects financed by donor aid are brought within the budget. While this will not be possible immediately, a useful first step could be adopting a unified framework in which spending entities would report plans and execution to the Ministry of Finance.

Financial management

In September 2004, the interim government agreed to a number of important commitments with the International Monetary Fund to improve the quality of Iraq’s financial management. These include the preparation of regulations to implement the Financial Management Law adopted in June 2004. These agreements included introducing a single treasury account; reporting monthly consolidated fiscal accounts; implementing modules for the Financial Management Information System; reforming the system of budget classification; and strengthening expenditure controls and audit.

A subsequent joint World Bank-International Monetary Fund report on public financial management (Ahmad and others 2005) includes a comprehensive analysis of the existing system and recommendations for a range of short- and medium-term measures to strengthen budget preparation and execution. The government has since agreed with the World Bank, the International Monetary Fund, and bilateral donors on a program of technical assistance and capacity building to implement the Financial Management Law, including budget classification, accounting, debt management, direct foreign investment, control and audit, and payroll and human resource management.

The Financial Management Law does not itself provide a complete picture of the fiscal architecture required to rebuild the budget as the primary policy instrument of government. This will require further political and administrative decisions in key areas. One is the appropriate roles for various institutions within the expenditure management process. Consistent with emerging best practice in other areas, the government may, for example, wish to consider downsizing the role and responsibilities of the Ministry of Planning and, scaling up the role and capacity of the Ministry of Finance to take on full responsibility for all activities related to budget preparation and execution. Another would be developing the role of the parliament and the Supreme Board of Audit as the key institutions for overseeing the budget process and the value for money of budgetary expenditures. Finally, extensive capacity building is needed in a host of areas, ranging from treasury operations to debt management to financial auditing.

Strengthening the budgetary framework appears to be the main fiscal policy issue. 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.

Intergovernmental fiscal relations

As with most countries in the Middle East and North Africa region, Iraq under the Ba’ath regime was a centralized, constitutionally unitary country with fiscal, administrative, and political relations favoring a dominant central government and weak local governments. For the most part, the system of local government developed in Iraq under reconstruction reflects the structures that existed on paper under the Ba’ath regime, but were largely overshadowed. There were 18 governorates (or provinces), whose borders have not been changed under reconstruction. They were administrative rather than governmental units, in that they had no real control over revenues and expenditures, which were decided by central authorities (Doane 2003).

Under the Coalition Provisional Authority, a number of efforts were made to transform the system of subnational governance and empower local governments to assume responsibility for a wider array of basic services. The provisional authority decided in mid-November 2003 to accelerate the transfer of authority to Iraqi officials, which led to the top-down creation of new council structures and selection procedures. The purpose of this "refreshment" was to make Governorate Councils more representative and more consistent across governorates. Unfortunately, the refreshment exercise did not fully live up to its expectations. Newly created councils often lacked basic skills and had no greater legitimacy than the councils initially created by the coalition forces.

The result has been a confusing patchwork of legislation and practice. The former local government framework still exists, except where explicitly overridden by more recent legislation and regulations. These legal structures decentralized authority at least to the governorate level. Governorate Councils are elected bodies (as of January 2005) funded through the national budget. They appoint a governor, review the line ministry plans and budgets, and organize the administration of public services within the governorate. They have the authority to raise revenues from their own sources.

The gap was immense between the formal law and the practice under the former regime, and a number of these discrepancies continue into the present day. As a general rule, local councils have found it difficult to exercise their authority over staff from central line departments, who continue to report through traditional ministerial reporting relationships. Actual control over many decisions concerning basic services continues to rest with the central line ministries, who report to the Supreme Council of Ministers. However, there are exceptions. The Kurdistan regional government, for example, appoints employees, including healthcare workers and teachers, who are paid by the central government in Baghdad and operate under central government regulations (Ahmad and others 2004). At present, a commission is working to sort out this mixture of leftover and temporary law as part of the constitutional process.

As Iraq finalizes its constitution and reflects on a wide range of issues that will define the nature and structure of its government, designing a coherent system of intergovernmental fiscal relations will require careful attention.

To what extent should Iraq decentralize?

Although there are no clear technical answers to this question, anecdotal experience indicates the value of decentralization. Countries in every region of the world, whether they have unitary governments (e. g., China, Mexico, Uganda) or federal (Brazil, India, Russia), have increasingly moved to more decentralized governance structures for a variety of reasons (box 6.2).

Box 6.2. Decentralization

Decentralization can play a useful role in empowering people to support processes of democratization, and it can help accommodate diverse populations and maintain national unity. It can improve the efficiency of service delivery by moving decision making closer to the citizenry, which is particularly important in countries where central governments are failing to perform their functions adequately. Countries have also occasionally chosen to decentralize for problematic reasons—to reduce large budget deficits by pushing expenditures down to local levels, while retaining revenues at the central level.

Political imperatives typically determine the extent and modalities of decentralization. However, fiscal and administrative questions will have an important impact on key development outcomes, such as the efficiency of service delivery, the equity of government expenditure, and the stability of the economy. Any future Iraqi government will need to address a number of important issues in this area. Some are basic questions that will help define the nature of the state, while others are more technical and will help determine the effectiveness of the state.

Different degrees of local autonomy are possible in either a federal or a unitary framework, but the rights of local governments are enshrined only in federal countries. Whether Iraq ultimately follows a unitary or federal path, harmonious intergovernmental relations will depend on, the perceived equity in the sharing of benefits from the nation's oil resources. Furthermore, Iraq's decentralization can be either symmetrical or asymmetrical (i. e., either giving equal autonomy for all subnational units or providing greater autonomy to certain areas). In many countries, asymmetry in the way different regions are treated (often in response to ethnic, religious, or economic heterogeneity) has worked towards building national allegiance. Examples include both developed and developing countries: Belgium, Bosnia-Herzegovina, Canada, China, Japan, Germany, Indonesia, Philippines, Spain, and Switzerland.

How many levels of government does Iraq need?

Should the current system of governorates be transformed into elected provincial governments? Although the political participation of provinces is already mandated through their involvement in the determination of the new constitution (i. e., the ability for three provinces to veto any proposed constitution), their overall roles in governance need to be considered much more comprehensively. In addition, local capacity will require attention. Decades of isolation have deprived administrators of exposure to international experience and associational benefits (e. g., regional municipal associations). Regional variations in administration are fairly pronounced as well.

For which functions should each level of government be responsible?

An important guiding principle can be that of subsidiarity, whereby responsibilities for public services are given to the lowest possible level where they can be discharged effectively. Where geographic spillovers occur, the appropriate level of service provision is best determined on the basis of externalities. Thus, garbage collection is seen as a local issue, although local delivery of public health or education are seen as issues that can affect the whole country and, as such, their provision may be ensured at the central level. Because such spillovers vary within sectors, it is advisable to determine jurisdictional responsibility at the level of the functions. The other key issues affecting jurisdictional responsibility involve public safety and the rule of law, particularly concerning arrangements for local, regional, and national internal security forces. There is much scope in Iraq for greater decentralization of functions. Formal statutory establishment of responsibilities will be key.

How should local governments be financed?

Since ideally "finance follows function," once functions are assigned, the determination of appropriate local revenues may follow. Typical sources of finance for each level of government are intergovernmental transfers, local taxes, user charges, and local borrowing. Given that over two-thirds of Iraq's GDP is generated from oil, intergovernmental transfers will continue to be the main source of financing for local governments for the medium term. Different types of transfers can be used to address different concerns. Of primary importance for intergovernmental grants is the need to ensure "vertical balance"—that is, to enable local governments to finance the functions for which they are responsible. Block grants are typically assigned to subnational levels for this purpose, often based on population size and sometimes adjusted for the varying cost of delivering services throughout the country. In addition, conditional grants are assigned to local levels to ensure that services delivered locally but of national importance (e. g., public health, education) are adequate. Finally, depending on the degree of "horizontal equity" desired in a particular society, intergovernmental grants are allocated to redistribute resources. An important question for Iraq is to what extent should transfers contain a redistributive element to bring up standards in the lagging regions? The answer depends on how differentiated the provinces are in their income levels and their own potential sources of revenues. One of the main goals of intergovernmental transfers is to equalize, at least to some degree, development and well-being across all subnational governments. Thus, poor subnational governments can be assured of some minimum financial support to provide a nationally agreed-upon minimum level. How the equalization transfer is constructed therefore becomes critical to the overarching goal of poverty reduction. At the same time, it signals the government's seriousness about achieving national cohesion.

Given the centralized tax base and the inevitable importance of intergovernmental transfers in Iraq, it is particularly important that transfers be transparent and predictable, so as to enable local planning and hard budget constraints (clear knowledge by local governments that they must manage their resources within a fixed budget envelope provided by the central government). Although transfers will continue to play the key role in financing local services, local taxes are an important method of strengthening accountability, because these marginal revenues can be clearly linked to local officials' decisions about marginal expenditures. Expanding local tax bases is an important aspect of improving subnational governance.

Although subnational borrowing on credit markets may be a desirable financing mechanism in the future, it could be destabilizing now. Until a clear intergovernmental framework is implemented and its credibility proven, any borrowing that rapidly expands local expenditures and softens budget constraints could possibly threaten macroeconomic stability. Thus, a clear regulatory framework to strengthen transparency and determine the rules of subnational borrowing would need to be developed over time.

How should local governments be held accountable?

Because the draft constitution remains vague on the lines of authority and responsibility are now unclear between central and subnational administrations, institutional arrangements need to be developed that would define accountability and create appropriate incentives for each level of government. One issue that could be clarified, for example, is which level of government has the authority to hire and fire different types of officials. Furthermore, channels of “social accountability” need to be opened and strengthened, so that local governments and their constituents will have opportunities to engage in productive dialogue and partnerships.

Perhaps the most important point to emphasize at this early stage of Iraq’s decentralization effort is that each of the issues mentioned above must be considered both on its own and in conjunction with the others. Experience throughout the world highlights the danger of unintended consequences and the disturbing propensity of states to move toward an incoherent or inconsistent intergovernmental framework.[18] Decentralizing expenditure functions, for example, without adequately funding them leads to weak service delivery. Soft budget constraints between levels of government can create incentives for local governments to act irresponsibly (i. e., to overspend, undertax, overborrow, or use local state-owned enterprises or state banks to cover local expenditures) in the expectation that the central government will bail them out. But unless the central government provides adequate supplemental provisions for the poorer regions, decentralizing expenditure functions can lead to growing inequality. Fiscal decentralization without adequate political and administrative accountability can lead to local corruption. A coherent framework for decentralization—and for intergovernmental relations broadly—needs to take into account this multitude of issues.

Human resource management

Iraq now lacks many of the features of modern human resource management. Institutions with a clear mandate to manage the civil service are absent. Administrative skills and experience are lacking, and some areas are overstaffed and functions misaligned. Guidelines governing the basic elements of employment, promotion, termination, recruitment, and performance evaluation are not yet in place or enacted. Controls are not robust. Because basic data-gathering functions are nonexistent, most employment data are unreliable. Budgets are not reconciled and financial safeguards are weak, leading to strong suspicion that fraud is pervasive.

The civil service is a high priority for reform of human resource management. Primary legislation (National Civil Service Law 24, dating from 1983 but first issued in 1960, Staff Law 25 of 1960, and the Instruction of 1960) is preserved only insofar as it may be used to provide “redress for adverse managerial actions,” which is unsatisfactory in the absence of guidelines governing the many potential forms of termination. There is also

[18] In South Africa, however, a post-apartheid White Paper had provided the country with an excellent road map for reforming and decentralizing government: www.treasury.gov.za.

little guidance to help civil service managers and protect civil servants from potentially contentious issues. Under the Coalition Provisional Authority (Order 30), the Ministry of Finance is the primary authority for all policy, procedure, and disciplinary issues relating to public service employees, an arrangement that does not conform to international best practice. The payroll process and disbursement systems are also known to be weak. An audit report produced by the accounting firm of KPMG in June 2004 provides examples of weaknesses in controls. Areas of the payroll system that are vulnerable to irregular payments or reporting have been identified. Fundamentally, there is an urgent need to provide a resilient and secure end-to-end payroll process that incorporates significant fraud-prevention, effective internal controls, and individually traceable disbursements across the whole of the civil service.

Anticorruption

Problems of corruption are widely perceived to be a significant governance and developmental concern in Iraq. In 2003, the country ranked 111th on Transparency International's Corruption Perception Index, the lowest of any country within the Middle East and North Africa region. By 2004, Iraq ranked 129th out of 145 countries, in the company of Cameroon, Kenya, and Pakistan. The recently established Commission on Public Integrity receives about ten calls a day reporting various abuses or perceived abuses. A number of audit reports have identified consistent irregularities in accounts and lax financial and procurement controls:

- In January 2005, a report of the U.S. Inspector General found that the Coalition Provisional Authority disbursed $8.8 billion to Iraqi ministries "without assurance the moneys were properly accounted for."
- In July 2004, an audit of the Development Fund for Iraq uncovered a number of areas of concern, including the absence of oil metering; the use of barter transactions for certain oil sales; and the use of noncompetitive bidding procedures for some contracts. The audit concluded that the weaknesses in monitoring oil extraction and financial transactions required corrective action.
- The audit also found problems with an inadequate control environment within Iraqi spending ministries, including outdated management information systems, limited computerization, inadequate training, and poor dissemination of the Ministry of Finance's policy manual on accounting procedures.
- A report by the Office of the Inspector General of the Coalition Provisional Authority reached similar conclusions, identifying the lack of transparency of Iraqi funds since the transfer of power to the Iraq Interim Government as being particularly problematic.
- U.S. Defense Contract Audit Agency examinations related to nearly $7 billion in reconstruction work and found $133 million in questionable costs and $307 million in unsupported costs.

Although anecdotal evidence indicates that corruption is a significant problem in Iraq, it is difficult to confirm these perceptions empirically. No surveys have explicitly addressed corruption issues, and there is little robust statistical information on the scope and scale of the problem. The public opinion information that does exist indicates that perceptions of corruption do not appear to weigh heavily upon the public's mind. Problems of poor security, unemployment, crime, occupation, and infrastructure are consistently cited as being of greatest public concern, and corruption is not among the top ten issues of greatest importance. Several interpretations could account for these findings. The first is that they reflect a hierarchy of values, in which safety, security, and economic well-being are thought to be more important than clean and transparent government. They could also reflect a general acceptance of at least certain types of corruption as a way of life, rather than an administrative pathology to be stamped out.

To combat problems of corruption, a number of initiatives launched under the Coalition Provisional Authority remain in place. Perhaps the most significant was the establishment of independent offices of inspectors general within individual Iraqi ministries. The inspectors general 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. As of July 2004, inspectors general were in place in all cabinet ministries, although their effective functioning will take time to develop. In addition, the Commission on Public Integrity was created, and the existing Supreme Board of Audit was revitalized and tasked with enhancing the economy, efficiency, effectiveness, and credibility of the Iraqi government. It was also tasked with collaborating with the Commission on Public Integrity and the inspectors general of individual ministries to ensure that the government remains honest, transparent, and accountable. The Commission on Public Integrity was charged with the criminal investigation of corruption cases and violations of the code of conduct, including those coming from anonymous sources. It was charged with promulgating mandatory financial disclosure regulations and a revised code of conduct for public officials. It was also tasked with responsibility for public information and awareness. Assessments of the external audit function by the World Bank and the International Monetary Fund have indicated that the Supreme Board of Audit's design and legal framework are largely adequate. Nonetheless, there is a significant need to strengthen its independence, improve transparency, upgrade business processes, and initiate capacity building and training.

To be successful, Iraqi anticorruption efforts need to operate along a number dimensions. The four described below are particularly important. It is also important that any efforts to combat corruption be grounded in a rigorous, empirically based analysis of the scope and magnitude of the problem.

- *Strengthening the legal and regulatory framework.* Issues that need to be addressed include (a) the definition of corruption within the penal code and the legal mandate of various accountability institutions charged with detecting and combating it, (b) the links within the accountability chain, including procedures for investigating, prosecuting, and trying cases involving corruption or administrative discipline and sanctions, and (c) the legislation intended to promote integrity within the public sector, ranging from ethical codes of conduct to financial disclosure and conflict of interest provisions.

- *Developing strong accountability institutions*. Accountability institutions, such as supreme audit boards, anticorruption agencies, inspectors general, ombudsmen, and the like are another important link within the disciplinary chain. Often, such agencies lack the necessary mandate, staffing, budget, and independence to function effectively. Their administrative and investigative procedures can be ponderous, their equipment inadequate and antiquated, and their staff lacking in important skills, such as forensic accounting or techniques of net asset evaluation.

- *Supporting prevention within individual agencies and line departments.* Corruption is not spread uniformly throughout the public sector, but is often concentrated in departments with significant revenue (tax and customs), expenditure (education and public works), or regulatory functions (police and building inspection). It is therefore important that the departments most prone to corrupt activity have active programs aimed at minimizing their vulnerability. Prevention is typically the first and most important step, and many solutions can be employed at the organizational level. Some enhance transparency and monitoring performance, either internally or externally; others streamline business processes to reduce opportunities for graft and speed money; others improve internal financial controls or reform personnel practices. Many are under the control of the organization itself and can be put in place rapidly, if significant political will exists. In some cases (such as improving human resource management), broader changes within the public sector may be necessary.

- *Enhancing public opinion and awareness.* Many of the most successful anticorruption programs involve a component addressing public awareness and education. Hong Kong's highly successful Independent Commission Against Corruption, for example, devoted the greatest proportion of its administrative budget to raising awareness within the community as to what constitutes corruption and what can be done about it. The result was a significant shift in public attitudes and awareness and a greater willingness to come forward with complaints.

Summary of recommendations

The new Iraqi government will face a host of critical governance and public administration challenges that will take a decade or more to fully resolve. Many issues, such as the appropriate devolution of responsibilities to the provincial and municipal level, are fundamentally political in nature. As such, they will be informed by technical judgments, but not determined by them.

In the narrower field of public administration, in the short-term, any Iraqi government will need to focus upon getting the basic systems and procedures in place that will allow it to mobilize financial and human resources efficiently, deliver services effectively at the most appropriate level, and preserve integrity within government. These basic reforms should be implemented in a fashion that, at a minimum, does no harm to the effective medium- to long-term functioning of the Iraqi state—such as, for example, avoiding the pernicious practice of salary top-ups by donor organizations, which distort the incentive framework within the civil service. More positively, such reforms will facilitate the evolution of the public sector into an effective, high-performing entity.

For public financial management

- Improve the comprehensiveness and transparency of the budget process, integrating all important revenue and expenditure streams.
- Determine the appropriate role of institutions in the expenditure process, including unification of the budget preparation process within the Ministry of Finance.
- Improve internal reporting, control, accounting (particularly for oil revenues), and audit procedures.
- Strengthen capacity of the Ministry of Finance (particularly in public debt management) and of the Supreme Board of Audit.

For intergovernmental fiscal relations

- Forge a political consensus on the optimum number and appropriate assignment of responsibilities to various levels of government.
- Analyze expenditure assignments and costs of service delivery at various levels of government, so that the fiscal requirements are known.
- Devise a system of grant and transfer payments, taxes, user fees, and borrowing that matches the assignment of expenditures.
- Develop appropriate legislation, regulations, and incentives to prevent corruption and problems of irresponsible fiscal behavior among subnational governments.

For human resource management

- Establish two regulatory bodies to oversee the civil service: one to make human relations policy, and the other to monitor compliance and serve as an independent avenue of appeal.
- Create basic human relations and payroll management tools, including a review of staff grading across ministries, an employee verification process, capabilities for establishment control and manpower planning, streamlined payroll calculation rules, and comprehensive vacancy lists.
- Enact new legislation that defines the guiding principles of public sector employment and identifies or creates institutions responsible for civil service management.
- Introduce regulations to define contractual terms and conditions for the civil service: recruitment and selection procedures; terms and conditions of employment; policy statements and operational guidelines to avoid discrimination; employee rights; employee benefits; disciplinary and grievance procedures; redundancy and transfers; termination.
- Develop the capability within each line ministry to make human relations strategy operational.
- Enhance payroll technology and develop an operational payroll and job application strategy.

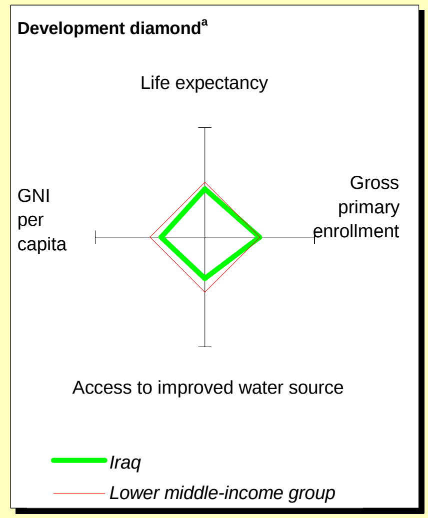
For anticorruption

- Review legal codes addressing corruption, asset disclosure, conflict of interest, and whistleblower protection and revise as necessary.

- Conduct survey and diagnostic work to better understand public attitudes toward corruption and identify key problem areas.
- Strengthen the capacity of independent anticorruption agencies, such as the Commission on Public Integrity and the inspectors general.
- Develop ministerial and departmental anticorruption plans for key revenue, expenditure, and regulatory agencies most vulnerable to corruption.
- Develop a public awareness and education program.

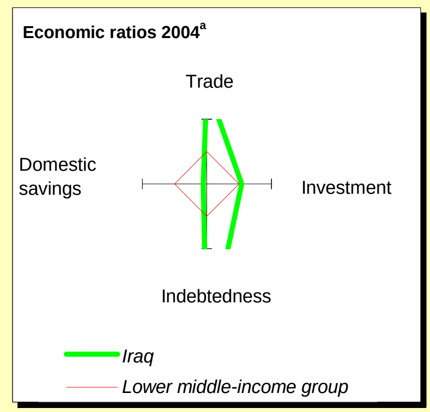
Annex. Iraq at a glance

POVERTY AND SOCIAL	Iraq	Middle East and North Africa	Lower middle-income
2005			
Population, mid-year *(millions)*	27.9	312	2,704
GNI per capita *(US$)*	1,188	2,210	1,490
GNI *(US$ billion)*	33.2	744	3,900
Average annual growth, 1999-05			
Population *(%)*	2.8	1.9	0.9
Labor force *(%)*	2.4	2.9	1.2
Most recent estimate (latest year available, 1999-05)			
Poverty *(% of population below national poverty line)*	—	—	—
Urban population *(% of total population)*	67	58	49
Life expectancy at birth *(years)*	61	69	69
Infant mortality *(per 1,000 live births)*	102	43	33
Child malnutrition *(% of children under 5)*	12	—	11
Access to an improved water source *(% of population)*	61	88	81
Lliteracy *(% of population age 15+)*	65	69	90
Gross primary enrollment *(% of school-age population)*	110	95	111
Male	120	98	111
Female	100	90	110

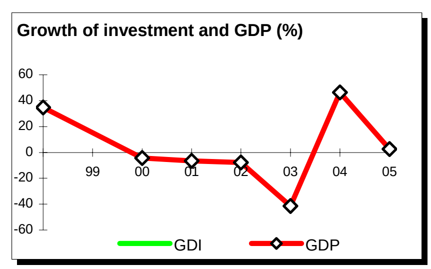


KEY ECONOMIC RATIOS AND LONG-TERM TRENDS

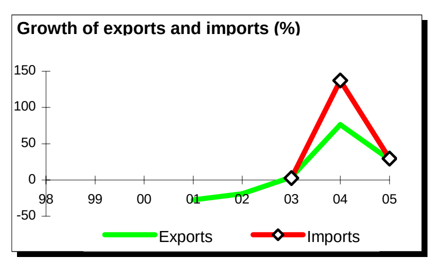
	2000	2001	2002	2003	2004	2005
GDP *(US$ billion)*	25.9	18.9	20.5	13.6	25.7	33.2
Gross domestic investment/GDP	—	—	—	—	26.6	37.1
Exports of goods and services/GDP	63.8	63.5	47.4	74.1	69.1	68.7
Gross domestic savings/GDP	—	—	—	—	2.9	4.6
Gross national savings/GDP	—	—	—	—	-10.2	6.9
Current account balance/GDP	—	—	—	—	-36.8	-14.4
Total External Public Debt/GDP	—	—	—	896	309	154
Total debt service/exports (actual amounts paid)		—	—	0	1	0.2
Present value of debt/GDP	—	—	—	896	309	154
Present value of debt/exports	—	—	—	1,209	447	225
(real average annual growth)	**2000**	**2001**	**2002**	**2003**	**2004**	**2005**
GDP	-4.3	-6.6	-7.8	-41.4	46.5	2.6
GDP per capita	0.2	2.0	-5.4	-44.2	43.7	-0.2
Exports of goods and services	—	-27.3	-19.1	3.8	76.4	28.1



STRUCTURE OF THE ECONOMY *(% of GDP)*	2000	2001	2002	2003	2004	2005
Oil sector	83.9	76.1	68.0	68.0	67.7	67.7
Non-oil sector	16.1	23.9	32.0	32.0	32.3	32.3
Agriculture	5.4	8.1	11.1	—	9.8	—
Manufacturing	0.9	1.6	1.7	1.7	1.5	—
Services	—	—	19.2	21.3	21.0	—
Private consumption	—	—	—	—	40.8	35.8
General government consumption	—	—	—	—	56.3	59.6
Imports of goods and services	—	—	47.9	74.0	92.7	93.1



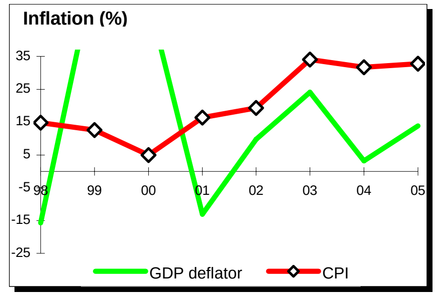
(average annual growth)	2000	2001	2002	2003	2004	2005
Agriculture	-11.6	1.2	17.0	-29.1	—	—
Industry	1.9	0.8	-10.9	-37.7	—	—
Manufacturing	-4.5	9.2	-14.5	-28.5	—	—
Services	5.4	0.4	2.5	-33.4	—	—
Private consumption	—	—	—	—	—	—
General government consumption	—	—	—	—	—	—
Gross domestic investment	—	—	—	—	—	—
Imports of goods and services	—	—	—	2.5	137.0	29.5



— is not available.
Note: 2004 and 2005 data are preliminary estimates.
a. The diamonds show four key indicators in the country (in bold) compared with its income-group average. If data are missing, the diamond will be incomplete.

PRICES AND GOVERNMENT FINANCE

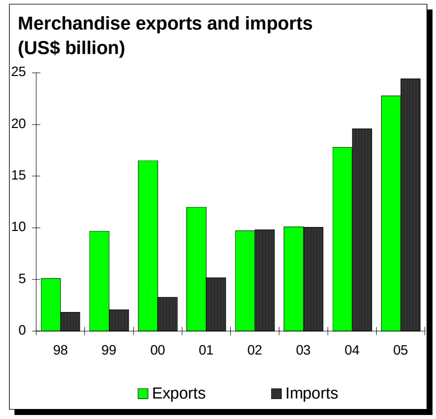
	2000	2001	2002	2003	2004	2005
Domestic prices						
(% change)						
Consumer prices	5.0	16.4	19.3	34.0	31.7	32.8
Implicit GDP deflator	52.6	-13.1	9.8	24.0	4.0	26
Government finance[b]						
(% of GDP, grants)						
Current revenue	—	—	—	—	80.0	93.6
Current expenditure	—	—	—	—	98.3	78.9
Capital expenditure	—	—	—	—	22.3	25.6
Overall surplus/deficit	—	—	—	—	-40.5	-10.9



Inflation (%)

FOREIGN TRADE

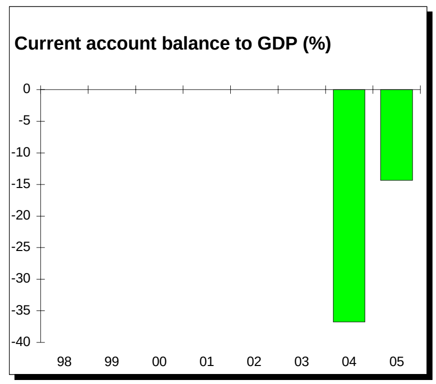
	2000	2001	2002	2003	2004	2005
(US$ million)						
Total exports (fob)	16,527	12,009	9,711	10,082	17,782	22,781
Crude oil	16,476	11,941	9,653	8,459	17,329	22,176
Petroleum products	—	—	—	—	—	—
Manufactured products	—	—	—	—	—	—
Total imports (cif)	3,320	5,180	9,817	10,063	19,587	24,416
Government imports	—	—	9,434	7,114	13,779	14,596
UN Oil For Food Program	—	—	—	—	3,488	1,929
Post OFFP govt. consumption	—	—	—	—	3,843	3,528
Refined oil products	—	—	0	138	2,651	3,428
Capital goods	—	—	—	—	3,799	5,711
Private sector imports	—	—	384	2,820	5,809	9,820
Consumer goods	—	—	288	1,128	—	—
Capital goods	—	—	96	1,692	—	—
Crude petroleum price ($/bbl)[c]	24.7	19.9	20.5	26.0	31.6	43.1
Proven oil reserves (billion barrels)	113	115	115	115	115	115



Merchandise exports and imports (US$ billion)

BALANCE OF PAYMENTS

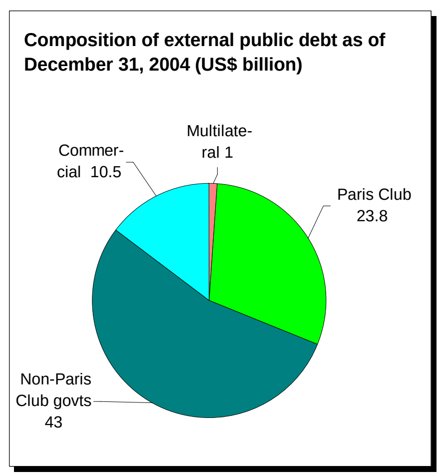
(US$ million)	2000	2001	2002	2003	2004	2005
Exports of goods and services[d]	16,527	12,009	9,711	10,082	17,782	22,781
Imports of goods and services[d]	—	—	9,817	10,063	23,847	30,893
Resource balance	—	—	-106	19	-6,065	-8,112
Net income	—	—	—	—	-5,395	-3,741
Net current transfers	—	—	—	—	2,004	7,090
Current account balance	—	—	—	—	-9,460	-4,763
Financing items (net)	—	—	—	—	-1,559	-1,409
Changes in net reserves	—	—	—	—	-6,332	-1,409
Memo:						
Reserves including gold *(US$ million)*	—	—	—	1,134	7,902	9,311
Conversion rate *(NID/US$)*	1,930	1,929	1,957	1,957	1,455	1,467



Current account balance to GDP (%)

EXTERNAL LIABILITIES

(US$ million)	2000	2001	2002	2003	2004	2005
External debt[e]						
Total debt outstanding and disbursed	—	—	—	121,900	79,400	51,200
Multilateral organizations	—	—	—	635	890	890
IBRD	—	—	—	101	0	0
IMF	—	—	—	80	436	436
Paris Club Creditors	—	—	—	38,900	23,800	18,100
Of which Japan	—	—	—	7,249	—	—
France	—	—	—	5,580	—	—
Germany	—	—	—	5,482	—	—
United States	—	—	—	4,010	0	0
Italy	—	—	—	3,920	—	—
Russia	—	—	—	3,598	—	—
Non-Paris Club governments	—	—	—	67,365	43,000	—
Of which Gulf Cooperation Council	—	—	—	48,190	—	—
Commercial creditors	—	—	—	15,000	10,500	3,000
Of which commercial banks	—	—	—	2,500	1,750	—
UNCC Compensations[f]	—	—	—	—	18,992	52,466



Composition of external public debt as of December 31, 2004 (US$ billion)

b. Fiscal accounts are a consolidation of government budgets, aid flows, and spending by the Development Fund of Iraq (DFI).
c. Iraqi oil prices carry a discount that reflects the quality of Iraqi blends and frequent security-related supply interruptions.
d. Data for services is only available on a net basis and is added to imports; exports data shown here are for mechandise exports only.
e. Estimates based on partial data from the creditors. These have not been reconciled and may be incomplete. Data for 2004 and 2005 assume full application of the first and second stage of debt reduction, including comparable treatment of non-Paris Club debt.
f. UNCC is the UN Compensation Commission (www.uncc.ch). Amounts awarded for 2005 are outstanding as of January 24, 2006.

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