

## **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<sup>1</sup> 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 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.

## Note

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<sup>i</sup> 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](http://www.iamb.info).