

Inclusive and sustained growth in Iraq

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Question

What are the main constraints to inclusive and sustained growth in Iraq, and what are the priority areas for intervening to support inclusive growth? Focus on identifying barriers to and opportunities for private sector growth in Iraq.

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1. Summary

Iraq faces significant economic challenges, in particular stemming from its dependence on oil revenue and the country's bloated public sector. Private sector growth is particularly constrained by the dominance of state-owned enterprises (SOEs), restrictive regulations, lack of access to finance, shortage of skilled labour and inadequate infrastructure.

This review drew largely on reports by international development partners (most notably the World Bank) as well as policy papers; it found a dearth of relevant academic literature. While there was significant mention of women in the literature, it made negligible reference to persons with disabilities. Key findings of the review are as follows:

- **Recent growth has not translated into poverty reduction:** Economic growth has fluctuated substantially in recent years, growing up to 2014, but is currently low. Following the defeat of ISIS¹ and rising oil prices, the macroeconomic outlook for Iraq is better but this has not translated into broad-based growth: poverty and inequality in Iraq are high. There are both geographical disparities in growth and development (poverty is higher in the southern governorates) and certain groups are worst off: internally displaced persons (IDPs), youth and women.
- **Iraq's long history of conflict and instability has undermined growth and development.** In particular the 1991 Gulf War and the stringent sanctions imposed on Iraq up to 2003 saw oil revenues stalled, decline of non-oil and agriculture sectors, and reduced investment in services, leading in turn to deteriorating development outcomes. Post-2003 insecurity and the 2005-06 sectarian civil war, along with the conflict with ISIS from 2014, all led to loss of infrastructure as well as making it very difficult for the government to focus on reconstruction and deterring investment.
- **Iraq's economy is heavily dependent on oil**, accounting for 58% of GDP in 2015 (World Bank (WB), 2017: 13). However, this does not provide the basis for broad-based economic growth because: one, it generates only 1% of total employment and cannot meet the needs of the country's growing population; and two, oil wealth is not invested effectively (but used to expand an already bloated, inefficient public sector). Oil dependence fuels a rentier state and undermines diversification and private sector growth.
- **Iraq is characterised by weak governance and high levels of corruption.** Governance shortfalls have turned what should have been advantages – oil wealth, demographic and geographic diversity – into liabilities: oil dependence and ethnic and sectarian divisions. Corruption is endemic and seen in polls as the most important challenge facing the country (WB, 2017: 20). Weak governance stems in part from lack of human capacity, due to a prolonged brain drain from the country as well as the post-2003 policy of 'De-Ba'athification' (removing party members from public sector employment).
- **The bloated, inefficient public sector** dominates the economy, accounting for nearly half of total employment and spending amounting to 61.1% of GDP (Krishnan et al, 2014: 8). Rising oil revenues post-2003 only served to further expand the public sector, as the government saw public sector jobs as one of the few benefits it could deliver to people.

¹ Islamic State of Iraq and Syria, also referred to as Daesh.

The size of the public sector is not reflected in access to or quality of basic services, which are widely seen as extremely deficient.

- **The private sector is the key to creating jobs and promoting sustainable growth.** There is recognition in the literature that Iraq needs to diversify from oil, and that this has to be led by the private sector. In the long run this is the only way to prevent further conflict. However, the private sector is constrained by a number of factors:
- **Dominance of state-owned enterprises (SOEs):** most non-oil private firms have been crowded out by SOEs, which have long served as sources of patronage for Iraqi regimes. Many SOEs are defunct, but still officially employ and pay large numbers of staff. Obstacles to vital SOE reform include reluctance on the part of governments because of the significant social costs of closure or downsizing (with large lay-offs).
- **Laws and regulations act as an impediment to private sector development.** Iraq was ranked 168 out of 190 countries in the *Doing Business 2018* report, faring particularly badly in access to credit and resolving insolvency (WB, 2018b: 168). Iraq has trade barriers, mainly regulatory and bureaucratic practices, which restrict the level of trade and investment. One consequence of Iraq's challenging business environment is the country's very large informal sector – which is a serious constraint on formal firms.
- **There is a shortage of skilled labour in Iraq** stemming from the country's long-standing brain drain, poor development indicators, and failure by the education system to provide the skills and training needed in a modern, knowledge economy. The private sector also struggles to attract personnel because of the greater appeal of public sector jobs, with their higher benefits and pensions.
- **Difficulties in accessing finance.** The financial sector in Iraq is both relatively small compared to GDP and dominated by the state, making it uncompetitive and unable to meet the needs of a growing private economy. State banks account for about 90% of all assets and deposits (Tabaqchali, 2017: 5). The country's underdeveloped collateral system means that banks over-collateralize loans – typically seeking 140% collateral for a loan to a small firm (WB, 2012: 1-2). The amount of credit provided to the private sector amounts to less than 7% of GDP (compared with 55% on average in other MENA countries) (WB, 2017: 76).
- **Lack of infrastructure:** Inadequate power supply and weak transport networks have been identified as major constraints to private sector growth. Iraq loses an estimated USD 6-8 billion per year from flaring of gases associated with oil production in-field (WB, 2017: 89) – gas that could have been used for electricity production instead of expensive and polluting fuel imports. About 40% of total electricity generated is lost in the distribution network, and cost recovery is extremely low (WB, 2017: 89-90).
- **Specific challenges facing Kurdistan Region of Iraq (KRI):** The semi-autonomous KRI was less severely impacted by post-1991 sanctions and remained largely immune to sectarian conflict post-2003, allowing its government to promote private sector growth. However, it faces similar economic challenges to the rest of Iraq: oil dependence, a large and inefficient public sector, dependence on imports, and a weak financial sector. In recent years KRI has been hit by a series of shocks: loss of revenue due to disputes with the federal government, drop in oil prices, and nearby conflict with ISIS leading to the influx of large numbers of IDPs and Syrian refugees into the region. The KRI government has responded to the fiscal crisis by postponing investment projects, letting payments fall

into arrears and increasing borrowing – policies which in the medium-term will lead to reduced private sector productivity.

- **Areas for intervention to promote inclusive and sustained growth** identified in this review are oil diversification, investments in human capital and infrastructure, reform of the public sector and specifically of SOEs, and easing of the regulatory regime for the private sector. The 2017 *Report of the Task Force on the Future of Iraq* focuses on diversification (including through tax reform) whilst also calling for investment in oil and gas production; promotion of public sector reform by improving the private sector pension system; easing of regulations on private firms and international investment; using technology to tackle corruption; and facilitating private sector access to finance through funding from international partners as well as promotion of Iraq's capital markets. The World Bank's 2017 Systematic Country Diagnostic prioritises macroeconomic stability and more effective investment of oil revenues through improved public investment management, as well as reduction in the size and scope of the public sector and SOEs, and promotion of agriculture and tourism in Iraq.

2. Economic situation

Economic situation

Iraq's GDP growth rate has fluctuated substantially in recent years, rising from 5.8% in 2009 to 13.9% in 2012, before dropping to 0.7% in 2014.² It recovered, reaching 11% in 2016, but contracted to 0.8% in 2017 due to a 3.5% reduction in oil production to meet OPEC³ requirements.⁴

The fiscal deficit is estimated to have narrowed to 2.2% of GDP in 2017 due to higher oil prices and measures to contain current expenditures.⁵ Also thanks to both these factors, total public debt is estimated to have declined to 58% of GDP in 2017. In 2017, the current account deficit is estimated to have returned to a surplus equal to 0.7% of GDP. However, foreign reserves financed most of the balance of payment deficit, declining from USD77.8 billion at end-2013 (or 10 months of imports) to USD48.1 billion at end-2017 (or 7 months of imports).

The macroeconomic outlook in Iraq is expected to improve thanks to a more favourable security environment, increase in oil prices and the gradual pick up of investment for reconstruction (World Bank (WB), 2018). Following the complete liberation from ISIS of all Iraqi territory in December 2017, the Government of Iraq (GOI) is putting in place a comprehensive reconstruction package linking immediate stabilization to a long-term vision and initiating a recovery and reconstruction process.⁶

Poverty and inequality

While the macroeconomic picture in Iraq has, taken as a whole, improved over recent years, 'Iraqi leaders remain hard-pressed to translate macroeconomic gains into an improved standard

² <https://tradingeconomics.com/iraq/gdp-growth-annual>

³ Organization of the Petroleum Exporting Countries

⁴ <http://www.worldbank.org/en/country/iraq/overview>

⁵ All figures in this paragraph from: <http://www.worldbank.org/en/country/iraq/overview>

⁶ <http://www.worldbank.org/en/country/iraq/overview>

of living for the Iraqi populace' (CIA, 2018). The incidence of poverty remains high, with rising inequality.

Poverty

Iraq made some progress in reducing poverty between 2007 and 2012, but the latest figures point to a reversal of this trend. The poverty rate (those living below the national poverty line) increased from 18.9% in 2012 to an estimated 22.5% in 2014 (WB, 2018a: 2) – the 2014 figure is close to that of 2007 (WB, 2017: 27). It should also be noted that the modest poverty reduction between 2007 and 2012 was accompanied by rising inequality: per capita consumption in Iraq grew faster for the well-off than for the less well-off (WB, 2017: 29). Multidimensional poverty⁷ in Iraq is estimated to be 35% (WB, 2017: 29), up from 11.6% in 2011 (Rohwerder, 2015: 3). Of the various factors contributing to this, lack of sanitation, inadequate electricity and poor nutrition are among the most prevalent (WB, 2017: 30).

According to the World Bank, 'modest poverty reduction in the face of strong economic growth suggests that the relationship between growth, employment and earnings is weak' (Krishnan et al, 2014: 123, 125). The decline in headcount poverty between 2007 and 2012 was driven by an increase in earnings among the employed, rather than by an expansion in employment or by higher public transfers (WB, 2017). In particular, 'economic growth was not associated with job creation in the private sector where the majority of the poor work' (WB, 2017: 27). Conflict and violence, and oil dependence (see below), are among the key factors contributing to rising poverty in Iraq.

Unemployment in Iraq has increased, particularly for individuals from the poorest households, youth and those in the prime working age (ages 25-49) (WB, 2018a: 2). The unemployment rate is about twice as high in the governorates most affected by ISIS-related violence and displacement compared to the rest of the country (21.1% vs. 11.2%), especially among the young and uneducated (WB, 2018a: 2). Among the three million IDPs, unemployment is 55% higher than that of host communities (WB, 2018a: 2).

Inequality

Geographical disparities

The situation with regard to growth and development in Iraq is marked by strong spatial divergence. Historically poverty has been concentrated in the south and the centre of the country. Between 2007 and 2012 the poverty rate increased in the southern governorates by 1.8 percentage points (WB, 2017: 31). By contrast in central governorates it fell by 16 percentage points and in the northern governorates by 9 percentage points. Following de facto independence from Baghdad in the 1990s, the northern Kurdish Region of Iraq was less severely impacted by sanctions, and was thus able to meet basic needs more effectively (Krishnan et al, 2014). The poverty rate in 2007 in the Kurdish region was thus far lower than the rest of the country, at 4.3% and remained low in 2012 at 3.5%. But the crisis with ISIS has severely impacted the region, with poverty incidence levels estimated to have increased (and doubled in ISIS-affected areas) (WB, 2017: 37).

⁷ A person is defined as multi-dimensionally poor (or 'MPI poor') if they are deprived of at least one-third of the ten weighted indicators: years of schooling; school attendance; child mortality; nutrition; electricity; sanitation; water; flour; cooking fuel; assets.

There are also significant rural-urban differences in poverty headcount rates – higher in remote, rural and sparsely populated areas – though urban and semi-urban areas are often host to more poor people in absolute terms because of the higher population size (Rohwerder, 2015: 1). A range of factors are involved in spatial disparities in poverty rates and poverty reduction, including distribution of oil wealth, differential situations with regard to stability and security in the post-2003 period, differential impacts of ISIS post-2014, and continued neglect of the southern governorates (Krishnan et al, 2014: 112).

Excluded groups

As well as spatial disparities, poverty varies according to demographic traits and is higher among particular marginalised groups. It is significantly higher in larger families: the average household in the bottom 40% is larger (more than 10 members on average) and has more dependents (almost six) than a non-poor household (WB, 2017: 35-36). Moreover their household heads have a lower level of education than the heads of non-poor households. The poor are predominantly employed in private sector jobs, e.g. in agriculture, construction, commerce and transport, while almost 40% of the non-poor are employed in public administration, finance or commerce (WB, 2017: 35-36).

Internally Displaced Persons (IDPs)

As of the end of 2015 a total of 4.2 million people in Iraq had been internally displaced – 3.2 million as a result of the ISIS conflict, and 1 million people still displaced as a result of the 2006-07 violence in Iraq, in addition to 300,000 officially registered refugees (many from Syria) (WB, 2017: 39). The overwhelming majority of IDPs and refugees live outside camps: most have moved into urban areas, placing pressure on already stretched urban services (WB, 2017: 41). They are concentrated in particular governorates: the Kurdish Region of Iraq saw its population increase by 28% following ISIS attacks in August 2014 (WB, 2017: 40). IDPs accounted for 62% of the increase in poverty there, compared to just 2% in the south (WB, 2017: 42).

IDPs previously employed in the private sector will have lost their jobs and livelihoods (those in the public sector have in general continued to receive their salaries and pensions).

Unemployment among IDPs rose to 27%, almost three times higher than the rate for the population as a whole (WB, 2017: 42). Lack of employment and massive reduction in labour income, reinforced by loss of assets and services associated with having a proper dwelling, implies a considerable increase in the incidence of poverty among IDPs. Simulation results show that the headcount poverty rate for IDPs grew from 23% to 38%, twice the rate for the population as a whole (WB, 2017: 42).

Youth

Iraq's population is one of the youngest in the world, with nearly 50% under the age of 19 years, and one-third aged between 15 and 29 years (WB, 2017: 44). These figures are high by both regional and international standards: 60% of Iraqis are under the age of 25, compared to 54% of the population in Arab countries and 48% in developing countries (WB, 2017: 45). Low levels of female enrolment in education, high rate of early marriages and high adolescent birth rates are key factors in accounting for the country's young population.

While a high youth population represents the potential for a demographic dividend, this has not been realized in Iraq. Over 3.4 million Iraqi youths are out of school; 72% of women and 18% of men aged 15-29 years were neither in education nor employment nor training; and 33.4% of

these are illiterate or semi-literate (WB, 2017: 45). Youth unemployment is 34.6%: 57.7% for females and 30.8% for males (WB, 2017: 45). Labour force participation of youth (ages 15-24) has dropped markedly since the onset of the ISIS conflict, from 32.5% to 27.4% (WB, 2018a: 2). These factors lead to alienation of youth from state institutions and distrust of government, in turn fostering their radicalisation and facilitating their recruitment by militias and extremist groups. As well as the economic incentive to join such groups, youth also tend to find a sense of purpose as members of these organizations (WB, 2017: 46).

Women

Women in Iraq face significant economic, social and cultural constraints, as well as those related to the poor security situation in the country; these factors negatively affect girls' and women's participation in education and in the labour force, as well as their human capital outcomes (WB, 2017: 47). Gross education enrolment rates are much lower for girls than for boys, by 19, 32 and 15 percentage points in primary, intermediate and secondary school respectively. This translates into an illiteracy rate among adult women of 24%, more than double that among Iraqi men (11%) (WB, 2017: 47).

Female labour force participation is very low at 15% (even compared to the rest of the MENA region – 20 to 25% - which are themselves low by global standards) (all figures in this paragraph from WB, 2017: 48-50). 90% of Iraqi women of working age are not in the labour force; most who do work are employed in part-time jobs. Women's labour force participation rates vary greatly by education level, being highest among women with secondary and tertiary education. Women with low levels of education and skills are often self-employed and concentrated in private sector activities: these are usually informal, low-paying jobs with almost no access to benefits such as health insurance, maternity leave or pensions. Given the lack of private sector opportunities and poor work benefits, most women in the labour force seek public sector employment: overall 70% of employed women work in salaried employment, and two-thirds of all employed women are employed in the public sector. However, irrespective of sector, women earn significantly less than men with similar characteristics: in the private sector the gender wage gap is almost eight times wider than the gap in the public sector.

3. Constraints to inclusive and sustained growth

Chronic conflict and insecurity

Chronic insecurity in Iraq has had a massively detrimental impact on economic growth and development.

Historical legacy

Iraq has a long history of conflict, insecurity and turmoil. It was under Ba'ath rule for three decades, during which period it was an absolute dictatorship characterised by extrajudicial killings, enforced disappearances, torture and other grave human rights violations (WB, 2017: 9). Nonetheless the country performed well on many developmental and welfare indicators: prior to 1991 healthcare covered about 97% of the urban population and 79% of the rural, an estimated 90% of the population had access to safe drinking water; the infant mortality was 29 per 1,000 in 1989 (WB, 2017: 9). The Iran-Iraq war from 1980-1988, as well as causing massive loss of life, had serious negative effects on the economy. The war front involved Iraq's key oil producing and exporting facilities in the south, causing considerable destruction and putting an end to oil

expansion plans. At the same time, the country's economic base was narrowed as defence and food imports were prioritised. But overall, growth during this period stalled rather than completely collapsed.

This changed in 1991 with the invasion of Kuwait. Unlike the Iran-Iraq war, where Iraq had considerable international support, its assault on Kuwait was almost universally condemned (Krishnan et al, 2014: 5). The US-led force which drove the Iraqis out of Kuwait, pursued the Iraqi military into southern Iraq – causing further destruction there. A stringent UN sanctions regime, imposed after Iraq invaded Kuwait, remained in place until 2003. This had a massively detrimental effect on the economy: industrial imports were essentially frozen for the entire decade; the oil sector could accomplish only routine maintenance – new investment was impossible – and oil output in 1995 was less than in 1960; having defaulted on its international financial obligations, Iraq's capital market access was gone and the domestic financial sector was insolvent (Krishnan et al, 2014: 5). Non-oil industry and the agriculture sector saw a devastating decline during the sanctions era: in agriculture, for example, cereals production in 2000 was around one-quarter of its 1990 level (WB, 2017: 12).

Given that sanctions were expressly designed to make it impossible for the government to deliver basic services (albeit they were moderated slightly in 1997 with the Oil-for-Food Programme⁸), it is not surprising that the country's development indicators deteriorated substantially. Poverty rates and infant and child mortality soared; per capita GDP fell to USD174 by 1994 from an estimated USD 2,836 in 1989 (WB, 2017: 10). This was accompanied by a rise in corruption, and a "brain drain" from the country.

Post-2003 insecurity

Following the US-led invasion in 2003, the country saw a rapidly deteriorating security situation in 2004 and sectarian civil war in 2005-6. This coincided with the increase in oil revenues. The security situation made it impossible for the government to focus on reconstruction, especially for fragile network infrastructure such as electricity and water, or to address chronic and accumulating sector problems such as agricultural decline. At the same time, 'a new layer of displacement and internal fragmentation of cities was added to previous episodes' (Krishnan et al, 2014: 6). Broad-based economic development and diversification – which needs such basic infrastructure – was therefore put on hold until some semblance of stability could be restored (Krishnan et al, 2014). Instead, as seen, the government focused on security sector spending and creating public sector jobs, as well as giving pay increases, to secure public loyalty.

Conflict with ISIS

2014 saw further conflict, this time with ISIS. The ISIS war and widespread insecurity caused the destruction of infrastructure and assets in ISIS-controlled areas, diverted resources away from productive investment, severely impacted private sector consumption and investment confidence, and increased poverty, vulnerability and unemployment.⁹ The unemployment rate is about twice as high in the governorates most affected by ISIS compared to the rest of the country

⁸ The Oil-for-Food Programme was established by the United Nations in 1995 to allow Iraq to sell oil on the world market in exchange for food, medicine, and other humanitarian needs for ordinary Iraqi citizens without allowing Iraq to boost its military capabilities. The first shipments of food under the programme arrived in Iraq in March 1997.

⁹ <http://www.worldbank.org/en/country/iraq/overview>

(21.6% vs. 11.2%). At the end of 2017, the cumulative real losses due to the conflict stood at 72% of the 2013 GDP and 142% of the 2013 non-oil GDP.¹⁰

Dependence on oil: lack of diversification

Major oil exporter

Iraq's economy is dominated by oil. Iraq is the world's fourth largest oil exporter (exporting about 3.7 million barrels per day of the estimated 4.2 million barrels per day that it produced in 2015), accounting for 6% of global oil exports (WB, 2017: 13). It holds the world's fifth largest proven reserves of petroleum (though the country is greatly under-explored); moreover, the cost of oil production in Iraq is one of the lowest in the world because of its relatively uncomplicated geology and its multiple, onshore super giant oilfields located close to coastal ports (WB, 2017). Iraq's contracts with major oil companies have the potential to further expand oil exports and revenues, but to realise this potential the country will need to make significant upgrades in its oil processing, pipeline, and export infrastructure (CIA, 2018). While oil production is expected to increase in 2019, following the expiry of the OPEC agreement restricting output, from 2020 the rise is expected to be only marginal – reducing overall growth – as the GOI cannot afford to significantly increase investments (WB, 2018a).

Differential distribution of oil wealth

Oil wealth is differentially distributed in Iraq: most of the country's proven oil reserves are in the south, with the remainder in the north, including 6% in the Kurdistan Region and 15% in Kirkuk. By contrast, the west of the country (Sunni-dominated) has no proven oil reserves, though it does possess gas (WB, 2017: 17). Oil exports from southern Iraq averaged 3.3 million barrels per day in 2016, up from 2015 (CIA, 2018). But oil exports from northern fields are hampered by fundamental disagreements between the Government of Iraq and the autonomous Kurdistan Regional Government (KRG) on the role of federal and regional authorities in the development and export of natural resources (see Section 5). 'Because of the differential geographic distribution of oil resources, any decentralization or federalism reform would need to ensure a stable and equitable resolution to resource sharing to ensure that there were no "losers" who had little choice but to continue the conflict' (WB, 2017: 17).

Dependence on oil revenue and inability to use this effectively

As well as being a leading oil exporter, Iraq is also the country most dependent on oil in the world: the hydrocarbon sector accounted for 58% of the country's GDP, 99% of exports and more than 90% of central government revenue in 2015 (WB, 2017: 13).

The World Bank Systematic Country Diagnostic notes that fiscal institutions in Iraq are weak and unequipped to deal with the complexities of an oil-dominated budget – making the Iraqi economy extremely vulnerable to a sudden decline in oil prices, as seen since 2014 (WB, 2017: 2). Economic institutions in Iraq are unable to generate productive spillovers from oil sector growth or from government spending, particularly as there are no incentives for the private sector to invest in the economy (see below). Instability (see below) is an additional factor in Iraq's inability to make effective use of oil revenue.

¹⁰ <http://www.worldbank.org/en/country/iraq/overview>

Rather than using oil revenue effectively to promote inclusive and sustainable growth, it has been used to expand the public sector. 'Economic decision-making today is dominated by short-term needs and rent-seeking. The government is prioritizing the rapid expansion of oil production in order to finance a bloated public sector and current spending needs – mainly wages – that are detached from any long-term diversification strategy' (WB, 2017: 2). Mansour (2018: 25) echoes this: 'The ease of receiving cash (*from oil*) leads to expansive and bloated bureaucracies rather than cost-effective and accountable governance'.

Oil revenue has also been used to provide costly fuel and electricity subsidies (estimated to account for between 7% and 13% of GDP), and undermined the need for taxation – in turn weakening the accountability link between citizens and the state (WB, 2017: 15). Furthermore, Iraq's dependence on oil revenue undermines private sector growth: 'The availability of oil rents reinforces the reluctance of the Iraqi government to foster the development of an autonomous private sector, transforming the private sector into an opportunity for political influence rather than as a potentially transformative force' (WB, 2017: 15).

Dependence on imports

The relatively undiversified nature of the overall Iraqi economy has led to a large gap between demand for and local production of tradable products – in turn, fuelling dependence on imports. Even when the country enjoyed strong GDP growth up to 2014 'the shrunken agricultural and industrial base still could not meet the population's demand for foods and goods. This gap was met by imports, with the result that the bulk of local production was in retailing and related industries' (Tabaqchali, 2017: 3). At the same time exports of locally produced goods are very limited – a typical feature of a rentier economy (WB, 2016). Twaij (2016) describes the destruction of domestic production: 'Walking around Baghdad, it is now near to impossible to find any Iraqi goods for sale in the streets....In Iraq the only flights fully booked in or out of the country are those going to China, where businessmen make deals to bring the cheapest possible products into Iraq'. Local manufacturers cannot compete. Tabaqchali (2017) notes that one factor in local industry being unable to compete with imports was weak or non-existent tariff collection. Before 2003 Iraqi imports stood at USD 2.682 billion per year: in 2016 the imports figure was over USD 45 billion per year – a massive increase (Twaij, 2016).

Need for diversification

Oil does not provide the basis for inclusive growth: the oil economy accounts for well over half of GDP, yet produces only about 1% of total employment and has few links to non-oil activities (WB, 2017: 14). As oil production ramped up in the 2000s, an enclave model of development emerged: the focus of the companies was on oil field rehabilitation and export infrastructure, and there were limited local spillovers (Krishnan et al, 2014: 7). Related to this is the fact that, unlike its oil-rich neighbours, Iraq has a significantly larger and rapidly growing population: continuing reliance on oil alone will not generate sufficient jobs (WB, 2017: 14). Oil dependence thus makes the prospects for diversification of the economy very limited. 'In the long term, it is critical that Iraq diversify its economy and reduce its almost total reliance on oil and gas receipts' (Atlantic Council, 2017: 11).

Weak governance

The World Bank Systematic Country Diagnostic (SCD) identifies Iraq's poor governance structure as the primary obstacle to more equitable and sustained development (WB, 2017: 6).

Iraq ranks unfavourably on many key indicators of good governance compared to other MENA countries, upper-middle-income countries and OECD countries (WB, 2017: 19). In 2015 it was ranked by the Fragile States Index as one of its high alert states, meaning that it lacks many of the basic administrative capacities required for effective governance (WB, 2017: 19).

The World Bank argues that because of weak governance, what should have been the country's advantages – oil wealth and demographic and geographic diversity – have been turned into liabilities - namely oil dependence and ethnic and sectarian divisions. 'Iraq's institutions have not been able to resolve the competing demands on oil wealth in the context of diverse demography and spatial inequalities or to promote social, economic and human well-being and development. Nor have those institutions succeeded in creating an enabling environment for productive job creation and the accompanying sustained economic growth' (WB, 2017: 6). Krishnan et al (2014: 10) note the impact of governance shortfalls on diversification: 'if effort and resources are being pulled into distortions caused by deficient procurement, arbitrary decision-making, and excessive procedures for commercial transactions, they are being directed away from job creation and productive investment'.

Corruption

One of the major issues in Iraq is corruption: bureaucratic corruption, bribery and nepotism are all rife (WB, 2017). '(S)ystematic corruption pervades all levels of government and is widely accepted as the price of doing business, and extortion and patronage networks are a major impediment to stabilisation, reconstruction and the delivery of basic services' (Abbott, 2017). Sassoon acknowledges that there was corruption under Saddam Hussein and this gained momentum during the sanctions, 'but at no point during the 35 years of authoritarian Ba'th regime was corruption as rampant and endemic as it is today' (Sassoon, 2012: 3). The ICG characterised the spread of corruption within Iraq's institutions as a virus and warned that the government's paralysis was contributing to 'the proliferation of criminal elements and vested interests throughout the bureaucracy' (cited in Sassoon, 2012: 3). On perceptions of corruption, Transparency International ranked Iraq 161 out of 168 countries in 2015 (WB, 2017: 19). In recent polls, Iraqi citizens and business owners identified corruption as the most important policy challenge facing the country, ahead of economic and even security concerns (WB, 2017: 20). Abbott warns that, as well as draining the treasury and wasting public money, corruption breeds resentment and violence – including extremism.

Lack of capacity

Yousif (2016) argues that many of Iraq's economic adversities –the difficulties in carrying through investment, poor public services and sluggish growth – are best understood in the context of prolonged institutional decline and decay in human capabilities, occurring notably since 1990. He points out that in an oil economy like Iraq's, where oil revenues accrue to government and where the state historically has been (and continues to be) central to capital formation and consumption, 'state capacity'¹¹ or governance quality are likely to play a prominent role in economic development' (Yousif, 2016: 213).

¹¹ Yousif defines state capacity as 'the ability to formulate and execute policies and rules or to deliver services' (Yousif, 2016: 214).

Yousif (2016) traces Iraq's brain drain to the 1990s, when the imposition of comprehensive economic sanctions resulted in economic and social collapse – prompting skilled and educated Iraqis to emigrate, and eroding state capacity. Sanctions severely restricted the state's ability to provide services and ensure security: the decline in services was accompanied by a rise in corruption, and in crime and lawlessness (Yousif, 2016).

The flow of knowledge and skills out of Iraq continued after 2003, driven by ongoing insecurity and the erroneous policies of the Coalition occupying powers. De-Ba'athification – including the removal of the four most senior levels of the Ba'ath party members from public sector employment - was particularly damaging. 'Many of the state's most competent administrators were fired overnight from an administration already severely weakened by two wars and more than a decade of sanctions, thus removing what was left of the state and its institutional memory' (WB, 2017: 12). The looting that followed this policy is estimated to have cost USD12 billion, equal to one-third of Iraq's annual GDP, and creating a climate of citizen insecurity and criminal impunity (WB, 2017: 12). All of this further fuelled the country's brain drain. The firing of 120,000 teachers and doctors after 2003, for example, negatively impacted services and led to many of these personnel leaving Iraq (Yousif, 2016: 226). 'The emigration of hundreds of thousands of competent and educated Iraqis fleeing the sectarian violence that erupted after 2003 led to a degradation of the civil service and a serious impairment of public services and of economic functioning overall' (Sassoon, 2012: 4).

Large public sector

The public sector in Iraq is marked by two key characteristics: one, its huge size – it dominates the economy; and two, its ineffectiveness in ensuring security and providing basic services.

Expansion post-2003

As noted, oil revenue has been used to greatly expand the public sector in the post-2003 era (prior to this war and sanctions meant oil revenue was not a significant area of discretion for the government). Once revenues started increasing, public sector positions were one of the few things the government could reliably deliver. Hence 'far from being an impetus to reform, growing oil revenues became an enabler of the status quo' (Krishnan et al, 2014: 11). The size of the public sector in Iraq – measured by public spending to GDP ratio – is one of the highest in the region at 61.1% of GDP, and the approximately 4 million public sector employees account for nearly half of total employment (Krishnan et al, 2014: 8). The public sector 'is by far the largest formal employer in the country, and its wage bill has become the single largest and fastest-growing expenditure item in the government budget' (WB, 2017: 2).

Public sector ineffectiveness

Yet growth in public sector employment has not animated the labour market overall: participation rates remain exceedingly low, especially for women (Krishnan et al: 2014). There are huge benefits associated with public sector employment: a 2007 study found that public sector employees were 83% more likely to have formal benefits than private sector workers (Krishnan et al, 2014: 8). 'Wait unemployment' pending a public sector job is thus one factor in the low labour force participation rate; others are the substantial number of discouraged workers as the labour market does not generate appealing jobs, and the lack of security (Krishnan et al, 2014).

Moreover, the public sector has been unable to effectively carry out its fundamental role of ensuring access to basic services – security, water, electricity and garbage collection as well as

education, health and social assistance services (WB, 2017: 20). Iraqis are very dissatisfied with their access to these basic services: just 30% of the population are satisfied with available education services, under 20% with available health services, and less than 15% with local security (WB, 2017: 20-21). Iraq's massive public payroll is thus 'not reflected in high quality public services and achieves little for the citizens of Iraq' (Twajj, 2016). The World Bank SCD highlights the fact that 'hiring of unqualified personnel through nepotism and political favouritism has weakened the technical capacity and discipline of the civil service and raised expenditure on salaries, crowding out funding for services' (WB, 2017: 21).

The World Bank warns: 'If the bulk of oil revenues continue to be allocated to public employment, wages and transfers, this will perpetuate the current situation, which is characterized by short-term consumption, import dependence, a skewed labour market, and a crippled private sector' (WB, 2017: 4).

4. Private sector constraints

Importance of promoting private sector growth

The private sector in Iraq is dominated by individual, micro and small businesses, mainly operating in retail and trade, construction and transportation services, as well as light industry (RoI, 2014). The majority of businesses are owned by sole proprietors, with the rest being largely family partnerships: the country has few large, multi-industry conglomerates. However, large private businesses are emerging in ICT, particularly mobile communications, in technical services for the oil and gas sector, and in manufacturing (RoI, 2014; WB, 2017: 72). Productivity in the private sector varies: Iraqi private firms perform better in this regard than others in the MENA region in textiles and garments, chemicals, pharmaceuticals, non-metals and equipment; by contrast, food processing and electronics have a relatively low level of productivity (WB, 2012: 1; RoI, 2014: 41).

There is recognition in the literature that Iraq needs to reduce its dependence on oil and develop the private sector. 'Economic diversification is crucially needed, driven forward by a revitalized national private sector' (RoI, 2014: 3). The private sector is seen as key to job creation and, in the long run, to conflict prevention. 'Effective delivery of basic services and creation of income-generating opportunities, particularly for youths in recently-liberated areas, is ...crucial to ameliorate the underlying fragility and prevent another cycle of violence and conflict in the country' (WB, 2018a: 2).

However, there are numerous constraints to private sector growth. As well as the general constraints to economic growth in Iraq detailed in the previous section, there are a number that have particular relevance and impact on the private sector.

Dominance of state-owned enterprises

'The dominance of the public sector in the Iraqi economy has prevented the emergence of a vibrant private sector and the associated job creation necessary for enhancing the welfare of all Iraqis' (WB, 2017: 4-5). State-owned enterprises (SOEs) have long served as sources of patronage for Iraqi regimes (Tabaqchali, 2017), as well as enabling them to ensure control of the sectors concerned. Most non-oil private firms (beyond a few small and micro, informal and

service-oriented enterprises) have been crowded out by SOEs (as well as the maze of regulations that hampers market activity) (WB, 2017).

One sector in which the continued dominance of SOEs has had a significant negative impact is agriculture. Cereals production in Iraq in 2000 was around one-quarter of its 1990 level (Krishnan et al, 2014: 11). While some problems (e.g. salinity, desertification) were longstanding, throughout the 1990s the agriculture sector was afflicted by lack of access to critical inputs, notably seeds. The agriculture inputs industries were concentrated around Baghdad (to facilitate regime control): this proved a major vulnerability from 2003 onwards as insecurity disrupted supply chains across the country, depriving many areas of critical agricultural inputs (Krishnan et al, 2014).

Reform challenges

Many state owned enterprises have been defunct since the 1990s (Krishnan et al, 2014). While SOE reform has been on the table for many years, limited tangible progress has been achieved (WB, 2017). Iraq's isolation following the invasion of Kuwait meant there was no internal or external impetus for modernization of the private sector (e.g. WTO membership). Following the ousting of Saddam Hussain and the rise in oil revenues in the 2000s, the poor situation with regard to security and stability meant the government had no appetite to undertake major reform of SOEs.

Reforming SOEs is in any case a huge undertaking: the World Bank estimates that 234,000 (37%) of the estimated 633,000 workers at Iraq's SOEs are redundant (WB, 2012: 3). The IMF estimates there are about 176 SOEs employing over 555,000 people of which 30-50% are excess positions, plus most SOEs are non-functional (Tabaqchali, 2017: 12). 'While maintaining them drains resources, the government cannot shutter them due to the significant social cost and privatizing them while maintaining the employment levels is a difficult circle to square' (Tabaqchali, 2017: 12). Given the obstacles to reform, the World Bank suggests that, in the near term, internal restructuring of viable SOEs to improve their ability to carry out their mandates is likely to be a more politically and socially feasible strategy than closure or privatization (WB, 2017: 5).

Regulatory environment

The regulatory environment in Iraq does not favour the private sector. The government's Private Sector Development Strategy 2014-2030 acknowledges that, 'current laws and regulations governing the private sector often act as an impediment to private sector development. In numerous instances, they are constraining the revitalization of the private sector as well as preventing the creation of new jobs' (RoI, 2014: 3).

Trade barriers

Iraq has trade barriers, mainly regulatory and bureaucratic practices, which restrict the level of trade and investment. These include: increasingly burdensome import procedures; corruption at the border; stringent requirements on certificates of origin; pre-shipment inspection certification requirements on agricultural products; significant behind-the-border barriers; and inadequate mechanisms in place to perform these processes or revise them to more progressive ones (Krishnan et al, 2014: 9). Krishnan et al (2014) note that many of these issues can be traced to Iraq having been absent from the international trading stage for more than three decades, and thus having little experience with free trade.

Restrictive private sector regulations

The World Bank identifies three ways in which the regulations can impede private sector businesses: (i) when regulations are applied but are not needed; (ii) when needed regulations are poorly designed; and (iii) when regulations are poorly applied and administered – it asserts that all three apply to Iraq (WB, 2017: 74). Many of country's 29,000 laws and regulations were made in the last century, but when new laws were made, the old laws were not repealed. 'As a result, the Iraqi legislative system is burdened with a heavy legacy of out-of-date legislation that works against the country's need for an open, transparent, and diversified economy' (WB, 2017: 74). Further issues include: regulations are often poorly designed, and their impact on the private sector is not given enough consideration; existing laws are poorly enforced; there is no effective and cohesive coordination among the various ministries regulating the private sector or between the government and the private sector; and many ministries do not have enough capacity to implement any reforms (WB, 2017: 74).

Private sector development is one of the weakest reform areas in an overall environment of very little structural policy reform: in 2018 Iraq ranked 154 for starting a business (up from 169 in 2014) and 168 for resolving insolvency because it is not possible to legally close a business (Krishan et al, 2014: 8; WB, 2018b: 168). Iraq's overall ease of doing business ranking in the 2018 report is 168 (out of 190), (WB, 2018b: 168) but it moved up 17 points with regard to getting electricity and 14 points with regard to registering a property (Hadad, 2018: 2). There are currently also long delays in transferring large sums of money into and out of Iraq – something which deters foreign investors (Atlantic Council, 2017).

Informal sector growth

One consequence of Iraq's challenging business environment is the growth of the informal sector. 'High costs of formal participation in the economy, weak services and legal protections, as well as lax legal and regulatory enforcement lead to the informal sector's growth' (WB, 2012: 4). This includes both firms that never formalize, and formal firms that partially conceal their activities. The informal sector in Iraq is very large compared to the formal sector; formal sector firms are squeezed between SOEs with open-ended funding and informal firms that are not required to comply with the same rules as them (Krishan et al, 2014: 8). In a 2011 survey of 756 enterprises, over 50% identified informal sector competition as a serious constraint (WB, 2012: 4).

Shortage of skilled labour

Long-standing brain drain

Iraq's long history of insecurity has severely impacted its human capital, both through a persistent brain drain from the country, as well as through worsening development indicators. Wide-scale conscription during the Iran-Iraq War severely aggravated existing manpower shortages: 'young university graduates as well as skilled and managerial labour was diverted to the military effort, ... hundreds of thousands died or were taken prisoner' (Yousif, 2016: 2019). The decade of the 1990s had a particularly devastating effect on human capital in Iraq. Skilled and educated Iraqis started emigrating as state capacity was eroded such that it became difficult to provide law and order (Yousif, 2016). The deprivations of sanctions led to emigration in much larger numbers: a million and a half Iraqis had left Iraq even before the 1991 Gulf War – by 2002 the number had increased to 4 million (Yousif, 2016: 223). This emigration has been

disproportionately middle-class: a 2007 survey of Iraqi refugees in Jordan found that 46% of those aged 16 or above had a bachelor's degree – much higher than the average for Iraq (Yousif, 2016: 226). Since 2003 conflict and instability has accelerated the loss in skilled personnel, holding back development (Yousif, 2016).

Deterioration in development outcomes

Sanctions and three wars also led to drops in primary and secondary school enrolment rates, and a decline in quality at all levels of the education system: spending on education per student averaged USD47 per student between 1993 and 2002, compared to USD620 in 1988/89 (WB, 2017: 10). Iraq's education and health systems used to be ranked near the top of the MENA region in the late 1970s, but have now fallen to near the bottom (WB, 2017: 2). In a 2011 survey of 756 enterprises, 24% of firms reported that an inadequately educated labour force was a major or severe obstacle' (WB, 2012: 3). While some progress has been in recent years in increasing primary school enrolment and gender parity at primary level, and in improving maternal health, 'much remains to be done in order for the country to progress towards sustained growth and poverty reduction' (WB, 2017: 2).

Lack of appropriate education

Sassoon highlights deficiencies in the education system, particularly at higher levels. On the one hand, the preponderance of state employment 'dampens the urge to acquire higher education' as opportunities are limited (Sassoon, 2012: 5). On the other, teaching and curricula are traditional, restricting participation in the knowledge economy. 'Overall, there has been very little emphasis on technical education, and the majority of graduates are still in humanities and social sciences at a time when Latin America, India, and Southeast Asia have pushed the boundaries in technology and engineering' (Sassoon, 2012: 5).

A further issue highlighted by Sassoon is the marginalisation of females in education, and thus in employment. A trend of families having little incentive to invest in schooling, especially among low-income families and for girls in rural areas, began during sanctions in the 1990s but gathered momentum after the US-led invasion of Iraq (Sassoon, 2012). Sassoon notes that unemployment of women is much higher than that of men, whether in rural or urban areas and in both the educated and less educated categories. 'In the long run, it is difficult to see how countries can grow and develop without the active economic participation of half their population' (Sassoon, 2012: 5).

Public sector competition

As well as the overall lack of skilled labour in Iraq, the private sector faces the additional challenge of being unable to match the benefits provided in the public sector – diminishing the former's appeal for potential employees. 'The perception that public jobs are secure and relatively highly paid attracts skilled and educated workers, reducing their availability to private employees' (WB, 2012: 3). Tabaqchali (2017: 3) echoes this, noting that not only were SOEs unproductive and a huge drain on government resources, 'but they also attracted employees from the private sector, which could not compete with the generous state benefits'. He describes the recent introduction of social security benefits on a par with public sector employees as removing 'one of the largest impediments against private sector employment development' (Tabaqchali, 2017: 11).

Access to finance

State dominance

The financial sector in Iraq is dominated by the state, lacks competition and thus is unable to play an effective role in meeting the needs of a growing private economy (WB, 2012). The financial sector is relatively small in relation to the country's GDP and is dominated by banks which hold over 75% of assets (WB, 2012: 1). The banking system is dominated by state banks which account for about 90% of total assets and deposits, mostly from the state and SOEs (Tabaqchali, 2017: 5). This stems from legislation requiring the government and SOEs to hold accounts and deposits only with state banks, to only accept cheques issued by state banks, and for payment of salaries and pensions to be restricted to state banks (Tabaqchali, 2017). State dominance of the banking sector is also enforced by the link to SOEs and the difficulties in reforming those. 'Despite their (SOEs) lack of viability the government could rely on the two large state-owned banks, Rafidain and Rashid – themselves insolvent – to lend to the SOE sector for payroll financing' (Krishnan et al, 2014: 7). This in turn locked in continued state dominance of the financial sector, since financial sector restructuring would have opened up the issue of wider SOE reform (Krishnan et al, 2014). The commercial banking sector accounts for about 40% of private sector loans and deposits, but lacks the capital, deposit base and infrastructure to become the engine for loan expansion (Tabaqchali, 2017: 5).

Challenges in accessing credit

Securing access to finance is very difficult for private sector entities. Iraq's collateral system is very underdeveloped, with challenges at all stages of the secured lending chain: collateral registration, enforcement and disposition. Banks demand that firms over-collateralize loans: small firms report average collateral value of 140% of loan value, medium firms 180% and large firms 303% (WB, 2012: 1-2). Not surprisingly, private firms mainly rely on internal funds or retained earnings to finance both working capital and new investments. It is estimated that fewer than 5% of SMEs in the formal sector have received bank loans (WB, 2017: 76). The amount of credit provided to the private sector amounts to less than 7% of GDP (compared with 55% on average in other MENA countries) (WB, 2017: 76). *Doing Business 2018* ranked Iraq at 186 (out of 190 countries) in getting credit (WB, 2018b: 168). This hampers growth: 'The current limited access to finance makes it an arduous task for businesses to modernize or expand. New avenues to obtain financing, accessible to more businesses, especially SMEs, are needed' (Rol, 2014: 3). 'The lack of credit available to entrepreneurs and to small and medium enterprises... prevents growth' (Atlantic Council, 2017: 11).

The Iraqi Stock Exchange is small and under-developed (WB, 2012). It has been through a 'boom and bust' cycle in recent years. The first foreign portfolio inflows came in 2010 in the wake of the entry by regional banks and companies that acquired majority stakes in local entities - expanded trading volumes and increased liquidity led to a boom. But the ISIS invasion and collapse in oil prices caused foreign portfolio inflows to reverse as investors exited en masse – the market dropped 68% from its peak in 2014 to hitting bottom in 2016 (Tabaqchali, 2017: 9). 'With total capitalisation at under 5% of GDP, the market is still in the very early phases of its evolution and has yet to play a significant role in the economy' (Tabaqchali, 2017: 9).

Lack of infrastructure

Inadequate power supply

Private sector growth is hampered by lack of infrastructure, in particular access to adequate power supply. In the 2011 survey of firms across Iraq, a majority reported that inadequate power supply seriously hindered their operations: the average firm suffered nearly 600 interruptions in the preceding year, resulting in losses of 14% of sales (WB, 2012: 4). Tabaqchali (2017: 3) highlights that the state's 'failure to provide electricity to meet the needs of industry acted as an additional obstacle to its development'.

Electricity production in Iraq is greatly hampered by the flaring of natural gas associated with oil production: close to 60% of the country's gas production is flared in-field (WB, 2017: 89). The end result is that 'a country that is rich in energy resources relies on expensive and imported fuels to produce electricity, costing an estimated USD 6-8 billion per year' (WB, 2017: 89). Gas flaring is not only costly and wasteful but the use of alternative fuels (primarily diesel and heavy fuel oil) generates more local pollutants and greenhouse gas emissions than would have been the case with gas.

The electricity sector in Iraq has a number of concurrent challenges (WB, 2017: 89-90): It suffers from deficiencies at all stages, from generation capacity to distribution. Low operational efficiency, high levels of electricity losses, and obsolete network equipment have led to average levels of aggregate technical and commercial losses of around 40% of total electricity generated. This means that nearly half of the energy transferred to the distribution network after being generated is lost before any revenue can be collected. Cost recovery is also extremely low, and the collected revenues cover only about 10% of the operational expenditures.

Weak transport infrastructure

Effective and efficient internal and external transport networks are needed for improved trade (WB, 2012). The World Bank Logistics Performance Index (2010) showed Iraq behind the region and other middle income countries in trade logistics efficiency: it ranked 148 out of 155 countries (WB, 2012: 4). The cost of getting a container into and out of Iraq – averaging USD 3,500 per container – was the highest in the region (WB, 2012: 4). Iraq's weak transport network undermines economic diversification and private sector development in multiple ways: it undermines connections between regions, and reduces the potential economic and social interactions between them; it is an obstacle to the movement of people and goods, hurts trade and competitiveness, and prevents people and firms from accessing services and markets (WB, 2017: 90). The main issue is chronic underfunding compounded by lack of a sector strategy, weak institutions, and a complex conflict-affected environment (WB, 2017: 90).

Reform entails considerable challenges. Improving provision of electricity in Iraq will require reducing the costs of producing electricity as well as reforming tariffs, reducing gas flaring, and increasing the use of Iraq's massive gas supplies to produce electricity in place of more expensive alternative fuels. Improving infrastructure more broadly will require focusing on public investment management and governance to reduce significant waste and corruption in infrastructure spending.

5. Situation in Kurdistan Region of Iraq (KRI)

The Kurdistan Region of Iraq (KRI) is a constitutionally recognised semi-autonomous region in northern Iraq, and its government (KRG) has the right to exercise legislative, executive and judicial powers except in areas listed in the constitution as being exclusive powers of the federal government (WB, 2016). KRI was less severely impacted by sanctions following the invasion of Kuwait than the rest of the country: 'its de facto autonomy from 1991 onwards meant it could meet its basic needs more effectively during the sanctions years' (WB, 2017: 17). Poverty rates in Kurdistan were thus lower than other parts of the country in 2007, and fell by nearly nine percentage points between 2007 and 2012 (WB, 2017: 31). KRI has also been largely immune to the insecurity and conflict witnessed elsewhere in Iraq following the US-led invasion of 2003 (WB, 2016: 1).

Progress in private sector growth

Better security makes KRI a better environment for foreign investors than Baghdad (Atlantic Council, 2017). 'This has allowed KRG to promote its burgeoning private sector and attract foreign investments in both oil and non-oil sectors' (WB, 2016: 1). The 2006 Investment Law followed by the establishment of a streamlined licensing process overseen by the Board of Investment in KRI offered incentives to foreign and regional investors to support infrastructure and real sector development. It is estimated that KRI represented on average almost 55% of all foreign direct investment (FDI) in Iraq prior to the ISIS conflict (WB, 2017: 75). This surge of investment helped to boost private-sector-led job creation. On average, KRI added approximately 32,300 jobs per year in the private sector compared to 31,900 jobs per year in the public sector between 2007 and 2012 (WB, 2017: 75). Most of the jobs went to the urban and rural poor, primarily in sectors such as construction, commerce and retail, transport and logistics, and agriculture (WB, 2017: 75). However, it should be noted that most private sector initiatives and investments have been geared towards public procurement opportunities, especially in the services sector, while there is an absence of supporting innovation and competition to help to modernize the economy (WB, 2017).

Economic challenges

Moreover, KRG faces similar economic challenges and has similar structural weaknesses to the rest of Iraq. Specifically, it too is affected by:

- a) high dependency on the oil sector – prior to the suspension of federal transfers (see below) oil export revenues accounted for 85% of KRG fiscal revenues (WB, 2016: 2);
- b) an excessive role of the public sector in the economy – KRG public spending to GDP ratio is over 50% (compared to 61% for the whole of Iraq); it is the main employer accounting for over 50% of total employment. 'Despite the strong entrepreneurial spirit and potential, the local private sector in KRI is small and under-developed due to the significant crowding out by the public sector' (WB, 2016: 3);
- c) dependency on imports – as with the rest of Iraq, there is a large gap between demand for an local production of tradable products in KRI, which is filled by imports amounting to 90% of non-oil GDP (WB, 2016: 3). 'Under the current policy regime it is hard for the local businesses to compete with imports to diversify and grow' (WB, 2016: 3);
- d) weak financial system and dependence on cash economy – KRI has a poorly developed financial sector, including weak financial infrastructure and low access to finance, especially for SMEs. There is a strong preference for cash in business transactions.

The *Report of the Task Force on the Future of Iraq* notes that, 'When oil prices were high the KRB, like Baghdad, failed to invest in diversifying the economy, or to expand local production of agricultural or manufactured goods to reduce the almost total reliance on imports' (Atlantic Council, 2017: 9).

On top of these structural challenges, KRI has been hit in recent years by a number of shocks (WB, 2016: 4):

- Conflict with ISIS from mid-2014 within 13 miles of Erbil, leading to the influx of 1.8 million Syrian refugees and Iraqi IDPs – increasing KRI's population by 28%;
- A sharp decline in international oil prices, from USD 115 a barrel in June 2014 to USD 35 in December 2015, leading to less revenue from direct sales;
- A sharp fall in revenue transfers from the central government, from USD 12 billion in 2013 to about USD 1 billion in 2014, which was suspended in June 2015.

The major influx of refugees and IDPs severely constrained the government's ability to provide basic services, leading to deterioration in the standard of living of the population and increased poverty rates (doubling in host communities such as Dohuk) (WB, 2016: 4). 'Local access to public services including healthcare, education, and access to water and electricity has been dramatically reduced' (Atlantic Council, 2017: 9). Moreover, the increasingly difficult political and security environment beginning in 2013-2014 resulted in job losses in the private sector and in growing public sector employment (WB, 2017).

KRG response to fiscal crisis

KRG has responded to the fiscal crisis by trying to increase oil revenues and implementing austerity measures. In 2007, the KRG passed a law to develop oil and gas reserves in Kurdistan Region of Iraq independent of the federal agreement. It has signed about 50 contracts with foreign energy companies to develop its reserves, some of which lie in territories whose status is disputed between Baghdad and Erbil. Some of the companies have left or returned blocks, citing lack of commercial prospects. In 2014 KRG began exporting oil unilaterally through its own pipeline in Turkey, which Baghdad claims is illegal. In the absence of a national hydrocarbons law, the two sides have entered into four provisional oil- and revenue-sharing deals since 2009, all of which collapsed. In September 2016 the two sides began implementing a fifth ad hoc agreement to split oil exports from Baghdad-controlled fields in Kirkuk. In October 2017, following a referendum on independence for the Kurdistan Region of Iraq, which the federal government considered illegal, federal forces regained control of disputed areas controlled by KRG, including oil-rich areas (Hiltermann, 2017). This led to the KRG losing half its oil revenue (WB, 2018a: 1).

In 2015 KRG also seized the monies in the Central Bank of Iraq branches in Erbil and Sulaimaniyyah, including the regulatory capital of Iraqi public and private sector banks that were deposited at these branches, causing the illiquidity of a number of private sector banks (Atlantic Council, 2017: 9).

Austerity measures implemented by KRG include: suspension of some 4,000 public infrastructure projects (Atlantic Council, 2017: 9); letting payments fall in arrears, including wages and salaries of government employees; borrowing domestically from private and foreign companies and banks, and borrowing externally. The World Bank warns that 'the impact of reduced investment in infrastructure will be felt in the medium-term through lowering private sector productivity and crowding out private investment. Also, arrears in payments to oil companies and contractors create an uncertain business environment' (WB, 2016: 1). The Task

Force on the Future of Iraq similarly warns that ‘these actions depress consumer spending, inhibit growth and damage public confidence’ (Atlantic Council, 2017: 9). Frustration with the state of affairs in KRI has already prompted the outflow of thousands of educated Kurds, many of whom had returned to the region after 2003 to help develop their homeland (Atlantic Council, 2017: 9).

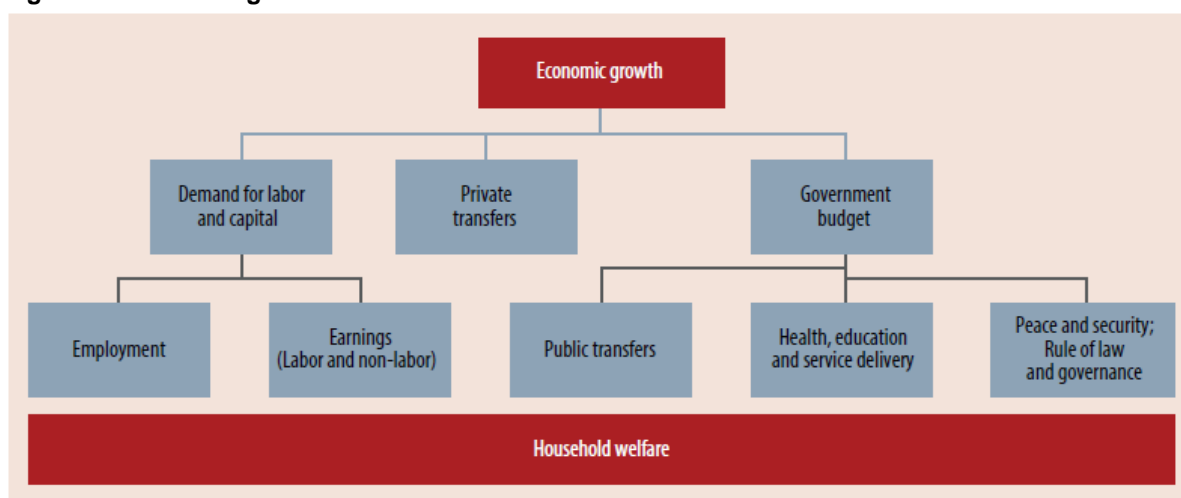
6. Areas for intervention

In general, economic growth in a country can translate into welfare improvements for its citizens through the following channels (Krishnan et al, 2014: 17):

- By enhancing the demand for labour, capital and other inputs and therefore boosting employment and earnings (labour and non-labour);
- By boosting the resources available to the government to transfer, redistribute and provide services to the population;
- The establishment and maintenance of peace and security and the rule of law.

Each of the above – employment, income (earned and unearned), the access to and quality of basic services, and the overall environment – contribute directly or indirectly to household welfare, and therefore to poverty reduction and shared prosperity (Krishnan et al, 2014).

Figure 1: Economic growth and welfare: main channels



Source: Krishnan et al, 2014: 17.

As detailed in this report, Iraq faces challenges in relation to all three. Based on the literature review and the constraints to inclusive, sustained growth - and specifically to private sector growth - identified in this report, the following areas for intervention emerge:

- Reduction in Iraq’s oil dependency through economic diversification, in particular private sector growth;
- Reduction in the size of the public sector;
- Governance reform, in particular to tackle corruption;
- Improvements in provision of basic services to achieve better development outcomes, in particular skilled human capital for the labour force;
- Improvements in access to finance for private sector entities;

- Improvements in provision of infrastructure, notably electricity and roads.

Report of the Task Force on the Future of Iraq

The 2017 *Report of the Task Force on the Future of Iraq* identifies a number of measures in the above areas to support economic reform in the country:

- Diversification - It is critical that Iraq diversify its economy and reduce its almost total reliance on oil and gas receipts. In particular it needs to invest further in agriculture and manufacturing to spur local job creation, to reduce its dependence on imports, and to improve its long-term economic prospects;
- Tax income - Diversifying sources of income also requires the Iraqi government to enforce its tax and customs collections system – instituting automated deductions could significantly help in this process;
- Oil and gas production - It is imperative that the Iraqi government continues to prioritize investment in the oil and gas sector and works to maximise the efficiency of the institutions that deal with foreign companies working in the sector. These resources provide the foundation of the Iraqi economy and even a transition away from oil dependency will require that they are effectively deployed;

Renegotiating contracts with oil companies could make this more manageable. The government also could benefit from moving away from its technical-service agreements, which levy high fees per barrel on the government at a time when oil prices are low, and which fail to incentivise cost efficient investments in infrastructure on the part of oil companies. Additionally, speeding up decision-making processes and strengthening institutional capacity are important to maintaining and growing international investment in the sector;

- Public sector reform - Incentivising public sector employees to transition into the private sector will require the government to limit the extremely generous pensions offered by the public sector, and to use the resources saved to jump-start a pension system open to private sector employees. Balancing out the benefits available to public and private sector workers is critical to reducing the massive burden placed on the public purse by a bloated public sector currently seen as a lifelong financial guarantee for those who work in it. The Iraqi government should also implement steps that encourage public sector workers to move on;
- Regulatory reform - Simplifying the legal steps for starting and running a business and clamping down on officials who extort local companies will be critical first steps toward enabling the expansion of the private sector;

International investment in Iraq can be substantially aided by regulatory reform, by a much more permissive visa system, and by the formation of a high-level commission (perhaps housed in the prime minister's office) that can help international companies cut through the deeply obstructive bureaucratic system that is currently limiting foreign direct investment;

- Corruption - Tackling entrenched corruption is tough but necessary to reduce the massive market distortions that prevent a balanced economy from taking root. Partnering with technology companies can offer one way of reducing opportunities for graft in the system. The Iraqi government's partnership with a private company to pay public sector employees through a biometric card system has been one successful initiative reducing

the vulnerability to corruption of the previous cash-based payment system, but it needs to be rolled out more comprehensively;

- Access to finance - The United States, its partners and international finance institutions can support the availability of credit by mandating that a proportion of their assistance be made available to SMEs;
- Capital markets - Iraq could be encouraged to further develop its capital markets. Functional capital markets encourage corporate and institutional transparency, allow both early-stage and mature companies to raise equity and debt capital, facilitate new company formation, attract foreign investment (which in turn strengthens international ties), create wealth, and allow a broad segment of the population to participate in the country's prosperity. In addition, functional capital markets can play a critical role in developing vital infrastructure and in post-war reconstruction efforts.

Unlisted firms could be offered tax incentives to list on the Iraq Stock Exchange (ISX), and some state-owned companies could be privatized and listed on the Exchange as well. The credit worthiness of the Iraq Stock Exchange could be further enhanced if internationally recognized financial institutions are permitted to act as custodians for securities listed on the ISX.

- Bank transfers - It is important that the Iraqi government make it easier for foreign companies to transfer money in and out of Iraq, while keeping the sanctity of the anti-money laundering and anti-financial crime and terrorism-financing regime.

World Bank Systematic Country Diagnostic

The World Bank's 2017 Systematic Country Diagnostic prioritises macroeconomic stability and public sector reform, as well as exploitation of Iraq's agricultural and tourism potential (WB, 2017: 111-112):

- Macroeconomic stability - Consolidation efforts are required to address urgent balance of payments needs, to bring spending in line with global oil prices and to ensure debt sustainability. Reforms to the electricity sector, to subsidies, to SOEs and to PFM are also critical in the medium term to reduce corruption and make room for the investment spending that is central to sustaining growth.
- Investment of oil revenues - allocating more oil revenues to investments in public capital would provide the broadest benefits in terms of diversification and economic transformation. However, this requires the government to improve the current very poor public investment management (PIM) in a context of a functional medium-term fiscal framework, an explicit debt management strategy, and strengthened PFM. To minimize losses due to poor PIM, the government should consider setting aside a portion of oil revenues in an overseas transitional saving fund while it addresses the weaknesses in public investment management.
- Reduction in size of public sector - This a hugely challenging undertaking as it goes to the heart of the governance, ethnic, and sectarian issues that bedevil the country. Building adequate human resource information systems and strengthening oversight in the civil service are critical to stemming the rampant use of favouritism in hiring and promotions, often following political or sectarian lines. Outright layoffs are unlikely to be politically feasible, and most potential reforms are difficult and politically controversial. Sustaining the efforts to reduce Iraq's massive public sector wage bill is, however, essential. Measures include the replacement of only a small proportion of public

employees who leave the public sector through natural attrition, as well as the completion of the audits of wage earners and pensioner payrolls that have been embarked upon, including follow-up measures to cancel illegal payments. While these measures would be just a start towards restructuring the public sector, they would send the important signal that existing practices need to change.

- SOE reform – Gradually limiting the scope of public sector activities will be essential to revitalizing the private sector. As noted, non-oil private firms have been crowded out by SOEs. In the near term, internal restructuring of the most viable SOEs to enable them to better carry out their mandates is likely to be a more politically and socially feasible strategy than closure or privatization. In the medium term, it will be necessary to convert the hidden SOE subsidies into explicit budget expenditures, which may lead to increased public pressure for SOE reform. In the financial sector, a more level playing field between public and private banks will be required if the sector is to grow sufficiently to finance the private sector.
- Agriculture and tourism – Iraq has considerable agriculture resources. With its holy Shia sites and historical heritage, Iraq continues to attract millions of tourists – especially religious tourists – despite difficult circumstances. Both agriculture and tourism present numerous opportunities for growth.

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