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IRAQ
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Currency Equivalent

1 US\$ = 1,182 Iraqi Dinars (ID)

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Acronyms and Abbreviations

ANS	Adjusted Net Savings	MPI	Multi-dimensional Poverty
BaU	Business as Usual	NDP	National Development Plan
BTI	Bertelsmann Transformation Index	NGO	Non-governmental Organization
CAR	Capital Adequacy Ratio	NOPB	Non-oil Primary Balance
CBI	Central Bank of Iraq	NPL	Non-performing Loan
CPA	Coalition Provisional Authority	OECD	Organization for Economic Cooperation and Development
COED	Cost of Environmental Degradation	OPEC	Organization of Petroleum Exporting Countries
COMSEC	Council of Minister's Secretariat	PDS	Public Distribution System
CSO	Civil Society Organizations	PEFA	Public Expenditure and Financial Accountability
EITI	Extractive Industries Transparency Initiative	PFM	Public Financial Management
FAO	Food and Agriculture Organization	PHCC	Primary Health Care Center
FBSA	Federal Board of Supreme Audit	PIH	Permanent Income Hypothesis
FCV	Fragility, Conflict and Violence	PIM	Public Investment Management
FDI	Foreign Direct Investment	PMT	Proxy Means Test
GCC	Gulf Cooperation Council	PPP	Public-Private Partnership
GDP	Gross Domestic Product	PSSD	Pensions and Social Security Department
GPI	Gender Parity Index	SCD	Systematic Country Diagnostic
ICA	Investment Climate Assessment	SME	Small and Medium Enterprise
ICG	Iraq Crisis Group	SOE	State-owned Enterprise
ICT	Information and Communications Technology	SOMO	State Organization for Marketing Oil
ID	Iraqi dinar	SPC	Social Protection Commission
IDP	Internally Displaced Person	SPF	State Pensions Fund
IFC	International Finance Corporation	SPN	Social Protection Net
IFI	International Financial Institution	SSN	Social Safety Net
IHSES	Iraq Household Socioeconomic Survey	UAE	United Arab Emirates
IMF	International Monetary Fund	UMIC	Upper Middle Income
INTOSAI	International Organisation of Supreme Audit Institutions	UNDP	United Nations Development Programme
IOM	International Organization for Migration	UNOCHA	United Nations Office for the Coordination of Humanitarian Affairs
IPD	Institutional Profiles Database	WDI	World Development Indicators
IPCT	Iraqi Telecommunications and Posts Company	WHO	World Health Organization
IPP	Independent Power Project	WTO	World Trade Organization
KRG	Kurdistan Regional Government		
KRI	Kurdistan Region of Iraq		
MENA	Middle East and North Africa		
MFI	Micro-finance Institution		
MOF	Ministry of Finance		
MOH	Ministry of Health		
MOLSA	Ministry of Labor and Social Affairs		

Executive Summary

1. **Iraq's development has been thwarted by decades of conflict.** Today it is an upper middle-income, resource-rich, yet fragile and conflict-riven country. This report identifies three factors that have shaped Iraq's development in recent decades: its oil wealth, its geographic and demographic diversity, and failed governance.
2. **Mineral wealth has been a key underlying factor in Iraq's development since the 1950s.** The world's fourth largest oil exporter, Iraq also holds the world's fifth largest proven reserves of petroleum. Yet oil wealth has not been successfully exploited as a platform for sustained and equitable development. Iraq is the world leader today in terms of dependence on oil, with the hydrocarbon sector accounting for 58 percent of the country's GDP, 99 percent of its exports, and more than 90 percent of central government revenue in 2015. Unlike some of its oil-rich neighbors, however, Iraq's reliance on oil does not represent a viable source of broad-based economic development. The country's large and rapidly growing population means that, even under optimistic scenarios for oil production, continued reliance on oil alone will not generate sufficient jobs to ensure the welfare of all Iraqis. Moreover, Iraq has been unable to generate productive spillovers from oil as the sector creates few jobs and has negligible links to the rest of the economy.
3. **The greater Tigris-Euphrates basin has, over millennia, hosted an ethnically, politically and socially diverse population.** Today's Iraq is not only geographically diverse – dominated by the Tigris and Euphrates rivers, with mountains, plains, desert, marshes, and access to the sea – but is also demographically diverse. While Shia and Sunni Arabs and Kurds represent the country's largest religious and ethnic groups, Iraq is home to numerous other communities, including Christians, Turkmen, Faili Kurds, Shabak, Circassians, and Yazidis among others. Iraq is also characterized by spatial diversity. Most relevant in today's context, the country's oil wealth is differentially distributed across the country. The bulk of proven reserves are located in the south, with most of the rest being in the north. The differential geographic distribution of oil resources has critical implications for any discussions about decentralization in Iraq. Poverty and welfare are geographically differentiated as well, and conflict has led to more pronounced spatial divergences not only in poverty but also in the delivery of services. These geographic inequalities have not been adequately addressed, which is why they persist.
4. **Poor governance has transformed Iraq's strengths – oil wealth and diversity – into the twin liabilities of oil dependence and ethnic and sectarian fragmentation.** Iraq's institutions, which were not robust even in the 1970s, the decade of rapid economic growth and progress in many aspects of human development, have been severely debilitated by decades of wars, sanctions, and conflict. Despite its size, the state has in many cases not been able to effectively provide security, development, or the most basic services. Poor governance has contributed to undermining the state's legitimacy, giving rise to a multitude of alternative groups seeking to capture resources and power. These have ranged from sectarian and ethnic militias to Daesh. Close links between political and militarized groups have exacerbated existing political divides along sectarian lines and further weakened governance. External intervention has brought sanctions and wars as well as massive humanitarian and development assistance.
5. **Persistent poverty and arrested development are the symptoms of Iraq's predicament.** There has been no overall movement towards reductions in either poverty or income equality in Iraq

since 2007. Headcount poverty as measured in 2014 has remained virtually unchanged at 22.5 percent. What limited gains in poverty reduction had been achieved up to 2012 had been reversed by 2014 as a result of a resurgence in violence and the worsening of the economic environment due to the collapse of oil prices. More than 4 million Iraqis have been displaced by the country's various conflicts.

6. The loss of human capital over the past three decades in Iraq has been massive, a legacy of conflicts and continuing fragility. While the Iraqi education and health systems were ranked near the top of the MENA region in the late 1970s, they have fallen to near the bottom today. Achievements in increasing literacy and reducing gender disparities have been erased. Although some progress has been made in increasing primary enrollment and gender parity at the primary level and improving maternal health, much remains to be done in order for the country to progress towards sustained growth and poverty reduction. A huge vulnerable population exacerbates pressure on an already weak system, sharpens disparities of access between regions, and is poorly served by the education and health systems and by social safety nets.

7. Efforts to resolve Iraq's many development challenges are severely hampered by insecurity and poor governance. 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. Fiscal institutions are weak and unequipped to deal with the complexities of an oil-dominated budget, which has made the Iraqi economy extremely vulnerable to a sudden decline in oil prices, as has been evident since 2014. Even though it has been unable to ensure the country's security or to provide basic services, the public sector dominates the economy. It 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. State-owned enterprises (SOEs) dominate the financial and non-financial sectors and enjoy significant privileges, thus crowding out private firms and impeding factor reallocation. Yet only one quarter of all SOEs are profitable. A substantial number are seriously decapitalized, inefficient, and in a state of physical degradation, and many appear to have a limited rationale for existing apart from providing public employment. The weak and stagnant private sector is incapable of generating significant employment opportunities for the tens of thousands of young Iraqis who swell the ranks of the unemployed each year. Consultations with the private sector around this report noted that politically connected firms capture public sector contracts, further reducing the opportunities available to other entrepreneurs. Iraq has neglected its non-oil infrastructure, and poor quality services are aggravated by inadequate infrastructure and low levels of public investment. With few exceptions, the private sector is not yet in a position to play a major role in the non-oil economy.

8. Efforts to tackle Iraq's fundamental challenges and to appease competing interest groups have included the drafting of a new constitution, the holding of national and regional elections, and the approval of numerous laws. To date, these efforts have yielded only limited success in terms of resolving the country's governance and security challenges. A key question facing Iraq today is whether a new governance structure can be peaceably built that has a better chance of distributing power and resources more equitably. A new social contract is needed, one which places a high value on the sustainability of social and political systems as well as on environmental and fiscal sustainability. Wealth analysis indicates that the country is not accumulating any wealth but is depleting it rapidly as oil wealth is consumed without the parallel creation of human or physical assets. The costs

of environmental degradation, particularly the degradation of water resources, are huge, amounting to over 6 percent of GDP in some recent years.

9. Decentralization is frequently discussed as a potential way to ensure political and social sustainability, to reduce Iraq's ethnic and sectarian struggles, and to reverse the decline in service delivery and accountability. Absolute central control of resources no longer appears to be a viable alternative. Solutions that recognize differential conditions and capacities across Iraq – the semi-autonomous Kurdistan region is a case in point – may be a possibility. It is essential, however, to recognize that, while some are concerned about the government of Iraq being over-centralized, others are worried about fragmentation. Some have recommended the devolution of power to Shia and Sunni Arab, and Kurdish communities, but these proposals raise serious concerns. For example, Iraq's oil reserves are concentrated geographically rather than being distributed evenly. Decentralization would make it difficult for the federal government to enforce the equitable distribution of wealth. Iraq's three major communities are not as geographically contiguous as is often assumed, giving rise to potential discrimination or worse against large groups of minorities. Moreover, the premise of political legitimacy based on sectarian identity ignores many other cross-cutting identities such as tribe, class, or rural/urban dwellers. Strongly aligning Iraq's political institutions with its sectarian identities is likely to entrench the zero-sum nature of the competition for resources and power that has already generated so much instability in the country (Fitzsimmons, 2008).

10. This Systematic Country Diagnostic (SCD) argues that the priorities for Iraq going forward are clear: (i) reestablishing security; (ii) rebuilding the social contract and state legitimacy; and (iii) managing its oil wealth equitably and sustainably. There is no unique path to achieving these goals, although unless security is established, it is difficult to imagine a path to prosperity. While the ability of international finance institutions (IFIs) is limited in ensuring greater security, the international community still has a critical role to play. Regional power struggles are being played out in Iraq, undermining efforts to reach domestic political solutions. External support of sectarian factions and militias outside the control of the government is a destabilizing factor, and one that undercuts the government's legitimacy.

11. Reconstructing a fractured, sectarian governance architecture and restoring its legitimacy will be central to the success of all other reforms. Promoting inclusion, trust, and social cohesion between citizens and government, as well as among citizens, will require appealing to the most excluded and vulnerable groups, including youths and internally displaced persons (IDPs). Examples of interventions aimed at re-building social trust include visible emergency reconstruction programs implemented in areas where confidence in state institutions is very low, where marginalization is widespread, and where radicalization is particularly worrisome. IDPs, refugees, and Iraqi youths all suffer disproportionately from a lack of access to basic services and jobs. Therefore it is critical to focus efforts on increasing access to services for both host and IDP communities, especially social protection for the urban poor. In addition, support for building physical assets (for example, supporting housing reconstruction and repair in conflict-affected areas) would increase social and political stability and allow the eventual return of IDPs, as well as provide local employment. Improving the provision of vital services would also restore the population's faith in the state, thus shoring up its legitimacy. Focusing on rehabilitating schools in conflict areas, where one in five schools has closed, would enable some of the 3.5 million children of school age presently not receiving any education to return to school. Schools are the best places for providing psycho-emotional support to

conflict-affected children and youths, and education can play a pivotal role in promoting resilience among conflict-affected populations, thus eventually fostering social cohesion.

12. Improving the delivery of public services would fortify trust and legitimacy between citizens and the state. Iraqis have witnessed a dramatic deterioration in most basic services. As a result, the poor and near poor are greatly in need of well-targeted and effective social protection programs, to weather the current highly volatile economic and social conditions. The government's current efforts to move Iraq's Social Protection Net from categorical targeting to a new targeting methodology based on proxy means testing, as well as the establishment of a unified registry of beneficiaries, would enhance the capacity to help IDPs and would help to ensure that benefits go to those most in need. The rebuilding of destroyed or damaged infrastructure is essential to enable the effective delivery of services and the integration of Iraq's increasingly isolated regions to increase national cohesion. For example, both citizens and businesses are demanding better electricity provision. Improving the provision of services will depend in part on reducing the costs of producing electricity as well as on reforming tariffs, reducing gas flaring, and increasing the use of Iraq's massive gas supplies for producing electricity in place of more expensive alternative fuels. Improving infrastructure services more broadly will also require focusing on the nuts and bolts of public investment management and governance to reduce what appear to be significant waste and corruption in infrastructure spending. The successful implementation of much needed local investment programs could also be a way to create jobs at the local level, but it is very difficult for local administrations to implement such programs because of their limited capacity and the lack of reliable resource flows from the center, among many other constraints. Overcoming some of these constraints to local capacity and financial management is essential.

13. The poor management of Iraq's immense oil wealth is one of the key constraints facing the country. The government has failed to equitably and sustainably exploit national resources to reduce poverty and ensure shared prosperity. Competition over the control of resources has exacerbated ethnic and sectarian divisions, with a consequent deterioration in governance, security, and state legitimacy. If the bulk of oil revenues continues 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 labor market, and a crippled private sector. The role of the public sector, the prime beneficiary of mineral wealth today, needs to be redefined. Allocating more oil revenues to public capital investments would provide the broadest benefits in terms of diversification and economic transformation. However, Iraq has a poor record of public investment management (PIM) so it will be necessary to tackle this problem within the context of a medium-term fiscal framework, an explicit debt management strategy, and strengthened public financial management (PFM). To minimize losses due to poor PIM, a portion of oil revenues can be set aside in an overseas transitional saving fund while Iraq's investment management and associated systems are strengthened. In parallel, hiring freezes can be implemented and civil service payroll audits should be conducted to identify ghost workers, absenteeism, and workers receiving more than one salary. While these measures will only be the first moves towards restructuring the public sector, implementing them would signal a change to existing clientelistic hiring practices that have greatly reduced the civil service's capacity.

14. 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. A strong private sector is also a prerequisite for economic diversification and for sustainable growth. Yet outside the oil sector most non-oil private firms (beyond a few small and micro, informal, and service-oriented enterprises) have been crowded out by SOEs and by the maze of regulations that creates a hostile environment for market activity. SOE reform has been on the table for many years, but limited tangible progress has been achieved. In the medium term, it will be necessary, for the sake of fiscal transparency, to convert hidden subsidies into explicit budget expenditures; this 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 before the banking sector will be able to fulfill its role in financing the private sector. 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.

15. The consequences of failing to tackle Iraq's weak governance, conflict, and fragility are not difficult to imagine. The country has unfortunately already witnessed some of them during the sectarian violence that racked the country between 2005 and 2007 and in the more recent rise of Daesh. Beyond the loss of life and displacement that a deterioration in governance and security would entail, the impact would affect all aspects of economy and society. What progress has been achieved in terms of the provision of social services and safety nets would be reversed, the losses in the accumulation of human capital would deepen, and hard-won advances in attracting investment would be undone. Trust among citizens and between citizens and the state would be further reduced. The slow process of constructing governance and the legitimacy of the state would receive a further blow. It is not clear that the institutional capital exists for Iraq to recover from more crises.

16. Numerous obstacles and risks lie in the way of achieving progress on the priorities identified in this SCD. Sectarianism may worsen and, with it, security, which will derail any progress that has been achieved to date and will make it impossible to improve governance and state legitimacy. Efforts towards decentralization may falter, putting in question the potential for improving service delivery and accountability at the local level. Macroeconomic and fiscal risks may undermine economic reform efforts. Attempts to redefine the role of the public sector, which is critical to revitalizing the private sector and to ensuring fiscal health, may face insurmountable opposition. And external shocks, to which Iraq is highly susceptible, may derail efforts to strengthen security and the rule of law.

17. Nevertheless, Iraq's rich diversity and wealth also present numerous opportunities. Under the right circumstances, oil and gas can be a stepping stone to diversification. Iraq has considerable agricultural resources and, unlike most of its oil-rich neighbors, has a population large enough to contemplate skills specialization. With its holy Shia cities and historical heritage, Iraq continues to attract millions of tourists – especially religious tourists – despite difficult circumstances. When conditions – namely security – have allowed, Iraq has been able to attract significant investment. And despite its highly constrained environment, numerous improvements in welfare have been achieved, including reductions in maternal mortality, increases in safe births, increased primary enrollment rates and gender parity at the primary level, and the initiation of wholesale reforms to the social protection net. It is now time to overcome the fundamental constraints to improving security and governance and increasing social cohesion to begin to achieve Iraq's potential and to improve the welfare of all of its citizens.

IRAQ

Systematic Country Diagnostic

I. INTRODUCTION

1. This Systematic Country Diagnostic for Iraq identifies the three characteristics that underlie Iraq's predicaments: its poor governance, dependence on oil wealth, and ethnic and regional diversity. It posits that the combination of oil wealth and ethnic and religious fragmentation has led to conflict, violence, and fragility due to long-standing governance problems and the inability of institutions to ensure an equitable allocation of resources among the country's population and regions. Tackling these complex issues – re-shaping the pernicious governance architecture, channeling oil wealth towards efforts to make sustainable improvements in well-being, and improving security – will be necessary for Iraq to achieve a new and workable social contract.
2. Systematic Country Diagnostic reports are a product of the World Bank Group and reflect consultations with the national authorities, civil society, the private sector, and other stakeholders. As the scope of the SCD is not limited *a priori* to areas or sectors in which the World Bank is engaged, it is expected to stimulate an open and forward looking dialogue between the World Bank Group, the Iraqi government, and the public. The report is organized as follows. Section II lays out the country context of Iraq and discusses the three characteristics noted above (poor governance, dependence on oil wealth, and ethnic and regional diversity) that have led to Iraq's fragility, conflict, and violence. Section III discusses the main features of poverty and exclusion in Iraq, while Section IV presents the key challenges facing the country and their relation to the three identified characteristics. Section V discusses social, economic, and environmental sustainability, and Section VI concludes with a prioritization of these constraints in the context of tensions or tradeoffs that are inherent to Iraq's social and economic realities.

II. UNDERSTANDING IRAQ'S PREDICAMENT

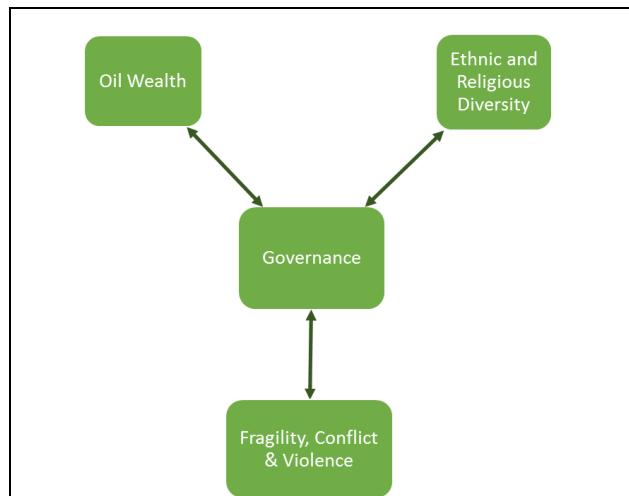
3. The SCD hypothesizes that Iraq's poor governance structure is the primary obstacle to more equitable and sustained development. Good governance is necessary to enable equitable service delivery managed by strong, accountable institutions. However, Iraq's governance structure has failed, over decades, to manage what should be its advantages – namely oil wealth and demographic and geographic diversity. Instead, it has converted them into liabilities - namely, oil dependence and ethnic and sectarian divisions. Iraq's institutions continue to be ineffective in meeting the public's basic needs for physical, economic, and social security. Their weak response to public demands for accountability has undermined their legitimacy and the legitimacy of the state itself. 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. These arguments form the basis of the SCD's analysis, which will focus on Iraq's recent challenges as well as its opportunities, exploring the constraints that may shape the options available in the future.

4. Beyond Iraq's domestic challenges, external geopolitical factors have also aggravated and exploited Iraq's circumstances. External actors have historically played an important role in

Iraqi affairs and the present is no different; the influence of the US-led coalition is a case in point that is discussed briefly in the next sections. Most obviously, Iraq's oil wealth makes it a country of considerable international interest and importance. However, perhaps more crucial than this is its geographic and political location, making it a key player in the ongoing jockeying for power in the region. Many of the Middle East's major geopolitical struggles are being played out in Iraq. Under Saddam Hussein, Iraq was part of the Sunni block of countries – alongside Turkey and Saudi Arabia – maintaining a balance with Shia Iran. Today Iraq is governed by its majority Shia population, a vital shift in the region's balance of power. The role of Iran in Iraq is of consequence to Turkey, which has its own ties to the Sunni Turkmen in Northern Iraq around Mosul, and interest in the political evolution of Iraqi Kurdistan. Daesh's control over stretches of Iraqi territory and its involvement in the civil war in Syria is a deep source of conflict and instability for Iraq, drawing in global powers and regional actors. These interests and conflicts in and around Iraq make it difficult to achieve domestic political stability or to control key variables affecting the country's development. However, this has also meant that extraordinarily high levels of international resources have been poured into Iraq's reconstruction efforts (Box 1).

5. In sum, the state has been unable to perform its core functions, including the provision of security and justice, the resolution of conflicts, and the delivery of public goods and services. Addressing the country's governance failings will be essential to making any progress in resolving the violence and fragility that has resulted from the interplay between oil wealth and ethnic and geographic fragmentation (Figure 1). These governance failures also shed light on why previous reform efforts have often had little success. Unless Iraq's weak institutions and governance are embedded into the design of any reform, even the best technical efforts are unlikely to succeed. The remainder of this chapter presents a brief overview of Iraq's legacy of conflict and discusses the three elements identified by the SCD as the underlying constraints to Iraq's development: oil dependence, ethnic and geographic fragmentation and disparities, and governance and security failures.

Figure 1. Governance Failures Are at the Core of Iraq's Predicament



Box 1. External Assistance to Iraq

External actors and assistance have influenced events in Iraq to a significant extent., as outlined in paragraph 4 above. The scope of international assistance given to Iraq has been extraordinary. Funding from the US has been the largest component of international assistance, at about US\$60 billion (although close to US\$25 billion of this was targeted security-related expenditures including the training and equipping of the Iraqi security forces). Another major contribution to Iraq has been the cancellation of 80 percent of Iraq's Paris Club debt (or US\$32 billion). In 2003, the international community promised an initial US\$13.5 billion in grants and loans, but these commitments remained largely unfulfilled for years (SIGIR, 2013). The International Reconstruction Fund Facility for Iraq (IRFFI) was established in 2004 as a mechanism to enable donors to channel resources and coordinate support for reconstruction and development activities. Twenty-five donors committed US\$1.84 billion to IRFFI, which was jointly administered by the United Nations and the World Bank. Iraqi funding, including the Development Fund for Iraq (DFI) and capital budgets, however, constitutes the largest component of spending on reconstruction between 2004 and 2013, at about US\$146 billion.

Despite the volume of resources involved, the reconstruction process has not yet been comprehensively assessed so it is not clear what lessons can be learned about this assistance. This kind of assessment is well beyond the scope of this report. Here we simply highlight some of the lessons that have emerged from evaluations by others, mainly of US assistance, as well as some lessons from a review of the experience of the IRFFI.

Overall, it would be fair to say that security and service delivery have yet to improve in Iraq despite 13 years of assistance. Given the decimation not only of infrastructure but of service delivery, institutions, law and order, and intangibles such as trust among Iraqis as well as between citizens and the state, the task of reconstruction – including a rebuilding of institutions – was always going to be extremely challenging. While some individual projects have been successful, on the whole the outcomes of international assistance have been disappointing. A number of reasons for this have been put forward including:

- Institutional capacity in Iraq is weak as a result of the decimation of the state following wars and sanctions, and, not least, the de-Baathification decisions taken by the Coalition Provisional Authority (CPA), and this has severely hampered reconstruction efforts.
- Widespread corruption was exacerbated by the weak rule of law and the massive inflow of resources. Early decisions by the CPA sharpened sectarianism and introduced a zero-sum approach to reconstruction efforts. Failure to stem the growth of sectarian groups within ministries weakened institutions, slowed decision-making, and “transformed corruption into a political agenda” (SIGIR, 2013, p. 13).
- Insecurity increased the cost of all activities. It often made it necessary to implement and supervise projects from a distance, thus isolating development actors who were left to focus on inter-donor coordination and restricting their interaction with Iraqis beyond a few elites who may have had their own development agenda.
- Limited consultation, involvement, and meaningful Iraqi input in the selection of programs and projects has been noted in the evaluations, particularly in the report from the Special Inspector General for Iraq Reconstruction (SIGIR). By bypassing Iraqi institutions, the design and relevance of interventions was severely negatively affected. The limited involvement of Iraqis in the design and planning of reconstruction efforts did little to foster the sustainability of project objectives over time.
- The emphasis on humanitarian assistance by some agencies did not help to build functionally competent, legitimate state institutions over time.

One basic yet forceful lesson that can be learned from this experience is that resources, whether financial or technical, are not sufficient on their own to achieve Iraq's development objectives. Restoring the legitimacy of the state and building robust, inclusive institutions are the essential ingredients, and need to be taken into consideration for successful interventions.

6. Today it remains unclear whether there is any anchor or political force that is able to credibly promote measures to establish security, legitimacy, and functionality in the state. The following sections identify the key aspects of Iraq's predicament today: the flawed governance architecture that mediates oil wealth is leading to a realignment of political and economic sway along sectarian lines, aggravating violence and insecurity. There have been few proponents of a vision of a workable new social contract that rejects narrow zero-sum sectarianism, and those who have emerged (for instance, some of the secular political groupings that have achieved electoral success) have not succeeded in leaving their mark on Iraq's institutions. Citizens' dissatisfaction with the current insecurity, corruption, and poor services has not yet been effectively harnessed as a force for change, although this may in fact be Iraq's best hope for breaking the cycle of mismanagement and violence.

A. Legacy of Conflict and Poor Governance

7. The greater Tigris-Euphrates basin has, over millennia, hosted an ethnically, politically, and socially diverse population with a shared, common dependence on its resources, resulting in a shared identity. At the same time, from civilization's earliest recorded time, Iraq has witnessed internal regional and ethnic struggles seeking to align political institutions across Iraq with a diversity of socio-economic religious cross-cutting identities. The roots and fault lines of today's conflicts are deep and persistent. Internal conflicts have often been intertwined with conflict among external powers – Greeks, Parthians, Persians, the Arab Caliphate, Ottomans, and, more recently, Europeans and regional actors. Conflicts have always had, as they do today, multiple axes (Sunni/Shia, Persian/Arab/Ottoman/Kurd, Anglo-American/Russian, and Socialist-secular/pan Arab/Cold War proxies). This the long reign of Saddam Hussein, the sectarian militia battles of 2004 to 2007, the rise of Daesh, and the failures of the various governments. And while the forces that have shaped today's events have been patently molded by the legacy of the Saddam Hussein era and by the external interventions that followed, there is also much to be learned by revisiting the decades that preceded the rise to power of the Baath party (see Box 2). In particular, ethnic and sectarian divisions have not always been the determining characteristics of the Iraqi political sphere but have ebbed and flowed, so treating them as fixed elements considerably narrows Iraq's policy options.

8. During the three decades of Baath rule, Iraq was an unbridled dictatorship, characterized by extrajudicial killings, enforced disappearances, torture, and other grave human rights violations. Nevertheless, until 1991, it performed well on many developmental and welfare indicators. Before 1991, healthcare covered about 97 percent and 79 percent of the urban and rural populations respectively and was based on an extensive and expanding network of health facilities linked up by reliable modes of transport and communications. The country had a well-developed water and sanitation system, and 90 percent of the population was estimated to have access to safe drinking water. Infant mortality had fallen from 71 per 1,000 live births in 1965 to 29 per 1,000 in 1989, while under-5 mortality had declined from 111 to 44 per 1,000 live births. Women were being rapidly incorporated into the labor force, and in the public sphere – though less so in the private – they enjoyed equal rights to men in many areas (Ali and Shah, 2000)

9. The series of events that led to the unravelling of the state and the country's mounting turmoil are well known. At the end of a nearly decade-long war with Iran in 1988, a war which

claimed the lives of between 250,000 and 500,000 Iraqis (and 1million Iranians), falling oil prices and war debts contributed to a worsening economic crisis in Iraq. Relations with its other neighbors also suffered as Saddam Hussein accused Kuwait and the United Arab Emirates of conspiring against Iraq by exceeding OPEC quotas and alleged that Kuwait was extracting oil from Iraqi fields. Spurred by these pressures and perceived grievances, the Iraqi army invaded and annexed Kuwait in August 1990. Five-and-a-half months later, an international coalition led by the United States launched a bombing campaign that severely damaged Iraq's civilian and military infrastructure and forced the capitulation of the Iraq army.

10. The invasion of Kuwait and the subsequent sanctions era marks a fundamental rupture in Iraq's development. After the initial invasion of August 1990, the United Nations Security Council imposed comprehensive sanctions to coerce Iraq into withdrawing from Kuwait. The sanctions, designed specifically to make it impossible for the government to deliver services, were kept in place until the fall of Saddam Hussein in 2003, though they were moderated slightly in 1997 by the Oil-for-Food Program. Iraq's assets were frozen and it was banned from importing anything not expressly permitted by the United Nations, with foreign companies being forbidden from doing business with Iraq, with very limited exceptions. The impact of these restrictions was huge given that, before the invasion of Kuwait, Iraq had imported roughly 70 percent of its food, medicine, and agricultural chemicals (World Bank, 2014).

11. The 1990s was a catastrophic decade for Iraq. Poverty rates and infant and child mortality soared, basic medicines were severely rationed, and malnutrition surged. Per capita GDP, estimated at US\$2,836 in 1989, fell to US\$174 by 1994 as a result of an 85 percent reduction in oil production and the devastation of industry and services. Infant mortality in southern and central Iraq rose from 47 per 1,000 live births during the 1984 to 1989 period to 108 per 1,000 between 1994 and 1999, and under-5 mortality rose from 56 to 131 per 1,000 live births (Ali and Shah, 2000). A decade of sanctions combined with three wars has had a devastating impact on the country's human capital. By 2000, primary school enrollment had fallen to 93 percent, while secondary enrollment had declined from 47 to 38 percent. Quality also declined at all levels of the education system. Teaching and learning conditions deteriorated, teacher quality eroded, curriculum content was distorted or became outdated, and policy and system development came to a standstill. Spending on education plummeted. While the education budget represented about 6 percent of GDP in 1988/89, with expenditure per student being about US\$620, the average expenditure per student had slid to a mere US\$47 on average between 1993 and 2002, funded largely from the Oil-for-Food Program (UN/Word Bank, 2003).

Box 2. Construction of the Iraqi Polity and State: From Ottoman Times to Baathist Rule

Iraq was forged out of the three Ottoman provinces of Baghdad, Basra, and Mosul following the fall of Ottoman Empire that had ruled Iraq for five centuries. In 1918, British forces had gained control of these provinces, which they intended to absorb into the British Empire over the objections of the Arab and Kurdish inhabitants who believed that they had been promised independence. A compromise was reached giving Britain a mandate to administer the provinces under the international supervision of the League of Nations and with a vague promise of eventual independence. Iraqi resentment over this arrangement led to a strong nationwide revolt in 1920 that extended across the rural-urban divide and included all religious and ethnic groups, demanding the departure of British troops and the complete independence of Iraq within its “natural borders” from Mosul in the north to the Gulf in the south. The British suppressed the uprising with great difficulty and at the cost of over 8,000 Iraqi lives and 500 British and Indian ones, according to British estimates.

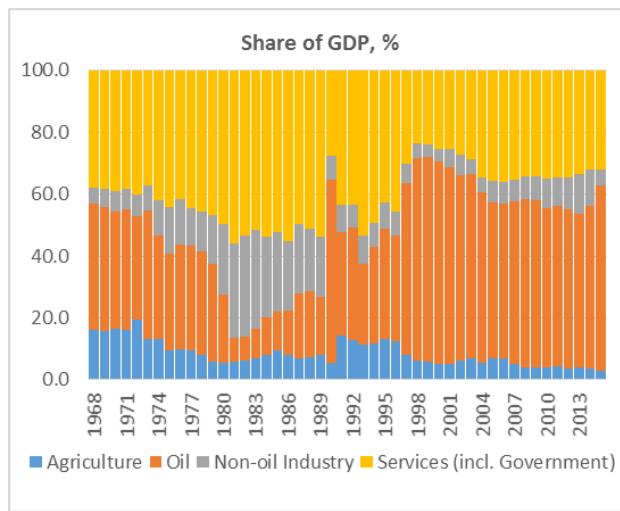
In 1921, the British chose King Faisal I to head a constitutional monarchy that united the three provinces. Faisal, a Hashemite from the Hijaz region of Arabia (near Mecca in the present-day Kingdom of Saudi Arabia), was attracted by the promise of Arab independence and had raised an army of tribesmen to fight the Ottomans and had established himself as an ally of the British during the World War I. It was during the mandate period of 1920 to 1932 that Iraq's borders were largely drawn, “through the resolution of competing claims to territory and sovereignty by deployments of power, including acts of insurgency and counterinsurgency, as they are in all other countries.” (Pursley, 2015) The formation of Iraq's borders with Syria, Najd (the present-day Kingdom of Saudi Arabia), and Turkey during this period involved the manipulation of French and British colonial interests against each other by the local population in the northwest, negotiations with the expanding Kingdom of Saudi Arabia and with tribes in the south, and eight-year long negotiations with the newly independent Turkish State to define Iraq's border with Turkey north of Mosul. Despite this, the narrative of Iraq as an artificial state – and the fallacy that the current borders of Iraq were drawn up by the Sykes-Picot agreement – emerged in the early years of the state's formation.

Although Faisal was not Iraqi, he was determined to gain sovereignty from Britain, which eventually was achieved in 1932. Faisal died in 1933 and was succeeded by his son Ghazi, who ruled until 1939. After a period of regency, Faisal II, the grandson of Faisal I, ascended to the throne in 1953. The regency and following years were a tumultuous period. The Iraqi economy fell into a recession and then into a depression following World War II. Inflation was uncontrolled, and standards of living fell. Loyalty to the monarchy was damaged by the re-occupation of Iraq by Britain and by the Portsmouth Treaty of 1948 and the 1955 Baghdad Pact which allowed Britain to continue to play a role in Iraqi affairs. Large protests greeted news of each of these alliances, resulting in the deaths of hundreds of demonstrators and an increasing deterioration of loyalty to the Iraqi crown. The participants in the demonstrations included students, workers, and the urban poor. Although the protests were initially spontaneous, they coalesced through several political organizations including the Communist Party, the Progressive Democrats, the Kurdish Democrats, the National Democratic Party, and the Independence Party. Thus, before Saddam's ascent to power in the late 1970s, the Iraqi political spectrum was full of parties with ideological rather than sectarian platforms.

In 1958, the monarchy was deposed in a military coup led by Brigadier Abd al-Karim Qasim, and Iraq was established as a republic. The new regime quickly constituted a government comprising representatives from Iraq's numerous parties. In its early years, it enacted social, legislative, and economic reforms that curbed corruption and served the interests of Iraq's poor. Large sections of society were impatient for change and showed their support for the government. Investments were made in education, infrastructure, manufacturing, and health care. Socially and economically progressive policies were formulated and implemented. Nevertheless, the state gradually became devoid of political compromise, reinforcing the culture of an absolute leader and a militarized Iraqi society in contrast to what had existed in previous decades. Abd al-Karim Qasim was eventually deposed and executed in a coup in February 1963 that was organized by the Baath party's military wing, which was itself deposed by pro-Nasserist military officers later that same year. In July 1968, the Baath party took power for a second time. Ahmed Hassan al-Bakr assumed the presidency, and his relative, Saddam Hussein, was appointed vice president. Hussein became president in 1979 and remained in power until the US-led invasion of Iraq in 2003.

12. **The devastating decline in non-oil industry and agriculture during the sanctions era illustrates their impact** (Figure 2. GDP by Economic Activity, 1968-2015). In agriculture, for instance, cereals production in 2000 was around one-quarter of its 1990 level. Some of the sector's problems, including water supply for irrigation, salinity, and desertification, predated the conflict era, although all sectors suffered from a lack of access to critical inputs throughout the 1990s. The impact of the sanctions was not uniform across Iraq however; Kurdistan generally fared better as it had more access to inputs and was more able to evade sanctions through grey market trade (World Bank, 2014).

Figure 2. GDP by Economic Activity, 1968-2015



Source: World Development Indicators

13. **In March 2003, a military coalition led by the United States and Britain invaded Iraq, and a month later the coalition troops controlled the country.** The Coalition Provisional Authority (CPA) dismantled the Baath Party and the Iraqi army, measures which have had a lasting impact. The Baath party was “disestablished,” and the four most senior levels of members within the Baath party were “removed from their positions and banned from future employment in the public sector.” It should be noted that, in Saddam Hussein’s Iraq, membership in the Baath party was the standard requirement for much state employment, and many joined the party in title only. 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. A number of key institutions were dissolved, including the army, navy, air force, and the Ministry of Defense. The sweeping de-Baathification policy left tens of thousands of public sector employees as well as security personnel unemployed, without pensions, and with no prospects of participating in state institutions in the future (World Bank, 2016). The widespread violence and looting that followed the dissolution of security forces lasted nearly a month and severely damaged the state’s administrative capacity; 17 of Baghdad’s 23 ministry buildings were completely gutted. Overall, the looting is estimated to have cost as much as US\$12 billion, equal to one-third of Iraq’s annual GDP, creating a climate of citizen insecurity and criminal impunity (Dodge, 2014).

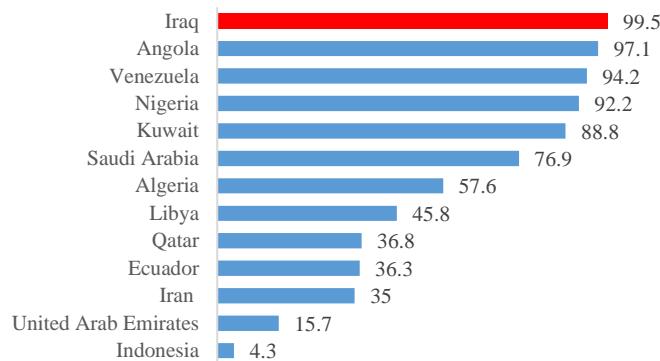
14. De-Baathification, intended originally as a necessary vetting mechanism, quickly turned into a tool of political retribution and sectarianism. Opposition groups perceived the government as using state institutions in a sectarian manner to marginalize them. What had been an insurgency against US occupation mutated into an all-out civil war with sectarian rhetoric used to justify the killing of civilians and population transfers. The violence peaked in 2006 and 2007, with over 25,000 recorded civilian deaths in each of those years. Shia and Sunni militias, whether state-sanctioned or outside the control of government, operated with impunity; many militias continue to exist today. A military surge by coalition troops and agreements between the government and Sunni tribes succeeded in dramatically reducing the violence, and between 2009 and 2012 the average number of civilian deaths fell by over 80 percent. Violence has surged again since 2013 as Daesh campaigns have taken an increasing toll.

B. Oil Wealth and Oil Dependency

15. Oil dominates Iraq's economic and political framework. Iraq is the world's fourth largest oil exporter (exporting about 3.7 million barrels per day of the estimated 4.2 million barrel per day that it produced in 2015), being responsible for 6 percent of today's global oil exports and 9 percent of total global reserves. It also holds the world's fifth largest proven reserves of petroleum, although Iraq remains greatly under-explored compared with other major oil producing countries. 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. Iraq is today also the country most dependent on oil in the world, with the hydrocarbon sector accounting for 58 percent of the country's GDP, 99 percent of exports, and more than 90 percent of central government revenue in 2015 (Figure 3. Oil Exports as a Percentage of Total Exports, OPEC Members)

16. The economic wreckage of wars and sanctions, combined with the dissolution of the country's key institutions, meant that growing oil revenues in the post-2003 period reinforced the status quo rather than becoming an impetus for reform. The central government alone has expanded to 44 percent of GDP today, and the public sector is by far the largest formal sector employer. Public sector jobs were one of the few reliable instruments for distributing oil wealth that the post-2003 government had at its disposal, and public sector jobs as well as wages have continued to grow over the past 13 years. Likewise, the dominance of SOEs was strengthened as the state had no incentives to restructure them. Aside from their value as means of economic control, they provided jobs for many Iraqis. State dominance of the financial sector continued as the insolvency of the system made reform difficult, and banks expanded as their government business grew (World Bank, 2014).

Figure 3. Oil Exports as a Percentage of Total Exports, OPEC Members



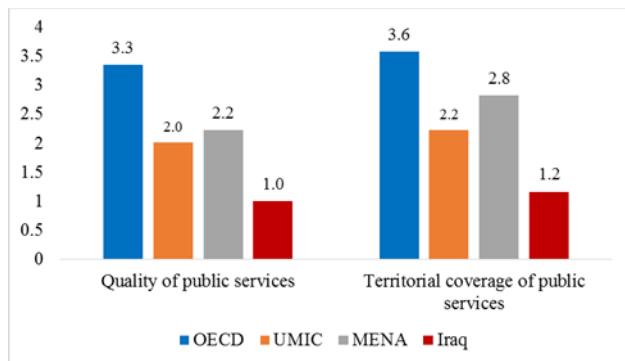
Source: OPEC

17. Iraq's current reliance on oil is not a viable source of broad-based economic development. Two key aspects underlie this. First, unlike its oil-rich neighbors in the Gulf Cooperation Council (GCC) – and even they have grave concerns about economic sustainability – Iraq has a significantly larger and rapidly growing population, estimated at 35.7 million today.¹ Even under optimistic scenarios for oil production, continuing to rely on oil alone would not generate sufficient jobs. Second, the current 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. These constraints are exacerbated by limited government effectiveness and policy uncertainty as well as the legacy of conflict and violence (World Bank, 2012a). This raises the question of whether there are any prospects for diversifying the economy, which will be touched upon in Section IV. In the absence of greater security and changes in the role of the public sector, diversification is likely to remain elusive.

18. Under the status quo, the economy will remain dominated by an oil-financed public sector, with its attendant shortcomings in terms of weak service delivery and its bloated civil service. Public sector spending as currently allocated and managed is not delivering the results that Iraqis expect (Figure 4). There is a significant tension between the enormous need for the state to improve the delivery of basic services and the overwhelming role that the state plays in the economy. And while the oil economy represents well over half of GDP, it produces only about 1 percent of total employment and has few links to non-oil activities. Rather, oil revenues have enabled the rapid expansion of the public sector.

¹ No census has been undertaken in Iraq in recent years; the latest full census was in 1987. The Central Organization for Statistics has developed models to produce population estimates and projections.

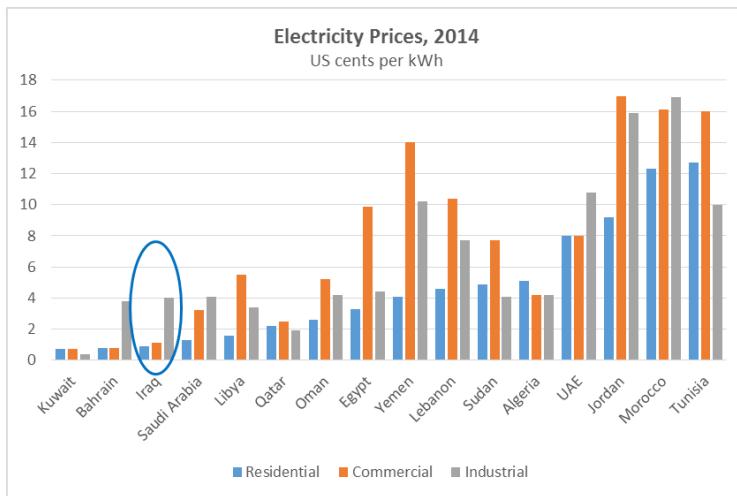
Figure 4. Quality and Coverage of Public Services



Source: Institutional Profiles Database, 2012

19. In addition to its impact on jobs, Iraq's oil wealth has reduced the need for taxation and weakened the accountability link between citizens and the state. Compounding this, policy makers have not incorporated the implications of oil depletion and the need to save for the future, leading to a bias towards current consumption and subsidies, harming fiscal sustainability (World Bank, 2012a). Fuel and electricity subsidies in Iraq are estimated to amount to between 7 and 13 percent of GDP and are reflected in very low prices as seen in Figure 5 (IMF, 2015). 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 (World Bank, 2015a).

Figure 5. Electricity Prices, 2014



Source: Regional Center for Renewable Energy and Energy Efficiency, 2015

C. Ethnic and Religious Diversity and Spatial Inequality

20. **A second underlying characteristic and theme of this report is Iraq's ethnic, religious, and regional diversity.** Geographically, Iraq is characterized by sharply differentiated regions. The country is dominated by the Tigris-Euphrates alluvial plain, with mountains in the north, vast and sparsely populated deserts in the west and southwest, and marshlands in the south along the rivers. The marshlands are a rare aquatic landscape in the desert, providing habitat for Maadan (Marsh Arabs) with their unique culture as well as for important populations of wildlife, and were recently declared a UNESCO World Heritage site. The Tigris and Euphrates rivers converge in the delta of Shatt al-Arab, which flows into the Gulf. Iraq is almost completely landlocked but for a 65 kilometer-wide outlet at its southern tip where it meets the Gulf. Basra, Iraq's only port city, lies on the banks of Shatt al-Arab. North of the delta is a rolling plateau that produces most of Iraq's grain harvests. The Zagros Mountains rise in the northeast, north of the cities of Mosul and Kirkuk. This terrain includes valleys, terraced hills, and pastures, making rain-fed agriculture possible.

21. **Discussions about Iraq's ethnic and religious diversity are often framed in terms of sectarian tensions among Iraq's Shia and Sunni Arabs, and Kurds.** However, sectarianism in Iraq is also easy to caricature and misunderstand or overstate. The current turmoil results less from a centuries-old feud among Sunnis, Shias, and Kurds than from a struggle to compete for power and resources in a post-2003 Iraq characterized by crippled institutions and power vacuums. There are no reliable demographic numbers for Iraq. No full census has been held since 1987 as the 1997 census did not include the three Kurdish governorates.² Nevertheless, according to government statistics from 2010, 97 percent of Iraq's 35 million population is Muslim, with Shia Muslims constituting a 60 to 65 percent majority. Shia are predominantly Arab but also include approximately 2 million Turkmen, Faili Kurds, Shabak, and Circassians. Sunni Muslims constitute 32 to 37 percent of the population, comprising Arabs, Kurds, a small number of Turkmen, and Circassians. Kurds – mainly Sunni – constitute an estimated 15 to 20 percent of Iraq's population.

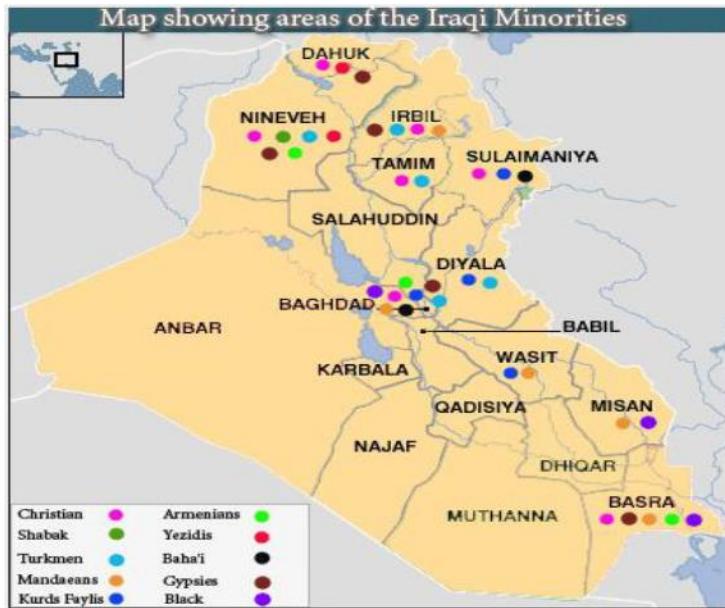
22. **Iraq previously had a thriving non-Muslim population.** The pre-2003 Christian population may have been as high as 1.5 million, or 5 percent of the population, whereas estimates of the number of remaining Christians range from under 400,000 to 800,000. At least 14 Christian denominations continue to exist in Iraq, with the Chaldean Catholics being the largest group. An Ottoman census in 1917 counted 80,000 Jews in Baghdad out of 220,000 residents. In 1948, there were an estimated 150,000 Jews in all of Iraq. However, by 2008, the Iraqi Jewish population was thought to number fewer than 10 individuals (New York Times, 2008). The Yezidis, Shabak, Kakai, Mandaean-Sabeans, and Bahai are other groups.

23. **The usual division of Iraq into three major groups associated with distinct territories – a Shia south, a Sunni center, and a Kurdish North – is also something of a misrepresentation.** Iraq does not have neat ethnic dividing lines. Kurds dominate the North and Shia the South, yet neither is a homogenous group, and all groups have significant political and intra-sectarian divisions. While there has never been a census of Iraq that shows exactly how Sunnis, Shia, Kurds, and other groups are divided or where they are located, elections have made it clear that its cities and governorates all have significant minorities. Iraq's various groups are highly intermixed across many

² Population and population growth figures in this SCD are based on numbers produced by the Iraq Central Statistical Organization based on its population projection models.

regions, particularly in the larger cities like Baghdad, Basra, Mosul (at least until the Daesh takeover), Erbil, and Suleimaniya (Figure 6). Depending on which percentage cut-off is used, only one-third to one-half of Iraq's provinces can be said to be demographically dominated by a single group (Vanzo, 2008).

Figure 6. Distribution of Iraq's Minorities



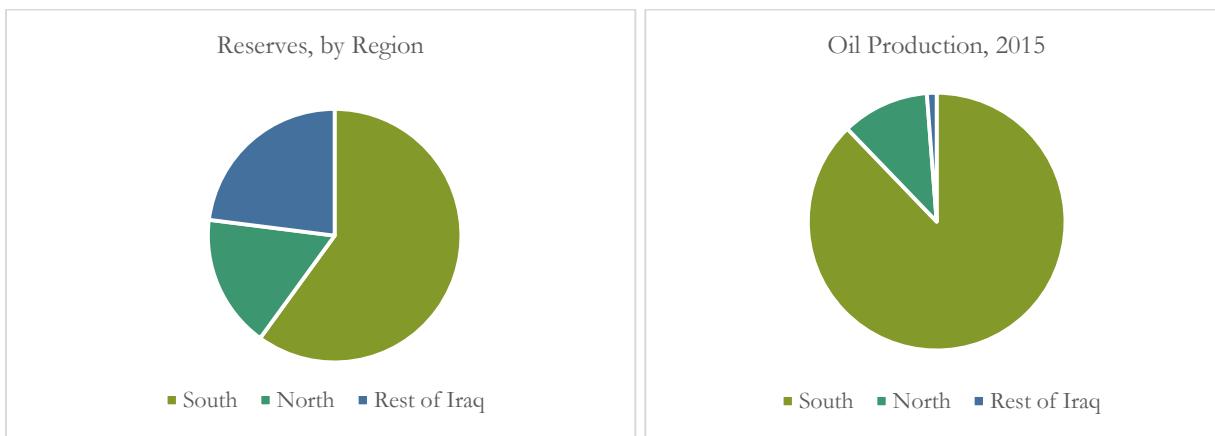
Source: European Parliamentary Research Service, 2015

24. **Iraq is spatially diverse in many ways, but most importantly its oil wealth is differentially distributed across the country** (Figure 7). The bulk of the country's proven reserves are located in the south, with most of the remainder in the north – including 6 percent in the present Kurdistan region and 15 percent in Kirkuk. The Sunni-dominated west has no proven oil revenues (although it does possess gas). Oil wealth and its distribution is at the center of the dispute between the central government and the Kurdistan Regional Government (KRG). According to their existing agreement, the KRG was to export 550,000 bpd through Ceyhan, Turkey (250,000 bpd from its own fields and 300,000 bpd from federal fields) for the central government's State Oil Marketing Organization (SOMO). In return, the central government would resume making agreed-upon budgetary transfers to the KRG. However, this agreement has not been fully implemented and, since June 2015, the central government has suspended the transfers and the KRG's oil deliveries to SOMO have stopped. 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.

25. **The geographical impact of violent conflict over the past decades has also varied.** Whereas the Kurdish region had been the most victimized before the 1990s, its *de facto* autonomy from 1991 onwards meant that it could meet its basic needs more effectively during the sanctions years. On the other hand, the southern provinces experienced a double negative impact – the destruction of wars compounded by a failed rebellion. Even after 2003, these spatial differences continued as a result of significant and persistent variations in the quality of service delivery across the country. With the

level of security being uneven across the country, new differences between provinces emerged. In the South, while oil continued its self-contained, enclave development, other sources of economic activity such as pilgrimages to holy sites in Karbala and Najaf, trade with Iran, and the Basra port came into play as growth drivers in some areas. The provinces north and west of Baghdad on the other hand, remain highly contested between sects, ethnicities, tribes, and insurgents (World Bank, 2014).

Figure 7. Oil Reserves and Production, by Region, 2015



Source: International Energy Agency (2012)

26. **Poverty and welfare are geographically differentiated as well, and conflict has led to more pronounced spatial differences not only in poverty rates but in the delivery of services.** There are three levels of administration in Iraq – governorates, districts, and sub-districts. Each of Iraq's 18 governorates is subdivided into districts (*qadhas*) and sub-districts (*nahiyas*). For the purposes of this poverty analysis, the country can also be divided into five divisions consisting of groups of governorates with approximately equal population sizes – Kurdistan, North, Baghdad, Central, and South.³ The sub-districts with the highest poverty rate are in the Southern governorates, despite their oil wealth. On the other hand, the sub-districts with the highest number of poor people are in urban centers with many residents (World Bank, 2015b). Access to and the quality of services, including water, electricity, education, and health, also vary widely across the country. These differences result in spatial differences in many human development indicators, including early marriage and motherhood, child stunting, and educational outcomes. The labor market is fragmented spatially as a result of violence and insecurity. While people are able to move to nearby governorates in order to increase returns to their human capital, moving across the country is much more difficult. People with similar characteristics can thus have different welfare levels depending on where in Iraq they live (World Bank, 2014).

³ The divisions are defined as follows: Kurdistan = the three governorates of the Kurdistan Regional governorate, Duhouk, Erbil, and Suleimaniya. North = the three governorates directly south of Kurdistan and to the North of Baghdad—Ninawa, Kirkuk, and Salahaddin. Baghdad = the single governorate of Baghdad, the capital city. Central - the governorates to the east, west, and immediately south of Baghdad —Anbar, Diyala, Najaf, Karbala, Wassit, and Babil, South = the five southern-most governorates of Iraq—Qadisiya, Thi Qar, Muthanna, Maysan, and Basra.

D. Governance Failures

27. **The rebuilding of state institutions that have been destroyed or severely weakened over decades of conflict and sanctions – and, in many cases, their creation – is one of the key challenges for Iraq.** Iraq ranks unfavorably on many key indicators of good governance compared to the averages for other MENA countries, to upper-middle-income countries (UMIC), and OECD countries. Although little accurate and detailed data can be collected on the state of governance on the ground,⁴ existing indicators paint a picture of persistent governance challenges, as will be illustrated in this section. The public sector's institutional effectiveness and capacity is weak. In 2015, the Fragile States Index ranked Iraq as one of its high alert states, meaning that it lacks many of the basic administrative capacities required for effective governance. The latest Bertelsmann Transformation Index, World Governance Indicators, and Institutional Profile Database show Iraq performing poorly in relation to the OECD, UMIC, and MENA on standard measures of institutional capacity and effectiveness, including administrative capacity and efficiency and the capacity for implementation.

28. **Corruption is a key symptom of poor governance, and bureaucratic corruption, bribery, and nepotism are all major problems in Iraq.** At the central government level, the combination of a weak yet resource-rich rentier state has allowed competing groups to capture state resources and contracts, decimate institutions, and undermine the development of a competitive private sector. The various power groups (such as sectarian and ethnic groups and militias) regard governance structures simply as means to capture rents and thus vie for control over them. When governance is weak at the state level, the leaders of non-state power groups derive their legitimacy from the degree to which they are able to capture resources and reallocate them to their constituencies (see Box 3). The informal sectarian quota system, which since 2003 has guided the distribution of ministerial positions as well as minor government posts,⁵ is a prime example of this and is one of the principal causes of the bloated public sector, which severely constrains government effectiveness and service delivery.⁶ The lack of confidence in public institutions that has arisen because of corruption is profound.

29. **Numerous qualitative and quantitative indices attest to Iraq's poor global rankings in a range of categories.** For example, on perceptions of corruption, Iraq ranks 161 out of 168 countries (Transparency International, 2015) and also scores poorly relative to its income- and regional peers on the World Governance Indicators' measure of the control of corruption (Figure 9Error! Reference source not found.). The massive influx of reconstruction resources that followed the

⁴ Between 2012 and 2015, Iraq scored consistently below the MENA average on the Statistical Capacity Index, which measures the capability of national statistical systems based on the quality of their statistical methodology and source data, and the periodicity and timeliness of producing data. Iraq's 2015 score was 52/100 compared to MENA 63/100. Also, Iraq has not held a nationwide census since 1987.

⁵ Following the overthrow of Saddam's regime in 2003, Iraq's main political blocs representing the country's major identity groups (Shiites, Sunnis, and Kurds) informally agreed to a system of ethno-sectarian quotas, or *mubasasat* in Arabic, in the apportionment of high-level government positions to ensure each group's representation in government. Under the *mubasasat* system, cabinet posts, along with the positions of prime minister and president, have been allocated in line with an ethno-sectarian formula that also takes into account the number of seats won by each group's political parties in elections. Today, the quota system has permeated the rank and file bureaucracy, well beyond high-level positions.

⁶ Plans for a widespread reform of government were announced in August 2015 in response to popular anti-government protests over electricity shortages and corruption, including an initiative to replace cabinet ministers with technocrats. The plans encountered tough opposition as political parties would not agree to limit their own influence, resulting in an escalation of the political crisis (Oxford Analytica, 2016).

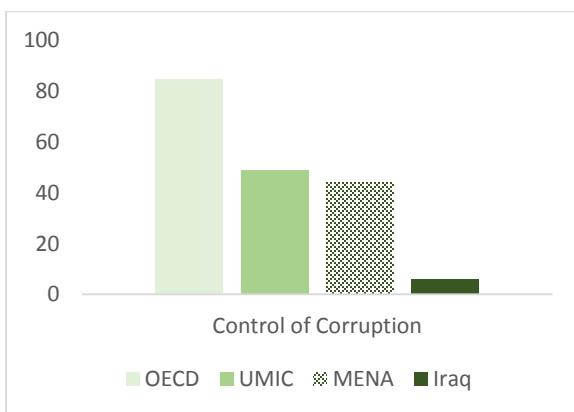
2003 invasion and the previous decade of sanctions and deprivation overwhelmed the spending, management, and oversight capacities of the shattered Iraqi public sector. Underscoring the magnitude of the problem, recent polls have found that Iraqi citizens and business owners believe that corruption is the most important policy challenge facing the country, ahead of economic and even security concerns (Box 3), as well as the biggest constraint on business (Figure 10). Also, corruption in Iraq often leads to or entails violence, which is not always characteristic of corruption elsewhere (Williams, 2009).

Box 3. The Rise of Ethnic and Sectarian Identities

Some experts have argued that the Iraqi population had a social contract with Saddam Hussein and the Baath Party whereby they tolerated dictatorship and the absence of human rights in return for modernization and economic development and that the war with Kuwait and the sanctions that followed had breached that contract. Others contend that the notion of a contract between the ruler and the ruled was a foreign notion and that Hussein derived his legitimacy from his absolute power.

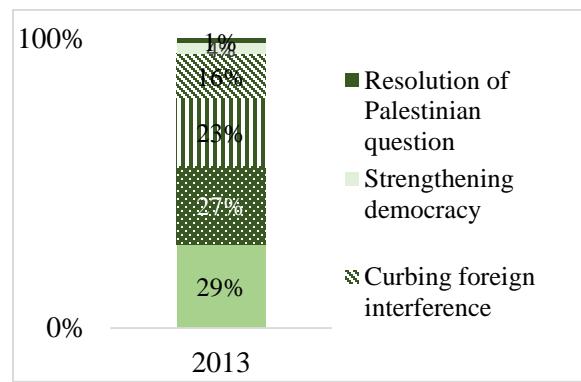
Today, a valid hypothesis would seem to be that, in the absence of a legitimate state for all citizens, of inclusive civil society institutions and acceptable levels of security and basic services, sectarianism became the primary mode of political association and the sole reliable means of accessing power and security. The rush to compete in the post-2003 environment – and in Iraq state capture has appeared to be the objective of most organized political actors – resulted in massive insecurity and violence. “Organization along sectarian lines was the most obvious short-term solution to chaos. The pre-existing state machinery had been destroyed by the rapidity and scale of de-Baathification.” (Mutter, 2015) The violence and political deadlock that this engendered have made it all but impossible to meet the paramount challenge facing Iraq today, namely re-building a state structure and the rule of law within it.

Figure 8. Control of Corruption



Source: World Governance Indicators, 2014

Figure 9. Citizen Poll on the Key Challenge Facing the Country

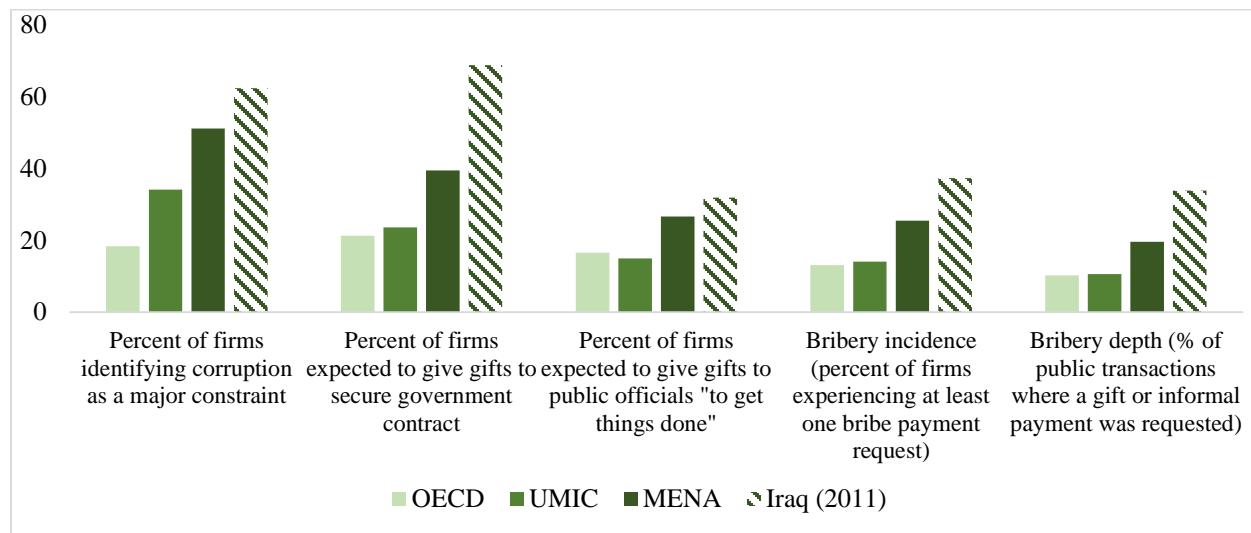


Source: Arab Barometer, 2013

30. A central indicator of governance and state capacity is the ability of the government to ensure access to basic services – security, water, electricity, and garbage collection as well as education, health and social assistance services. The concept of access encompasses equity of access, the quantity and quality of the services received, and the consistency of their availability (Cammett and MacLean, 2014). Iraqis are very dissatisfied with their access to these basic services. Just 30 percent of the population is satisfied with the available education services, satisfaction with

health services is under 20 percent, and less than 15 percent of the population is content with local security. In July 2015, largescale protests erupted in southern Iraq in response to power outages and the mismanagement of public utilities and a few weeks later spread to Baghdad, evolving into a broader campaign for reform of the political system.

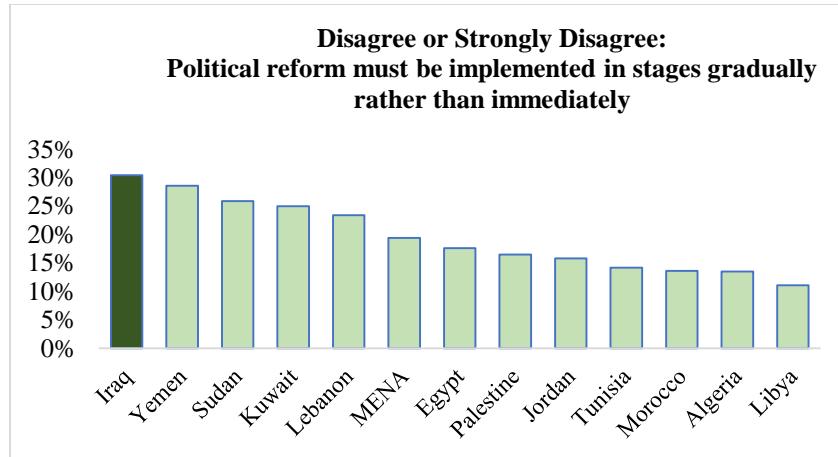
Figure 10. Firms' Experience of Corruption in Interactions with Government



Source: World Bank Enterprise Surveys, 2011

31. **Not only is governance an indicator of state capacity, but it is also a reflection of state legitimacy.** The hiring of unqualified personnel through nepotism and political favoritism has weakened the technical capacity and discipline of the civil service and raised expenditures on salaries, crowding out funding for services. This has perpetuated a sense of exclusion and disillusionment among the population and weakened state legitimacy and trust, completing the vicious cycle of the weakness of the Iraqi state. A 2012-13 survey found that 52 percent of Iraqis did not trust their government (or cabinet) much or at all, and 39 percent considered the government's performance to be either bad or very bad. The feeling of exclusion is reflected in the data: Iraqis have a higher impatience with reform than the populations of comparator countries (Figure 11), and they have an overwhelmingly negative perception of government performance although there have been some signs of improvement since 2011. Recognizing the legitimacy that can be gained by improving service delivery (and increasing security), Daesh has highlighted this, at least rhetorically, in the areas under its control. When Daesh captures a new territory, it puts a high priority on restoring basic services and providing humanitarian relief in order to ingratiate the new rulers with civilians. Although conditions have degenerated over time in these areas, the importance placed on service delivery highlights its central role in bolstering state legitimacy (Revkin, 2016).

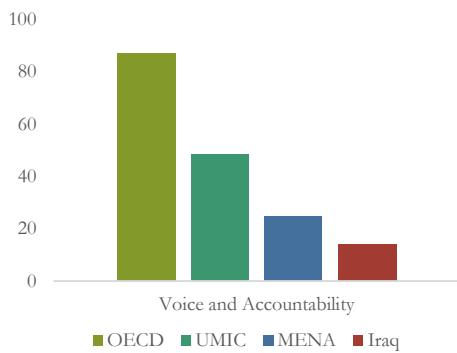
Figure 11. Impatience with Reforms



Source: Arab Barometer, 2012-13.

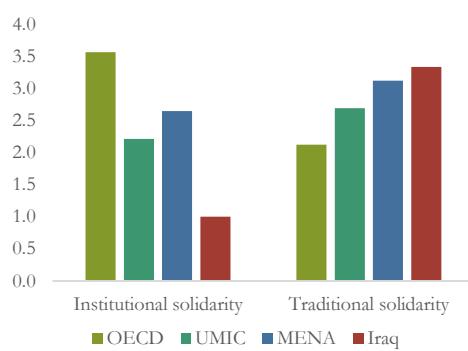
32. **Voice and accountability remain severely limited in Iraq by the lack of effective mechanisms for civil society to express its views or hold government to account** (Figure 12). While Iraq has no shortage of civil society organizations (CSOs), having grown rapidly since the fall of Saddam Hussein,⁷ many of the largest are closely associated with a religious or ethnic network, militia, or political party and do not serve the general public interest (Box 4). Given Iraq's weak central institutions, political stakeholders tend to try to coopt and manipulate CSOs to fill the void. Both the federal and provincial governments fund politically motivated CSOs, while independent CSOs largely rely on international donors to fund their activities (IRFAD, 2015). Few CSOs carry out independent audits, publish their funding sources, or report on their objectives and activities. Although the NGO Law passed by the parliament in January 2010 mandates minimal government interference in the affairs of CSOs, this is frequently violated in practice (BTI, 2016). This reality of weak broad (cross-cutting, formal institutional) solidarity across society juxtaposed with high levels of traditional solidarity or social cohesion is reflected in the Institutional Profiles Database's (IPD) measures of institutional and traditional solidarity (Figure 13).

Figure 12. Voice and Accountability



Source: World Governance Indicators 2014

Figure 13. Broad and Narrow Solidarity



Source: Institutional Profile Database 2012

⁷ An estimated 10,000 to 12,000 CSOs exist in Iraq, although there is no definite total. Many are not formally registered: in 2008 6,350 CSOs were registered with the government's NGO Directorate (NCCI, 2011).

33. Iraq's limited transparency undermines all aspects of policymaking and facilitates a culture of corruption, impunity, and weak accountability in the public sector. Iraq does not have a Freedom of Information (FOI) law, for instance, so citizens and journalists have no legal right to request information about government proceedings, policies, or projects. Iraq also scores poorly on the Open Budget Index, indicating that the government does not disclose meaningful budget information and provides citizens with few opportunities to engage in the budget process. Media freedom in Iraq generally, and in the KRI especially, is chronically lacking, with journalists and even bloggers being routinely threatened

Box 4. CSOs in Iraq

The CSO sector in Iraq can be broadly classified into three main groups, which differ significantly in terms of their composition, resource mobilization, and geographic area of operation. First, many CSOs are *service providers* that help to fill critical gaps in public service provision and to meet humanitarian needs. These tend to operate in larger and smaller cities, especially in slum areas and areas of high fragility where the state is weak or absent. Most service delivery CSOs work closely with international development organizations. The second category of CSOs consists of *advocacy groups* that aim to influence political decision-making and to protect minorities and human rights. They tend to operate primarily in Baghdad and in the governorate capitals. Most view themselves as public educators rather than policy advocates. The third category, *political organizations*, consists of a diverse and sometimes obscure group that includes: (i) affiliates of political parties aiming to extend their power base; (ii) CSOs organized to support religious sects; and (iii) the political arms of some extremist groups and armed militias that focus on recruitment as well as communication and fundraising (NDI, 2011 and NCCI, 2011).

The capacity of CSOs differs widely, although a growing number of professional CSOs exist at the national and local levels. Public or academic institutions are needed to monitor and support civil society and to develop a nuanced understanding of the mutually reinforcing relationship between civil society and good governance. The development of effective CSO networks and shared standards for CSOs to report on their activities would greatly benefit civil society as a whole (UNDP, 2016).

34. Related to corruption and the lack of transparency is the frailty of oversight institutions whose authority is undermined by a weak separation of powers. Power has gradually become concentrated in the Executive in Iraq, which has undermined the oversight roles of the Judiciary and Parliament⁸ – a problem mirrored in the KRI, where there is little oversight of the Executive. Although oversight bodies have gained more power recently (Bradley and Majeed, 2015), Iraq's existing legal framework and enforcement mechanisms are not capable of effectively tackling corruption. Officials have had no incentive to give up the prospect of personal gains. While a host of institutions has been set up with the specific purpose of fighting corruption, such as the Commission on Public Integrity, the Joint Anti-Corruption Council, and Inspector General's Offices within ministries, their authority in relation to the courts remains vague and their work is regularly thwarted by political interference.

⁸ As a result of controversial court rulings, key institutions such as the Integrity Commission (anti-corruption), the Independent High Electoral Commission, and the Central Bank were brought under the direct control of the Cabinet.

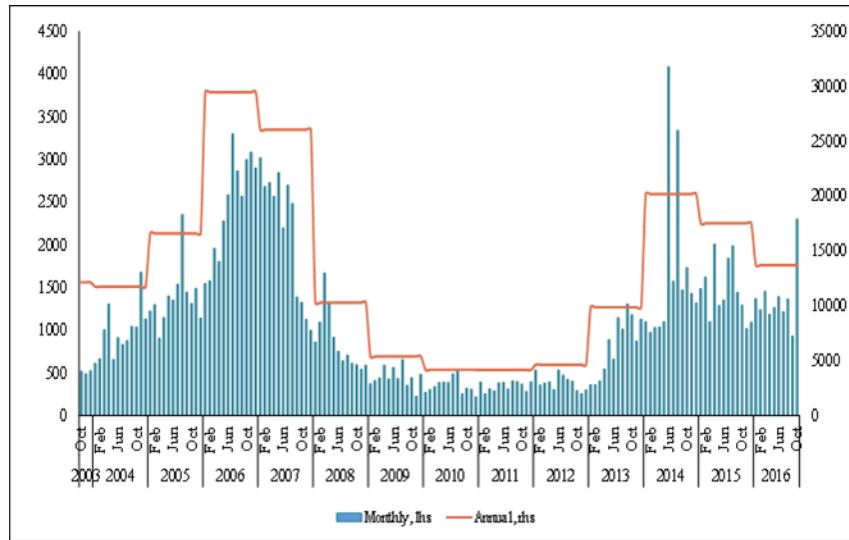
E. Violence and Fragility

35. **The Iraqi state is currently unable to guarantee security for its citizens, a role which is a litmus test of any government's legitimacy.** Without peace and security, maintaining growth is a significant challenge, as is making progress on reducing poverty and promoting broad-based prosperity. A coherent state is able to impose order on its population and holds a monopoly on collective violence throughout its territory. Only once a state has achieved the capacity to impose and guarantee order does the basis of its sustainability and legitimacy shift to its ability to provide infrastructure and deliver services to its population, and finally, to citizen participation and accountability. The underlying principle should be to make institutions accountable and functional under a reciprocal social contract with the people (Dodge, 2014 and Yoo, 2010). The costs of insecurity are enormous, from both an economic and a social and humanitarian perspective. Insecurity takes a severe toll on Iraqis trying to carry on their daily business and diverts public and private resources into maintaining security. There is the constant risk that violence as well as crime could wipe out years of investment. This discourages long-term investments, thus resulting in only short-term ventures that are more easily adaptable to uncertain and changing conditions (World Bank, 2012a).⁹

36. **Wars, sanctions, and domestic strife have taken a heavy toll on the Iraqi population** (Figure 14). Iraq's per capita GDP is estimated to have dropped from US\$3,500 in the early 1980s to about US\$770 in 2001. Per capita GDP has climbed to \$5,000 today, largely thanks to hydrocarbon revenues, but the cumulative impact of Iraq's troubled past and present continue to be acutely felt. The United Nations estimates that 10 million Iraqis (one-third of the population) need humanitarian aid of some form. Eight million Iraqis are poor, one-third of whom have fallen into poverty since 2014. Iraq's endowment of human capital has been steadily eroded as a result of decades of conflict. The sanctions that followed Iraq's invasion of Kuwait halted the country's development, obliterating the gains in welfare made in the 1970s. Health outcomes, for example, suffered a long-term deterioration. In the 1970s, Iraqi males enjoyed higher life expectancy than their counterparts in the Middle East and North Africa, but since 1980 (the beginning of the Iran-Iraq war), they have lagged behind. In 2011, Iraq's infant mortality rate was the second highest in the region after Yemen. Iraqi primary school enrollment rates were near the top of the MENA region a generation ago but declined precipitously throughout the 1990s (Figure 15). Although these enrollment rates have recovered, the lost decades have had a severe impact on Iraqis of all ages. The most prevalent level of education today is primary schooling or less, and 18 year olds in Iraq are as likely to have completed primary school as those aged 30 or older. Similarly, adult literacy rates are below the MENA average and well below the average for upper-middle-income countries.

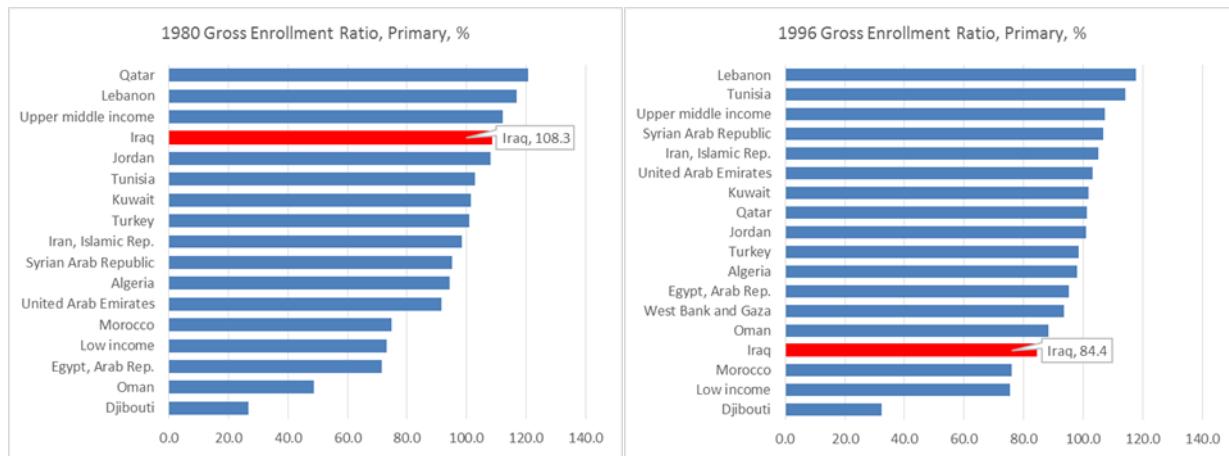
⁹ While it is difficult to quantify the economic and social impact of violence on growth and development, a number of studies have attempted to do this. The relationship between growth, development, and conflict can run both ways, with shocks to economic growth being associated with a significantly higher likelihood of conflict emerging, while conflict can also have substantial negative costs in terms of growth. A 2011 study in Iraq found that service provision can have a positive impact in terms of reducing insurgent violence, especially for smaller projects (Berman et al, 2011). A more recent World Bank study drawing on a district-level dataset for Iraq found that, while development efforts can mitigate the negative impact of violence, the required effort is substantial (World Bank, 2014).

Figure 14. Civilian Deaths from Violence



Source: Iraq Body Count

Figure 15. Gross Enrollment Ratios, 1980 and 1996



Source: World Development Indicators, 14 June 2016 Update

37. The 2006-7 civil war and more recently the Daesh insurgency have compounded the humanitarian crisis by creating a massive population of internally displaced persons (IDPs). Yet Iraq had IDPs even before these two events. The Baathist government adopted a deliberate policy of expulsion that intensified during the 1990s following popular uprisings in the north and south. An estimated 600,000 to 800,000 people were displaced in the north of the country and an estimated 300,000 in the center and south. While the main victims were the Kurds and Shia, particularly the Marsh Arabs and Shia opponents of the regime, the Saddam regime also targeted the smaller Turkmen

and Assyrian (Christian) minorities. Through the destruction of Kurdish villages, as well as the deliberate destruction of the habitat of the Marsh Arabs along the lower Tigris and Euphrates rivers, hundreds of thousands of people were displaced. (Fawcett and Cohen, 2002). The scale of violence over the last dozen years has been even more dramatic. Iraq today has a population of 4 million IDPs, second only to Syria and Colombia. This represents a staggering 11 percent of the population. The addition of refugees, mostly Syrians fleeing the conflict at home, brings the total number of displaced persons to 4.3 million. More than three-quarters of the displaced population has fled from only two governorates – Anbar and Ninawa.

38. The years of protracted violence have produced changes in family structure and a deterioration of child welfare. Women and children are the most heavily affected by the crisis, with 49 percent of IDPs being under the age of 18. There are an estimated 1.6 million widows, an increased number of female-headed households, and large numbers of orphans. Twenty percent of school-age children have dropped out of the education system in the last two years, including more than 2 million displaced children and children from host communities, partly due to the closure of 23 percent of schools during the 2015-2016 academic year.¹⁰ The psychological impact of the violence on children is likely to have a lifelong impact. Children who have been forced to flee their homes due to violence often exhibit changes in behavior as a result of their experiences. According to an assessment in the Kurdistan region, behavior changes were reported in 76 percent of children. Grave violations of children's rights are widespread, with one in five children being at serious risk of death, injury, sexual violence, or recruitment into armed groups. Violence against women and girls, particularly sexual violence, has been a widely used tactic of terror in the armed conflict. The conflict has increased the level of threat, both real and perceived, to women and girls, and families are increasingly seeing marriage as a way to protect women and girls and to increase household resources. Already high rates of forced and child marriage are increasing, and the once banned practice of temporary marriages for dowry is in resurgence. As of 2016, UNICEF monitoring data show that around 975,000 girls in Iraq were married before the age of 15, twice as many as in 1990.

39. As displacement is protracted and people exhaust their income and assets, the need to provide them with assistance and access to basic services rises. The government's capacity to meet these needs is very limited, and this situation has been compounded by severe resource constraints as a result of the drop in the price of oil. Nearly one-fifth of IDPs live in critical shelter arrangements, including unfinished or abandoned building, schools, religious sites, and informal settlements (IOM, 2016). Disease outbreaks, including cholera, are frequent. Within camps, only 50 percent of displaced children attend school; outside camps the numbers are worse, with only 30 percent of displaced children attending school. Nearly one-fifth of displaced families have lost key identity documents that are essential for access to education, medical, and social services as well as to Iraq's main social safety net, the Public Distribution System (PDS). Returnees face all of these risks, compounded by security breakdown, a widespread militia presence, and the targeting of people of specific ethnicities (UNOCHA, 2015). The Iraqis who remain in the Daesh-controlled areas of Anbar, Ninewa, and Kirkuk are yet another group dealing with particularly arduous living conditions. Micro simulations suggest that this group has suffered some of the greatest adverse repercussions of the economic, social, and security disruptions (World Bank, 2015).

¹⁰ OCHA Iraq (2015)

40. **Massive economic and social dislocation and poor governance have also given rise to a web of organized crime, which sustains many of the parties involved in today's conflicts.** In the current Iraqi context, crime serves both as a safety valve and a safety net and is “closely linked to non-state forms of governance, whether these provide security when the state fails to do so or provide services when the state marginalizes or neglects certain populations” (Williams, 2009). Perhaps the most lucrative source of illicit income is the diversion, theft, and smuggling of oil. Criminal activities and corruption have had a profoundly debilitating effect on the reconstruction of the economy and the rebuilding of state structures.

III. Poverty, Shared Prosperity, and Exclusion

41. **Persistent poverty is one of the symptoms of Iraq's predicament.** There has been no overall movement towards reductions in either poverty or income equality in Iraq since 2007; what gains were made in early years were lost to violence and conflict soon after. Certain groups, including IDPs, youths and girls and women, are particularly vulnerable in situations of conflict and poor governance. This chapter focuses on the evolution of poverty and inequality in Iraq and on some of the issues faced by excluded groups.

A. Poverty and Shared Prosperity

42. **Conflict combined with economic constraints in recent years have reversed the gains in poverty reduction that were attained between 2007 and 2012.¹¹** Headcount poverty in Iraq had fallen to 18.9 percent by 2012.¹² However, simulations suggest that this declining trend had been almost completely reversed by 2014, with headcount poverty estimated at 22.5 percent that year, close to the level recorded in 2007.¹³ These losses starkly illustrate how conflict and violence, as well as oil dependence, have increased poverty in Iraq. The significant regional differences in poverty dynamics and outcomes also reflect the differential impact of conflict and oil across Iraq and among its population.

43. **The modest declines in poverty in Iraq between 2007 and 2012 were driven by an increase in earnings among the employed rather than by an expansion in employment or by higher public transfers.** In particular, as will be discussed in other parts of this report, economic growth was not associated with job creation in the private sector where the majority of the poor work. Moreover, the oil sector, which represents almost half of Iraq's GDP and almost all its exports, accounts for only 1 percent of employment in the country, and growth in the sector does not directly

¹¹ The information presented here draws on the Iraq Household and Socioeconomic Surveys (IHSES), which are large, comprehensive surveys conducted in 2007 and 2012; 2014 data is based on the smaller Continuous Household Survey carried out that year.

¹² Measured by the national poverty line.

¹³ The 2014 poverty level was estimated using an extension of the micro-simulation methodology to provide an *ex-ante* estimate of the poverty and distributional impacts of the twin crises. The micro-simulation model superimposes macroeconomic projections on behavioral models based on the latest available household survey (the 2012 IHSES). The approach was used to analyze sectoral and aggregate macroeconomic data for Iraq, and a future microeconomic scenario was extrapolated from this projection. Large-scale population movements – such as the internal forced displacement of people from the Daesh-affected governorates – were explicitly taken into account in this approach. See Krishnan and Olivieri (2016) for further details.

create new jobs. Even in other sectors, job creation has not been sufficient to absorb the growing workforce. The exception is the public sector where oil revenues have enabled a significant expansion in jobs but where relatively few of the poor are employed.

1. Poverty and Inequality: The 2007-12 Period

44. **Although poverty declined between 2007 and 2012, rapid economic growth translated into only a small reduction in poverty rates.** Over the five-year period between 2007 and 2012, Iraq's GDP grew at a cumulative rate of over 40 percent while per capita real consumption, the basis for measuring poverty, grew by only 9 percent in cumulative terms over the five-year period. High rates of GDP growth did not translate into commensurate consumption growth, resulting in a relatively small fall in poverty rates from 22.4 percent in 2007 to 18.9 percent in 2012. There was little change in other measures of poverty such as the poverty gap or the poverty squared gap in the country as a whole. The poverty gap, which measures the average shortfall between the consumption of the poor and the poverty line relative to the poverty line, fell by a little over half a percentage point (Table 1). In other words, those who were below the poverty line in 2007 had, on average, moved closer to the poverty line by 2012.

45. **Inequality has increased.** The consumption Gini coefficient for Iraq is relatively low at 27.9 (2012), though rising (Table 2). During the 2007 to 2012 period, consumption grew faster among those in the highest quintiles – the top 60 percent of the consumption distribution – than it did among those in the bottom 40 percent. However, it also grew in places where consumption levels were lower to start with, such as rural Iraq and in areas other than Baghdad and Kurdistan. In rural areas, where consumption grew the fastest, inequality also increased more rapidly: the ratio between the consumption of those in the 90th percentile and those in the 10th percentile increased by 12 percent over the five-year period (Table 2. Inequality in the Distribution of Per Capita Expenditure, Another way to view the rising inequality is via the shared prosperity indicator. While the average expenditure of those in the bottom 40 percent of the consumption distribution grew by 1.1 percent during the period in question (Table 3), the average expenditure growth rate of the overall population was nearly double this, at 2.0 percent. Thus, the poor were losing out and falling behind average Iraqis.

Table 1. Overall Poverty

	Poverty Headcount Rate			Poverty Gap			Squared Poverty Gap		
	2007	2012	Change	2007	2012	Change	2007	2012	Change
Urban	15.7	13.5	-2.2	2.8	2.5	-0.3	0.7	0.7	0.0
Rural	39.0	30.7	-8.3	9.5	7.6	-1.9	3.4	2.7	-0.7
Total	22.4	18.9	-3.5	4.7	4.1	-0.6	1.5	1.4	-0.1

Source: Authors' calculations using the 2007 and 2012 IHSES

46. **Growth incidence curves illustrate the increasing inequality that accompanied the reduction in poverty in Iraq.** These curves show the annual growth in per capita expenditure for each percentile of the distribution. For a given percentile, the height of the curve represents the growth in per capita expenditure for that percentile of the population. These curves show how incomes change across quintiles over time: if the growth rates of the lower quintiles are higher than those of

the upper (in other words, there is a downward sloping curve), then consumption growth was pro-poor. This was not the case in Iraq. Per capita consumption grew faster for the well-off than for the less-well off, with the differential being greater in rural areas than in urban areas (Figure 16).

**Table 2. Inequality in the Distribution of Per Capita Expenditure,
Urban and Rural Areas**

	Bottom Half of the Distribution		Upper Half of the Distribution		Interquartile Range	Tails	Gini
	p25/p10	p50/p25	p75/p50	p90/p75			
Total							
2007	1.28	1.33	1.36	1.36	1.81	3.15	26.49
2012	1.32	1.37	1.39	1.38	1.90	3.46	27.94
Urban							
2007	1.25	1.33	1.35	1.36	1.79	3.04	26.02
2012	1.30	1.36	1.38	1.36	1.87	3.33	27.39
Rural							
2007	1.28	1.33	1.31	1.33	1.75	2.97	24.23
2012	1.33	1.38	1.37	1.34	1.89	3.34	27.00

Source: Authors' calculations using the 2007 and 2012 IHSES

Table 3. Shared Prosperity: Annual Consumption Growth of the Bottom 40 Percent

Year	Iraqi dinars (on average thousands, 2012 terms)	
	Bottom 40	Overall
2007	101.8	171.4
2012	107.6	188.9
Annualized growth rate	1.1	2.0

Source: Authors' calculations using the 2007 and 2012 IHSES

47. Estimates indicate that multidimensional poverty (MPI) in Iraq – poor health and education outcomes and limited access to essential services – is at 35 percent, which is higher than consumption poverty.¹⁴ Both the MPI and consumption poverty measures suggest similar spatial patterns in poverty, with Kurdistan enjoying the lowest levels of poverty on both indicators, whereas the South suffers from the highest MPI and consumption poverty rates (Figure 17)¹⁵. The

¹⁴ See Annex 1 for a definition of multi-dimensional poverty (MPI).

¹⁵ Divisions, as used in Figure 17 and in the remainder of this chapter are groupings of governorates of approximately equal population size, and are defined as follows: Kurdistan: the three governorates of the Kurdistan Regional governorate, Duhouk, Erbil, and Suleimaniya; North: the three governorates directly south of Kurdistan and to the North of Baghdad—Ninawa, Kirkuk, and Salahaddin; Baghdad: the single governorate of Baghdad, the capital city; Central: governorates to the east, west and immediately south of Baghdad —Anbar, Diyala, Najaf, Karbala, Wassit, and Babil; and South: five southern-most governorates of Iraq—Qadisiya, Thi Qar, Muthanna, Maysan, and Basra.

gaps between the two indicators do suggest, however, that increases in consumption do not always go hand in hand with improved welfare in human development aspects. Of the various factors that contribute to the MPI, a lack of sanitation, inadequate electricity, and poor nutrition are among the most prevalent deprivations in the country (Figure 18). Moreover, the vast majority of households suffer multiple deprivations in human development, with 63 percent of households suffering from two or three simultaneous deprivations, while 11 percent experience four or more (World Bank, 2014).

Figure 16. Growth Incidence Curves - National, Rural/Urban, and Divisional

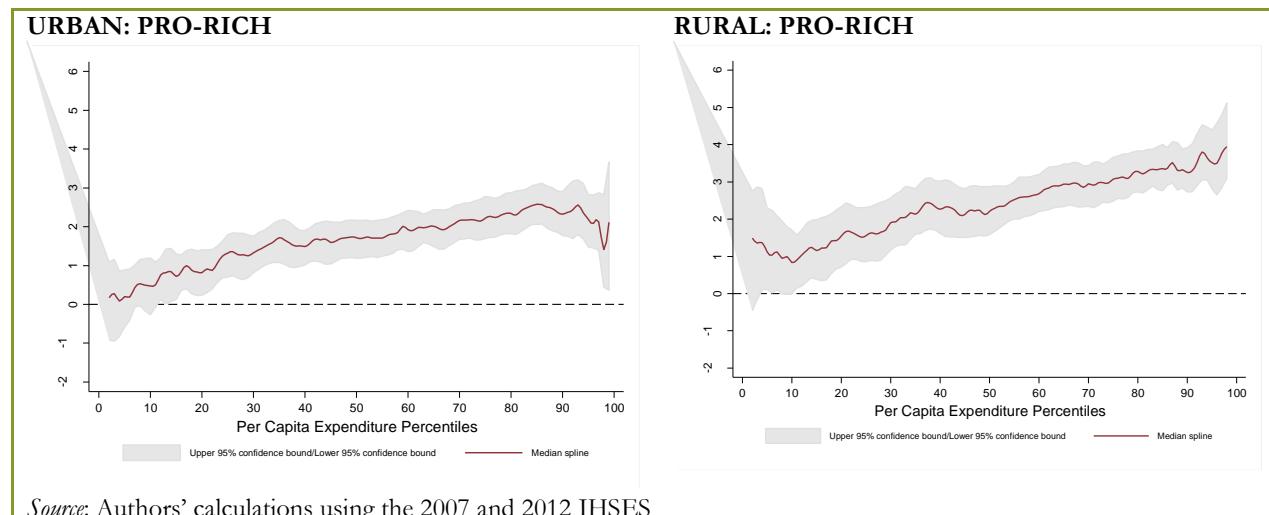
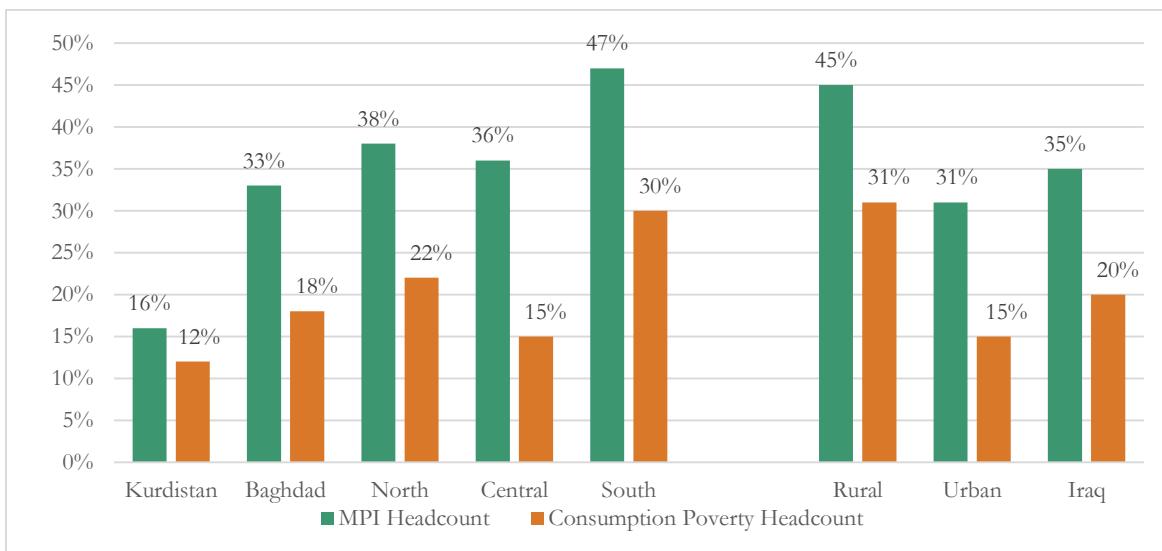
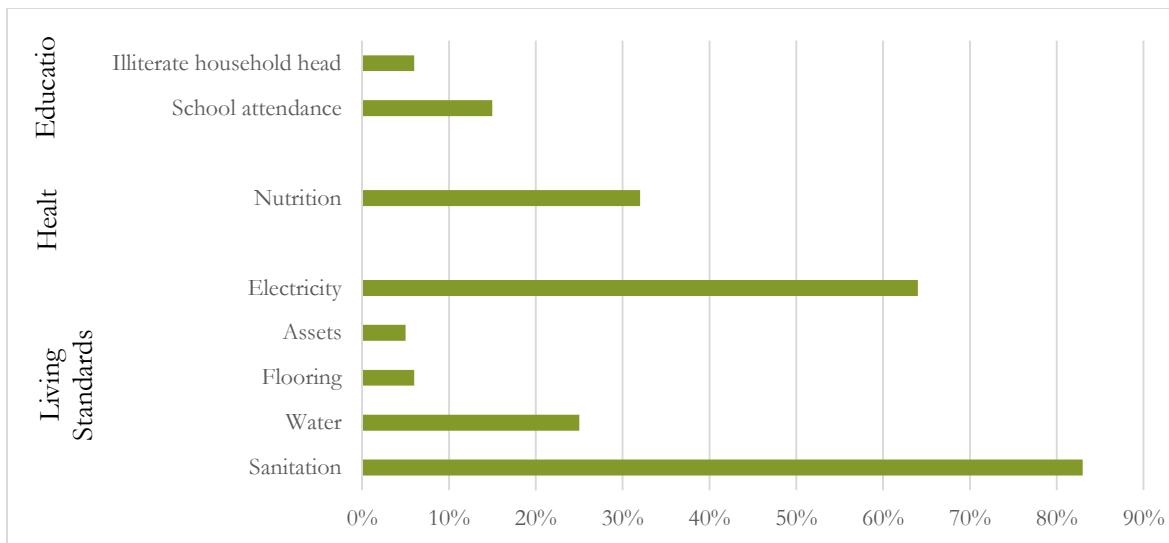


Figure 17. Consumption Poverty and MPI in Human Development



Source: World Bank, 2014

Figure 18. Dimensions of Deprivation



Source: World Bank, 2014

i. *Spatial Disparities in Poverty and Poverty Reduction*

48. **Poverty reduction has been spatially uneven across Iraq, with a more rapid decline in rural areas than in urban areas albeit from higher initial levels.** Between 2007 and 2012, the poverty rate in rural areas dropped from a high of 39 percent to 30.7 percent. There was a smaller fall in absolute terms (2.2 percentage points) in urban areas but a significant one relative to the baseline (a 14 percent decline). The poverty gap was also somewhat smaller in rural areas than in urban areas in 2012, suggesting that not only did poverty fall in rural areas but that the depth of poverty did as well.

49. **Poverty also varies across governorates.** Dividing the country into three main regions, Baghdad, Kurdistan, and Rest of Iraq, Figure 19 indicates that a significant share of each region's population is in the bottom 40 percent of the income distribution. Although the poor constitute a smaller proportion of the population of Kurdistan, they make up a larger proportion in the Rest of Iraq. The decline in poverty between 2007 and 2012 was concentrated almost exclusively in the central and northern governorates. The poverty rate in central governorates fell by 16 percentage points, while the rate in the northern governorates fell by nearly 9 percentage points. The change in other areas was modest. In Kurdistan, poverty levels were relatively low to start with at 4.3 percent, and poverty did not fall significantly in Baghdad, the most populous governorate in the country. In contrast to the overall improving trend nationally, in the southern governorates the poverty rate increased by 1.8 percentage points. Historically, poverty has been concentrated in the center and the south of the country (Table 4).

50. **The evolution of inequality also varies spatially.** Overall, per capita consumption grew faster for the well-off than for the less-well-off, except in Kurdistan and the central governorates where the growth-incidence curves in Figure 20 are relatively flat. The major difference between Kurdistan and the Center is the higher rate of consumption growth in the latter throughout almost the entire consumption distribution. In Baghdad and the North, while overall consumption growth was positive, there was almost no change in consumption for those in the lower deciles of the distribution. In the South, consumption growth was negative for those in the lowest deciles, while

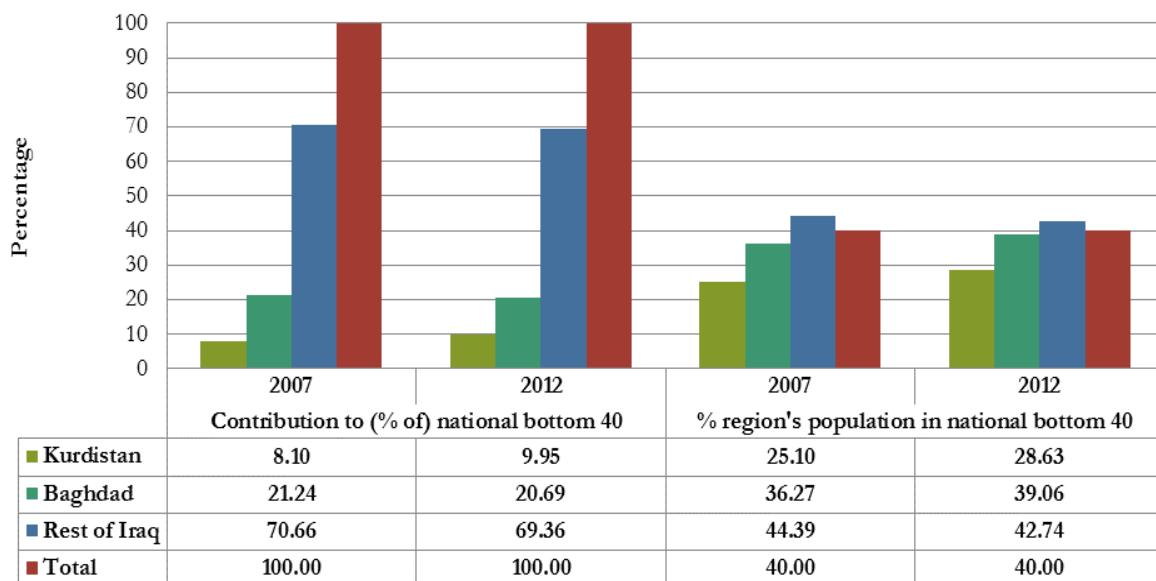
growth in consumption among households in the top deciles was similar to that for the Center. This declining consumption among households in the bottom 40 percent of the distribution is directly reflected in the increase in headcount poverty rates.

Table 4. Spatial Differences in Poverty Rates (National Poverty Line)

	Poverty headcount rate			Poverty gap			Poverty squared gap		
	2007	2012	Difference	2007	2012	Difference	2007	2012	Difference
Kurdistan	4.3	3.5	-0.8	0.8	0.6	-0.2	0.2	0.2	0.0
Baghdad	12.6	12.0	-0.6	2.1	2.0	-0.1	0.6	0.5	-0.1
IS-affected	28.0	25.7	-2.3	6.5	5.6	-0.9	2.1	1.8	-0.3
Other North	23.7	14.9	-8.8	5.4	2.8	-2.6	2.1	0.8	-1.3
Center	31.8	15.8	-16.0	6.7	3.1	-3.6	2.1	1.0	-1.1
South	31.8	33.6	1.8	6.6	8.6	2.0	2.1	3.2	1.1

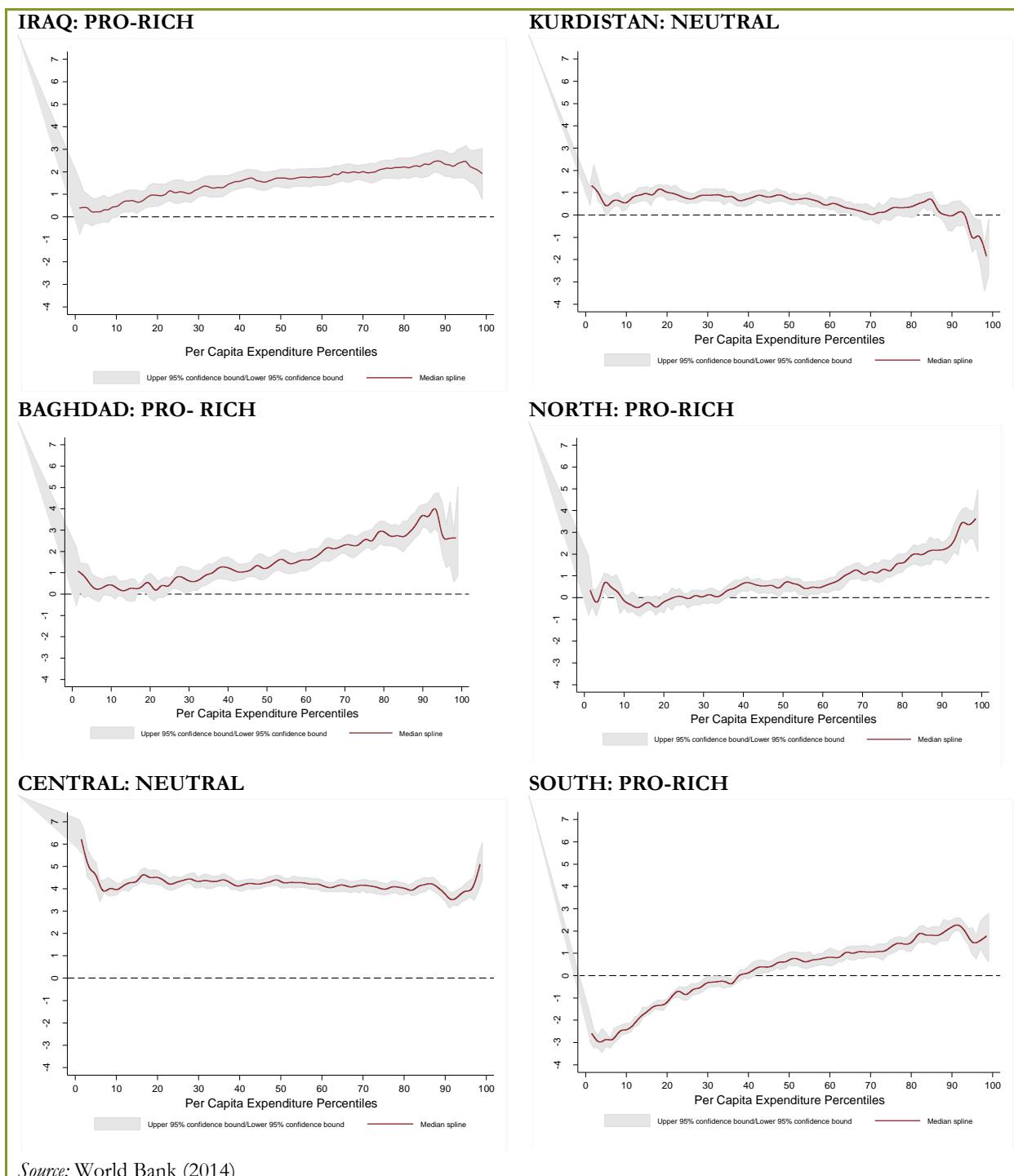
Source: World Bank Staff Calculations using the 2007 and 2012 IHSES

Figure 19. Shared Prosperity and the Distribution of the Bottom 40 Percent



Source: Authors' calculations using the 2007 and 2012 IHSES

Figure 20. Growth Incidence Curves, National and Divisional

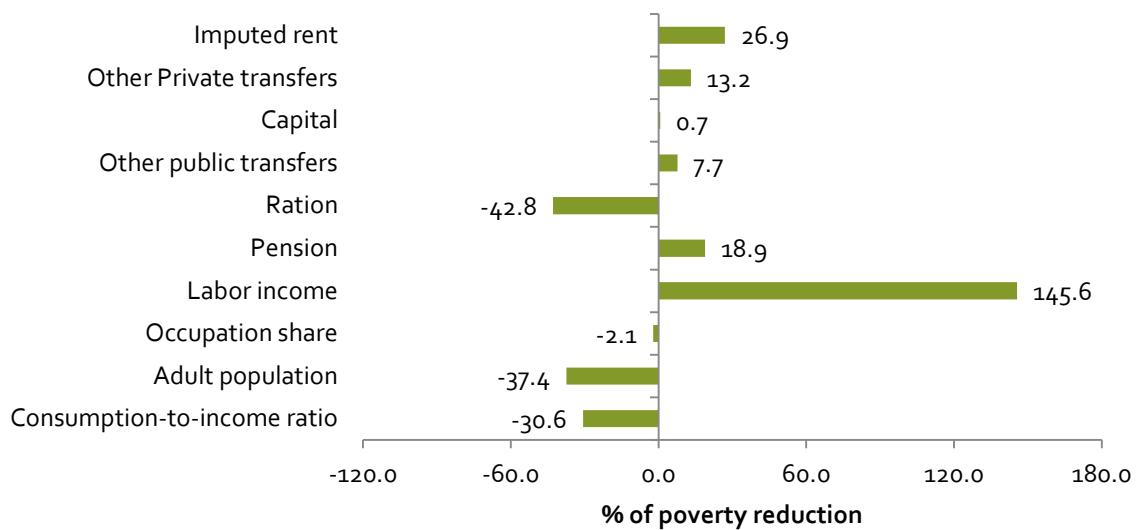


Source: World Bank (2014)

ii. Drivers of Poverty Reduction

51. The reduction in poverty between 2007 and 2012 was mainly driven by changes in labor income rather than growth in employment (Figure 21). Had the contributions made by other variables to reducing poverty remained constant, the change in labor income alone would have brought poverty headcount rates to 17.2 percent in 2012 (compared with the actual 18.9 percent). Pensions and public transfers other than the PDS explained almost 27 percent of the reduction in poverty. On the other hand, the decline in implicit income from PDS transfers following reform of the system acted counter to poverty reduction. In fact, the reduction of PDS ration transfers would have nearly halved the reduction in poverty when everything else is held constant. Private transfers, especially domestic remittances, contributed 13 percent of the total reduction in poverty. Demographic factors, in particular the declining share of adults in poor households and the consumption-income ratio, hindered poverty reduction. The contributions of the various factors varied across the country as illustrated in Figure 22.

Figure 21. Factors Contributing to Poverty Reduction



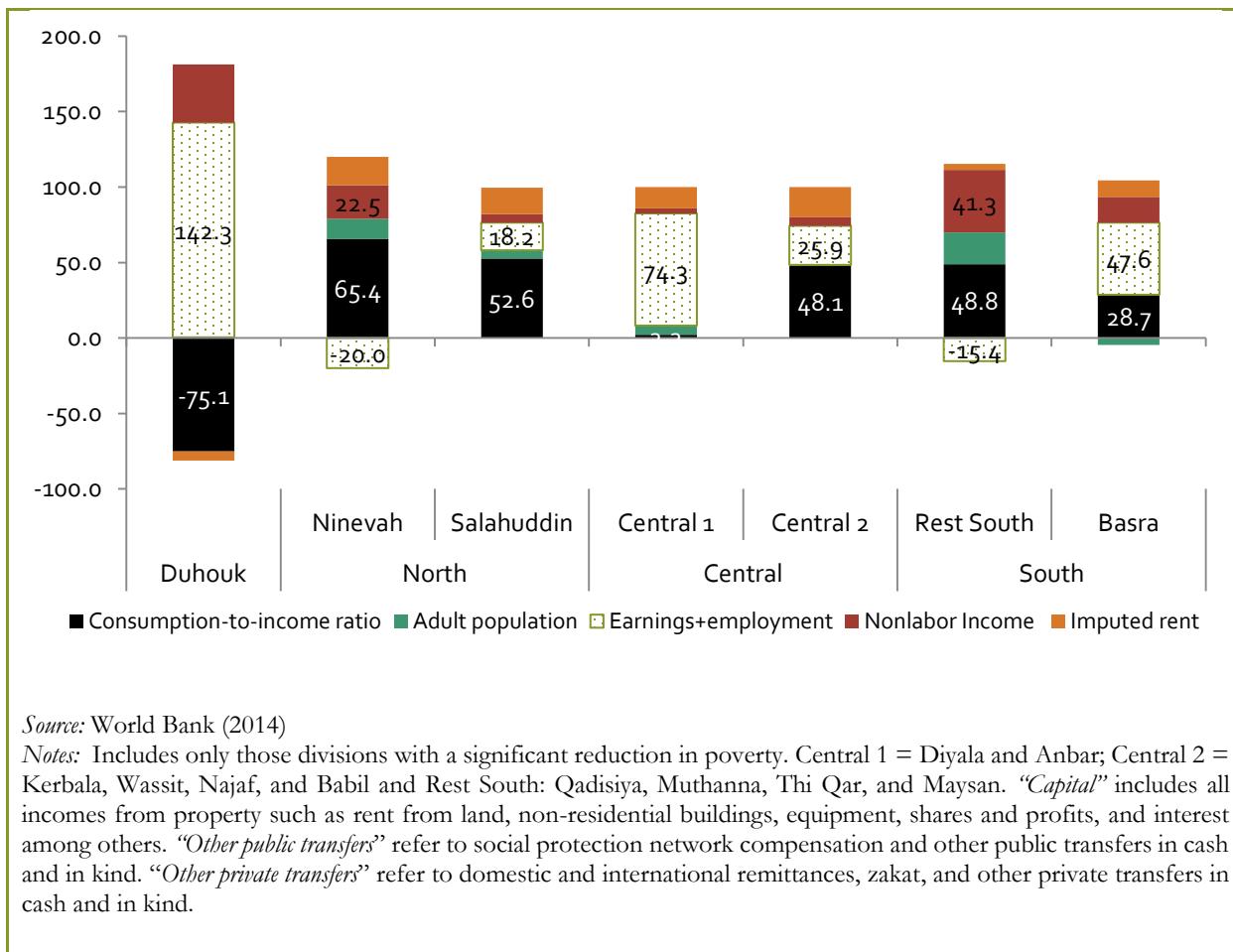
Source: World Bank (2014)

Notes: "Capital" includes all income and rent from property such as land, non-residential buildings, equipment, shares and profits, and interest among others. "Other public transfers" refer to social protection network compensation and other public transfers in cash and in kind. "Other private transfers" refer to domestic and international remittances, *zakat* (charity payments), and other private transfers in cash and in kind.

52. Higher employment contributed to poverty reduction in only two of the five subdivisions where headcount poverty rates fell (Duhouk and Central 1). In the other three subdivisions where poverty fell (Basra, Central 2, and Salahaddin), lower levels of employment among the poor increased poverty. The same pattern was found among those divisions where headcount rates increased: declines in employment contributed to increases in poverty. The limited role played by

employment in reducing poverty underscores the insignificance of Iraq's small and stagnant private sector, a topic discussed later in this report.

Figure 22. Significant Poverty Changes by Division



iii. Who Are the Poor? A Profile of Poverty

53. **The average household in the bottom 40 percent is larger and has more dependents than a non-poor household and their household heads have a lower level of education of the heads than of better-off households.¹⁶** Households in the bottom 40 percent have more than 10 members on average, including almost six dependents. Four out of five heads of households in the bottom 40 percent have a primary education or less, and two-fifths are employed in agriculture, construction, commerce, and transport (predominantly private sector jobs). These households are almost equally likely to live in an urban or a rural area. In contrast, almost 80 percent of households in the top 60 percent are located in urban areas, with a typical household size of seven members, including about four dependents. Forty-two percent of the heads of households in the top 60 percent possess at least a primary education, and almost 40 percent are employed in public administration, finance, or commerce. In 2012, belonging to a male-headed household increased the probability of

¹⁶ Annex 2 includes a table summarizing the mean characteristics of the poor and the non-poor in Iraq.

being in the bottom 40 percent by 9 percent (even though over 90 percent of all households are headed by males). One conjecture is that this may reflect the expansion in social protection transfers provided to households headed by widows.

54. **Poverty rates were negatively associated with the human capital of the household head during the 2007 to 2012 period.** In 2012, if a household was poor, the probability that the household head had less than a primary education was 52 percent. By contrast, households whose head had completed secondary or a higher level of schooling accounted for only 5 percent of the poor.

55. **Surprisingly, full-time employment is not associated with a lower incidence of poverty,** with the poor and the non-poor being almost equally likely to have an unemployed head of household. The poor are more likely to be distinguished by their sector of employment rather than by their employment status. Poor household heads tend to work in agriculture and fishing and in the construction, transport, storage, and communication sectors. Working in the construction sector, in particular, increased the risk of being in the bottom 40 percent by 8 percent in 2012. Employment of the household head in public administration, finance, and mining sectors, which are largely public sector jobs, lowered the odds of the household being in the bottom 40 percent by 11, 9, and 16 percent respectively in 2012.

2. The Impact of the Twin Crises: Reversals in Poverty Reduction in 2014

56. **The twin crises – namely the oil price declines and the Daesh insurgency – are estimated to have erased the reduction in poverty achieved between 2007 and 2012, raising the poverty headcount to 22.5 percent in 2014 and pushing an additional 3 million people into poverty.¹⁷** Poverty headcount rates are estimated to have increased by 7.5 percentage points between the non-crisis (business as usual, BaU) scenario and the crisis scenario. The twin crises are also estimated to have increased the poverty gap (by 3 percentage points) as well as causing the severity of poverty for the country as a whole to grow by 1.3 percentage points (Table 5).

Table 5. Regional Poverty Impact, Crisis versus Business as Usual

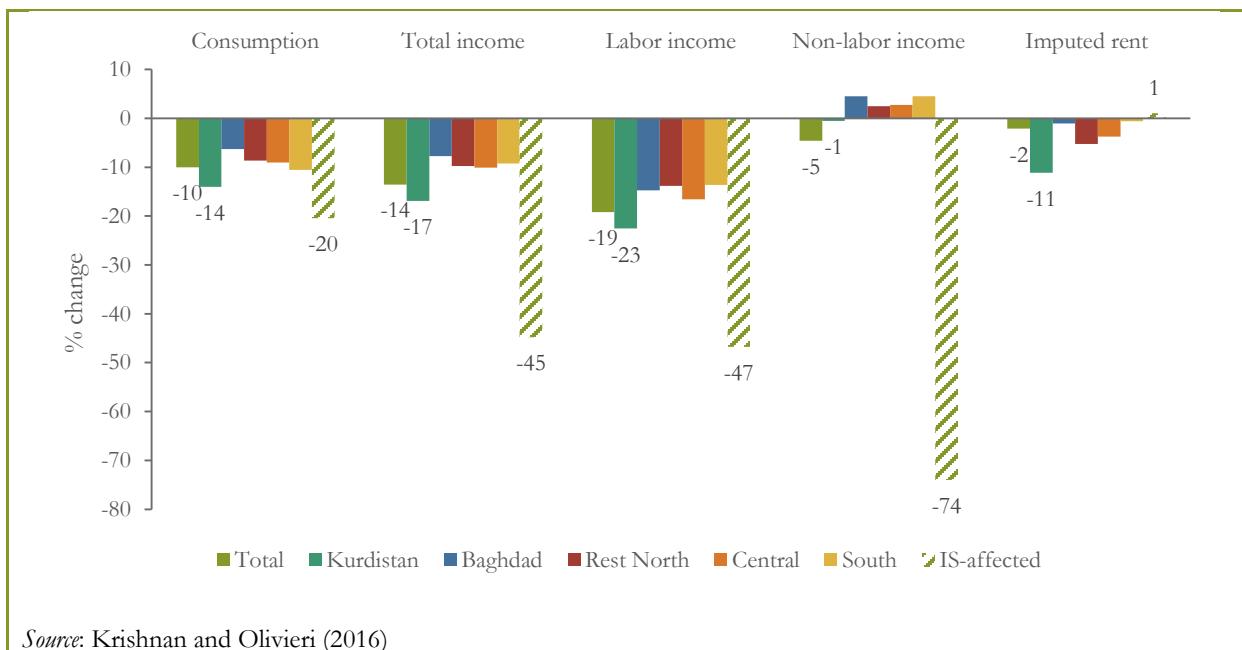
	Head Count			Poverty Gap				Severity			
	2012	2014		Impact	2012	2014		Impact	2012	2014	
		BaU	Crisis			BaU	Crisis			BaU	Crisis
Iraq	18.9	15.0	22.5	7.5	4.1	3.9	6.6	2.7	1.4	1.7	3.0
Kurdistan	3.5	3.5	12.5	9.0	0.6	0.6	3.7	3.1	0.2	0.2	1.7
Baghdad	12.0	8.5	12.8	4.4	2.0	2.3	3.4	1.0	0.5	1.2	1.6
IS-affected	25.7	20.5	41.2	20.6	5.6	5.3	14.2	8.9	1.8	2.2	7.3
Rest-North	14.9	12.1	17.7	5.6	2.8	2.9	4.4	1.6	0.8	1.2	1.8
Centre	15.8	12.7	18.6	5.8	3.1	2.9	4.6	1.7	1.0	1.1	1.8
South	33.6	26.1	31.5	5.5	8.6	6.8	8.9	2.1	3.2	2.7	3.7

Source: Krishnan and Olivieri (2016)
Note: BaU = business as usual

¹⁷ See footnote 22 for an explanation of the simulation methodology underlying the 2014 estimates.

57. **A reduction in employment and in income underlies the rise in poverty.** Non-employment (which includes both the inactive and the unemployed) seems to have increased by over 800,000 compared to the non-crisis level as a result of the collapse of oil prices and the massive displacement resulting from the Daesh insurgency. Moreover, a shift of workers from more productive or higher earning jobs to less productive jobs with lower earnings (from the manufacturing and construction sector to the agriculture and services sectors) is estimated to have led to an average 20 percent decline in total household labor income in 2014 (or a 14 percent decline in total household income). The magnitude of these effects is higher in Daesh-affected regions and Kurdistan than in others. For instance, total income is estimated to have been nearly halved in Daesh-affected areas (Figure 23). The increase in unemployment rates, combined with the reduction in both labor and non-labor income, translates into lower per capita consumption. Simulation results show a 10 percent reduction in average per capita consumption for Iraq as a whole. This is 4 percentage points lower than the estimated decline in total income, which seems reasonable given that households might have smoothed their consumption during difficult events and over time.

Figure 23. Changes in Per Capita Income Components - Crisis versus Business as Usual



58. **Although the negative impact of these crises has affected all regions, the intensity has not been the same across the country.** The impact has been more severe in Daesh-affected areas and Kurdistan than elsewhere. In those areas, poverty incidence levels are estimated to have doubled and quadrupled respectively, while the Center has increased its poverty incidence by 6 percentage points followed by smaller increases in the Rest of the North, South, and Baghdad. The welfare levels of the poor have also deteriorated in all regions as have the poverty gap and severity indices, with the most severe effects being in the Daesh-affected and Kurdistan regions. The poverty gap and its severity are estimated to have increased more in the South than in other regions, which is likely to reflect the higher share of the population living close to the poverty line there prior to 2014 (World

Bank, 2015). The adverse welfare effects in Kurdistan and the Daesh-affected governorates are also likely to have been underestimated as they did not take into account the expected increase in the prices of basic need items in the Daesh-affected governorates or the suspension of public sector salaries in Kurdistan during some months of 2014. The suspension of federal transfers to Kurdistan has also exacerbated the region's plight.

i. *Who Was Most Impacted by the Twin Crises? A Profile of the “New Poor”*

59. **The impact on the “new poor” – the households that have become poor as a result of the twin crises – is four times deeper than the impact on the rest of the population, as measured by losses in per capita consumption and income.** Households identified as “new poor” are estimated to have suffered a fall of more than 40 percent in per capita consumption and close to a 51 percent drop in per capita income as a consequence of the crises. These results are shown in Figure 24, which shows the disproportionate impact on households living in governorates affected by Daesh and in Kurdistan. Almost all of the losses in per capita income suffered by the “new poor” are a result of the decline in labor income, estimated at roughly 60 percent (Table 6). However, per capita non-labor income also declined by 35 percent between the business as usual and crisis scenarios. Again, these effects were more severe in Kurdistan and Daesh-affected regions.

Figure 24. Impact on Per Capita Consumption and Income (Crisis versus Business as Usual), % change

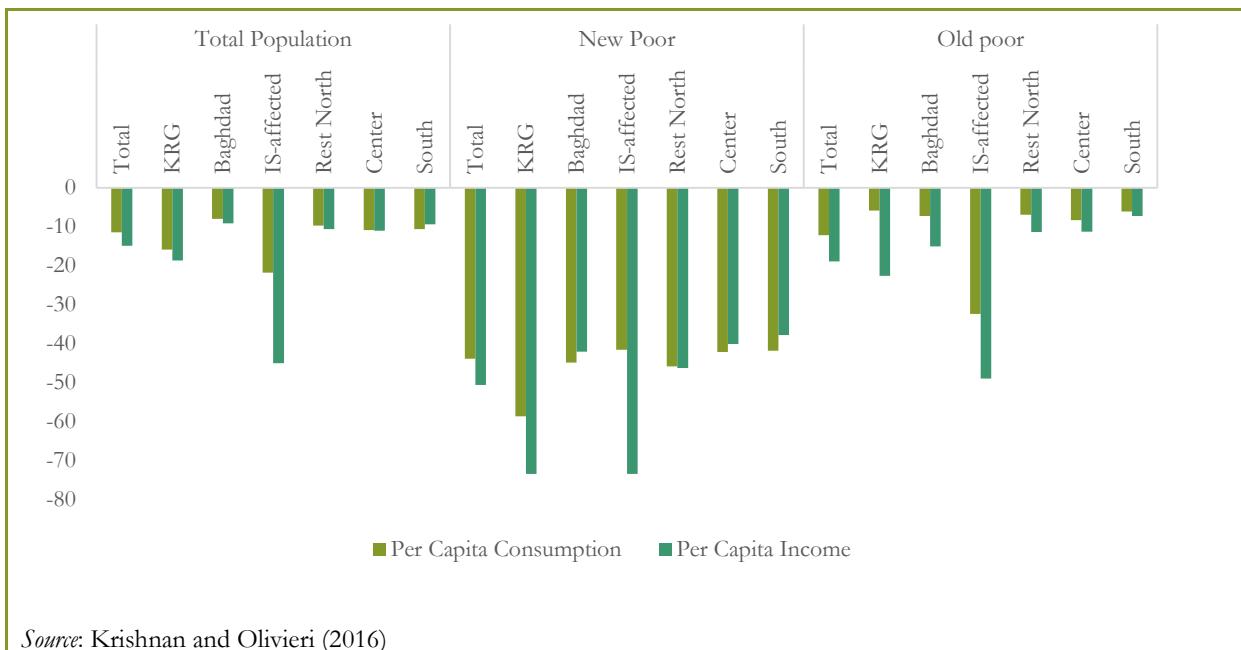


Table 6. Impact on Components of Household Per Capita Income, Crisis versus Business as Usual

	New Poor			Old Poor			Total Population		
	BaU	Crisis	%	BaU	Crisis	%	BaU	Crisis	%
Per capita consumption	108.5	60.8	-43.9	56.1	49.2	-12.2	155.2	137.4	-11.5
Per capita household income									
- Total income	144.0	71.0	-50.7	81.4	66.0	-19.0	182.5	155.3	-14.9
- Labor income	110.6	45.8	-58.6	54.2	41.4	-23.6	124.1	99.4	-19.9
- Non-labor income	20.0	12.9	-35.3	17.7	15.4	-12.7	28.8	27.0	-6.3
- Public transfers	16.1	11.0	-31.5	14.3	12.7	-11.2	20.8	19.8	-4.9
- Private transfers	3.9	1.9	-51.2	3.4	2.7	-19.2	8.0	7.2	-10.1

Source: World Bank staff calculations, 2016

B. Excluded Groups: IDP, Youths, and Gender Inequality

1. Internally Displaced Persons

60. Beginning in June 2014, Daesh militants extended their influence from Syria into Iraq's northern and western provinces of Anbar, Ninawa, Salahaddin, and, to a lesser extent, Kirkuk, and Diyala. As mentioned above, an estimated 354,000 families were internally displaced between June and December of 2014, representing about 2.1 million individuals.¹⁸ The bulk of the forced displacement of people took place in the five Daesh-affected governorates, with Anbar, Salahaddin, and Ninawa alone accounting for 90 percent of the displaced families (Figure 25). Sixty-three percent of these IDPs crossed into other governorates, about half of them into the three governorates of Iraqi Kurdistan. By 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 Daesh conflict and 1 million people still displaced as a result of the 2006–2007 violence – in addition to 300,000 officially registered refugees.^{19,20} After Yemen and Syria, Iraq had the third highest number of newly IDPs in 2015 (Figure 26).²¹

¹⁸ Data from the IOM Displacement Tracking Matrix, January to December 25, 2014

¹⁹ UNHCR registered over 244,000 Syrian refugees in Iraq in 2015, with 97 percent residing in the Kurdistan Region of Iraq (KRI). Moreover, more than 43,000 refugees and asylum-seekers of nationalities other than Syrian and an estimated 50,000 stateless persons were registered in Iraq in 2015, including 11,015 residing in the center and the south of Iraq. Most refugees living in central and southern locations are of Iranian, Palestinian, and Sudanese origin while those in the KRI are predominantly Iranian and Turkish refugees.

²⁰ Displacement has been a critical issue in the socioeconomic development of Iraq over the last four decades. Conflicts and violence as well as the ethno-sectarian realities of the country have caused internal and external migration. More than 2.8 million people were estimated to have been internally displaced in Iraq as of November, 2008. Approximately 1.6 million are thought to have been displaced by sectarian and generalized violence since the Al Askari mosque bombing of February 2006, and approximately 190,000 more had been displaced by military operations and generalized violence from 2003 to 2005. An estimated 1.2 million were displaced by the policies of the former government of Saddam Hussein. In addition, it is estimated that more than 2 million Iraqis have sought refuge in neighboring countries (IDMC, 2008).

²¹ IDMC (2016)

Figure 25. Displacement of Families from the Northern and Western Governorates

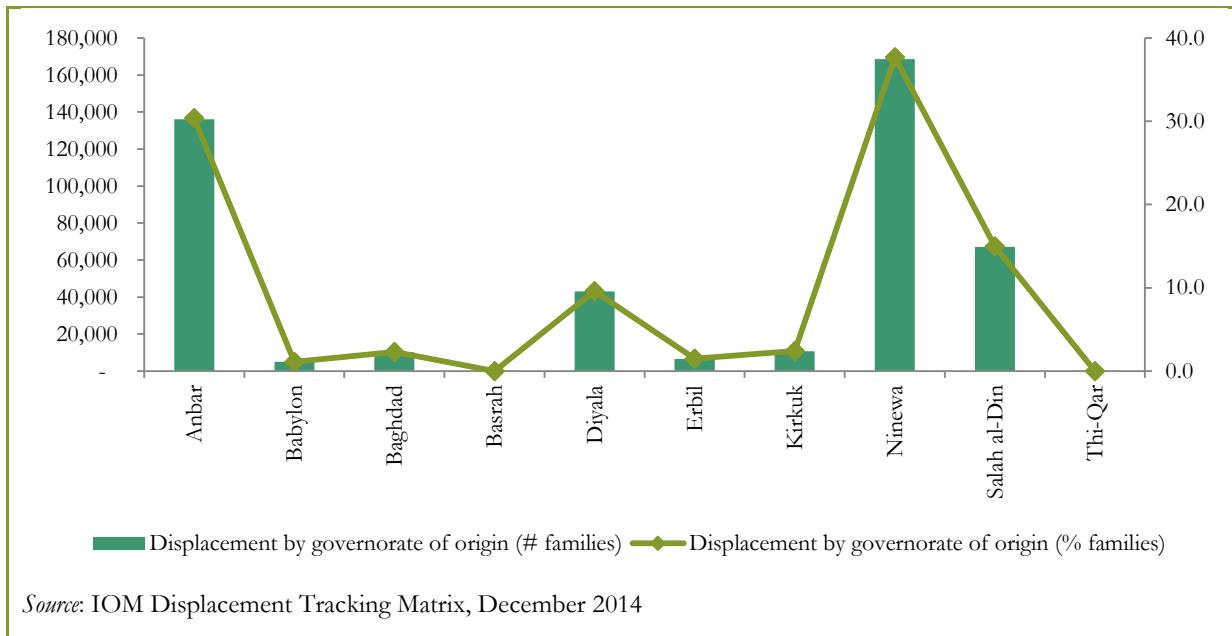
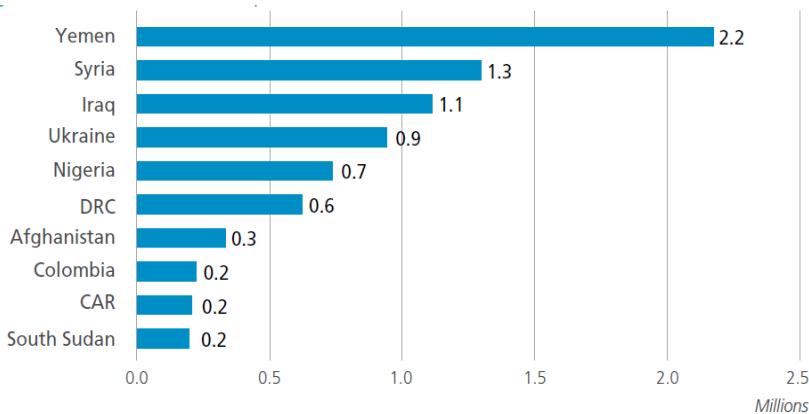


Figure 26. Countries with Most New Displacements Associated with Conflict and Violence, 2015



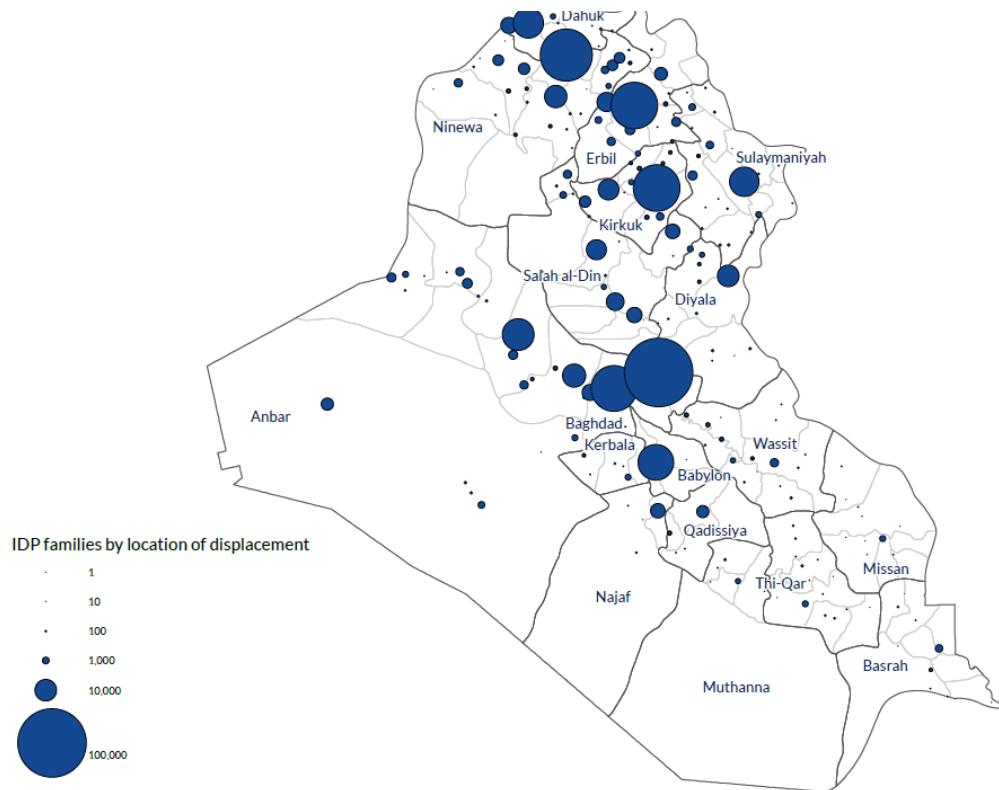
Source: IDMC, 2008.

61. The IDPs displaced since January 2014 originate from 8 of Iraq's 18 governorates.²² Most IDPs are originally from the governorates of Anbar (42 percent) and Ninawa (35 percent). There are also several governorates with high levels of IDPs displaced within their governorate of origin including Kirkuk, Diyala, and Anbar. In terms of destination, IDPs are highly concentrated in certain places, with some governorates receiving more than others (Figure 27). Daesh's attacks in August 2014 triggered an initial internal displacement of some 800,000 people into three governorates of the KRI, namely Duhouk, Erbil, and Suleimaniya. This increased the population of the KRI by 28 percent.

²² IOM, 2016.

As of June 2016,²³ 84 percent of the total identified IDP population (3.2 million) were located in just seven of the 18 governorates of Iraq.²⁴

Figure 27. Number of IDP Families by District of Displacement, June 2016



Source: IOM Displacement Tracking Matrix Round 48

62. **Most IDPs move into urban areas.** Some 90 percent of IDPs and more than 60 percent of refugees reside outside of camps.²⁵ This has pressured already stretched urban services. Even without the influx of IDPs, Iraq's urban population growth has been growing by 3 percent every year since 2011,²⁶ and 57 percent of the country's urban population lives in slum areas.

63. **The welfare and consumption of IDPs are negatively affected in various ways.** Their consumption is likely to have been reduced by a decrease in the quality or flow of services received from housing as well as the loss of immobile durable goods and assets. Those previously employed in the private sector will have lost their jobs and livelihoods (IDPs who held public sector jobs have in general continued to receive their salaries and pensions). They would also have lost some or all of their

²³ IOM Displacement Tracking Matrix (DTM) Round 48, June 2016

²⁴ The Kurdistan Region of Iraq (KRI) consists of the Duhouk, Suleimaniya, and Erbil governorates; the South consists of the Basra, Maysan, Najaf, Thi Qar, Qadisiya, and Muthanna governorates; the Central North consists of Anbar, Babil, Baghdad, Diyala, Kerbala, Kirkuk, Ninawa, Salahaddin, and Wasit governorates.

²⁵UNHCR: <http://reporting.unhcr.org/node/2547>

²⁶ World Development Indicators. World Bank Staff estimates based on United Nations, World Urbanization Prospects.

private transfers as their communication with their relatives and the wider community was been disrupted (Krishnan and Olivieri, 2016).

64. **The per capita consumption of IDPs has shrunk by twice as much as that of the population at large.** Per capita household consumption is estimated to have decreased by almost 22 percent as a result of the twin crises (Figure 28). The impact of the crises on total per capita income was even more severe (a reduction of 61.6 percent) assuming that households smoothed their consumption during the most difficult times. The reduction in consumption was driven mainly by a massive reduction in labor income of 62.5 percent as a consequence of job losses. The unemployment rate rose to 27 percent among this population, almost three times higher than the rate for the population as a whole.

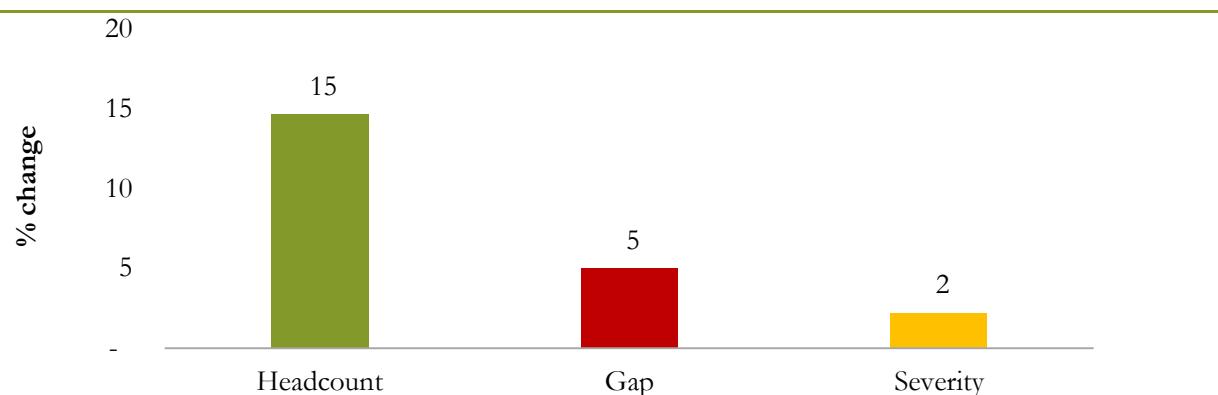
65. **The lack of employment and the massive reduction in labor income reinforced by the loss of assets and services associated with having a proper dwelling implies a significant increase in the incidence of poverty among IDPs.** Simulation results show that the headcount poverty rate for IDPs grew by 15 percentage points from 23 to 38 percent, twice the rate for the population as whole. In other words, 4 out of 10 internal displaced individuals became poor as a consequence of the crises. Additionally, the poverty gap and its severity also increased by 5 and 2 percentage points for this population (Figure 29).

Figure 28. Impact of Crises on Household Welfare (Crisis versus Business as Usual), % Change



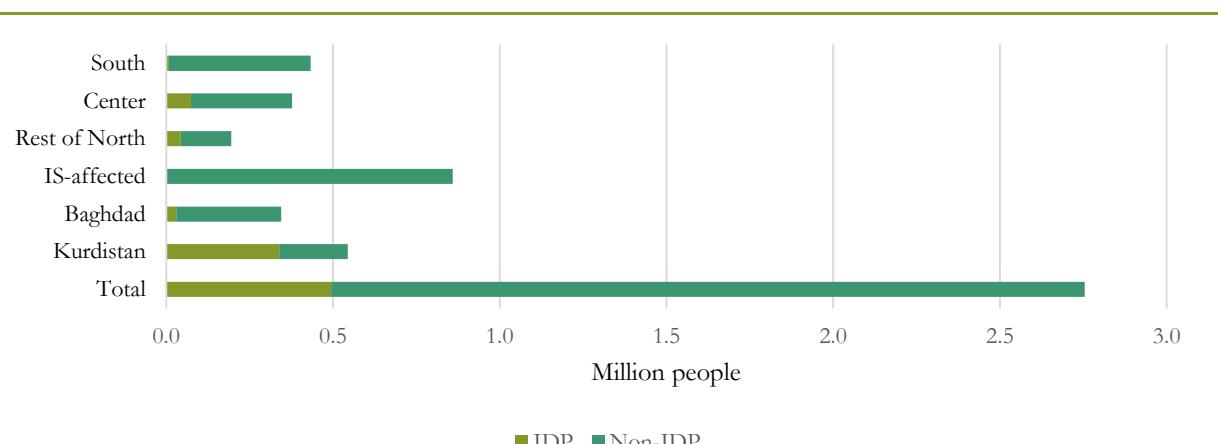
66. **Overall, IDPs account for half a million of the total number of people who fell into poverty as a consequence of the twin crises** (Figure 30). This represents almost 20 percent of the increase in the total number of poor (2.8 million poor). However, this effect varies significantly among regions. In Kurdistan, IDPs accounted for 62 percent of the increase in the number of poor, whereas in the South they only accounted for 2 percent. That being said, not all IDPs have become poor as consequence of the twin crises. Poor IDPs only comprise 6 percent of the estimated total number of 8 million poor people in Iraq following the twin crises, and only one-third of them have fallen into poverty as consequence of the crises.

Figure 29. Changes in Poverty for IDPs (Crisis versus Business as Usual)



Source: Krishnan and Olivieri, 2016

Figure 30. Additional Number of Poor, IDPs and Non-IDPs



Source: Krishnan and Olivieri, 2016

67. **A large number of displaced people will not be able to return to their homes because of destruction or continuing conflict.** In addition, there appear to be *de facto* restrictions on the movement of IDPs (for example, of Sunni Arabs into the KRI and Baghdad and on their return to liberated areas), which may affect their ability to access critical services. It will be necessary to facilitate their integration within their host communities by eliminating unequal access to housing, employment, and basic services.²⁷ Supporting housing reconstruction and repair in conflict-affected areas would strengthen social and political stability and enable IDPs to return to their original locations, as well as providing local employment opportunities and helping to develop local small- and medium-sized contractors. It would also spur demand in a number of complementary sectors, such as construction materials and related services (Box 5)²⁸

²⁷ IOM Iraq (2013)

²⁸ World Bank (2015)

Box 5. Housing in Iraq

Iraq has a large and growing housing deficit following decades of sanctions, conflict, and substantial under-investment in new formal housing, which has been exacerbated by rapid population growth, ongoing urbanization, and large inflows of displaced people. The housing deficit continues to increase and is currently estimated by the Ministry of Construction and Housing to amount to at least 2 million units (Ministry of Construction and Housing, 2010). The quality of the existing housing stock is deteriorating as a result of the proliferation of substandard informal settlements.

The formation of new households is generating a demand for at least 200,000 units per year, even without accounting for displacement and conflict-related damage. The rapidly growing demand for housing has been fueled by population growth of 3.3 percent annually (between 2010 and 2015) and will likely further accelerate as the average household size continues to decrease (6.5 people per household in 2012, down from 7.6 in 1997). These factors will create the need for at least 3 to 3.5 million new units by 2020 if the current rate of housing construction stays the same. In addition, meeting the housing needs of IDPs and re-building the housing stock damaged by conflict will require further substantial investments.

The existing housing stock is of low quality, partly because substandard informal housing has been growing rapidly, with nearly 2.4 million people living in slums. Recent estimates (2014) indicate that 30 to 40 percent of the population lives in very poor housing conditions and that at least 10 percent of housing units are overcrowded and lack proper maintenance (World Bank, 2015h). Up to 90 percent of homes built in the last 30 years are self-constructed and likely to be informal. In Baghdad alone, more than 740,000 people were living in slums in 2013, most of whom had no access to water, sanitation, or other basic public services.

The situation is particularly severe in those governorates where many of the 3.2 million IDPs have sought shelter. The massive inflow of IDPs has created a huge demand for new units (more than 500,000 units), mainly in and around urban areas. Housing supply has not kept pace with demand, and this has put a severe strain on public services, creating tensions between IDPs and their host communities. The return of IDPs to their homes is hindered by the growing number of housing units that have been damaged or destroyed in areas affected by the conflict with Daesh (World Bank, 2015i). A 2015 assessment led by the World Bank in conflict-affected areas found damaged housing units to account for as much as 26 percent of the housing stock in the most affected cities such as Ramadi.

Housing remains unaffordable for many Iraqi families, placing a significant burden on household budgets. The large inflow of IDPs and migrants to urban areas has put substantial pressure on the housing market. In 2012, low-and middle-income families spent over 35 percent of their monthly income on housing, utilities, and maintenance (CSO, 2012). Unable to afford housing, more than half of Iraq's urban population (including the majority of the displaced) live in slum-like conditions (UN Iraq, 2016). On the supply side, weak institutional and coordination capacity, poor land management, centralized urban planning, and a weak housing construction industry have limited the housing supply in the country. Between one-fifth to one-quarter of Iraqi households rent, but very little formal rental stock is produced by the private sector (World Bank, 2014d).

Increasing the availability of affordable housing is important to maintaining social cohesion and preventing further unrest in Iraq. A number of issues need to be resolved in this regard, including enhancing affordability by increasing access to housing finance, improving the targeting of subsidies to reach the lowest income households, and restricting the role played by the government to policymaking and regulation while effectively engaging the private sector to build and deliver housing services.

2. Youths

68. **Iraq's population is one of the youngest in the world, with nearly 50 percent of its population being younger than 19 years old and approximately one-third between 15 and 29 years old.** Iraq's youth population is high by regional and international standards, with 60 percent

being under 25 years old compared to 54 percent in Arab countries and 48 percent in developing countries respectively. A high rate of early marriages and a low level of female educational enrollment, both of which have a direct impact on fertility rates, are partly responsible for this large youth population. Iraq has one of the highest adolescent birth rates in the region with 59 births per 1,000 females, compared to 46 in Egypt, 39.2 in Turkey, and 29.5 in Iran (World Bank, 2015f).

69. The large youth population presents both opportunities and challenges for Iraq's economic development. Young people can add vitality and innovation to the Iraqi economy, yet if not properly integrated, they may constitute a drain on limited national resources. Low levels of education make it difficult for young people to succeed. Over 3.4 million Iraqi youths are out of school, and fully 72 percent of women and 18 percent of men between the ages of 15 and 29 were neither in education nor in employment or training (UNDP, 2014). Among youths aged between 15 and 29 years old, 33.4 percent are illiterate or semi-illiterate, just one-third have completed primary school, 28 percent have finished middle or high school, and only 7 percent have completed post-secondary education. Despite low enrollment and graduation rates, education is an important goal for Iraqi youths,²⁹ but economic factors often prevent them from continuing their education. Youth unemployment is high at 34.6 percent, 57.7 percent for females and 30.8 percent for males. Young people are underrepresented in government jobs, while the weakness and stagnation of the private sector prevents it from being an engine of employment for Iraqi youths (Figure 31).

70. Constraints on their mobility further disadvantage Iraqi youths. The 2005-2007 sectarian war, followed by continued ethnic and religious conflict, has created invisible barriers that separate communities across Iraq. Geographic isolation severely constrains opportunities for all Iraqis, as insecurity prevents them from venturing far beyond their communities. More than 40 percent of those aged between 15 and 24 years old do not enjoy a sense of security in their daily lives.³⁰ Increasingly, in many areas affected by recent conflict, geographic boundaries tend to coincide with sectarian identities, limiting contact between ethnic and religious groups and further reinforcing sectarian divisions.³¹ For many young Iraqis, their geographic location determines their social, economic, and even marital decisions. Geographic isolation facilitates the recruitment of young Iraqis into militias as local strongmen take advantage of community grievances to mobilize youths by giving them a role in the protection of their communities.

71. Poor public services further alienate Iraqi young people from state institutions and increase their distrust of government. Youths have limited interactions with government officials or elected representatives, as most Iraqi public officials are enclosed within the protected Green Zone for security reasons. They judge the government based on the effectiveness of its delivery of public services and security. The National Youth Survey (2009) found that only 6 percent of youths believed that they had the opportunity to voice their opinions and be heard in political institutions.³² Furthermore, in many communities, their only contact with the government is through the Iraqi Security Forces, which is particularly distressing for Sunnis given the largely Shia composition of the military (although in some recently liberated areas Sunni tribes are now more involved in ensuring security). Almost 50 percent of youths said that they have no trust in politics, and just 40 percent

²⁹ Iraq National Youth and Adolescents Survey, 2009.

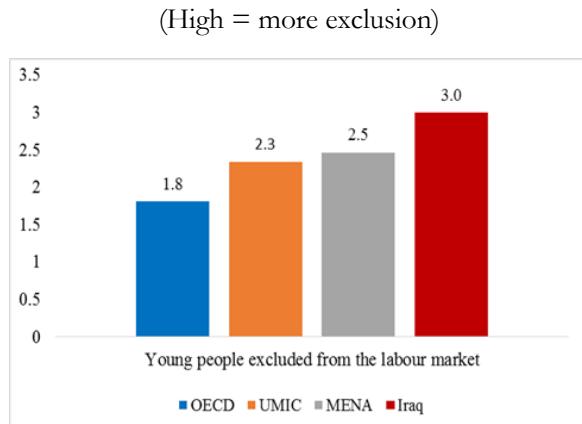
³⁰ Iraq National Youth and Adolescents Survey, 2009.

³¹ International Crisis Group, 2016.

³² Iraq National Youth and Adolescents Survey, 2009.

perceived the value of taking part in social and political life, which indicates high level of youth alienation from civic life long before the current escalation of conflict.³³

Figure 31. Youth Exclusion from the Labor Market



Source: Institutional Profiles Database 2012

72. Youth exclusion (lack of education, employment, trauma, discrimination, and neglect) coupled with mistrust of government authorities has fostered their radicalization and facilitated their recruitment by militias and violent groups. A recent Arab Youth Survey (Burson-Marsteller, 2016) has highlighted the connection between youth unemployment and the potential for radicalization. Almost a quarter (24 percent) of surveyed youths listed the lack of jobs and other opportunities as the main reason for some youths joining Daesh.³⁴ In countries such as Iraq where Daesh has a significant presence, young people have worse perceptions of the economy and of sectarian conflict.³⁵ Militias and extremist groups may fill the void left by the government by offering marginalized youths a sense of identity and opportunities for upward socioeconomic mobility. Low incomes and unemployment reduce the opportunity costs of rebellion.³⁶ Most Iraqi youths who have joined militias or Daesh have few economic prospects and have failed to complete primary or secondary education. As reported by the Iraq Crisis Group (ICG), young militants typically worked in precarious labor conditions and earned no more than ID 25,000 per week (US\$21.4), making it almost impossible to afford even basic rent at ID 200,000 (around US\$180).³⁷ In contrast, Daesh offers young combatants anywhere from US\$400 to US\$1,200 per month, in addition to the authority that youths gain within their communities.³⁸ Youths joining extremist groups circumvent traditional community hierarchies and ascend to positions of power that would be unreachable for them in state institutions. Shia youths have also flocked to join militias for non-financial reasons following the fatwa issued by Iraq's Shia spiritual leader, Ali al-Sistani, which summoned them to volunteer in the defense of the country and their holy shrines. Therefore, while youths have an economic incentive to join sectarian or extremist groups, they also tend to find a sense of purpose as members of these organizations.

³³ Ibid

³⁴ ASDA'A Burson-Marsteller (2016)

³⁵ Ibid

³⁶ World Bank (2011a)

³⁷ International Crisis Group (2016)

³⁸ US Government Congressional Research Service

3. Gender Inequality

73. **Over recent decades, the rights of Iraqi women have been significantly eroded, and their parity with men has been set back in a number of areas.** While the legal position of women is still relatively strong compared with other countries in the region (Box 6), the main constraints are largely economic, social, and cultural as well as being related to the deterioration in security in Iraq. These factors negatively affect girls' and women's participation in education and in the labor force as well their human capital outcomes.

74. **Inequality in access to education in Iraq is largely explained by gender.** One in three girls aged 12 to 14 is not enrolled in school, while one in ten of those in the same age group has never attended school (UNIAU). Nevertheless, over the past decade, gender parity in primary education has improved substantially, and an overall increase in the education attainment of younger generations of women is evident, particularly in Kurdistan. Despite these advances, gross enrollment rates are much lower for girls than for boys by 19, 32, and 15 percentage points in primary, intermediate, and secondary school respectively. Social constraints are the most important in explaining why women have never attended school or have dropped out, with 40 to 50 percent of females in Iraq (with the exception of Kurdistan) citing these as main reasons. These reasons include the prevalence of early marriage, family concerns, parental objections to girls' school attendance, and the expectation that daughters will not be key wage-earners (World Bank, 2014). In some cases, especially in rural areas, schools are simply not within travelling distance for either girls or boys, and this is compounded by the fact that girls are needed at home to work on farms. The lack of intermediate schools that can prepare girls for higher education is another obstacle. According to the National Development Plan, "for every three elementary schools, there is only one intermediate school." With limited places, girls may often simply be left out (UNDP Iraq, 2012). The result is that illiteracy among adult women, at 24 percent, is more than double that among Iraqi men (11 percent).

75. **Illiteracy and limited educational achievement affects all aspects of a woman's life and those of her family.** Low educational attainment among women is correlated with ignorance of health issues and difficulties in accessing professional medical care, low labor force participation and high unemployment, and an increased likelihood of early marriage – setting in motion a vicious cycle of exclusion and lack of opportunity. Despite a legal prohibition on forced marriages and on early marriages for girls under the age of 18 without judicial consent, families often agree to marriage on behalf of their children. There are many reasons why families marry girls off at early ages, but early and forced marriages are often the outcome of poverty. Young girls or women are married off to reduce stress on their family's resources and in return for compensation that helps the family to purchase basic commodities (UNDP 2012). Nearly one-third of Iraqi girls are married before the age of 18, with 5 percent married by the age of 15, and start having babies shortly thereafter. Early motherhood is strongly correlated with poor early childhood nutrition outcomes and stunting (World Bank, 2014).

Box 6. The Erosion of Women's Rights in Iraq

The push for gender equality in Iraq has its roots in the 1920s when Iraqi women's organizations began to lobby for social, economic, and political parity with men. The gains in girls' education during this period are illustrative of the impact of the movement. The first school for girls was opened in 1889 with 95 pupils, and by 1930 there were 11,000 girls attending 45 public and private primary girls' schools. A secondary school was opened in 1929, and the first women were admitted to the medical college and law school in Baghdad in the 1930s (Efrati, 2008). The passage in 1959 of the Code of Personal Status, a landmark in Iraqi women's rights, was a key achievement of the women's movement. The Code instituted a minimum age for marriage (18 years old), restricted polygamy and divorce, and substantially reformed inheritance laws. That same year the Qasim government appointed a woman as Minister of Municipalities, the first woman to hold a ministerial position in the Arab world.

After the nationalization of the oil industry in 1972 under the Baath regime, Iraq's burgeoning economy faced labor shortages that women were encouraged to fill. The incentive was a host of labor and employment laws, including compulsory and free primary education for both girls and boys, the eradication of illiteracy, civil service jobs, equal pay for equal work, and maternity benefits. By 1980, girls represented 45 percent of primary students, up from 29 percent in 1970, and accounted for 31 percent of secondary and tertiary students. Women constituted a significant proportion of students and professionals in medicine, engineering, teaching, and in the civil service. The share of women in the non-agricultural labor force rose from 7 percent in 1968 to close to 20 percent by 1980 (Al-Sharqi, 1982 and Lasky, 2006). This dynamic continued in the 1980s as the Iran-Iraq war created severe labor shortages. Women's share in the labor force had risen to 25 percent by 1984 (Efrati, 1999).

Women attained the right to vote in 1980, and in 1986 Iraq ratified the Convention on the Elimination of all Forms of Discrimination Against Women (CEDAW), although it maintained reservations on a number of articles, especially those in relation to women's and girl's rights within the familial structure on the grounds that these are largely dictated by Islamic law (HRW, 2003).

However, in the late 1980s these advances in women's status were reversed as a result of a combination of factors. Saddam Hussein's decision to embrace Islamic and tribal traditions as a political tool to consolidate power was a key factor, leading to the introduction of decrees and legislation that weakened women's legal status in the labor code, as well as in the criminal justice system and personal status laws. As the economy constricted, in an effort to ensure employment for men, the government pushed women out of the labor force and into more traditional roles in the home. The international sanctions imposed on Iraq in the 1990s also had a disproportionate impact on women and girls. The gender gap in school enrollment increased dramatically because families' financial constraints led them to withdraw girls from school to help in the home. Women's freedom to travel abroad was also legally restricted, and formerly co-educational high schools were required by law to provide single-sex education only (Human Rights Watch, 2003).

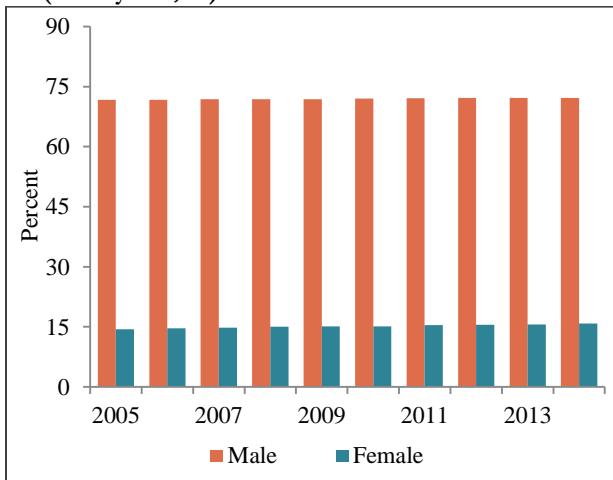
Iraq's current Constitution states that all Iraqis are equal before the law and prohibits discrimination based on sex. Nevertheless, it fails to grant women equal rights within the family. It cites Islam as the basic source of legislation, forbids the passing of laws contradictory to its "established rulings," and allows each religious group to govern its own personal status matters, thus legalizing discriminatory practices with regard to marriage, divorce, child custody, and inheritance (SIGI, 2014). Other discriminatory elements remain in the Tax Code, Personal Status Code, and Penal Code, including assumptions that reinforce women's traditional roles and preclude their full exercise of choice and economic independence, leading to pay inequality between men and women and restrictions on women from working in certain sectors (UNDP Iraq, 2012).

76. **Female labor force participation, at 15 percent, is low even relative to rates in the rest of the MENA region**, which are themselves, at 20 to 25 percent, strikingly low by global standards (Figure 32 and 33). Ninety percent of Iraqi women of working age are not in the labor force. Most of those who do work are employed in part-time jobs, and underemployment for women has increased

over time. Very few women who are not employed and of working age report that they are looking for work (World Bank, 2014). Women's labor force participation rates vary greatly by education level and only approaches parity with men (as well as in employment rates and pay) after they earn a university or college diploma (UNDP Iraq, 2012). For adult women with intermediate or lower levels of education, labor force participation is less than 10 percent, while for those with a secondary education, rates double to 24 percent and increase more than six-fold for those with a secondary and tertiary education, reaching 67 percent (compared to male participation rates of 70 to 75 percent). At the same time, however, there was an 8 percent decline in employment among the most highly educated women between 2007 and 2012, and the most educated women also have the highest rates of unemployment of around 5 to 6 percent (World Bank, 2014).³⁹

77. 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. Women working in the informal economy or private sector are generally excluded from the protections of the labor code as these do not apply to women "who are engaged in a family enterprise in which only family members work and which is under the authority and supervision of the woman's spouse, father, mother, or brother" (UNDP Iraq, 2012). In a 2013 study, only 7 percent of sampled private sector firms reported that a woman was one of its principal owners compared to 34.9, 33.5, and 24.4 percent in Egypt, Lebanon, and Libya respectively (Rimmer, 2013). The agriculture sector (along with public services, see below) has a particularly high share of women, whose participation in the sector has increased from 30 to 50 percent between 1980 and 2010 (World Bank, 2016).

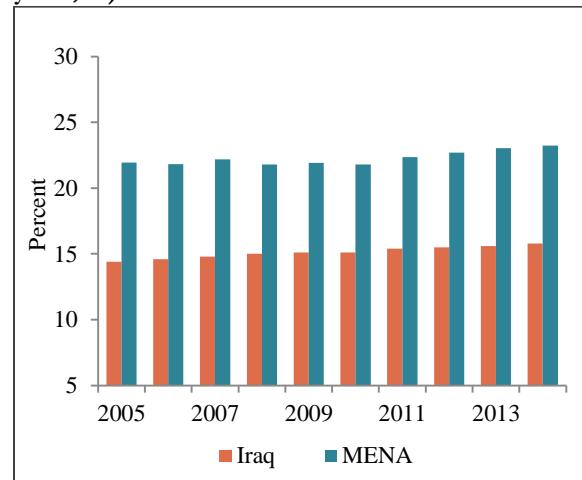
Figure 32. Iraq Labor Force Participation – (15-64 years, %)



Note: Modeled ILO estimates.

Source: World Development Indicators.

Figure 33. Female Labor Force Participation (15-64 years, %)



Note: Modeled ILO estimates.

Source: World Development Indicators.

³⁹ World Bank, World Development Indicators, 2014

78. **Given the lack of private sector opportunities and the sector's poor work benefits, most women who do participate in the labor force choose to seek public sector employment.** Overall, 70 percent of employed women work in salaried employment, and two-thirds of all employed women are employed in the public sector. This is particularly true for those who possess secondary or higher levels of education. Most women's income in the public sector goes to skilled employees (those with a complete secondary education). Public sector jobs pay more than private sector ones and are accompanied by significant benefits. Nearly half of workers in the public administration are women, although few of them are in senior or decision-making positions (UNDP Iraq, 2012).

79. **Irrespective of sector, women earn significantly less than men with similar characteristics, which is a further disincentive to work.** In the public sector, on average, males earned 20 percent more than women in 2012. Human capital characteristics only explained 13 percent of this gap. In the private sector, the wage gap is almost eight times wider than the gap in the public sector, with the bulk of the gap being largely unexplained and therefore perhaps attributable to discrimination (World Bank, 2014).

80. **Women in Iraq have been significantly affected by insecurity.** In addition to imposing restrictions on movement that reduce access to education, health, and jobs, a feature of post-conflict settings with high unemployment and poor overall security such as Iraq is often a high incidence of violence, particularly various kinds of gender-based violence. Nearly half (46 percent) of married women in Iraq are exposed to at least one form of spousal abuse, and humanitarian organizations report a rising trend in the incidence of intimate partner and other domestic violence attributed to forced displacement. The lack of legal recourse for Iraqi women survivors of violence is a particular problem. With the exception of several laws in Kurdistan, Iraqi laws on homicide, domestic violence, and rape specify lesser, alternative, or no penalties when the victim is a woman rather than a man (UNDP Iraq, 2012).

IV. Challenges and Opportunities

81. Oil dependence, ethnic and sectarian fragmentation, weak governance, and insecurity have left their mark on all aspects of Iraqi society and economy. This section focuses on the key challenges, as well as some opportunities, that need to be considered if sustained and inclusive growth and poverty reduction are to be possible: (i) imbuing economic management with longer-term goals to ensure the sustainability of the benefits from Iraq's oil wealth; (ii) strengthening the country's weak institutions to increase their legitimacy, transparency, and accountability; (iii) revitalizing the private sector to enable it to play a greater role in job creation and diversification; (iv) protecting and upgrading human capital, which has declined enormously through the decades of conflict; (v) rebuilding infrastructure to support the economy and poverty reduction; and, critically, (vi) safeguarding and ensuring the sustainability of natural resources to secure the livelihoods and welfare of the population in the coming years. However, making progress in any of these areas will require improving security conditions and strengthening institutions so that they are able to accountably provide necessary basic services. It will be essential to rebuild trust in institutions and resolve the governance failures that have resulted in a state where ethnic and sectarian fragmentation stymies all efforts towards achieving any long-term positive outcomes for Iraq.

A. Economic Management

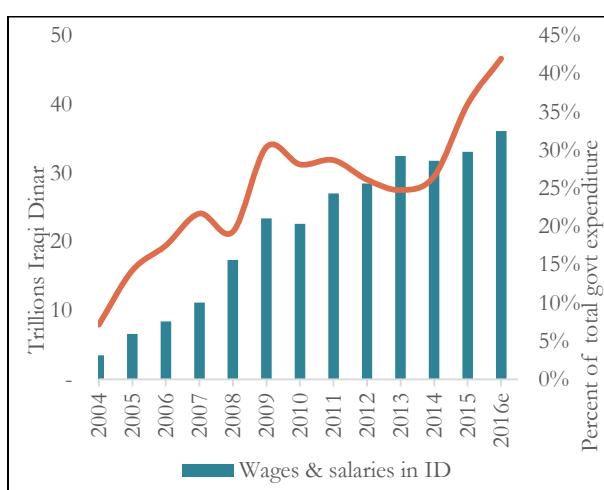
82. Economic management in Iraq is dominated by short-term needs and is focused on the rapid expansion of oil production to finance a large current spending program that is unrelated to any longer-term diversification strategy. This has prevented diversification and has limited essential investment spending at the expense of current outlays. This is not merely a product of the current difficult economic conditions brought about by plummeting of oil prices and increased security spending but characterized Iraqi economic management even in the boom years preceding the global financial crisis. It is a product of the country's weak institutions and an approach to policymaking that views oil revenues and the public sector as the reward for power.

83. Oil revenues are used primarily to fund an enormous public sector, which has had widespread direct and indirect effects on the economy. Wages and compensation account for over 40 percent of total spending because of a generous public sector wage scale and large increases in salaries as well as in the number of employees. Public sector wages have risen sharply in the last decade (Figures 34 and 35), and, as a proportion of GDP, the public wage bill in Iraq is one of the highest in the MENA region. Compounding this are severe weaknesses in payroll management including major gaps in the human resources information systems. The dominance of this type of spending has severely crippled the traded goods sector. The consumption needs of the population are largely met by imports, negating the potentially beneficial impact of government spending on the real economy in terms of the provision of goods and services. Other than wages, public spending consists of a few other key items. Transfers and subsidies account for a further one-fifth of total spending and largely comprise the Public Distribution System (PDS), pensions, and fuel subsidies.⁴⁰ The weaknesses of the PDS and pensions systems are discussed in another section of this report. With the high current expenditures on wages and on security, public investments are limited and have borne the brunt of the fall in oil prices. Moreover, the potential impact of public investment is severely hampered by deficiencies in the selection, implementation, and management of projects, thus perpetuating the

⁴⁰ Implicit fuel subsidies due to below-market pricing are even larger than on-budget subsidies (World Bank, 2014b).

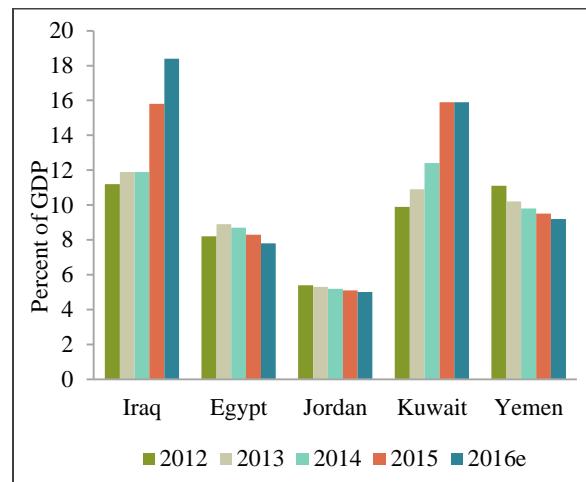
economy's dependence on oil production and revenues. Another notable budget item, albeit one for which data are scarce, is the financing of state-owned enterprises (SOEs), which has constrained private sector development (World Bank, 2012a).

Figure 34. Growth of Public Sector Wages



Sources: Ministry of Finance, Iraq, and IMF staff estimates and projections.

Figure 35. Comparison of Public Sector Wages in MENA Countries



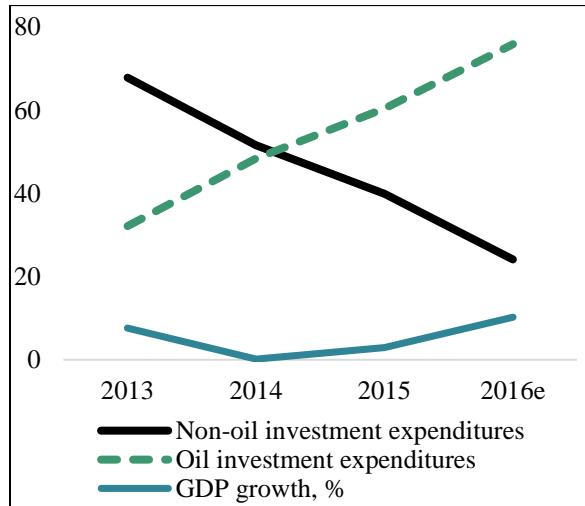
Sources: Iraqi authorities and IMF staff estimates

1. Absence of Oil Revenue and Expenditure Management

84. **Iraq's fiscal institutions are not equipped to deal with the complexities of an oil-dominated budget and are unable to buffer the economy from the impact of oil price volatility.** The absence of any coherent revenue management policies impedes diversification and sharpens the procyclicality of public spending. Given the absence of fiscal buffers or mechanisms to smooth spending, including Iraq's lack of access to capital markets, revenue volatility translates into spending volatility. This procyclicality in public spending has meant that capital expenditures in the non-oil sector have tended to be under-funded and to be subject to a stop-start cycle of activity, which is undermining the economy's long-term development and prospects for diversification (Figures 36 and 37).

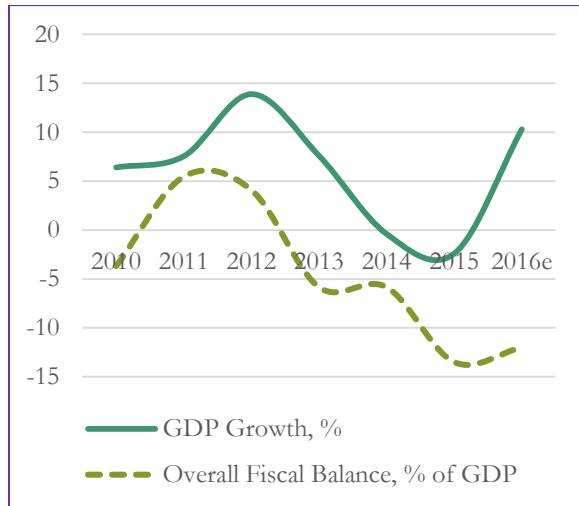
85. **As these trends continue, the non-oil sector is being overwhelmed by the oil sector.** Non-oil sector growth is even more volatile than that in the oil sector and starts from a much smaller base (Figures 38 and 39). It is less integrated with the government and external sectors than oil and is too small and underdeveloped to counteract the incentives and absorption capacity that pull resources towards the oil sector (World Bank, 2012a). Because Iraq's formal economy consists largely of oil and the public sector, all other activities are forced into the informal economy. This is evident from the dominance of the public sector in formal employment, the poor quality of private sector jobs, the meager growth in the non-oil sector, and Iraq's lack of integration into the global economy.

Figure 36. Public Investment, % of GDP



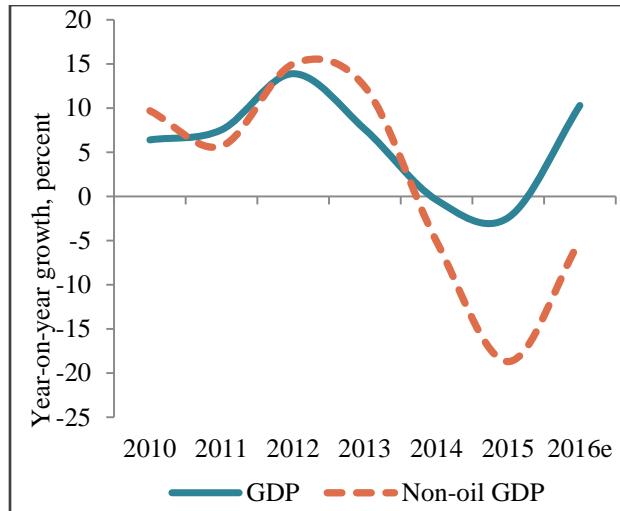
Source: IMF, and World Bank staff estimates.

Figure 37. Pro-cyclical Expenditures



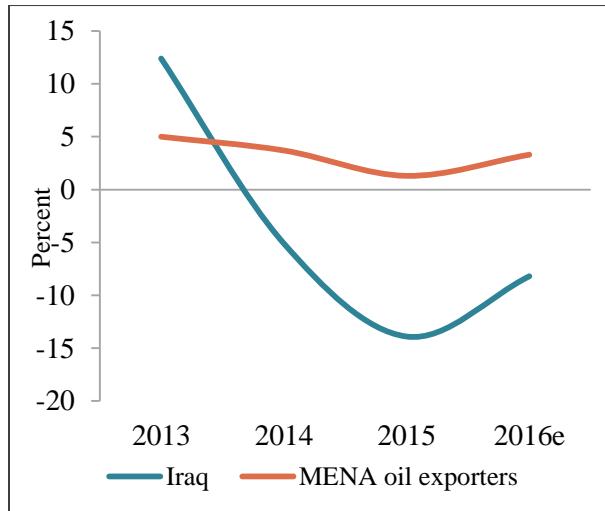
Source: IMF, and World Bank staff estimates.

Figure 38. Non-oil and Total GDP Growth



Source: IMF, and World Bank staff estimates.

Figure 39. Iraq and MENA Oil Exporters



Source: IMF databases

86. Iraq today is allocating the bulk of its revenues to public sector employment and wages as well as to transfers, which has boosted short-term consumption but has also increased the country's import dependence, skewed the labor market structure, and crippled the private sector. While Iraq's current spending needs are large and urgent – public sector wages and transfers constitute a vital safety net for a large number of households – it is as essential to ensure that there is

also a sustainable basis for consumption in future decades. A World Bank study (World Bank, 2012a) showed that the choices about the future use of will have a major impact on the future dynamics in the economy. The study modeled four options for the future use of Iraq's oil revenues: (i) public sector pay and numbers; (ii) public capital; (iii) transfers; and (iv) foreign saving. The underlying dynamic of the model was the tradeoff between consumption and investment and the impact of this tradeoff on key economic sectors. In the near term and given the constraints inherent in the economy, the study concluded that domestic investment will continue to be financed largely by the government. The broadest benefits of diversification in terms of employment and additional revenue sources will be produced by allocating oil revenues to public capital. However, the near-term positive impact of this option is likely to be diminished by deficiencies in Iraq's system of public investment management or adjustment costs. Allocating oil revenues to transfers or to foreign saving will increase consumption but will not transform the economy because the lack of capital accumulation leaves the economy increasingly dependent on imports.

87. Investing in public capital would raise labor productivity, increase wages, and sustainably increase output and consumption. Any adjustment costs could be reduced in the near term by creating an overseas transitional saving or "parking" fund where a portion of revenues would be set aside while the public capital stock was being increased. The offshore parking fund would avoid the steepest phase of adjustment costs, which otherwise would claim more than 50 percent of every dinar spent on public investment. The implicit assumption is that improvements in public investment and expenditure management would take place simultaneously. This approach would be preferable to a fiscal rule, a concept that has met with limited success in resource-exporting countries with stronger institutions than Iraq's due in part to the difficulties inherent in responding to a rapidly shifting structural environment. Implementing a binding annual fiscal rule targeting deficits or debt linked to medium-term revenue projections seems unrealistic in the Iraqi context, which is characterized by substantial structural changes and oil price volatility. It might be more promising to develop a functional medium-term fiscal framework, a debt management strategy, and a strong PFM system (World Bank, 2012a).

88. The oil revenue boom of the early and mid-2000s was not able to meet the expectations placed upon it because Iraq's governance framework had led to fragmented policies focused on short-term gains. Overall, the role played by the Iraqi state in the economy is misaligned. It struggles to provide basic services such as security, water, and electricity, while at the same time constraining private sector development by dominating the administrative and operational landscape. As is discussed elsewhere in this report, the private sector needs to be given the opportunity to become an integral player in Iraq's economy and development. The challenge of expenditure smoothing, productive investment, and diversification cannot be met by fiscal policy and public investment alone; they need to be supported by a flexible non-oil economy. This should include: (i) a financial sector that can diversify funding sources for investment and act as a shock absorber; (ii) a labor market and private sector capable of creating sufficient numbers of high quality jobs; and (iii) an investment climate that promotes private sector activity. Today, the private sector is being crowded out by the massive public sector, an exceedingly weak business environment, and a financial sector that does not play any developmental role in the economy. The formal private sector is squeezed between SOEs that have hindered the functioning of product and factor markets and an informal sector with lower costs. Making progress on these issues will require the government to tackle the governance failures that have turned the public sector into a space for extracting rents and for sectarian influence.

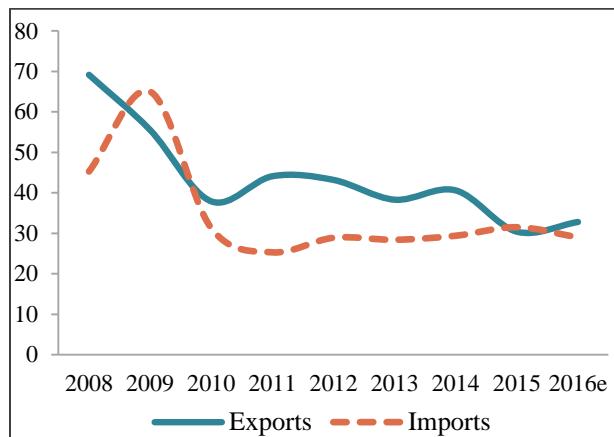
2. Diversification and Trade

89. **What is the potential for diversifying Iraq's economy?** The legacy of conflict and state dominance make any assessment difficult. On the positive side, Iraq has a fairly varied geography and climate, enhancing the scope for both agriculture and tourism. Also, the country's population of over 30 million allows for skills specialization as part of a diversification strategy that would not be available to a smaller country, and Iraq was more diversified in the relatively recent past. Yet the obstacles are numerous as this report illustrates, going well beyond the current security constraints. The potential of Iraq's rivers and agricultural production has been degraded by environmental neglect and upstream diversion by Iraq's neighbors. Economic policies have been devoted to maintaining short-term crude oil production levels and ensuring the availability of essential imports at the cost of other activities and a longer-term perspective. Iraq's human capital has been eroded as the education and health systems have suffered from decades of sanctions, conflict, and poor administration, the blunt implementation of de-Baathification, and a massive brain drain of skilled Iraqis. Nevertheless, the World Bank's Country Economic Memorandum for Iraq (World Bank, 2012a) highlighted some sectors that have the potential to lead any diversification strategy, albeit with significant reservations – agriculture, tourism (particularly religious tourism), the energy sector, and petrochemicals. However, this will require massive investment in physical and human capital, a new role for the public sector, and an expanded private sector capable of meeting the challenge.

90. **Iraq is less integrated into the world economy today than it was just a decade ago.** The ratio of imports and exports to GDP – a broad measure of a country's integration into the world economy – declined by more than half from 120 percent in 2004 to 50 percent in 2014 (Figure 40). A sharp decline in the share of both exports and imports as a percentage of GDP lies behind this trend. The fall in oil prices during the financial crisis, followed by the most recent declines since 2014, have had a considerable negative impact on trade volumes, although the statistics also highlight the inability of the economy to tap into new products and markets. Iraq has not managed to develop many export products besides oil. As illustrated by Figure 41, Iraq has the lowest number (332) of export products among its comparators and significantly lags behind other OPEC countries with similar per capita incomes. The number of exported products in Iraq is also significantly lower than in other countries in the region with smaller economies like Kuwait and Qatar. While Iraq's reliance on oil is not new – crude oil accounted for 96 percent of its exports in 1980 – the export basket was more diversified and included a number of industrial products, including food processing, textiles, mechanical parts, and chemicals and fertilizers, as well as a wider range of agricultural products. Today, in contrast, gold products represent over 75 percent of non-oil exports (see Annex 2).

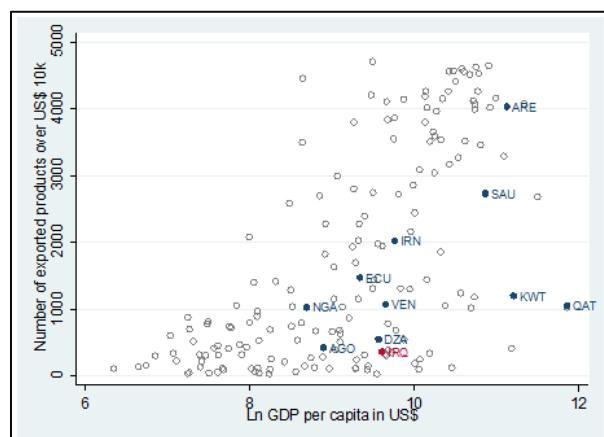
91. **The case for increasing Iraq's integration with its neighbors is compelling in terms of supporting its growth and diversification.** Integration would increase its market size without which achieving and sustaining productivity growth would be difficult. Yet progress on integration has been stalled for decades because of geopolitics and rivalries, including the Iran-Iraq war, the invasion of Kuwait, developments in Kurdistan, and more recently the civil war in Syria, as well as rivalries between regional powers. Iraq is also not a member of the World Trade Organization (WTO) member and thus lacks a number of basic disciplines and institutional structures for trade development (World Bank, 2012a).

Figure 40. Exports and Imports, % of GDP, 2004-2014



Source: IMF, and World Bank staff estimates

Figure 41. Number of Exported Products and Per Capita GDP (US\$ PPP)



Source: World Development Indicators and UN COMTRADE.

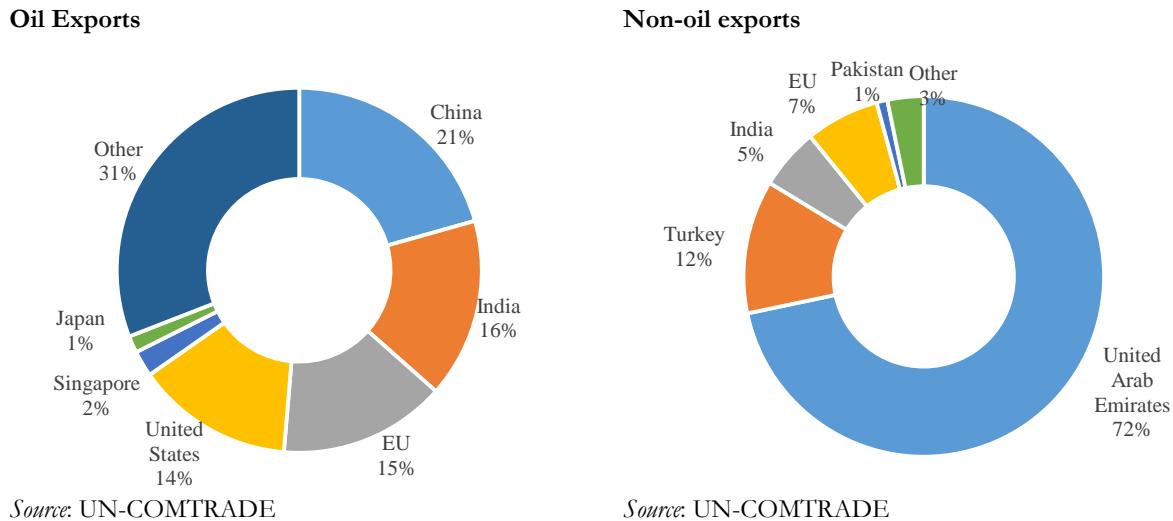
92. **With respect to trade in particular, the potential for the geographical diversification of Iraqi exports remains largely untapped, especially within the region.** In spite of a number of regional and bilateral trade agreements, Iraq's trade and investment flows with its regional trading partners remain limited, even though the benefits of expanding economic ties in the region would be significant (World Bank, 2014c). The UAE has emerged as the main destination of Iraq's non-oil exports, and Turkey has remained an important partner. However, a decade ago Jordan was the second largest importer of Iraqi goods, with Morocco being another key partner, but these ties have not survived. Iraq's oil exports are more diversified in terms of destinations than non-oil exports, with no country accounting for more than one-quarter of Iraqi exports, which are distributed as far afield as North America, Europe, and South and East Asia (Figure 42). By contrast, the majority of non-oil exports are shipped within the region, with the vast majority going to either the United Arab Emirates (72 percent) or Turkey (12 percent).

93. **The potential of the services sector and services trade has also remained largely untapped in Iraq.** As illustrated in Figure 43, Iraq was an outlier in the MENA region in terms of the contribution of services trade to GDP as of 2012, with a share less than half that of the MENA region average of 16 percent, and even relative to other fragile and conflict affected countries (13 percent). The margin for growth is therefore significant. Moreover, the services sector and services trade are essential inputs into any form of production, as well as a major component of any country's connectivity, which makes them a key determinant of Iraq's competitiveness and essential to growth and diversification in the country. Services could also become an important source of exports outside the oil and gas sector as well as a source of jobs as has been the case for other countries in the region.⁴¹ Beyond the economic dimension, reforming the regulatory framework and improving the supply of

⁴¹ For example, countries of the Gulf Cooperation Council have heavily invested in services sectors such as retail and wholesale trade, tourism and hospitality, finance, and construction, which is likely to contribute more than 60 percent of their GDP growth and jobs creation (McKinsey, 2015).

services would be of immense benefit to Iraqis. The major gaps in the delivery of vital services such as health care and education have resulted in Iraqis seeking services abroad, resulting in higher costs for both consumers and the state.

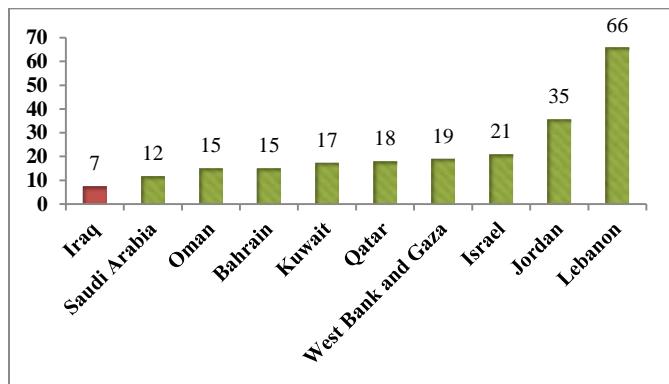
Figure 42. Share of Exports by Destination, 2014



Source: UN-COMTRADE

Source: UN-COMTRADE

Figure 43. Trade in Services, 2012, % of GDP



Source: World Development Indicators, 2016

94. **From a policy perspective, a number of obstacles – at and behind the border – affect Iraq's capacity to harness the benefits of trade integration.** Iraq's restrictive trade policies such as import bans, excessive import duties, and licensing requirements are not only impediments to trade but create considerable opportunities for corruption. While Iraq made a significant step forward in 2010 by adopting a new tariff schedule, the number of non-zero bands need to be reduced and tariffs lowered. Iraq lags behind its peers in terms of trade facilitation, including customs efficiency, transport, and logistics, and ranks well behind both its regional peers and other middle-income countries in the efficiency of its trade logistics. This is evident in the World Bank's Doing Business's "Trading Across Borders" indicator, which ranks Iraq at 178 out of 189 economies as of 2016 (Table 7). The indicators measures the time and cost associated with the logistical process of exporting and importing (e.g. in

terms of documents, procedures, and infrastructure). In transport, customs, competition, and other areas, regulations have been adopted to improve the situation but have not been implemented, often due to a lack of resources. The country's legislation on transport and logistics is out of date as is its deteriorating infrastructure, which is increasing trade costs and delays. These factors combined with slow and costly procedures for export and import licensing and the low skills of the workforce all contribute to a poorly developed logistics chain and consequently poor service delivery. Informal cross-border trade of both imports and exports is extensive, which undermines the incentives for firms to take part in formal trade. In the case of services, there are many restrictions beyond the border that pose a disincentive for foreign professionals to work in Iraq such as the conflicting requirements of different local authorities, nationality requirements, a lack of equivalence for diplomas, residency requirements for visas, and restrictions on the performance of audits by foreign firms and professionals. Removing these would help to unleash the potential of this sector and create local jobs and growth.

Table 7. Trading Across Borders

Indicator	Iraq	Middle East & North Africa	OECD high income
Time to export: Border compliance (hours) ①	69	65	15
Cost to export: Border compliance (USD) ①	1,018	445	160
Time to export: Documentary compliance (hours) ①	504	79	5
Cost to export: Documentary compliance (USD) ①	1,800	351	36
Time to import: Border compliance (hours) ①	131	120	9
Cost to import: Border compliance (USD) ①	644	594	123
Time to import: Documentary compliance (hours) ①	176	105	4
Cost to import: Documentary compliance (USD) ①	900	385	25

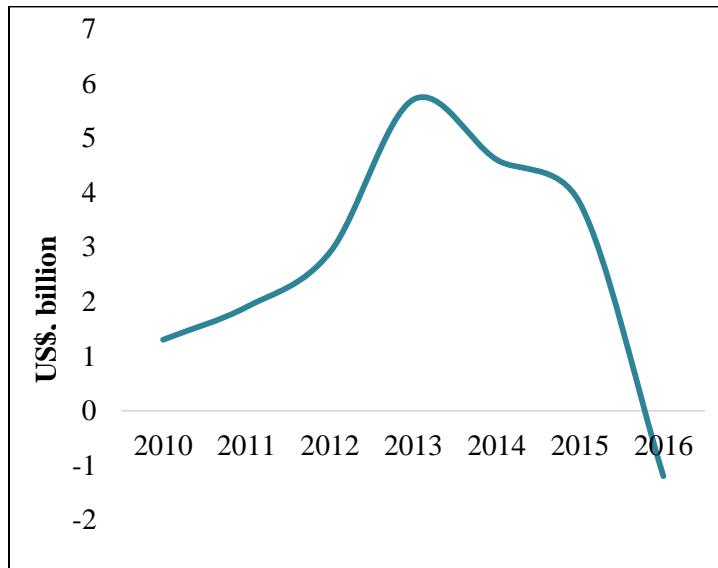
Source: World Bank, Doing Business, 2016

95. Foreign direct investment (FDI) is a crucial ingredient for both trade and diversification, and Iraq had been relatively successful in attracting it until the recent collapse in oil prices and upsurge in violence (Figure 44). Between 2004 and 2013, Iraq had experienced a tenfold increase in FDI inflows (Figure 45). In 2013 FDI inflows stood at close to US\$6 billion, an amount similar to inflows to significantly larger economies such as Egypt and Nigeria. Iraq's FDI was also the second largest as a share of GDP (3.1 percent) among the OPEC countries behind Angola (Figure 46). While the bulk of FDI was received by the oil and construction sectors, other sectors also benefitted including transport, energy, and real estate. Moreover, the magnitude of these flows indicates that Iraq is capable of attracting large amounts of foreign capital as well as skills, technology, and international business networks not available domestically.

96. Nevertheless, in Iraq, as in other countries affected by fragility, conflict and violence (FCV), perceptions of political risk influence FDI even more than security concerns, highlighting the importance of tackling governance-related weaknesses. Following the sharp increase between 2010 and 2013, FDI flows into Iraq began to decline. A survey conducted in July 2010 of 60 multinational enterprises that had investments in at least one FCV country explored investors' attitudes towards political risk. Clearly, political risk must be a far more salient issue for investors in FCV countries than for those operating in other developing markets. Somewhat

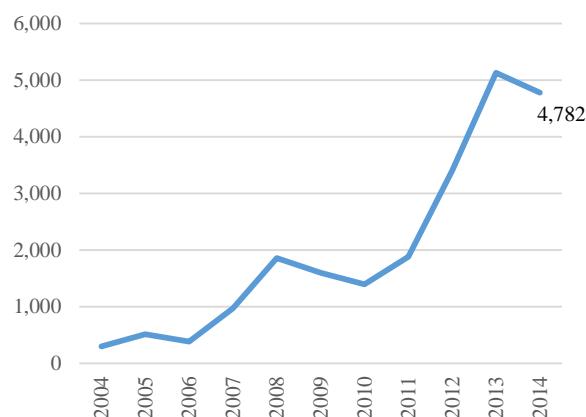
surprisingly, the survey showed that foreign investors in FCV countries are more concerned about adverse government interventions such as regulatory changes, failure to honor sovereign guarantees, currency restrictions, expropriation, and breaches of contract than they are with political violence, war, civil disturbance, or terrorism. Weak institutions, a breakdown in the rule of law and in judicial systems, poor public finances and high levels of corruption all discourage FDI. Other concerns expressed by foreign investors in the survey included the possible destruction of assets resulting from the conflict itself, the lack of inputs or workers with the necessary skills because of a lack of infrastructure, weak institutional and regulatory frameworks, and abrupt declines in domestic demand or lasting impoverishment that persists beyond the end of hostilities. Iraq's oil sector, oriented as it is towards exports, would not be affected by demand shocks, and, while in theory extractive sector investments are particularly vulnerable to asset destruction because of their capital intensity, the concentration of those assets in a small number of locations potentially makes them easier to secure, which reduces the risk of them being destroyed. However, all of these concerns would apply to investments outside the oil sector, diminishing the potential for FDI to contribute to diversification until Iraq's institutions and governance are strengthened.

Figure 44. Fall in FDI Inflows into Iraq since 2014



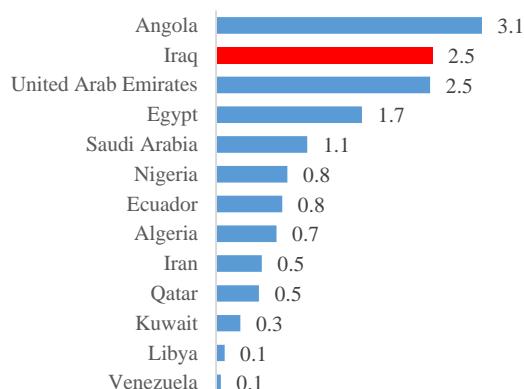
Source: World Bank and IMF staff estimates.

Figure 45. Iraq FDI Inflows, US\$ million



Source: UNCTAD

Figure 46. FDI Inflows, 2014, %



Source: UNCTAD

97. While FDI inflows into sectors other than oil and gas are needed, oil and gas could serve as a stepping stone for the diversification and upgrading of the economy. Participating in global value chains can provide Iraq with capital, technology, and skills transfers and would be an important step towards upgrading the economy. Maximizing such benefits and spillover effects to other sectors is key. The oil and gas value chain is a long and complex one, from production to marketing and upstream services including technology and signal processing, geotech-analysis, exploration, evaluation, and delineation, legal evaluation (for example, acquisitions and contracts), technical and market evaluation (financial risk management), and facility development. The inputs required at the production stage include not just goods and physical infrastructures (such as machinery, tools, pipelines, and supplies) but also services. These services are extremely broad in scope, ranging from accommodation and health services for workers to transportation and marketing. Later stages include refineries and businesses to transform oil into intermediate products (such as chemicals) and finished products (from clothing to food and health products). Through workforce and local enterprise development, these services, whether free-standing or embedded in other goods and services (e.g. transport, professional services) could contribute to increasing the competitiveness of Iraq's economy. Today's enclave model for oil and gas development, self-contained and with few linkages to Iraq's non-oil sectors, militates against harnessing these spillovers to the rest of the economy, although it is necessitated by security and service delivery concerns.

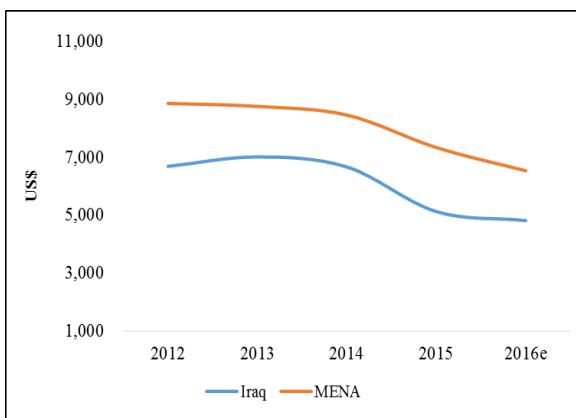
3. Near-Term Challenges

98. Iraq's overwhelming dependence on oil revenues and the absence of revenue management and expenditure smoothing mechanisms has made the economy extreme vulnerable to a sudden decline in oil prices, as has been seen since 2014. The recent fiscal shock due to the massive fall in oil prices and the Daesh conflict has had a significant impact on Iraq's economy. Per capita GDP has contracted markedly, falling from US\$6,672 in 2014 to an estimated US\$5,127 in 2015 (Figures 47 and 48). After strong growth that averaged 8 percent in the four years up to 2013, Iraq's economic growth decelerated to 0.1 percent in 2014 and then expanded by 2.9 percent in 2015 as a result of a 19 percent increase in oil production, which included the KRI's oil

production (Figure 49). In 2016, GDP growth is expected to have reached 10 percent, sustained by the continued expansion of oil production. The non-oil economy, however, is bearing the brunt of the twin shocks, and has contracted for three consecutive years as the economic crisis, violence, and political instability have undermined consumer confidence, decelerated private sector consumption and saving, and constrained non-oil public investment. Oil investment increased from 48 percent of total public investment in 2014 to a projected 76 percent in 2016, while non-oil investments have declined. Continued insecurity and the fall in oil prices have resulted in a sharp decline in FDI.

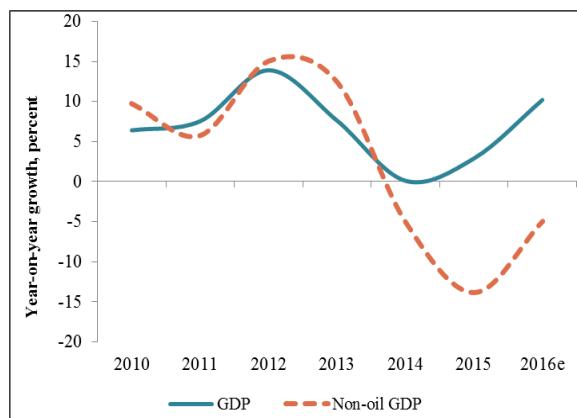
99. Lower oil revenue coupled with high humanitarian and security spending have rapidly widened the fiscal deficit. It stood at 12.3 percent of GDP in 2015 and was projected to be 8 percent in 2016, up from about 5 percent of GDP in 2014 (Figure 49, Table 8). Oil prices, which fell from an average of US\$96.5 per barrel in 2014 to US\$35.5 in 2016, have resulted in a sharp reduction in government revenues. The government has had to rely on increased volumes of oil exports to partially compensate for the fall in prices. On the expenditure side, the government cut non-oil capital investment and prioritized the more rigid elements of spending – wages, pensions, security, and debt service. Oil-related investments have also been protected in order to safeguard export volumes. Due to its limited financing options, the government has also had to resort to additional domestic and external financing and a buildup of arrears (estimated at 6.1 percent of GDP) to bridge the financing gap.

Figure 47. Impact of Twin Shocks on Growth



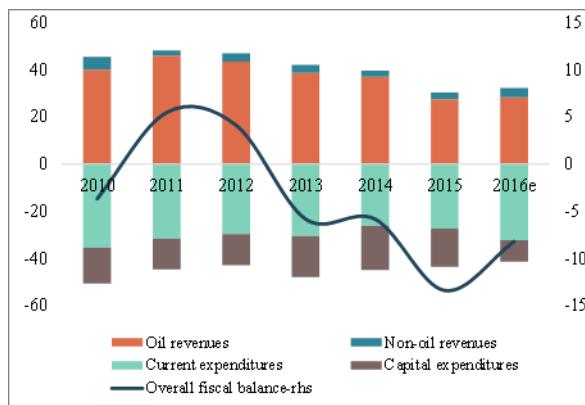
Source: IMF and World Bank estimates

Figure 48. Economic Disruption and Contraction in Per Capita GDP



Source: IMF and World Bank estimates

Figure 49. Deterioration of the Fiscal Balance



Source: IMF and World Bank estimates

100. **Public debt has grown rapidly.** While Iraq's financing needs are large, it has limited sources of financing. Because the country has historically run budget surpluses, it has not developed a treasury bond market and has not issued bonds over the past decade. The deficits are largely being financed by domestic bank financing; in 2016 most of this will be refinanced at the discount window of the Central Bank of Iraq given the liquidity constraints of the banking sector. This domestic financing would be reversed if external financing from IFIs were to become available. Iraq's total debt was projected to increase to 63 percent of GDP by the end 2016, up from 33 percent of GDP in 2014 and 56 percent of GDP in 2015. Assuming continued growth and narrowing fiscal deficits, debt is expected to have peaked in 2016 and to decline thereafter. However, debt levels are sensitive to shocks, particularly to GDP growth, and the primary balance and external debt remains highly vulnerable to a current account shock, such as a further reduction in oil prices or a real exchange rate depreciation.

101. **Because of the need for increased domestic financing, the government has had to draw on its foreign exchange reserves to finance imports.** Oil export revenues decreased to about US\$49 billion in 2015, down from over US\$84 billion in 2014. Combined with rising security-related imports, this resulted in a current account deficit of 6.1 percent of GDP in 2015 compared with a surplus of 2.7 percent of GDP a year earlier. The current account deficit was projected to further increase to 6.8 percent in 2016. To partly finance this deficit, the government has drawn on its international reserves, which have declined from about US\$67 billion at the end of 2014 to US\$54 billion at the end of 2015 and are expected to have fallen further to US\$43 billion by the end of 2016. The strong reserve accumulation during the period 2010 to 2013 has helped to smooth the pace of contraction in domestic demand and in fiscal policy. Iraq's external position could be improved if higher oil prices follow OPEC countries' decision to cut oil production.

Table 8. Key Macroeconomic Indicators, 2013-2019

	2013	2014	2015	2016		2017	2018	2019
				Est.	Proj.			
Economic growth and prices								
Real GDP (percentage change)	7.6	0.1	2.9	10.2	1.1	0.7	1.1	
Non-oil real GDP (percentage change)	12.4	-5.1	-13.9	-5.0	3.0	2.0	3.0	
GDP deflator (percentage change)	0.0	-2.6	-23.4	-11.5	9.7	6.4	4.7	
GDP per capita (US\$)	7,021.0	6,672.0	5,127.0	4,818.0	5,200.0	5,434.0	5,608	
GDP (in ID trillion)	273.6	266.7	210.2	205.1	227.4	243.8	258.0	
Non-oil GDP (in ID trillion)	148.0	142.6	140.3	139.0	149.3	158.8	170.6	
GDP (in US\$ billion)	234.6	228.7	180.3	173.8	192.4	206.2	218.3	
Oil production (mbpd) 1/	3.0	3.1	3.7	4.5	4.5	4.5	4.5	
Oil exports (mbpd) 2/	2.4	2.6	3.4	3.8	3.8	3.8	3.8	
Iraq oil export prices (US\$ pb)	102.9	96.5	45.9	35.5	42.0	45.7	47.0	
Consumer price inflation (percentage change; end of period)	3.1	1.6	2.3	2.0	2.0	2.0	2.0	
Consumer price inflation (percentage change; average)	1.9	2.2	1.4	2.0	2.0	2.0	2.0	
(In percent of GDP)								
National Accounts								
Gross domestic investment	26.9	25.9	24.3	17.4	20.2	18.7	18.2	
<i>of which:</i> public	17.4	18.4	15.1	8.1	11.2	9.9	9.2	
Gross domestic consumption	69.5	69.6	81.7	89.3	86.6	85.0	84.5	
Of which: public	21.0	18.5	22.3	25.7	23.5	21.7	20.3	
Gross national savings	28.1	28.6	18.2	10.6	13.4	12.5	15.3	
Of which: public	11.2	13.1	2.8	-0.1	4.4	4.5	7.7	
Saving - Investment balance	1.1	2.7	-6.1	-6.8	-6.8	-6.2	-2.9	
(In percent of GDP, unless otherwise indicated)								
Public Finance								
Government revenue and grants	42.2	39.1	30.2	32.2	34.8	35.1	34.3	
Government oil revenue	38.6	36.9	27.4	28.3	30.1	30.6	29.7	
Government non-oil revenue	3.5	2.2	2.8	3.9	4.6	4.5	4.6	
Expenditure, of which:	48.0	44.9	42.5	40.4	41.8	40.5	36.0	
Current expenditure	30.6	26.1	27.4	32.3	30.6	30.6	26.8	
Capital expenditure	17.4	18.4	15.1	8.1	11.2	9.9	9.2	
Overall fiscal balance (including grants)	-5.8	-5.4	-12.3	-8.2	-7.0	-5.4	-1.8	
Non-oil primary fiscal balance (percent of non-oil GDP)	-67.6	-58.6	-45.0	-43.1	-45.4	-41.2	-37.6	
Memorandum items:								
Total government debt (in percent of GDP) 3/	31.2	32.6	54.9	61.3	61.9	63.1	61.4	
Total government debt (in US\$ billion) 3/	73.1	74.6	97.8	106.6	119.1	130.2	134.0	
External government debt (in percent of GDP)	25.3	25.2	36.7	37.8	38.2	40.3	38.7	
External government debt (in US\$ billion)	59.3	57.6	66.1	65.7	73.5	83.2	84.5	
(In percent, unless otherwise indicated)								
Monetary indicators								
Growth in reserve money	12.6	-9.6	-12.6	2.2	-2.0	8.5	8.5	
Growth in broad money	15.9	3.6	-9.0	5.1	3.0	8.5	9.2	
Policy interest rate (end of period)	6.0	6.0	6.0	
(In percent of GDP, unless otherwise indicated)								
External sector								
Current account	1.1	2.7	-6.1	-6.8	-6.8	-6.2	-2.9	
Trade balance	9.9	11.2	-0.1	-0.8	-0.4	1.8	2.4	
Exports of goods	38.3	40.6	31.3	28.3	30.1	30.5	29.7	
Imports of goods	-28.4	-29.4	-31.5	-29.0	-30.5	-28.8	-27.3	
Overall external balance	-1.3	-10.3	-7.1	-3.5	-2.3	-3.3	-0.3	
Gross reserves (in US\$ billion)	77.8	66.7	53.7	43.0	38.5	38.1	37.3	
In months of imports of goods and services	10.8	10.9	9.6	6.7	5.9	5.8	5.6	
Exchange rate (dinar per US\$; period average)	1166.0	1166.0	1167.0	
Financing gap (US\$ billion) 9/	0.0	0.0	0.0	0.0	0.0	6.5	0.6	

Sources: Iraqi authorities; and IMF and World Bank staff estimates and projections.

1/ Does not reflect KRG production during 2013 and 2014.

2/ Reflects KRG exports through State Organization for Marketing Oil (SOMO).

3/ Includes arrears.

4/ Positive means appreciation.

B. Weak Public Sector Institutions

102. **Good governance and strong, accountable, institutions are essential to restoring the legitimacy of the state and to reducing poverty and boosting shared prosperity.** They create an enabling environment for sustained economic growth that helps to reduce poverty, they allow the effective implementation of social and distributive policies that promote social, economic, and human wellbeing and development, and they protect the population from economic and social exclusion, thereby boosting shared prosperity. In fragile and conflict-ridden countries, governments often lack the capacity, accountability, and legitimacy to credibly perform their important functions such as guaranteeing security, resolving conflicts, and delivering public goods and services.

103. **Iraq's public sector institutions have not been successful in equitably allocating resources across the country and its population because for decades they have been captured by sectarian interests and decimated by corruption.** The politicization of state institutions and the pillaging of state resources have undermined the effective and equitable delivery of services, thus exacerbating the crisis of legitimacy, the challenges to state authority, and, ultimately, the spiral of violence that we see in Iraq today. As noted in the 2011 World Development Report, weak institutions and a lack of legitimacy undermine states' ability to provide basic security, justice, and economic opportunities for their citizens and can therefore be a key cause of conflict (World Bank, 2011a). This holds true in Iraq, where the fragility of key public institutions and processes is reflected most starkly in the chronically weakness of its civil service, public financial management, state-owned enterprises, public investment management, and judicial system.

1. The Civil Service

104. **The public sector has been the predominant formal employer in the country since the beginning of the Republic, as, with few exceptions, private sector firms were and continue to be small and informal.** De-Baathification and the exodus of tens of thousands of the most qualified employees due to conflict and violence intensified the disintegration of the public sector, which was already severely weakened by wars and sanctions in the 1980s and 1990s. Employment and promotion in the civil service have become increasingly non-meritocratic, and the sector has come to be viewed as a *de facto* social safety net. Iraqis queue for a secure job in the public sector, often for months or years, because of the job security, higher salaries, and benefits as well as one of the most generous pension systems in the world⁴² (World Bank, 2015c). However, this degree of employment generation by a large public sector is unsustainable. In the long term, sustainable jobs will only be created in an attractive investment climate and a predictable, low-cost business environment that enables the growth of a robust and productive private sector.

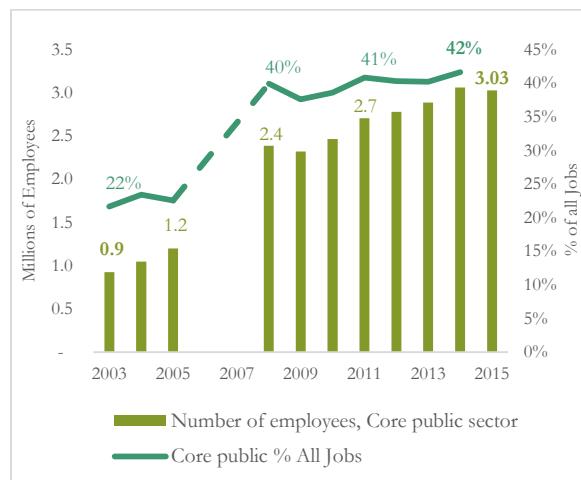
105. **In addition to undermining the quality of the civil service, the dramatic rise in clientelistic hiring since 2003 has contributed to a ballooning of public sector employment and of the wage bill.** Between 2003 and 2015, the core public sector (i.e. excluding SOEs) expanded from 0.9 million to over 3 million employees, making it the country's largest single employer, providing approximately 42 percent of all jobs in Iraq (Figure 50). Adding in SOE employees would bring total employment in the public sector to 3.5 million, close to one half of all of the jobs in the country. The core public sector wage bill, estimated at approximately US\$30.5 billion (ID 36.1 trillion) in 2016, has

⁴² An increase of 1 percentage point in the public employment rate of young person's governorate of birth reduces the labor force participation of that youth by more than 40 percent from already low levels (World Bank, 2014).

become both the single largest and fastest-growing expense item in the government budget. Between 2004 and 2016, expenditure on core public sector wages and salaries expanded by almost 940 percent, while the share of the wage bill in the overall government budget grew six-fold from 7 to over 44 percent, representing 18 percent of GDP in 2016⁴³ (Figure 51). This is extremely high by global standards, even when compared to oil exporters and other MENA countries.

106. Because of a lack of effective human resource information systems and oversight in the relevant ministries, there has been a rampant use of favoritism in hiring and promotions. Audits have uncovered thousands of ghost workers and workers illegally receiving two salaries. While some agencies have tried to introduce competitive recruitment procedures, in many instances recruitment is used to further political and sectarian agendas. This dynamic is reflected in indices of meritocracy and favoritism in public sector hiring. In Iraq merit matters far less for promotion and social mobility than in OECD countries, in UMIC, and even in other MENA countries on average, while networks and favoritism matter far more (Figure 52). Meanwhile, the government's strategy of using expanded hiring and generous *ad hoc* wage hikes to gain popular support in the context of an ailing economy has compounded the country's problems over the medium and long term. Not only is the bloated public sector fiscally unsustainable, particularly in the wake of falling oil prices, but it has also provided workers with a disincentive to consider private sector employment, which is already depressed due its lower average wages,⁴⁴ job security, and benefits.

**Figure 50. Core Public Sector Employment
2003-2015**



Source: Iraq Ministry of Finance and World Development Indicators

Figure 51. Government Wage Bill

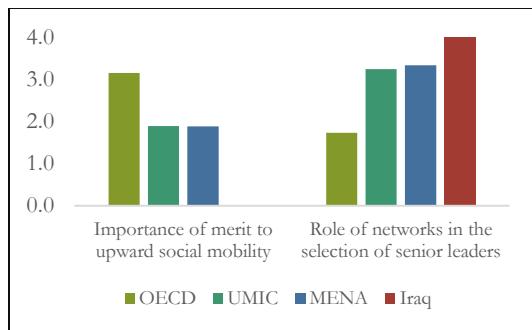


Source: Iraq Ministry of Finance and the IMF

⁴³ Again, these statistics exclude SOEs. Expenditure on wages and salaries in SOEs is significant, representing approximately one-fifth of total public spending on wages and salaries during 2009 to 2013 (World Bank, 2015).

⁴⁴ One estimate of the average wage gap between public and private employees indicates that the ratio is 5:1. (World Bank, 2014b).

Figure 52. Meritocracy and Favoritism in Public Sector Employment



Source: Institutional Profiles Database 2012

107. **Salaries in the public sector are significantly higher than in the private sector for people with equivalent education levels.** The gap increases with education level. Public sector employees who have completed a secondary school or higher earn salaries that are over 40 percent larger than they would in the private sector, while public sector workers with lower educational attainment earn salaries that are 20 percent higher than their private sector equivalents. Also, allowances and bonuses in the public sector are particularly large, complex, and frequently regressive and account for 60 percent of total personnel compensation costs (World Bank, 2015c).

108. **Repeated and ongoing conflict and fragility in Iraq have significantly constrained the options available to policymakers to solve the problems of the civil service in the near term.** Although pay scale reforms and elimination of ghost workers would yield some much-needed fiscal savings and would signal a shake-up of the status quo, these measures would not by themselves significantly alter the character of the civil service in the short term. More extreme measures such as outright layoffs do not appear to be feasible because, despite its distortionary effects, the public wage bill is essential to sustaining economic activity and maintaining social peace given the dearth of private sector jobs, thus giving the government little room to maneuver. In the medium term, a complete (gross) freeze on hiring is not optimal as some flexibility is needed to meet shifting public sector employment needs. However, reducing the net wage bill by attrition (in other words, filling only a small portion of the public sector positions vacated by the 60,000 to 80,000 employees who retire every year) could represent a significant reduction in the wage bill each year. For this to be feasible, an agreement would need to be reached among Iraq's ministries who currently have loyalties to different ethnic and sectarian political stakeholders. Politicians need to stop using civil service jobs as distributive spoils and to turn the administration into a leaner, more professional machine focused on the effective provision of public services.

109. **The government has identified the civil service as a core area for reform.** It has tried to trim the wage bill by pledging to implement a hiring freeze except for the security, health, and education sectors (which constitute more than 60 percent of total public sector employment). However, so far the ministries in question have refused to carry out the central government's orders. In 2015, the government also attempted to introduce a new salary scale that would cut the pay for highest grade civil servants, although this was partly rolled back in the face of public protests (World Bank, 2015c). The most promising initiative is the recent steps taken by ministries to introduce the biometric identification of employees and new direct deposit payroll systems as these have the

potential to reduce numerous forms of payroll fraud, including a variety of “ghost” workers, double dippers, and absentee employees, which are estimated by the Federal Board of Supreme Audit (FBSA) to number in the tens of thousands. The FBSA is currently carrying out a comprehensive government-wide audit of wage and pension payrolls to identify these fraudulent payees.

2. Public Financial Management

110. Effective public financial management (PFM) is a critical foundation for basic economic governance and for ensuring the performance, legitimacy, and accountability of the state. PFM interventions tend to focus on increasing aggregate fiscal discipline, allocating resources according to national priorities, and encouraging accountability in public spending. For fragile states, PFM reform can be an important part of state-building that is particularly significant when it is associated with efforts to increase transparency and accountability, to develop sustainable capacity and to support service delivery (Gill, 2015).

111. In Iraq, enhancing PFM will be crucial for rebuilding the legitimacy of the state, in addition to ensuring accountability and efficiency in the management of public resources. Weaknesses in the PFM system increase the risk of waste, abuse, and corruption. The most recent comprehensive assessment of the Iraqi PFM system using the Public Expenditure and Financial Accountability (PEFA) methodology took place in 2007.⁴⁵ It awarded Iraq the lowest possible score (D) on a large number of performance indicators, indicating that there was substantial scope for improvement.⁴⁶

112. In Iraq, however, as is the case in many fragile and conflict-affected countries, the formal channels by which public finance and procurement are managed mask the actual processes through which resources are raised and spent. These parallel processes are obscure and difficult to influence or change, especially as they shift power from the state to other actors, thus ensuring that formal PFM systems remain weak, unreliable, and corrupted. In Iraq, as elsewhere, the main challenge is often providing incentives to governing elites and other interests to support the legitimate formal system rather than the shadow arrangements (Porter et al, 2010). The difficulty in Iraq is that the volume of resources that can thus be seized – oil revenues, aid resources, and other state income – is vast, making it harder to develop the necessary incentives. More concerted global interdiction efforts – such as the Extractive Industries Transparency Initiative (EITI) – are needed to target illicit resource flows, particularly trans-border flows through money laundering, corruption, or criminal enterprises.

113. Fragile states are particularly weak in the implementation phase of PFM, in other words, budget transparency and execution, including crucial downstream processes like cash management, procurement, payroll control, and internal control. This is also the case in Iraq (Porter et al, 2010). These transactions tend to involve multiple agencies and individuals acting at some remove from the center where it is possible to exercise considerable discretion with no supervision or

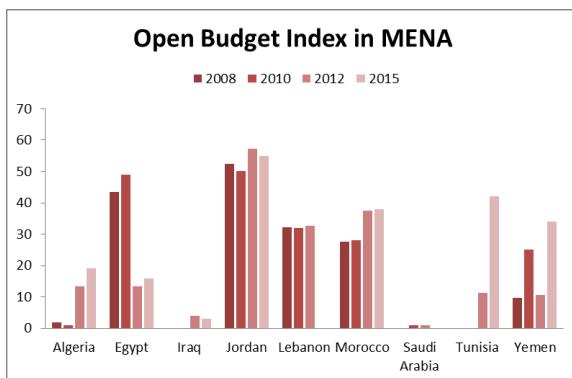
⁴⁵ PEFA is a tool for countries to benchmark their PFM system against existing good international practices. The PEFA framework disaggregates this consensus into 64 PFM process dimensions that are critical to an open and orderly PFM system.

⁴⁶ World Bank (2008).

control (Fukuyama, 2004). Focusing on improving these processes is more important than upstream processes such as budget preparation, multi-year frameworks, or program budgeting and is more likely to bear fruit in terms of improving results and accountability in government spending. Similarly, rather than passing laws and regulations at the center, it may be more effective to strengthen central-local links through revenue sharing agreements with governorates and municipalities that are linked to performance and supported by strengthened PFM. In Iraq, it is likely to be necessary to strengthen PFM in the oil and security sectors and to move away from using cash-based transactions. While this is a highly contentious area, progress is possible. One of the first actions undertaken by the current government when it took office was to identify 50,000 ghost workers on the payrolls of the Ministries of Defense and of the Interior.

114. Iraq's PFM processes and systems are typical of fragile states with the same sorts of challenges in numerous areas. A key challenge for the government is to track spending across the various stages of the budget cycle. Line ministries and affiliated agencies often lack reliable data on the availability of funds and cannot commit expenditures in a timely fashion. Cash management is weak, and the government often has insufficient cash available to meet its financial obligations as they fall due. The IMF estimated that the accumulation of domestic arrears in Iraq was 2.5 percent of GDP at the end of April 2015, and while procedures for authorizing government purchase orders are designed *inter alia* to help to control arrears, they are not effective in the absence of a sound commitment control system. There are additional weaknesses in the government's ability to allocate resources in accordance with its sectoral strategies. The PFM legal framework needs to be strengthened, including the provisions for management, oversight, and transparency of hydrocarbon revenues, the principles of fiscal responsibility, the roles and responsibilities of the key PFM institutional actors, and cash management (Figures 53 and 54). Other important priorities should be strengthening PFM systems at the subnational level, implementing an integrated financial management system to replace and improve current manual PFM processes, and improving the publicly available information on the federal government's budget and its implementation, an area where Iraq has been at the bottom of relevant international indexes.

Figure 53. Budget Transparency in MENA Countries



Source: Open Budget Partnership

Figure 54. Budget Transparency in Iraq



Source: Open Budget Partnership

115. Some basic reforms can be very challenging, a case in point being procurement reform. Procurement is often at the center of fiduciary concerns but it can also be at the heart of rent seeking and clientelistic behavior. In Iraq, public procurement is a major component of the national economy. Public procurement was roughly estimated to represent 25 percent of the country's GDP or over US\$50 billion in 2013 (World Bank, 2013). Yet real change and implementation in this area has been elusive. Poor procurement processes have been identified as a major cause of bottlenecks in budget execution (World Bank, 2012a and 2014b). Widespread corruption in public contracting is a major contributor to the weakness of Iraq's business climate (World Bank, 2012b). Additionally, there is a broad consensus among stakeholders that government at the federal, regional, and local levels continues to struggle to spend its procurement budget because of a weak capacity to implement projects and programs. Nationally, less than 64 percent of capital expenditures, on average, is executed.⁴⁷ While some positive steps have been taken recently, including the development and implementation of standard bidding documents, the publication of a national implementation manual, and enhanced training of procurement professionals, much more is needed to ensure real change. An important lesson of the Bank's engagement in procurement reform in Iraq is the difficulty of trying to address public procurement reform in isolation without also taking into account the problems of instability, corruption, and weak capacity. Yet it is impossible to fix the entire system at once. It will be necessary for the government to prioritize interventions and to understand the key players who need to be engaged in the reform process. Most importantly perhaps, procurement reform will require strong political leadership (World Bank, 2013).

116. As in the case of procurement, a well-functioning public investment management (PIM) system would allow Iraq to realize the benefits of its public expenditures, reducing waste as well as corruption, and, crucially for re-building state legitimacy, improving the delivery of basic public services like health, education, water, and electricity. Unfortunately, Iraq currently lacks an effective PIM framework. The result has been the inefficient selection of projects, repeated cost overruns and delays, low levels of execution (in the 50 to 60 percent range), and substandard completed outputs. The government's limited capacity means that it is unable to prepare appropriate project feasibility studies, credible project cost analyses, or realistic project appraisals. There are bottlenecks at every stage of the PIM process, from procurement and contract management through to commitment, verification, and payment and oversight. Other constraints include supply bottlenecks, fuel shortages, poor coordination between implementing ministries, private sector constraints, and difficulties in resolving land disputes, not to mention the poor security situation. These structural issues are a major impediment to the efficient and cost-effective implementation of Iraq's substantial long-term reconstruction needs, as well as to the short-term requirement to prioritize capital spending efficiently given the necessity of fiscal consolidation (World Bank, 2014b).

117. Strengthening Iraq's accountability institutions is one step towards making PFM more robust and transparent. The Federal Board of Supreme Audit (FBSA) has been able to carry out its mission with some success despite difficult conditions. The FBSA is a financially and administratively independent institution whose chairman is appointed by Parliament and reports directly to it. Its staff are well-trained and remunerated in accordance with the salaries paid in the rest of the public sector. Its status and role are defined in the Constitution and in the FBSA law, both of which underscore its

⁴⁷ Average for the 2010-2013 period.

independence, its position in the governance system, and its role in performing forensic audits. Strong, technical and non-sectarian leadership, staff who receive regular professional training and support (through the assistance of development partners), and strong links to international professional organizations such as the International Organization of Supreme Audit Institutions (INTOSAI) and its regional equivalent, ARABOSAI, have helped the institution to carry out its functions even in the face of significant professional and personal intimidation.

3. State-Owned Enterprises

118. **State-owned enterprises (SOEs) represent another source of the weaknesses that characterize Iraq's public sector institutions.** There are 176 SOEs in the country (Table 9). Much of the sector's resources goes to pay the wages of their employees. In fact, a substantial number of SOEs seem to have a limited rationale for existing beyond the provision of public employment. The sector employs over 550,000 people, of whom 30 to 50 percent are thought to represent excess labor. In addition to being over-staffed, many SOEs are seriously decapitalized, asset-starved, inefficient, saddled with high production costs, and in a state of physical degradation.

119. **Publicly-owned companies dominate both the financial and the non-financial sectors.** Both financial and non-financial SOEs enjoy significant privileges that have further stifled private sector development by crowding out private firms and impeding factor reallocation. State-owned banks (for example Rasheed Bank and Al-Rafidain Bank) dominate the financial sector and have been pushed by government to increase directed lending to other nonperforming SOEs to cover their current operating costs (for example, wages) as well as to finance the government deficit. Non-financial SOEs operate in a wide range of sectors of the economy and are largely non-transparent, weakly accountable, and undertake sizeable quasi-fiscal activities that generate fiscal liabilities and risks.

Table 9. Public Companies in Iraq

Ministry	No. of Companies Studied	No. of Employees (x 1000)	No. of Profitable Companies in 2013
Ministry of Industry and Mines	71	145.4	12
Ministry of Electricity	24	83	0
Ministry of Oil	18	143.6	17
Ministry of Transportation	18	37	7
Min. of Construction & Housing	8	13.7	0
Ministry of Trade	7	10.5	3
Ministry of Agriculture	7	4.3	2
Ministry of Defense	6	20.5	0
Ministry of Water Resources	3	2.8	3
Ministry of Communications	3	18.3	0
Total	157	479.1	44

Source: Iraq Ministry of Finance (2016)

Note: Nineteen companies associated with the Ministries of Finance (12), Culture (4), Health (2), and Education (1) could not be studied because of a lack of information.

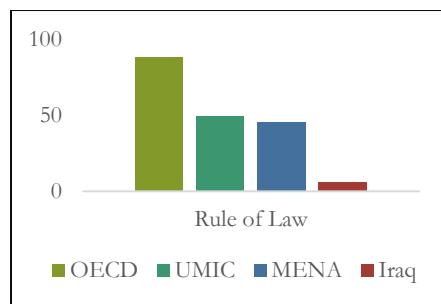
120. **The World Bank estimates that only one-quarter of all SOEs are profitable** (Table 9). The remaining companies are structurally loss-making and representing a burden on public finances. Because of poor reporting, however, the exact scale of the economic, financial, and fiscal costs that

Iraqi SOEs incur is unknown. Management of the SOE sector is weak and is fragmented among various ministries with little coordination by the Ministry of Finance beyond the provision of financial statements. This makes the strategic monitoring, restructuring, and fiscal risk management of SOEs challenging, even when the political will to do so exists.⁴⁸ The small size and weakness of the private sector and the regulatory difficulties facing it reinforce the SOE dominance of most Iraqi markets and limits the amount of information on relative market prices that is available to inform SOE planning. This makes it very difficult to calculate the magnitude of indirect public subsidies provided to SOEs, for example, in the form of utilities and credit received. If more information were available on these hidden subsidies, it might show that SOEs make even less income than reported and might lead to increased public pressure for SOE reform (Gunter, 2013).

4. Justice System and the Rule of Law

121. The administration of justice and the capacity of the legal profession have deteriorated after decades of dictatorship, conflict, and sanctions. Iraq is in last place in the MENA region and ranks in the bottom 10 percent worldwide on indices of the rule of law (Figure 55). The main reasons include the poor quality of legal education, years of domination of the justice sector by the executive branch, the country's fragile security situation, and the politicization of law enforcement. Iraq's judiciary still struggles to maintain its independence, poor security limits public access to court files and information, and judges routinely face political pressure and personal threats.

Figure 55. Rule of Law Percentile Rank



Source: World Governance Indicators, 2014

122. **The judiciary's weak institutional and professional capacity has many implications for the quality of the criminal justice system, for doing business, and for access to legal aid for the vulnerable.** Law enforcement, prosecution, criminal courts, and correction are all adversely affected. Iraq ranks number 122 (out of 189) in the Contract Enforcement Indicator of the Doing Business 2016 Report, largely due to the low quality of its judicial processes, the length of time taken to enforce a contract (520 days), and the high cost involved (28 percent of claim value). Finally, not only do poor security conditions hinder access to justice, but also many disadvantaged groups, including women and the poor, lack the legal aid that they require to access justice services.

⁴⁸ A committee was recently established to create a database to monitor the fiscal risks posed by non-financial SOEs and to update and publish their financial and employment data (Decree No. 446, October 18, 2015).

C. A Stunted Private Sector

123. **A legacy of autocracy and poor governance, conflict, and dependence on oil have combined to shape the Iraqi private sector.** In the sanctions era, resources became ever more concentrated on the public sector as the government's efforts and resources were increasingly focused on ensuring the survival of the regime rather than on productive investment, job creation, and diversification. This increased the marginalization of the private sector and led to a shift of many activities to the informal sector. The impact on productivity, job quality, and private investment is still felt today and is reflected in the stunted, weak state of the private sector. The public sector accounts for nearly 40 percent of all jobs and for nearly all formal sector jobs. Large and medium-sized firms contribute a negligible proportion of all jobs, and nearly two-thirds of workers are likely to have informal jobs with no social security benefits. The role played by SOEs in the economy also grew, as did their deficient procurement and excessive procedures and regulations for commercial transactions. The sanctions period also marked a growing detachment from government and the formal sector for many Iraqis.

124. **Decades of state-driven economic policy have tightly bound Iraq's economy to the state's needs.** As a result, there are few opportunities for private sector players to make their voices heard by the government, which significantly limits the extent to which they can influence the policies and regulations that affect them. The country's complex, non-transparent regulatory system compares poorly not only to those in OECD countries but also to those in the UMIC and MENA. The Iraqi government exercises wide powers but lacks sound the legal rules and institutions necessary to guide and implement an effective regulatory policy and to assess the impact of regulations, which has created an unfavorable environment for the private sector, especially small enterprises.⁴⁹ In an environment where investor confidence is subdued, the lack of government commitment to honor contracts in key sectors has discouraged foreign investments. Moreover, because of the state's longstanding dominance of the economy, credit systems and access to finance are severely limited.

125. **While job creation remains one of Iraq's largest development challenges, the private sector is poorly positioned to play its role as a creator of jobs.** In addition to security problems, it is plagued by lack of access to credit, high entry and exit barriers, and a slow and ambiguous legal and regulatory system. Like households, businesses suffer from the unreliable delivery of essential services, including water, electricity, sewerage, transport, and telecommunications. Although the potential for private sector engagement in post-conflict Iraq is significant, it is currently both under-developed and fragmented. Most private businesses in Iraq are very small. Most are in retail and trade, construction, and transportation as well as in the textile, food, engineering, and chemicals fields. The great majority of businesses are owned by sole proprietors, with most of the remainder being family partnerships. Many of the employees in small and medium-sized enterprises (SME) are unskilled short-term laborers. Moreover, even those with higher levels of education lack the relevant skills demanded by the market. Iraq only possesses a handful of large, typically family-run multi-industry conglomerates, and these are in retail, domestic trade, telecommunications, and construction rather than in traded goods and services (World Bank, 2014a). As a result, the productivity of Iraq's firms is generally lower than that of firms in other countries in the MENA region. Nevertheless, some sectors

⁴⁹ One positive development has been the establishment in February 2016 of a Task Force (within the Council of Ministers' Secretariat) to pursue regulatory and governance reforms, including measures to strengthen impact analysis systems and increase use of ICT solutions. However, the outcomes of this initiative are yet to be seen.

of the Iraqi economy have higher average levels of productivity than their regional peers. These include metals and equipment, textiles and garments, and chemicals and pharmaceuticals, suggesting that the potential exists for private-sector-led growth in an improved business environment (World Bank, 2015d). Additionally, well-targeted public investments could boost the private sector and create jobs. For instance, as highlighted in Box 7, a focused government strategy to support religious and other tourism would help to create jobs across the value chain.

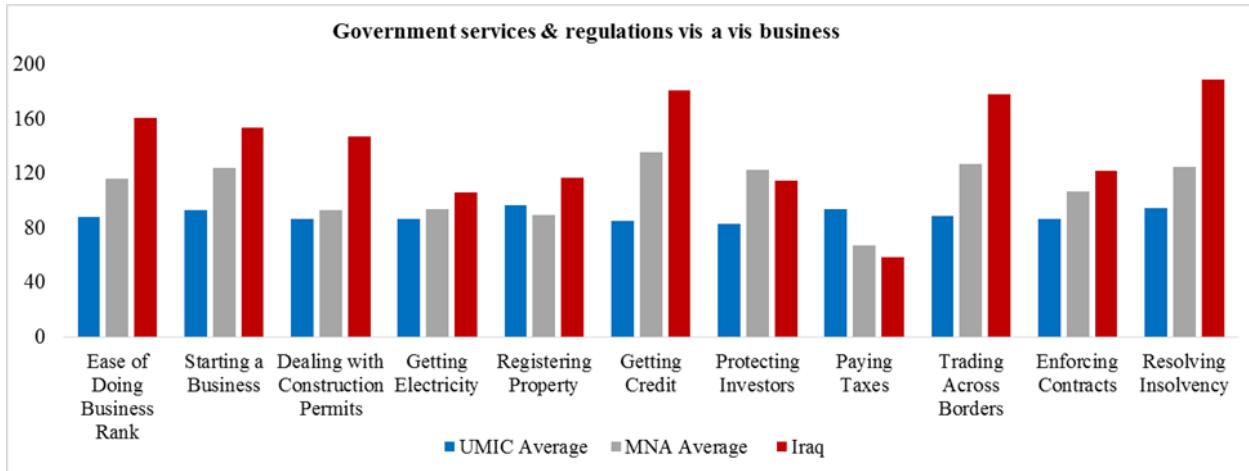
126. **Significant constraints to private sector opportunities in the non-oil economy were**

Box 7. Private Sector Concerns

Consultations held by the SCD team with representatives of the private sector in September 2016 to discuss this SCD highlighted many constraints to economic development in Iraq from a private sector perspective as well as the various factors that restrict the expansion of local private firms and SMEs. A major concern expressed by the representatives was the emergence of a pseudo private sector owned by political factions or parties. Participants noted that most of political parties have established several companies that obtain many of the government tenders for various projects, essentially putting the real private sector out of business. These same actors also create enormous obstacles to rationalizing the regulatory and business environment to create a more level playing field for all participants. There are limited opportunities for private sector voices to be heard by the government, and therefore private sector lobbying groups need to be strengthened. Public-private relations have been strained by the lack of any government commitment to upholding signed contracts, which has severely dampened investor confidence. The participants also pointed out that the banking sector, which is dominated by public sector banks, does not serve the needs of the private sector because of the laws and regulations set by the Central Bank of Iraq as well as their own conservative lending practices. Nor is there any organization to train the Iraqi citizens in the skills needed to work in private sector and there is a need to revise vocational education to focus on market needs. Other macro level issues that emerged from these SCD consultations included weak institutions, cumbersome regulatory processes, a lack of infrastructure (especially with regard to connectivity), and the absence of a strategic vision (the vision for tourism in the KRI was cited as an example) that would not only help to create jobs but also support local industries.

identified in the 2012 Investment Climate Assessment (ICA) carried out by the World Bank, which was based on a survey of about 800 Iraqi businesses (World Bank, 2012b). The most critical constraints identified by the ICA, namely political instability, corruption, unreliable electricity service, and a lack of access to finance, continue to be the most significant constraints to the Iraqi private sector today. Other factors identified by the ICA were the role of the state in Iraq's economy, including SOEs, as well as the poor performance of the banking sector. Also, Iraq's relative performance on a number of Doing Business areas is similarly weak (Figure 56). These latter factors often weigh more heavily on larger firms than smaller businesses. Moreover, the impact of these constraints varies across the country and is more likely to be identified as serious by firms located in Baghdad. Constraints are reportedly much lower in Ninawa, Kirkuk, Babil, and Suleimaniya than elsewhere in Iraq, which suggests that useful lessons can be learned not just from other countries but also from some of Iraq's regions – see Box 8: (World Bank, 2015d).

Figure 56. Constraints to Doing Business (low = best, high = worst)



Source: Doing Business Index, 2016

127. **Iraq's poor regulatory environment adds to the burdens imposed on the private sector by insecurity and poor services.** There are 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 (World Bank, 2014a). All of these apply to Iraq (Figure 57). Many of country's 29,000 laws and regulations were made during the 20th 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. Moreover, as the government has no policy for regulatory review and reform, regulations are often poorly designed, and their impact on the private sector is not given enough consideration.⁵⁰ Additionally, the 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. Also, many ministries do not have enough capacity to implement any reforms. A high degree of informality in the economy makes it difficult to enforce government regulations and further reduces their impact. Given the clear need to strengthen

⁵⁰ The international community is providing Iraq with capacity building and technical assistance to establish regulatory reform units to increase the effectiveness of regulatory reforms and to review existing laws and regulations.

institutional and regulatory governance, the Council of Ministers' Secretariat (COMSEC) has committed itself to pursuing regulatory and governance reforms to strengthen impact analysis of regulations and promote more effective Cabinet processes (World Bank, 2015d).

128. The private sector can only be revitalized if the role of the public sector in the economy is reformed. The funneling of oil revenues towards Iraq's oversized public sector - and to the few connected private actors benefiting from public contracts - needs to gradually make way to increased private sector activity. The public sector should focus on investments that can expand private sector capacity and activity and that are most likely to create increased opportunities for diversification. As with all reforms that imply a break with the existing governance architecture, this will require the emergence of a political force that is able to commit to re-establishing the legitimacy and functionality of the state.

Box 8. Potential for Foreign Direct Investment Dampened by Increasing Economic Pressures

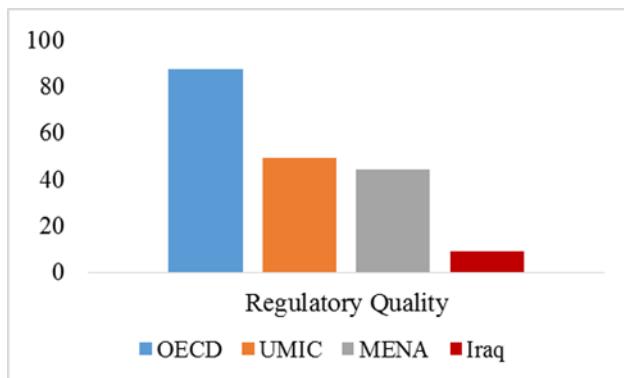
The Kurdistan Region of Iraq (KRI), given its relative stability and more conducive business environment, has been successful in attracting regional and foreign investors in key non-oil sectors such as housing, tourism, agriculture, health, and education to support its growing private sector. The 2006 Investment Law followed by the establishment of a streamlined licensing process overseen by the Board of Investment in KRI has offered incentives to foreign and regional investors to support infrastructure and real sector development. It is estimated [by whom?] that the KRI represented on average almost 55 percent of all foreign direct investment (FDI) in Iraq prior to the ISIS conflict. This surge of investment helped to boost private-sector-led job creation. On average, the 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. 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. However, the increasingly difficult political and security environment beginning in 2013-2014 has resulted in job losses in the private sector and in growing public sector employment. In addition, the sharp decline in oil prices coupled with the withholding of transfer payments by the federal government have increased the KRI's fiscal vulnerability (though these transfers have now been partly resumed). With KRG facing serious challenges in meeting its financial commitments, sizable arrears to the private sector have accumulated, and have resulted in the halting of almost all construction projects in the region.

Despite its progress in promoting private sector development, the KRI, like other Iraqi governorates, continues to face the challenges of a weak investment climate, limited access to finance for SMEs and entrepreneurs, inefficient labor market mechanisms and institutions, and a lack of appropriate infrastructure. Furthermore, 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. Tackling these constraints will be critical to unleashing the potential of the KRI to boost private-sector-led growth and job creation in the medium term.

*Implementation of the budget arrangement between the Central Government in Baghdad and the KRG was partly resumed in August 2016. The agreement provides for Baghdad to transfer to KRG 17 percent of the federal budget in exchange for exports of 0.55 million barrels per day (mpbd) on average from oil production areas controlled by KRG. Implementation of the agreement stalled in 2015 as oil exports from KRG fell below 0.55 mbpd to 0.15 mbpd and subsequently virtually halted as KRG exported its oil directly, and due to transfers from Baghdad to Erbil being below the agreed 17 percent. The parties agreed in August 2016 to resume the joint sale of oil and divide revenue equally. This agreement expires at the end of 2016 when a successor agreement is expected to be negotiated.

129. The 2012 ICA highlighted two constraints as being particularly binding to the development of a vibrant private sector - the financial sector and SOEs. The issues related to SOEs were summarized in a previous section. The following paragraphs provide an overview of the challenges in Iraq's financial sector.

Figure 57. Regulatory Quality



Source: World Development Indicators 2014

The Financial Sector

130. **Iraq's financial system remains underdeveloped.** According to the most recent estimates, total domestic credit to the private sector amounted to 9.2 percent of GDP in 2015, the lowest level in the region. The sector is small and dominated by state-owned banks that are used primarily for directed lending and budget support, rather than as a source of financing for the private sector. As with non-financial SOEs (see below), these banks benefit from significant privileges compared to private sector banks, which stifles competition as well as private sector growth. The three largest state-owned banks account for about 90 percent of the banking sector's assets and deposits. Although total financial sector assets amount to 87 percent of GDP, most of these are in government bonds, purchased in order to finance the budget. The amount of credit provided to the private sector amounts to less than 7 percent of GDP (compared with 55 percent on average in other MENA countries).

131. **Private and foreign banks have to operate on an uneven playing field that favors state-owned banks and face a number of challenges that hinder their growth.** Although there are significantly more private and foreign banks (46) than state-owned banks (7), an unfavorable regulatory environment (for example, stricter capital requirements than for state-owned banks), weak internal capacity, and the lack of an appetite for risk has constrained their growth and penetration into the banking sector. State banks have benefitted from the public's perception that they provide a *de facto* deposit guarantee and from restrictions imposed on the operations of the private banks. However, this changed with a decision in October 2015 by the Council of Ministers to level the playing field between public and private banks. From that time onwards, SOEs and ministries were allowed to deposit their money, open bank accounts, and deposit and distribute employee salaries and pensions through private banks, and to accept certified checks and letters of credit issued by them. The government also encouraged public banks to deposit their funds in private banks. As of the end of September 2015, the total deposits of the public banks in the private banks equaled ID 172 billion (approximately US\$147 million).

132. **Financing for micro, small, and medium-sized enterprises (MSMEs) is not well developed in Iraq.** It is estimated that fewer than 5 percent of SMEs in the formal sector have received bank loans. Bankers in Iraq have little experience in lending to SMEs, thus limiting financial

intermediation. Many banks are new and do not have the necessary skills to analyze credit risk or to carry out cash flow analyses. Also, although the Iraqi authorities have taken positive steps to enhance access to finance, challenges still remain. The 2014 Findex survey found that only 11 percent of the adult population has an account at a formal financial institution, the second lowest among the surveyed countries in the region, which is significantly below the upper-middle-income group's average of 70 percent. The survey also revealed a significant gap between Iraqi citizens who borrowed formally (4 percent) and those who did so informally (65 percent), suggesting that there is a much higher demand than is currently being served by the financial sector.

133. Microfinance holds some promise in Iraq as, prior to the conflict with Daesh, microfinance institutions (MFIs) were serving nearly 100,000 low-income entrepreneurs. However, this represented only 0.25 percent of all banks' assets. Recently, four MFIs operating in Daesh-controlled territory have ceased their lending operations, which has eliminated an estimated 15 percent of the market – representing over 20,000 active clients and US\$22 million in outstanding credit. In addition to security challenges, legal and institutional impediments also restrict the growth of microfinance as MFIs must be registered as NGOs and are supervised by the NGO Directorate, which lacks the specialized knowledge of microfinance needed to provide appropriate oversight.

134. Government directed lending undermines risk management in the state-owned banks. Although the Central Bank of Iraq (CBI) reports that the capital adequacy ratios (CAR) for the two largest banks are positive (4 percent in the Rafidain Bank and 19 percent in the Rasheed Bank), both are in fact believed by analysts to be severely undercapitalized. Accounting standards and practices are weak, many delinquent loans are either reported as performing or are ever-greened, provisioning levels are low even for reported NPLs, and the state-owned banks have never been audited so their precise financial position is uncertain. In addition, their liquidity is constrained, leading the CBI to halve their reserve requirements in 2015 (in order to enable the state-owned banks to finance the government deficit) by allowing half of their reserve requirements to be met by government bonds. More generally, the CBI reports that the CAR for the banking system is 22.06 percent and that non-performing loans (NPLs) are at 8.65 percent, but as noted above, it is likely that banks are weaker than they appear given the sector's lax accounting and auditing standards.

135. The CBI is effectively unable to supervise the state-owned banks, and its supervision of the small private banks is weak. In the KRI, as a result of a dispute over oil revenues between the federal government and KRG, the latter has drained cash from banks in Kurdistan and has effectively cut off the banking sector – including the CBI branches – from the rest of the country, leaving it largely unregulated and unsupervised. In addition, in Daesh-controlled territory, numerous bank branches have been destroyed and the contents of their vaults stolen. Poor data collection adds to this uncertainty. All of these factors have resulted in a fragile banking sector vulnerable to shocks.

136. The non-bank financial sector is small and under-developed. The stock exchange has the potential to provide issuers with access to sources of permanent and long-term capital via the issuance of equity and corporate bonds to institutional and retail investors, both domestic and foreign. The insurance sector in Iraq is dominated by the state-owned insurance companies, which benefit from being the sole provider of insurance services to the government.

D. Declining Quality of Human Capital and Skills

137. **The loss of human capital over the past three decades in Iraq has been massive as a result of conflicts and continuing fragility, and is undermining the prospects of Iraq's economy.** Countries that sustain high levels of growth for long periods of time have made substantial investments in deepening the human capital of their citizens (World Bank, 2013a). While the Iraqi education and health systems were ranked near the top of the MENA region in the late 1970s, they have fallen to near the bottom today. Previous achievements in increased literacy and reduced gender disparities have been erased. While some progress has been made in a number of areas in recent years, much remains to be done in order for the country to progress towards sustained growth and poverty reduction. A huge vulnerable population, including millions of IDPs and refugees, exacerbates existing pressure on an already weak system, sharpens disparities of access between regions, and is poorly served by the education and health systems and by social safety nets. Poor quality services are aggravated by inadequate infrastructure and low levels of public spending. Investing in the quality of Iraq's education, health, and social safety systems will be necessary to develop the human and social capital that the country will need to ensure a productive economy and a cohesive society.

1. Education and Skills

138. **A burgeoning youth population is placing increasing pressure on Iraq's underfunded education system.** Yet public spending in the sector has collapsed. In 1988/1989, the education budget was US\$2.5 billion (about 6 percent of GDP) and expenditure per student was approximately US\$620. Between 1993 and 2002, annual average expenditure per student had plummeted to a mere US\$47. School infrastructure suffered massive deterioration as maintenance and new construction were deferred year after year. Teacher training, curriculum modernization, monitoring and assessment, and the introduction of new teaching techniques were all neglected. While the available data are outdated and scarce, by 2008 public spending on education as a percentage of GDP stood at 3.5 percent of GDP,⁵¹ a low level when compared to neighboring countries such as Jordan, Morocco, and Egypt, which spend approximately 6.3 percent of GDP, and Kuwait, which spends 8.2 percent of GDP on the sector. Despite this, Iraq reached 97 percent primary gross enrollment in 2013, and gender parity at the primary level has been steadily improving, now standing at 0.84. Spending in the sector appears to have increased significantly in recent years (World Bank, 2014b), although the bulk of expenditures are allocated to staff remuneration, leaving little left over for quality-related inputs. Between 2007 and 2009, the average cost of an education public servant almost tripled and is estimated to have continued to grow. Between 2005 and 2008, the Ministry of Education experienced a 64 percent increase in its staff and a 156 percent growth in the cost of compensating its employees, with the cost doubling again a year later. Clearly the sector has not been immune to the pressures felt across the whole civil service.

139. **Another factor that significantly accelerated the degradation of the education system was the increasing brain drain as professors and capable technical workers fled the country.** Many professors who had come of age at the peak of the Iraqi education system of the 1970s and 1980s became disillusioned with the declining quality of the education system and the politicization of the curriculum, with some 3,000 or more having left the country after the Gulf War. Conflict has continued the exodus of educated and skilled Iraqis. Many see migration as their only chance to build

⁵¹ These are the most recent data available for federal Iraq.

a prosperous and safe future. The International Organization for Migration reports that more than 1.4 million Iraqis have fled the country, about 4 percent of the country's population. The flight of educated Iraqis in search of better opportunities abroad has had and will continue to have severe negative long-term consequences for the Iraqi economy and for the education sector specifically.

140. The legacy of war, sanctions, looting, and low investment has left a massive backlog in terms of school infrastructure. Low investment spending hampers the rehabilitation and construction of proper education infrastructure for the rapidly growing school age population - in addition to the influx of the refugees and IDPs. Due to a lack of classrooms, access to education in some areas has been reduced as has actual instruction time, and the quantity and quality of learning has suffered as a result. Multiple shifts per school day are prevalent across the country because of the lack of facilities. Most schools in Iraq teach for just four hours per day compared to a school day of at least five hours a day in most other countries. The number of school days in the academic year are also low at 151 days, which is 29 days less than the OECD average of 180 days. Relative to other MENA countries, Iraqi students generally spend less time in the classroom, contributing to a serious student learning deficit (EdDataII). Among 10 to 14 year olds, almost one in every five children is not in school, and among those between 12 and 16 years old, one in every five has not completed primary school. Also, children have moderately unequal access to schooling. One third of this inequality being due to the gender of the child, with girls having less access than boys.

141. Both gross and net enrollment rates decline sharply at levels above primary school (Figure 58 and Table 10). Gross enrollment rates for primary school stood at 106 percent in 2012, with net enrollment rates at 88 percent. However, at higher levels of education, both gross and net enrollment rates decline sharply. For every 100 students of intermediate-level school age in 2012, only 43 were of intermediate school age. Net enrollment in secondary schools stood at 23 percent in 2012. The pattern of gross and net enrollment rates decreasing sharply as the level of schooling goes up holds in each division of the country. The sole exception is Kurdistan where gross enrollment rates are above 100 percent even at the intermediate and secondary levels and net enrollment has risen to 61 percent at the intermediate level and 38 percent at the secondary level. More worrisome is the statistic that almost one in five children between the ages of 10 and 14 years old is missing school, while among those between 12 and 16 years of age, one in five has not completed primary school.

Table 10. Net Enrollment Rates

	Primary	Intermediate	Secondary
Baghdad	89	41	25
Other governorates	81	33	19
Kurdistan governorates	90	46	22

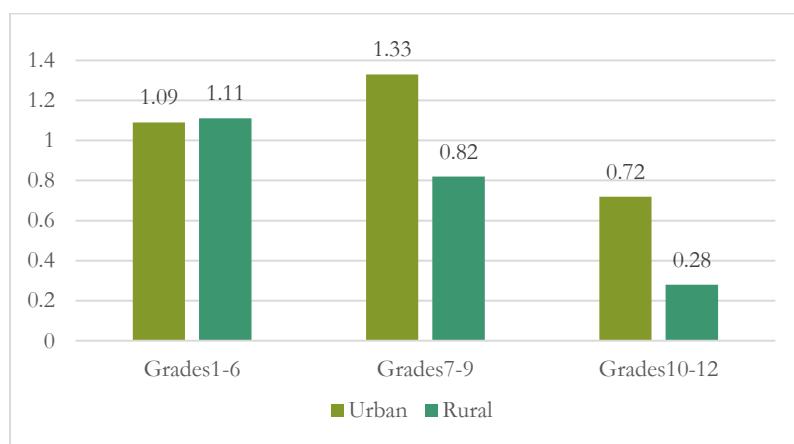
Source: 2007 IHSES

142. Important gender disparities persist. Gender parity exists at the primary level in Iraq as measured by the Gender Parity Index (GPI), in other words, the ratio of boys to girls. Parity declines rapidly at higher levels, with the dropout rates for girls rising after primary education according to data

from the 2007 IHSES. In contrast, in the Kurdistan region, the GPI is closer to one and was higher than the average GPI in other MENA countries for the period between 2005 and 2010 at all levels of education. Girls are more likely to be out of school in rural areas than in urban areas because of supply constraints (there is no available school or the parents cannot send them for economic reasons) or because the parents are not interested in educating their daughters. Growing social pressure for and acceptance of early marriage also discourages girls from continuing their education. This trend has become more pronounced with the growth in IDPs for whom the burdens of war have compounded the incentives in favor of early and child marriages and because of the lack of school facilities in the camps that host many IDPs.

143. Regional differences in education are also noticeable. Rural areas are more deprived than urban areas, both in terms of distribution and quality. While urban schools can have 6, 12, 18, or 24 classrooms, rural schools usually have only six classrooms, a very limited capacity. There are also fewer schools in rural areas. This is particularly true at higher educational levels. It is harder for rural areas to retain teachers as teachers prefer to move to urban areas after two years or less of rural service. Rural schools often lack teaching aids and other inputs, and some schools even lack basic requirements such as drinking water.

Figure 58. Gross Enrollment by Area and Grade Level, 2007-2008



Source: 2007 IHSES

144. The overall quality of education is poor, which has a negative effect on outcomes. Despite the absence of reliable data on learning achievement, it is clear that teaching and learning conditions have declined since 1990 and continue to be poor. Few and outdated textbooks and learning materials, inadequate teacher training, and little or no curriculum development and learning assessments compound the problem of reduced learning hours. The Iraq Instructional Survey-Maharat carried out in 2012 revealed that primary school students were not acquiring enough skills to read fluently and with comprehension and that they were limited to procedural knowledge of mathematical concepts but did not have a strong grasp of conceptual mathematics applicable to real-life problem-solving.

145. The quality of education is inextricably linked to the quality of teaching, but teacher quality in Iraq is undermined by inadequate training and supervision. Teacher surveys in Iraq and the KRI reveal a lack of targeted pre-service and in-service training programs for teachers across

all grade levels but particularly at the primary level. They also found that there is little supervision of teachers by the government, meaning that they get insufficient feedback for improvement. There is no specific mechanism to remove teachers who perform poorly from their jobs or to retrain them. Supervisors responsible for training are also in charge of teacher supervision, which creates a conflict of interest (EdDataII and Vernez et al, 2014). Furthermore, the distribution of competent teachers across the different governorates in Iraq and the KRG is unequal, thus exacerbating regional inequalities.

146. As in the broader public sector, administrative constraints also hamper progress in the education sector, particularly with respect to the hiring of teachers and curriculum reform. An agile and less bureaucratic structure at the Ministry of Education (MoE) would be more effective and efficient in using limited resources. The hierarchical structure of the MoE in Iraq needs to be reformed in order to ensure the effective implementation of any new education strategy. The current centralized structure means that the Minister of Education holds considerable decision-making power and does not delegate much authority to lower levels of the ministry. While the trend globally has been toward decentralized decision-making systems, in Iraq the Minister approves even the recruitment of teachers in the various directorates.

147. Compounding these challenges is the need to deliver education services to a broader and more vulnerable population. The Daesh crisis has led to the displacement of more than 4 million Iraqis and the influx of some 250,000 Syrian refugees. As a result, nearly 2.1 million children are not attending school today, and an additional 1.2 million children between the ages of 5 to 14 are at risk of dropping out. More than 5,300 schools across the country have been destroyed, damaged, or converted into shelters for displaced families. In northern Iraq, nearly 14,000 teachers have been forced to flee violence. Resources to cover the immediate and long-term needs of the population affected by the conflict are severely stretched, and these new challenges have increased disparities among the different regions across the country in terms of access to and the provision of education.

148. An inadequately educated workforce was identified as one of the top five constraints to an improved business environment in a 2011 survey of 756 firms. The existing technical and vocational education training (TVET) system, which is predominantly state run, is weak and is not geared to the needs of the job market. Low enrollment numbers at the secondary level reflect disinterest among young people in obtaining vocational training or opting for tertiary education in universities because of the lack of job prospects after graduation. There was a steep decline in enrollment in the 32 vocational institutes in the KRI since 2005, from 15,000 students to just 6,000 in 2010, and this trend has continued (Vernez et al., 2014). This may also be a result of the weak job market where there are few employment opportunities available.

149. Bringing out-of-school children back into the classroom and translating the success achieved in increasing enrollment at the primary level to the secondary and higher levels, and improving the quality and relevance of teaching are all needed. Increasing access to education for those in rural areas, for girls, and for vulnerable populations must also be a priority. The government has made significant strides in increasing access to education despite extremely challenging conditions and has achieved impressive increases in enrollment rates at the primary level and moderate increases in rates at the intermediate level. In an indication of the progress that might be possible should security improve and stability become a reality, the KRI has achieved remarkable advances in all aspects of its education system. The region established 2,200 K through 12 schools

between 2003 and 2012 and increased the number of tertiary education institutions from three in 2003 to 28 in 2015 in response to growing demand. Net enrollment at the secondary level rose substantially from 20 percent to 89 percent. It is now necessary for the government to turn its attention to improving the quality of teaching and increasing the relevance of the curriculum to the needs of the economy.

2. *The Health Sector*

150. **Iraq's health care capacity has been severely undermined by the effects of various wars, international sanctions, sectarian violence, political instability, and fiscal pressures.** The severe deterioration of health infrastructure, the difficulty in accessing health care, poor public health services including water and sanitation, malnutrition, and social fragility are all factors that undermine the health conditions of Iraqis today. As with education, health indicators – once considered the best in the region – have deteriorated. According to World Bank data from 2015, Iraq has higher under-5 mortality rates than the rest of MENA (34 per 1,000 compared with a MENA average of 25.5 per 1000) and infant mortality rates (27 per 1,000 compared with 21 per 1,000).⁵² The number of deaths per 1,000 live births is almost double the target of 15 deaths per 1,000 live births set out in Millennium Development Goals. Immunization coverage has also declined, with immunization rates for measles dropping from 81 percent in 2009 to 57 percent in 2014. Polio and DPT immunization, at 70 and 68 percent respectively in 2013, are well below the respective MENA region averages of 90 percent and 89 percent. However, some progress has been made. Maternal mortality fell from 78 to 50 per 100,000 live births between 2000 and 2015, and the share of births attended by skilled workers jumped from 72 percent in 2000 to 91 percent in 2011.

151. **A sharp rise in poverty is having a direct impact on health, especially among children.** According to a study by the World Food Programme in 2013, 11 percent of households in Iraq (about 2.6 million people) were extremely poor and food-insecure, while 25 percent of households were dependent on food rations. Malnutrition, which had at one point been virtually eradicated in Iraq, is again emerging as an important public health challenge, particularly for children under the age of 5. According to the Multiple Indicator Cluster Survey carried out by UNICEF in 2012,⁵³ one child out of four experiences stunted growth, 7 percent of children under the age of 5 experience severe malnutrition (wasting), and 8.5 percent are underweight. Furthermore, the high prevalence of anemia among women (approximately 36 percent of those aged between 15 and 49) continues to increase the risks of perinatal, maternal, and child mortality, as well as impaired cognitive functioning in children.

152. **Iraq today suffers from a double burden of disease.** Non-communicable diseases such as cancer, chronic respiratory diseases, and cardiovascular disease are the leading causes of death, but infectious diseases remain major causes of morbidity and mortality. Diarrheal diseases, acute respiratory infections (ARI), measles, mumps, typhoid, and leishmaniasis have substantially increased since 1990. The prevalence of TB is also on the rise, growing from 50 per 1,000 population in 2000 to 67 per 1,000 in 2014. Communicable diseases, particularly water-borne infectious diseases are also affecting the Iraqi population. Cholera and hepatitis E are endemic, and there was even an outbreak of polio in Iraq in 2014, though the country had been polio-free since 2000.

⁵² World Bank Databank

⁵³ UNICEF, Iraq Multiple Indicator Cluster Survey 4, 2011

153. Access to health services is limited, and geographical disparities are significant. In the public sector, health services are provided through a network of primary health care centers (PHCC) and public hospitals at very low charges. The PHCCs provide preventive and basic curative services. The main centers are located in urban areas with smaller centers in rural areas. Poor organization and shortages of staff and medications are significant impediments to delivering adequate services in the PHCCs. Despite this, the PHCCs are recognized as very important sources of health care provision, particularly for the poor. For secondary and tertiary care, patients are referred from PHCCs to hospitals, although it is estimated that only about 40 percent of Iraqis have access to these referral services because of the inadequate number and uneven distribution of public hospitals. Secondary and tertiary care are also provided by small private hospitals. Since there are no health insurance schemes in Iraq, the costs of private health care must be met out-of-pocket, which is well beyond the reach of many Iraqis. Moreover, although private hospitals are licensed by the Ministry of Health, they are still largely outside the national health supervision system (Cetorelli and Shabila, 2014).

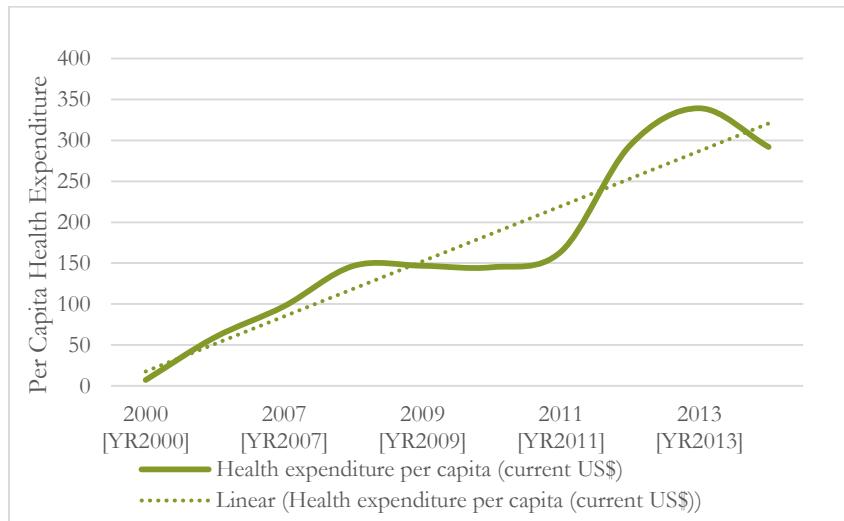
154. While demand for health services is increasing, the supply has not always kept pace. In 2011, the number of doctors per 1,000 population was 0.78, which is low in comparison to other countries in MENA (for example, 2.55 in Jordan and 3.2 in Lebanon). The ratio of emergency doctors is even lower, with only a handful serving in four governorates across the entire country. Many physicians emigrated during periods of war. Around 50 percent of specialized health care staff have left Anbar, Diyala, Ninawa and Salahaddin since June 2014, and an estimated 80 percent of health facilities in these regions are not functional. Nevertheless, countrywide between 2003 and 2012, the absolute number of PHCCs increased in all governorates although not at the same pace everywhere, but the increases were partially, and in a few cases totally, offset by the high rate of population growth. On average, there were 7.4 PHCCs per 100,000 population in 2012, but the population coverage of PHCCs diverges sharply by region. In 2012, the number of small PHCCs ranged from 0.1 to 5.9 per 100,000 population in the central and southern governorates and from 6.7 to 20.2 in the Kurdish governorates. The number of large PHCCs ranged from 2.6 to 4.3 in the central and southern governorates and from 5.4 to 6.8 in the Kurdish governorates. The distribution of public and private hospitals is also very uneven across the country. In most central and southern governorates, the limited growth in the number of hospitals was completely offset by population growth. At the governorate level, the number of public hospitals in 2012 ranged from 0 per 100,000 population (Maysan) to 0.8 in Erbil, while the number of private hospitals ranged from 0.7 per 100,000 population in Ninawa to 1.7 in Suleimaniya. In general, efforts to expand the provision of health services were hindered by the high rate of population growth, which has averaged 2.6 percent per annum. The relatively better condition of health infrastructure in Kurdistan is due to the relative state of security and stability there since 1991. The widening gap in health infrastructure between the Kurdistan region and the rest of Iraq is also related to the expansion of the private sector, which invested in 23 new private hospitals in the region since 2007 (Cetorelli and Shabila, 2014).

155. Most of the health sector in Iraq is financed by the government with a small but growing private sector financed by out-of-pocket payments from patients. Public facilities account for 63 percent of the total, most of which are managed and paid for by the Ministry of Health (73 percent). Total health expenditure as a percentage of GDP increased significantly from less than 1 percent in 2000 to 5.5⁵⁴ in 2014. This was associated with a significant increase in per capita spending

⁵⁴ World Bank data

(in current US dollars) from US\$0.7 in 2000 to US\$292 in 2014 (Figure 59). The burden of out-of-pocket expenditures on households is rising. Between 2008 and 2014, out-of-pocket expenditures steadily increased from 25.2 percent to 39.7 of total spending, a high share of which was accounted for by household spending on pharmaceuticals.

Figure 59. Per Capita Health Expenditures, current US\$



Source: World Development Indicators

156. **The large number of internally displaced persons (IDPs) as well as refugees further exacerbates the challenges facing the health sector.** The deteriorating security situation since June 2014, particularly in the Mosul, Salahaddin, and Ramadi governorates has further reduced access to health care among displaced populations. The influx of IDPs has led to a significant increase in demand for health services, which has challenged the health sector. Basic services in health facilities in IDP camps are either nonexistent or insufficiently equipped to handle the growing demand. Acute respiratory infections, skin diseases, and acute diarrhea remain the leading causes of morbidity in all camps. There has been a resurgence of polio (after 14 years during which Iraq was polio-free) and other infectious diseases (for example, leishmaniasis) among the local population.

157. **In the KRI in particular, the protracted budget crisis due to the collapse of oil prices and the suspension of federal transfers has tested the health sector's ability to respond to the growing health needs of the refugee and IDP populations.** While the KRI's health system and health indicators are generally better than the rest of Iraq, catering for such a large population increase is beyond its capacity. Recurrent health expenditures have not increased in response to the Syrian refugee and IDP crises, which has reduced per capita health spending on the host community. This has caused the performance of the health system to decline, including its equity and responsiveness. A significant amount of financial resources will be required to restore stability to the health sector and to enable the health authorities in the KRI to cope with influx of displaced people. A World Bank assessment of the impact of the Syrian crisis on the health sector in the KRI found that, in a low influx scenario, the total stabilization cost for the period between October 2014 and December 2015 was over US\$339 million, which translates to nearly US\$362 per refugee and IDP (World Bank, 2015f).

Importantly, this stabilization cost was assumed to be in addition to the expected annual health sector budgets of 2014 and 2015 had the budgetary crisis not occurred.

3. Social Protection

158. **Social protection systems have proven to be highly effective in tackling issues of inclusion, recovery, and renewal of the social contract in post-conflict societies, which is highly relevant to Iraq.** However, social protection in Iraq is inefficient and fragmented. The three main pillars of the system, namely social safety nets, social insurance, and labor markets, were conceived individually, with no links or integration. The social safety net (SSN) and indeed the entire social protection system is dominated by the Public Distribution System (PDS), an in-kind program in which the government purchases imported food to distribute to the public. The PDS is the primary safety net for the poor though it suffers from severe inefficiencies. Other safety net programs, including cash transfers, are not poverty targeted and cover only a small share of the poor. Pensions, though reformed in the past, are a drain on the treasury. They cover few of the poor and only a negligible portion of the private sector. Labor market programs put little emphasis on establishing a dynamic labor market and activating the population and collect very little useful data.

159. **In order to tackle the shortcomings of the social protection system, the government is introducing reforms to improve targeting and to create a unified registry of social protection beneficiaries.** These reforms are included in the Social Protection Strategic Roadmap for 2015 to 2019, which aims to integrate the country's various social protection programs under a coordinated policy framework. These changes would go hand-in-hand with an expansion of pension coverage, the unification of pension schemes, and a move towards the introduction of social pensions. This is an ambitious program, particularly in the Iraqi context, but it will be critical to reducing poverty, and increasing equity as well as enhancing the efficiency of public spending.

i. Social Safety Nets

160. **Limited employment opportunities and high poverty rates have increased the population's dependence on social assistance programs over time.** In 2012, 16.4 percent of household income in Iraq consisted of non-labor income, largely composed of transfers. Yet despite large spending on public transfers by the government, few of these resources reach the poor. Pension income reaches less than 20 percent of the poor, while social safety net cash transfers, which use categorical targeting, cover only 10.6 percent of the poor. In contrast, Iraq's largest social assistance program, the Public Distribution System (PDS) – which is the largest public food program operating in the world today – reached over 99 percent of the poor in 2012 and accounted for 64 percent of the total caloric consumption of the bottom 40 percent of households. The PDS provides food rations, with a minimum amount of caloric consumption, to the entire population. As a universal program, the PDS also reaches 95 percent of the non-poor and suffers from significant inefficiencies in procurement, distribution, and management.⁵⁵

161. **The PDS poses a dilemma for policymakers.** It is very effective in reaching the poor and guaranteeing a minimum standard of living, but it accomplishes this goal in a costly and inefficient

⁵⁵ The Daesh insurgency since mid-2014 is undermining the coverage of the PDS. The intensification of the conflict with ISIS has negatively affected the coverage of the distribution system, hampering the disbursement of some products to eligible households in areas under ISIS control. Smuggling and abuse of the system by ISIS has also been reported (IMF, 2015).

manner for the economy. This dilemma is exacerbated by the fact that there are no other large-scale safety nets functioning in Iraq that could accomplish this role should the PDS be eliminated. The cost of the PDS as recorded in the budget was 1.8 percent of GDP in 2014, and represents over 60 percent of the total cost of the entire social safety net system. (The administrative costs of the PDS, which amount to all costs other than food purchase costs, are relatively low, amounting to 0.3 percent of GDP as of 2014.) Overall, the PDS is a burden on the budget, does a poor job of targeting the poor, creates price distortions, and generates waste and creates governance problems (IMF, 2015a).

162. Attempts have been made to improve the targeting of the PDS, but success has been mixed, and simulations have shown that recent changes to the program have reversed poverty reduction in recent years.⁵⁶ Public sector employees with a monthly income of ID 1.5 million (US\$1,286) or higher have been excluded from the PDS in recent years. However, it was not possible to exclude private sector beneficiaries (who comprise around 50 percent of the total labor force) because of the absence of information about their salaries. Other attempts have been made to reform the PDS, although the most radical changes have not succeeded. In 2009, the government streamlined the list of subsidized commodities, which in effect eliminated subsidies on a number of products that had been available on ration cards prior to that time. However, more ambitious attempts to replace the PDS with a cash transfer system in 2012-13 led to widespread demonstrations, which caused the government to backtrack, leaving the in-kind nature of the system unchanged. As in other countries with similar schemes, the cumbersome structure of the in-kind subsidy system has led to governance issues. Several former officials were charged with embezzlement related to food imports. In addition, there have been delays in commodities reaching distribution outlets that have been attributed to poor management and corruption along the delivery channel (World Bank, 2014d and IMF, 2015a). Despite all of these past efforts, the PDS remains a costly and inefficient system and needs to be reformed further.

ii. The Cash Transfer Program

163. Iraq's Social Protection Net (SPN) is a cash transfer program that aims to target poor and vulnerable populations. The SPN distributes monthly grants to beneficiaries based on household size. In 2012, the SPN covered 4 percent of the population but with minimum targeting effectiveness as 71 percent of the beneficiaries were non-poor, while 89 percent of the poor did not receive SPN assistance that year. The program is inefficient and fragmented, providing cash transfers based on categorical targeting (including households with orphans, married students, widows, divorced women, and others), leading to significant leaks (2012 IHSES).

164. To remedy the problems associated with the SPN, a new poverty targeting initiative was launched in April 2016 to introduce proxy means testing (PMT). The initiative is administered by the Social Protection Commission (SPC), which was created in 2014. The targeting of the SPN is being sharpened and will include the crosschecking of beneficiaries against other databases, taking into account other income sources (such as government salaries and pensions) and other assets, and household visits conducted by trained social workers. In accordance with the Social Protection Strategic Roadmap for 2015 to 2019, the government also aims to establish a unified registry of beneficiaries across government ministries and agencies. The new targeting initiative will address the

⁵⁶ See Section III A above.

current fragmentation of databases across various agencies. An important aspect of the registry will be that it will enhance the capacity of the government to reach internally displaced people (IDPs).

165. There are many challenges to be faced in introducing the PMT as a targeting mechanism for the SPN. Capacity will need to be built in the SPC, and it will be necessary to put together a cadre of social workers to identify the poor and to undertake case management, particularly as liberated areas become accessible. Other challenges will include implementing conditional cash transfers to give beneficiaries an incentive to build their human capital, enhancing active labor market programs to help individuals to graduate from receiving benefits by entering into employment, enhancing data collection particularly of labor market statistics, introducing more robust information technology and infrastructure to enable communication among programs and geographic areas, enhancing customer service and payment systems to improve the governance of social protection programs, and improving strategic and operational communications and grievance redress mechanisms.

iii. Pensions

166. There are currently two mandatory pension schemes in Iraq covering public and private sector employees.⁵⁷ However, most of the covered employees are in the public sector under the State Pensions Fund (SPF). Around 48 percent of the total labor force currently contribute to the pension system, although fewer than 3 percent of private sector employees are covered through the Pensions and Social Security Department (PSSD) of the Ministry of Labor and Social Affairs (MOLSA). Both schemes are contributory and designed as pay-as-you-go defined benefit schemes.

167. A new pension law implemented in 2014 (Law 9/2014) has several design problems that are compromising the pension system's financial sustainability, efficiency, and equity. Moreover, the system has inherited a number of longstanding problems. During the post-war period between 2003 and 2006, for instance, new retirees from the two schemes received “flat-emergency” pension payments instead of regular pensions computed according to the social security law because, among other reasons, problems with individual records made it impossible to compute pensions according to the law. Today there are still more than 1 million people receiving such emergency pensions, while fewer than 200,000 beneficiaries receive pensions from the private pay-as-you-go scheme. The pensions have been slightly increased in an *ad hoc* manner as there is no automatic pension indexation. Currently estimated pension spending from the general budget is around 4 percent of GDP.

168. Iraqi policymakers now have an opportunity to fundamentally review the design of the country's pension system, including merging the existing schemes, improving the system's financial sustainability, adequacy, affordability, efficiency, and design, and implementing mechanisms to expand coverage. In the end, the choices that are made will necessarily reflect social preferences and cultural values but should be well-informed and driven by affordability. It is also important to emphasize that reforming pension system is always very sensitive politically. Pensions represent long-term commitments and, without proper data and analysis, the consequences of making some short-term decisions can be devastating in the medium and long term.

⁵⁷ Kurdistan has also two separate pension schemes covering around 50 percent of the labor force in the region (mostly public sector workers).

169. **The tables in Annex 3 present the main characteristics of the current pension schemes** (the SPF and the PSSD), as well as the characteristics of the SPF before the new law. As indicated in Table A3.1, the current contribution rate in the public pension scheme is 25 percent (10 percent from employees and 15 percent from the government as the employer). The total contribution rate for the pension program for private sector employees is 14 percent, but these employees also pay for work injury protection and health insurance programs. The total contribution rate for private sector employees for all of these programs is 17 percent. However, although required by law, most private sector employees in Iraq do not contribute to a pension scheme for their employees.

170. **The generosity of the current pension schemes is captured by the real implicit rate of return on the payments that individuals receive**, which ranges between 5 percent and 8 percent of their salary at the age of 60. Since individuals pay contributions and receive pensions – an operation similar to depositing savings in a bank and then withdrawing savings plus interests – it is possible to compute the implicit rate of return on these contributions. When benefit formulas are not well designed, this implicit rate of return varies with the retirement age and with members' wages and contributions histories. In general, the earlier an individual retires, the higher the rate of return. Under the new law, implicit rates of return are not very different from those under the old law. Individuals retiring between the ages 55 and 60 receive real rates of return significantly higher than 5 percent per year. Based on international experience, a real implicit rate of return should not be higher than 3 percent. Moreover, as indicated in Table A3.2, a person covered by the SPF under the new law can retire as early as the age of 50 (even earlier under the disability program), although most people retire at the age of 63 (the mandatory retirement age). Pension indexation is not specified by law, and instead pensions are only indexed in an *ad hoc* manner, which is not good practice by international standards. Regarding the benefit formulas, an accrual rate of 2.5 percent is high by international standards, and makes the scheme financially unsustainable.

171. **As indicated in Table A3.3, the current number of contributors in the public sector pension scheme is more than 3 million people, while fewer than 200,000 people contribute to the private sector pension scheme.** Currently more than 138,000 people are receiving benefit payments from the public sector pension scheme, and around 22,000 receive pensions from the private sector pension scheme. The estimated amount of revenues taken in by the PSSD in 2013 was 50 billion IQ dinars, while its expenditures represented more than 42 billion IQ dinars. In the case of the SPF, the estimated amount of revenues was 6.7 trillion IQ dinars, while its expenditures represented only 854 million IQ dinars given the fact that the scheme was only paying pensions to those who started retiring in 2006.⁵⁸

172. **The government envisions reforms to aspects of the pension system**, including the integration of the public and private pension schemes and the introduction of social pensions. The public sector scheme (SPF) will need to become self-financing or at least rely only minimally on the general budget. For this purpose, the qualifying conditions and benefit formulas of the scheme as described in Law 9/2014 will need to be changed. The integration of pension schemes would mean that private and public sector employees would be covered by the same national pension scheme. The

⁵⁸ As indicated earlier, more than 1 million people are receiving pension payments from the general budget (people who retired before 2006).

PSSD would need to be integrated into the SPF; expansion of coverage of the active labor force and beneficiaries is also contemplated, with a draft law currently in Parliament.

E. Critical Infrastructure Gaps

173. **Iraq has neglected its non-oil infrastructure.** Public investment has been severely curtailed in recent years, and is further hobbled by deficient public investment management. With a few exceptions, the private sector is not yet in a position to play a major role in the sector. Yet infrastructure is a key ingredient in relaxing many of the constraints on the Iraqi economy from service provision – the construction of much-needed schools and clinics – to water supply, irrigation, and power production, and distribution. Improved transport links are critical for increasing internal integration, promoting trade and commerce, widening access to job opportunities, equalizing welfare, and combatting the growing isolation of Iraqis by ethnicity and sect.

1. Energy Sector

174. **The energy sector has become a focal point for citizen dissatisfaction and an example of the inability of the state to provide the basic services required for an acceptable quality of life, for private sector growth, and for economic diversification.** Iraq's overall economy and its energy sector have both suffered from 30 years of international sanctions and conflict that have left institutions weakened and resulted in under-investment and chronic deterioration in infrastructure, in particular gas and power. The government, firms, and citizens all see inadequate electricity as their top concern because the electricity grid is able to only provide about 7.6 hours of electricity per day, leaving Iraqis having to rely on expensive and polluting diesel generators for power. Although conditions have improved in recent years for some firms, according to the Enterprise Survey in 2011, firms ranked access to and the reliability of electricity as the biggest obstacle to doing business —above informality and political instability. Almost 54 percent of the firms cited electricity as a major constraint, which is not surprising given that the many electrical outages in a typical month (41) and the loss of sales due to electrical outages (5 percent of annual sales) are above MENA regional average. Peak summer demand has typically exceeded actual generation by almost 50 percent, and Iraq's Integrated National Energy Strategy (Booz and Co, 2013) estimated the cost of power outages at US\$40 billion per year. This lack of reliable electricity services contributes to significant social frustration and unrest and undercuts the productivity of firms.

175. **The energy sector is a burden on Iraq's budget.** The Iraq Public Expenditure Review (World Bank, 2014) estimated that explicit subsidies for electricity use alone constituted 65 percent of all subsidies in the budget and 3 percent of total recurrent budgetary spending in 2010. However, the true cost of energy subsidies is higher than this. Not only are domestic end-user prices low in comparison to prices in other countries but they are also significantly below the opportunity cost of supply. Pre-tax subsidies for energy (including petroleum, natural gas, and electricity) amounted to 11 percent of GDP in 2011 (IMF, 2015).

176. **The electricity sector in Iraq has a number of concurrent challenges.** 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 percent 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 percent of the operational expenditures.

177. Inefficiencies in the energy sector impose a significant fiscal and economic burden on Iraq. Iraq is the fourth largest gas flaring country in the world, while at the same time it suffers from a shortage of natural gas for which it incurs large fiscal and balance of payments costs. Close to 60 percent of the country's gas production is flared in-field. Because Iraq is not capturing the gas produced during the flaring process in order to use it in electricity production, more than 50 percent of the fuel used to operate gas turbines consists of gasoil, crude oil, and heavy fuel oil, which are more expensive than natural gas and degrade the performance and useful life of generation equipment. The result is that a country that is rich in energy resources relies on expensive and imported fuels to produce electricity, costing an estimated US\$6 to 8 billion per year. Gas flaring is not only costly and wasteful but also 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.

178. There is a significant opportunity to diversify the energy mix, particularly by putting more emphasis on renewables, given Iraq's exceptional solar density and wind energy potential. The government aims to generate 10 percent of the domestic energy mix from renewables by 2020 and has been seeking foreign investors to build solar and wind farms across the country.

2. Transport

179. Prospects for economic diversification, private sector development, and employment growth in Iraq are hampered by a weak and underdeveloped transport sector. Iraq's weak transport network undermines connections between regions, and reduces the potential economic and social interactions between them. The underdevelopment of transport infrastructure (for all modes, including roads, railways, ports and airports) is an obstacle to the movement of people and goods, hurts trade and competitiveness, and prevents people and firms from accessing services and markets. The poor state of transport infrastructure constrains the development of a thriving private sector. The lack of a sector strategy, chronic underfunding, weak institutions, and a complex conflict-affected environment compound the problem. The entire sector has suffered from weak and unsuitable institutional and maintenance policies that have caused grave deterioration in transport infrastructure, which is a key enabler of development. The main problem is a lack of capital investment for periodic maintenance and new development to maintain basic standards. Underfunding rather than under-execution is the key constraint to transport in Iraq, unlike other infrastructure sectors. Similarly, effective transport institutions are needed to translate increased investments into a basic level of service delivery. Beyond investments, what is also needed is the development of a strategy and vision to guide the future of the sector.

180. The poor condition of the transport infrastructure and lack of transport services has significantly affected the mobility of Iraqis, particularly the poor, and especially in rural areas. Most of the Iraqi population is inadequately served by unpaved roads, with the worst conditions experienced disproportionately by certain income groups. For example, poor workers in non-wage agriculture are more likely than others to live on unpaved roads and to live more than five kilometers from a market. Upgrading transport infrastructure would considerably increase access to their health services, education, and job opportunities.

181. **At the macro level, economic growth is constrained as a result of the low level of annual capital investment in transport infrastructure and in roads in particular.** The bad condition of the road network raises the cost of trade and commerce and impedes the international and inter-regional mobility of goods and services. Weak economic integration contributes to low economic productivity. Poor access to labor and markets hinders firms, reduces the employment and economic opportunities available to households, and impedes access to health and education services. Poor road conditions have also led to a high rate of mortality from accidents. Furthermore, in a country divided by sectarian and other divisions, the ability to leverage a well-functioning road for political and social integration between regions and communities is weakened.

182. **The road network in Iraq is the most developed transport mode, but it is neither well connected nor maintained.** The air, sea, and railway networks all need significant upgrading. Railways and logistic hubs are under-developed but are crucial to Iraq's future given the country's geostrategic position and the need to reduce the heavy traffic burden on roads. Public transport, both urban and inter-city, is chaotic, resulting in poor mobility.

183. **Broadly, the transport sector faces a number of constraints.** These include administrative limitations, including low institutional capacity, combined with changes in leadership and priorities that can affect plans and programs. The relevant institutions have overlapping responsibilities, outdated management procedures, segmented processes, uncoordinated units, and there is a lack of reliable network surveys. Weak contracting procedures make it difficult to implement large maintenance, reconstruction, and development programs. Limited and unreliable service on transportation routes increases travel times for passengers and goods and reduces traffic safety. The lack of cross border facilities and procedures with Iraq's neighboring countries makes trading across borders difficult, as does the absence of sub-regional economic or corridor management arrangements.

184. **There is a need to accept political realities and to tackle immediate challenges with an incremental and practical approach that can be improved over time anchored in a coherent program of immediate, medium-term, and longer-term support.** This might mean initially focusing on developing asset management systems and adopting international standards and practices for planning and programming, procurement, financial management, and environmental and social safeguards, while the medium-term to long-term actions should focus on institution building and reform. In parallel, Iraq will need technical assistance with customs reform and the introduction of public-private partnerships, which could facilitate investment in the development of customs and border crossings and infrastructure development schemes.

3. Information and Communications Technology

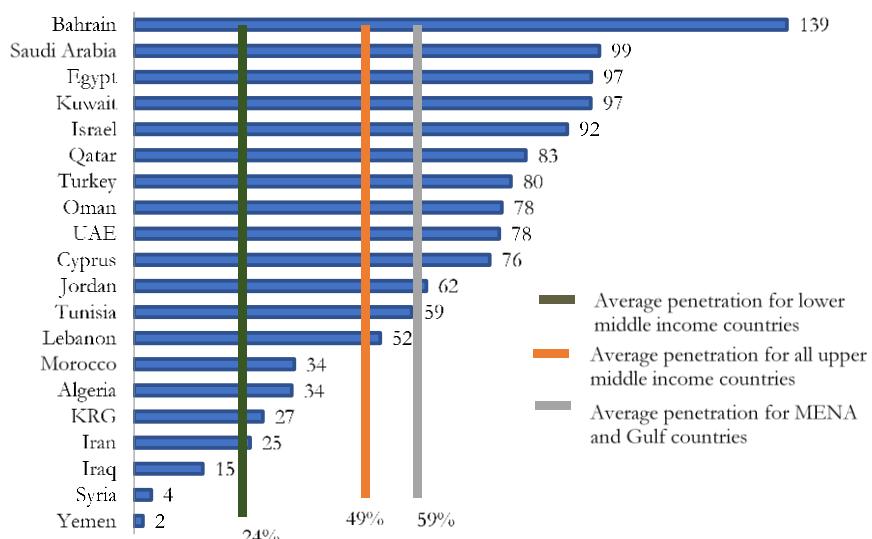
185. **After the oil sector, ICT is the second largest private-sector-led economic contributor to Iraq's GDP.** The total revenues of the three big mobile companies are US\$4.4 billion and total revenues of the government-owned wireline and broadband operator Telegeography was around US\$246 million in 2014. In terms of job creation, the percentage of direct jobs created in the ICT sector around the world is relatively modest, ranging from 3 percent of total employment in the OECD countries in 2013 (OECD, 2015) to an average of 1 percent in developing countries. However, ICT creates more jobs through spillovers into other sectors. The Ministry of Communications in Egypt reported that 2.8 indirect jobs were created for every ICT job in the period between 2008 and

2011. In the United States, each high-tech job creates 4.6 additional jobs in other sectors, and M-pesa, the mobile payment system in Kenya, generates income for more than 80,000 agents, jobs that are not considered to be ICT jobs.

i. *Broadband*

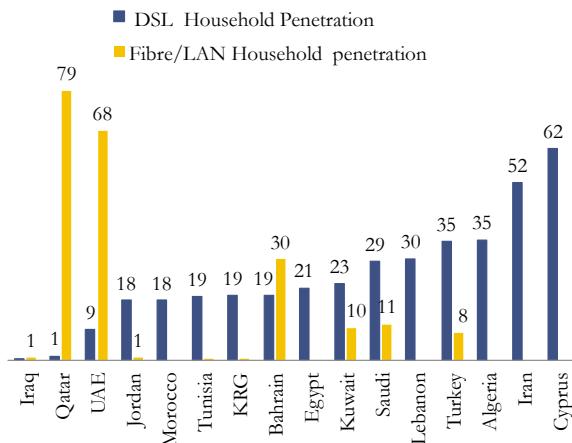
186. **In Iraq, the telecommunications, and especially the mobile market is relatively competitive**, with three mobile operators and one government-owned wireline and broadband provider. Mobile penetration is around 90 percent, indicating a high number of mobile SIM cards. However, there is considerable room for growth, especially in mobile and broadband services. Iraq has one of the lowest rates of mobile and fixed broadband adoption in the MENA region (Figures 60 and 61). On the other hand, mobile voice and broadband packages in Iraq are among the least expensive in the Arab countries, especially for lower usage plans (**Error! Reference source not found.**).

Figure 60. 3G Penetration: Subscribers as % of Population, 2015



Source: Telegeography 2015

Figure 61: Fixed Broadband Penetration: % of Households by Technology, 2015



Source: Telegeography

Table 11. Broadband Price Benchmarks, US\$ PPP

Mobile Broadband	Prices in Iraq	Arab countries Average	OECD Average	KRG Ranking out of 19 Countries
30 calls + 100 MB	\$ 4.15	\$ 30.60	\$ 17.17	2nd least expensive
100 calls + 500 MB	\$ 12.76	\$ 69.37	\$ 26.94	3rd least expensive
300 calls + 1GB	\$ 27.78	\$ 125.55	\$ 36.64	6th least expensive
900 calls + 2GB	\$ 70.80	\$ 265.75	\$ 44.15	8th least expensive

Source: TRA Bahrain, ARGNET annual retail price benchmarks, Telegeography, 2015

187. **Several legal, regulatory, and structural constraints impede the rapid growth of the telecom market in Iraq.** First, the Iraqi government has yet to pass the country's first telecommunications law to guide the direction of the sector. Policymakers are still debating several contentious issues, the most important of which are the government monopoly over the national optical fiber network and international connectivity. This monopoly and the inability of the national operator the Iraqi Telecommunications and Posts Company (IPTC) to provide good quality services at affordable prices is a considerable drag on all residential and business mobile and fixed services. Moreover, aging infrastructure and the inability of the government to fund, maintain, or operate such infrastructure greatly impedes growth in the mobile market as well.

188. **There is a growing appetite for investment in the telecommunications market in Iraq and it is one of the most dynamic of the private-sector-driven sectors.** Developing synergies with the infrastructure in other sectors such as transport and energy might be a cost-effective way to further expand access to internet services. Also, the government could foster the development of the market by encouraging more competition for telecommunications infrastructure as well as services, thus

accelerating progress towards realizing the economic and social opportunities that will arise from the universalization of high speed internet services.

ii. International Connectivity

189. **The telecom market can also play an important role in strengthening Iraq's connectivity and integration with other countries in the MENA region.** Iraq enjoys a prime geopolitical location that makes it an ideal hub for international connectivity, particularly for the countries of the GCC region and for international traffic between the Middle East, Europe, and Asia. Transiting international traffic through Iraq would generate more internet capacity for the country at competitive prices, create new business opportunities for domestic investors, and provide new jobs.

190. **There is considerable interest among domestic and foreign investors in making Iraq a regional hub for internet traffic.** For instance, there is the potential to expand fiber infrastructure from the submarine cable landing points in Al Faw to Turkey and Iran via Iraq. However, at present the government has no strategy or vision for transforming Iraq into a regional hub for international connectivity.

iii. Public-Private Partnerships

191. **Public-private partnerships (PPPs) are one of several ways to increase private sector participation in the economy, especially in key sectors such as energy, transport, and ICT.** However, to date, the government has been relatively unsuccessful in implementing (PPP) procurement for infrastructure development. This is due to a number of challenges including political instability, the security environment, and a lack of understanding of PPP procurement and contractual requirements within the relevant ministries. Successful private participation in infrastructure development in Iraq has so far been limited to the telecom sector, power generation in Kurdistan, and the Umm Qasr Container Terminal. In 2010 the Government of Iraq launched an unsuccessful independent power project (IPP) program that aimed to mobilize significant private investment, but this was canceled in 2011, reflecting a flawed tendering process and risk assessment that was inconsistent with market expectations in the Iraqi context. Some positive developments have been recently reported by the Ministry of Electricity in both the power generation and distribution areas. The ministry is working with local private partners to increase gas generation capacity and improve the distribution system and is also seeking foreign investors to develop Iraq's solar generation capacity. The long-term sustainability of these partnerships will depend on whether the weaknesses in procurement processes and contractual arrangements can be overcome to attract the private sector, especially foreign investors. It will also be dependent on the capacity of the private partners to deliver.

F. Agriculture and Threatened Natural Resources

192. **Iraq today faces very serious environmental problems,** ranging from poor water quality, soil salinity, air pollution, waste management problems, and contaminated sites to the deterioration of key ecosystems. It will be critical to address these issues in order to protect livelihoods, sustain growth, and support diversification in Iraq. The continued contraction of agriculture threatens incomes in rural areas and is a missed opportunity for Iraq in terms of food security – given the increasing pressure to feed a population that is growing at an annual rate of more than 3 percent - and in terms of diversifying the economy.

1. Agriculture

193. **Globally, agricultural growth has been shown to be an important driver of poverty reduction and job creation, especially among the rural poor.**⁵⁹ Agriculture is more labor-intensive than other sectors, and while the labor market and agricultural sector are dominated by males, the highest shares of female labor are in agriculture and the service industries. Rural households spend a higher share of their income on food than urban households, and the share of income spent on food generally decreases the richer households become. Iraq is no exception, but the importance of agricultural employment in Iraq has been on the wane, and the role of the sector has been undergoing significant changes. In 2012, about 30 percent of Iraq's rural poor in the labor force worked in agriculture, but only 12 percent of the heads of poor households worked in the sector. Interestingly, the composition of farm employment changed too – with the share of women in total farm employment increasing from about 36 percent in the early 1990s to 52 percent in 2012. It is important to discover whether this change is structural, but this will require more detailed analysis. If agricultural development can improve the allocation of resources within households, it will likely lead to better health and nutrition outcomes for children as well.

194. **The sector's low productivity and growth rates in Iraq are attributable to a variety of factors including the government's past policy of maintaining artificially low food prices through price and production controls and marketing restrictions.** Nationwide subsidized food distribution through the PDS using imported food has had a negative impact on the local grain market with consequent depressing effects on producer prices and on agricultural sector investments. Government policies in the agricultural sector have been characterized by state control and subsidization of farm inputs (fertilizers, seeds, insecticides, farm equipment, and machinery) and of the prices of strategic crops. The most important crop, wheat, has been the most controlled and the most affected by the lack of open markets. In addition, years of insufficient maintenance and funding have degraded agricultural services and physical infrastructure, particularly the irrigation network. During the recent conflicts, extensive looting damaged a range of government and private agricultural production and service facilities in central and southern Iraq. Climate change is another threat.

195. **Problems in irrigation are severe.** They range from widespread deterioration of irrigation infrastructure to the poor operation and maintenance of the systems, inefficient water use, soil salinity, weak institutional support, and the lack of a regulatory framework for the efficient use and pricing of irrigation water. Salinization is one of the most active land degradation phenomena in central and southern Iraq. The Food and Agriculture Organization estimates that approximately 60 percent of cultivated land has been seriously negatively affected by salinity, and 20 to 30 percent has been abandoned. Even on non-abandoned agricultural land, yields have declined by 30 to 60 percent as a consequence of salinization. The salinization of soil has the most negative impact on poor farmers and their livelihoods. The effects of climate change threaten further salinization. There will be more shortages of water resources in Iraq after Turkey and Syria develop their irrigation projects along the Euphrates, Especially as no international water use agreement has so far been signed by the three countries.

196. **Climate change threatens to exacerbate the effects of existing poor practices in agriculture.** Deforestation, land degradation, overgrazing by livestock, war, and rapid urbanization

⁵⁹ This section is based on World Bank and FAO (2011)

all hasten desertification and land degradation. The implications of climate change and land degradation pose serious threats, primarily to food and water security. Climate change is already affecting the agriculture sector and is set to be an increasing threat.

197. Significant investments in the sector are required to meet these challenges and to fulfill the sector's potential contributions to growth and diversification, food security, and employment generation. Yet there are no incentives in place to encourage private sector investment in food and agriculture. Because of the isolation of Iraq in recent decades, agribusiness and food and agricultural enterprises have not been able to benefit from international markets, modern production techniques, or global trading standards. There are few incentives to invest in agricultural processing industries or value chains because of the complicated and outdated administrative and regulatory system, the considerable shortcomings of the public agencies that are in charge of the advisory and technical services, erratic price policies, inefficient marketing networks, poor infrastructure, the limited amount of available market information, and the complicated and time-consuming export-import procedures. The requirements for licensing, registering, and closing businesses are unclear, and communications infrastructure is limited. Poor access to finance is a particular impediment, as access to credit is difficult outside government-subsidized credit programs. There is no private capital investment in the sector, and the near absence of institutional credit has made the cost of capital prohibitive for agricultural producers. Overall, the business environment lacks the transparent and clear legal frameworks needed for regulated market competition. Not only the fragile security environment and poor investment climate in Iraq, but also the lack of reliable market data, the weak enforcement of product standards, and unsystematic and underdeveloped distribution and logistics chains present formidable disincentives for private firms to invest in Iraq's agriculture sector.

198. The capacity of institutions like the Ministry of Agriculture and the Ministry of Water Resources to provide services to the sector has declined over the past two decades. There is little institutional coordination and cooperation in agricultural planning and project implementation. This weak institutional support has translated into a dramatic deterioration in the performance and coverage of the research and extension services, animal health and artificial insemination centers, plant quarantine, and disease control, mainly due to a lack of staff incentives and physical infrastructure. Agricultural information systems for the public sector managers of the sector are weak, and statistical information is sparse. This further hinders the effective development of agricultural policies, as well as the ability of managers to monitor and assess agricultural interventions.

2. Water

199. Unless there are changes in water management, Iraq may not have enough high quality fresh water to meet its development needs by as early as 2020 (T-Zero, 2015). Iraq currently has relatively abundant water compared to many other countries in the region - current annual, renewable freshwater availability of 2,200 cubic meters per capita compared to a regional average of 1,100 cubic meters. Yet rapid population growth is quickly reducing the gap between the demand for and the supply of water. Municipal and industrial demand for water has grown substantially, raising concerns about how to allocate water between competing uses. Declining water

quantity and deteriorating quality have put almost 40 percent of historically irrigated agricultural areas⁶⁰ out of production, while 70 percent of crop land is affected by high soil salinity, which significantly limits crop yields. The inadequate water supply also has a direct economic impact on the private sector. The Investment Climate Survey of 2012 noted that the average manufacturing firm in Iraq reported experiencing 17 water outages per month. To augment the public water supply, many firms rely on their own wells or commercial water providers, which adds to their costs.

200. **Iraq's water sector has suffered from decades of conflict and sanctions that left its institutions weakened and that have resulted in under-investment and chronic deterioration of its infrastructure assets.** Public spending on the water sector increased rapidly between 2007 and 2012 (World Bank, 2014b). Average annual public expenditure on water as a proportion of total federal spending in 2012 was almost 4 percent (from a low of 1.9 percent in 2007)—the equivalent of 1.8 percent of GDP.⁶¹ Compared to international benchmarks, the flows of funds moving into the sector are significant, although in MENA, many countries spend relatively abundantly on water.⁶² Nevertheless, the Iraqi water sector faces a significant investment gap.

201. **Most of the funds for the sector are provided by the government as consumers contribute very little even to the operation and maintenance of water services.** The high cost to operate and maintain the current water infrastructure is a significant fiscal burden, as there is a large gap between the cost of producing a cubic meter of water and the cost of the water supply and sanitation services as billed to users. Revenues cover only a small fraction of the system's operational and maintenance costs. The cost of connecting an additional person to the piped water and wastewater network is very high—ranging from US\$500 to US\$3,000 per capita (including both rehabilitation and expansion investments).⁶³ The higher costs in Iraq are a result of the challenges in delivering services to customers including: (I) security issues; (ii) deficiencies in budget allocation, investment planning, procurement, financial management, contract management, and monitoring; and (iii) technical standards that are set very high and apply to both rural and urban environments.⁶⁴ The high levels of subsidies in turn crowd out the possibility of expanding services to those not yet connected to the water supply and sewage network or to extend the reach of irrigation, which explains the lack of progress in expanding access.

202. **Increasing access to high-quality water services will be key to Iraq's economic growth and poverty alleviation.** Overall, Iraq has wide access to water and sanitation services because the government built large hydraulic infrastructure (dams and barrages), mainly in the 1980s. The poor have less access to improved water services than the non-poor, but the access gap between poor and non-poor is declining. In 2000, only about 40 percent of households in the poorest quintile had access

⁶⁰ Iraqi agriculture is predominantly irrigation-based (about 70 percent by value). The cereals subsector is the largest contributor to agricultural GDP, followed by “fruits and vegetables” and “livestock.”

⁶¹ The numbers, however, underestimate actual spending in the sector as they only capture the actual expenditures of three water agencies and there were no data available on what the governorates or the private sector spent on water.

⁶² The data presented here vary by country in what precisely is being measured as water sector definitions vary by country, as does the scope of each analysis.

⁶³ These figures are in contrast with the cost of water and wastewater connections in other countries. In a cross-section of countries, Fay and Yepes (2003) found US\$400 per water supply connection and US\$ 700 for a sewerage connection.

⁶⁴ The National Development Plan assumes that water supply systems are designed at 450 liters per capita daily (lpcd) in Baghdad and 350 lpcd elsewhere in Iraq. Median water supply consumption was only 158 lpcd in 2010 according to the IBNET Blue Book, which benchmarks utility performance internationally.

to improved sources, while 100 percent of households in the richest quintile had access. However, by 2012, access to improved water sources for the poorest quintile has increased to 72 percent.

203. Although there are still access gaps in water and especially wastewater services, the government's main focus should be on improving the quality of the services. The low quality of services has resulted – especially in the water and sanitation sector – in the private sector picking up where the public sector has failed. The private sector fills the gaps especially in the provision of drinking water and of sanitary facilities by selling bottled or desalinated water or booster pumps and by installing septic tanks.

204. While the lack of international agreements on the Euphrates and the Tigris rivers⁶⁵ constrain Iraq in its ability to plan its water resources in the coming years, there is scope for improving water use and quality within Iraq. Currently Iraq has a total renewable water supply of about 2,200 cubic meters per capita per year, of which only 1,042 m³ are generated in-country, which is close to the water stress threshold of 1,000 cubic meters per capita per year (water stress occurs when the demand for water exceeds the available amount for a period of time or when poor quality restricts its use). Water scarcity in Iraq will increase over time as a result of demographic pressures and climate change, resulting in an increased demand for water resources, which will be exacerbated by the deterioration of water quality. Improved management planning, and development of water resources in Iraq will be necessary to optimize the operation of dams and to reduce losses and inefficiencies in the water system.

205. Increased demand by riparian states – Turkey and Syria – on the Euphrates and Tigris rivers has also led to a decline in the water quality. While the present quality of water in the Tigris near the Syrian border is assumed to be good, the water quality of the Euphrates entering Iraq is poorer because it is negatively affected by return flow from irrigation projects in Turkey and Syria. The quality of the water in both rivers within Iraq is also affected by pollution inflows from urban areas such as Baghdad, return flows from irrigation, and poor wastewater treatment infrastructure. One of the most important contributors to poor quality of raw water in the Tigris and the Euphrates is the discharge of waste water and drainage from irrigated lands directly into the rivers. Large schemes such the Al Eshaqi drainage canal and others in different locations in Iraq need to direct most of drainage into the Third River rather than the Tigris or the Euphrates.

3. Environment and Natural Resources

206. Iraq's environment has been subject to a number of converging pressures stemming from population growth, the impact of three destructive wars and their disastrous aftermath, forced migration, poor land use planning, urban sprawl, and encroachment on fragile ecosystems. The drying and degradation of the Marshlands, low water inputs to Iraq, shrinking green spaces, and the violation and failure to enforce environmental laws have collectively resulted in the deterioration of the environmental and ecological integrity of the country. In the alluvial plains, the soil has been damaged by the deposits of large amounts of salt borne by irrigation overflows and wind and poor soil drainage. Desertification and soil erosion have reduced arable lands. These negative effects on the environment in Iraq are manifested in the scarcity and pollution of the water resources

⁶⁵ The Euphrates–Tigris River Basin represents a total area of 879,790 square kilometers that includes the following riparians: Iraq (46 percent), Turkey (22 percent), the Islamic Republic of Iran (19 percent), the Syrian Arab Republic (11 percent), Saudi Arabia (1.9 percent), and Jordan (0.03 percent).

(addressed above), air pollution and the deterioration of air quality, a reduction in biodiversity, and the pollution of marine waters.

207. **There are several reasons for the worsening of air quality in Iraq.** These include (i) the use of low quality fuel in transport, power generation, and the industrial sectors; (ii) a significant increase in the number of personal cars in the last decade or so; (iii) the absence of an adequate public transport system, with an aging vehicle fleet operating on low quality gasoline and diesel fuel with no regular inspection or maintenance; (iv) emissions from industrial facilities such as power stations, petroleum refineries, chemical production, brick kilns, and lead and aluminum smelters; (v) open burning of waste due to a lack of sufficient waste management facilities and services; and (vi) an increase in illegal logging and tree-cutting (for fuel use) in the absence of government initiatives aimed at the reforestation or maintenance of green belts.

208. **Gas flaring and dust storms are two other significant issues contributing to the deterioration of air quality in Iraq.** The continual flaring of associated and natural gas in oil fields leads to high levels of emissions. Currently, Iraq is flaring around 70 percent of all natural gas that it produces, releasing around 20 million tons of carbon dioxide per year to the atmosphere. The increase in the frequency and severity of dust and sand storms is the result of a host of factors including soil disintegration and erosion, the deterioration of vegetation, desertification, and the deterioration of green spaces (due to a lack of attention, insufficient irrigation, and the indiscriminate cutting of trees for security reasons and for an alternative source of energy).

209. **As a result of wars and the use of agricultural lands in industrial and urban activities, Iraq's biodiversity has deteriorated in kind and density.** The fragmentation of agricultural lands has led to a reduction in the number of green spaces serving as natural habitats of flora and fauna. The drying of the Marshlands has negatively affected migrating birds. The deterioration of biodiversity in Iraq can be attributed to: (i) overhunting and the use of poison, electrocution, and explosives in hunting; (ii) high salinity in lakes and rivers; (iii) ecological pollution from wastewater, air pollution, plant waste, and thermal pollution from power plants; and (iv) the introduction of invasive species and exotic types of fish and animals, which has had a negative impact on indigenous species in their natural habitats.

210. **Another challenge being faced by Iraq is the pollution of its marine waters.** The Iraq coastal water belt has a high fertility rate, which attracts the Gulf fish during mating seasons. It is also the passageway for migrating fish from the Gulf into Iraqi waters entering Shatt al-Arab, Khor al-Zubair, and the Marshlands where natural food is abundant. Recently, pollution from oil activities in the Iraqi ports has caused significant damage to regional waters, which has harmed biodiversity and negatively affected fisheries. A host of different factors have contributed to the increased salinity in Shatt al-Arab, which has reached high concentrations that have exceeded 30,000 pm in some cases.

211. **Iraq is one of the countries that has been hardest hit by climate change in the Middle East.** Between 1970 and 2004, Iraq's annual mean temperature increased by 1 to 2 degrees Celsius. Due to frequent droughts and a decline in precipitation, salinization has intensified through greater evaporation and water shortages. Extreme weather and a scarcity of resources exacerbated by climate change combined with ineffective government services has heightened conflict in Iraq. In addition, the impact of global action on climate change for fossil fuel exporters such as Iraq is likely to add a further significant layer of uncertainty for Iraqi policymakers.

V. Sustainability

212. This chapter identifies some issues related to social, environmental and fiscal sustainability of Iraq's current pattern of growth and development. It highlights the main risks to the sustainability of the process of growth, inclusion and poverty reduction.

A. Social and Political Sustainability: A Focus on Decentralization

213. **The current governance architecture in Iraq, which is based on sectarianism, is defective and has been patently unable to resolve the basic problem facing Iraq, the need to allocate oil wealth fairly across the country and the population.** Sectarian governance has also failed to ensure the provision of even the most basic services or to guarantee security. It has engendered widespread and deep corruption as a rational response to circumstances. The key question facing Iraq today is whether a new structure can be built in consensus and peace that has a better chance of equitably distributing resources. Iraq's social and political sustainability is likely to depend upon it.

214. **Decentralization is frequently discussed as a potential solution to Iraq's sectarian struggles as well as a way of reversing the decline in service delivery and accountability.** The term "decentralization" refers to a potential power-sharing arrangement between those who rule Baghdad, the semi-autonomous government in the KRI, and the country's provincial leaders. Central to the concept of decentralization is an increase in regional or local control over the use of oil revenues. Its form has been a constant and politically charged question as it is taken to mean different things to different people. Any exploration of greater local autonomy by the governorates often raises suspicions that the exponent wants to partition the country (Hiltermann et al, 2012). Yet legitimate and complex questions have been raised. Would Iraq remain viable as a country if other governorates or regions were given the same autonomy as the KRI? Is it possible to craft revenue-sharing arrangements that respect both regional and provincial ambitions as well as Baghdad's basic sovereign prerogatives? Would these arrangements function equally well for all regions – those rich in oil and gas and those that are less well-endowed?⁶⁶

215. **In Iraq to date, this fundamental question of governance has generated little more than stalemate.** The issue of decentralization is being handled largely in the context of the annual budget discussions. However, simply to throw more resources at subnational governments if they do not have the capacity or skills to spend them effectively is not a solution. On the other hand, if the government fails to respond to legitimate pressures for decentralization, especially in areas too far from Baghdad to make their local needs known, this may create a political backlash and renewed sectarian conflict.

⁶⁶ A study of a wide range of claims that decentralized systems can contribute to social and political stability, including as part of conflict avoidance and post-conflict reconstruction, found that the type of decentralization, the social context, and conflict experience all have an impact on key outcomes such as: (i) whether decentralization improves the way services are delivered and (ii) whether it accentuates differences between regions and causes citizens to identify with ethnic, geographic or minority groups, exacerbates local conflict, or enhances the power of opportunistic elites (Porter et al, 2010). However, a multi-country statistical analysis concluded that decentralization can mitigate conflict when it successfully brings subnational groups into a bargaining process with government, builds trust, and increases state legitimacy and is perceived to equitably share resources among regions in ways that reduces unevenness (Seigle and O'Mahony, 2006).

The extent of any political, administrative, and fiscal decentralization in Iraq will need to be built on political consensus (World Bank, 2010).

216. Asymmetric decentralization, under which the level of autonomy granted to subnational governments varies according to negotiations and agreed criteria, may be a promising concept for discussion. The Iraqi Constitution is based on the idea that federalism should be symmetrical and that the same amount of autonomy should be granted to all regional governments. This reflected reality in 2005 at the time when the constitution was being written and the KRI's post-1991 Gulf War autonomy became the effective floor for regional authority in the constitution. Yet this symmetry may not be a feasible goal today in terms of both the political cohesiveness of the country and the need to increase equity and reduce poverty. Taking an asymmetric path towards decentralization may allay fears that the government is moving towards partition while beginning to deliver on the promise of greater subnational autonomy enshrined in the Constitution. It could also safeguard the central government's key fiscal and monetary powers as well as its authority over oil contracting. Asymmetrical federalism has been used in several countries around the world to recognize diversity and manage internal conflict. For example, in the case of Banda Aceh and Indonesia, asymmetrical arrangements helped to end a long-running internal conflict. In Spain, an asymmetrical arrangement was used to prevent wider conflict by granting cultural and administrative autonomy to the Basque and Catalan communities (Hiltermann et al, 2012).

217. An orderly discussion built on the imperative of achieving political consensus may also be a way to avoid a division of the country along strict ethnic and sectarian lines. Iraq's three major communities are not as geographically contiguous as is often assumed (although recent violent conflict has increased this), giving rise to potential discrimination or violence against large groups of minorities. The example of the province of Diyala, a diverse Sunni-Shia-Kurdish province in north-east Iraq, is telling. When it sought to declare itself an autonomous region in December 2011, opponents of the decision took to the streets and violent protests broke out leading to arrests and the mobilization of state security forces. Moreover, basing political legitimacy based on sectarian identity ignores many other cross-cutting identities such as class and urban/rural location among others. Strongly aligning Iraq's political institutions with its sectarian identities is likely to entrench the zero-sum nature of competition for resources and power that has already generated so much instability. The experience of Lebanon is telling in this regard, where instability continues to exist under a government organized according to a division of rents among sectarian communities (Fitzsimmons, 2008 and World Bank, 2015g).

218. An asymmetrical model of decentralization may be able to respond to the desire of many Iraqis for greater accountability and better services through the granting of greater local control over resources. Today's highly centralized model leaves governors and provincial councils with very limited direct budgets, virtually no own-revenues, and no control over public sector hiring within their governorates. In many cases, most of the security forces operating in the governorates report directly to Baghdad, and accessing the small share of investment funds given to provincial councils requires a lengthy series of approvals from multiple ministries in Baghdad (Hiltermann et al, 2012). These kinds of complaints could be resolved by empowering local administrations by giving them more say over security and a larger share of oil revenues. Crucially, the current autonomy of the KRI would not be affected

219. **Calls for greater decentralization in the predominantly Arab provinces are driven primarily by functional rather than ethnic or sectarian motives** (as in the Kurdish areas). The desire for better government and more effective distribution of resources are often the principal goals, rather than the creation of autonomous provinces as a precursor to possible independence. In Iraq's main oil-producing southern provinces, the difference between their contribution to state revenues and the resources that they receive through the federal budget is a major factor in their support for decentralization. The Shia provinces of Najaf and Karbala have considered forming regions (i.e. a grouping of governorates) out of a desire for greater local control of the lucrative religious pilgrimage trade. In predominantly Sunni areas, sectarian considerations are a part of support for decentralization, given the Sunnis' strong sense of alienation from and sectarian discrimination by Baghdad, but these grievances might be allayed by granting them more local control over resources (Hiltermann et al, 2012).

220. **However, decentralization does not offer any guarantee of greater accountability or better service delivery.** Local elites may simply replicate the existing governance weaknesses at the local level. In fact, the administrative capacity and controls of subnational governments are likely to be significantly weaker than they are at the center, and the potential for waste, abuse, and corruption more acute (Box 9). Making budget allocations to local governments more transparent and predictable may be a pragmatic medium-term solution. Provincial governments, in turn, need to be accountable to citizens through an electoral system with tight links between geography and local representation. In practice, effective PFM systems are likely to be the key to whether any degree of decentralization increases the political legitimacy of central and local governments and improves the delivery of services. Decentralization is of course not a zero sum game (decentralization versus centralization). Where it works best, the central and decentralized agencies work closely together (Porter, 2010).

221. **It is essential, however, to recognize that, while some are concerned about the government of Iraq being over-centralized, others are worried about fragmentation.** Recommendations have been made to devolve power to Shia, Sunni, and Kurdish communities, but these moves are likely to involve some serious problems. For example, Iraq's oil reserves are concentrated geographically rather than being distributed evenly. Decentralization would make it difficult for the federal government to enforce the equitable distribution of wealth. Iraq's three major communities are not as geographically contiguous as is often assumed, giving rise to potential discrimination or worse against large groups of minorities; basing political legitimacy on sectarian identity also ignores other cross-cutting identities. Polls have indicated that a large majority of Iraqis oppose a three-way division of the country. Strongly aligning Iraq's political institutions with its sectarian identities is likely to entrench the zero-sum nature of the competition for resources and power that has already generated so much instability.

Box 9. The Status of Decentralization in Iraq

Iraq remains a highly centralized country. The 2005 Constitution and numerous subsequent laws have devolved a degree of political authority to the governorates. The first elections for governorate councils took place in 2005, and successive elections were held in 2009 and 2013, each more openly organized and with high voter turnout. However, the central government retains control over all fiscal powers and administrative appointments, leaving local governments – including elected governorate officials – as little more than executors. Since the nationalization of oil production in 1972, oil rents have been collected by the central government. Local governments' fiscal dependence on the central government and its irregular transfers constrain their ability to invest in and sustain quality service delivery, which causes citizens to lose faith and trust in the state.

Iraq's Constitution is ambiguous about the ownership of oil and gas. It specifies the ownership of petroleum resources by “the people of Iraq in all its regions and governorates.” While it places the management of existing fields in the hands of the federal government, it does not specify who should have jurisdiction over future oil fields and it recognizes the aspirations of the historically deprived regions, namely Kurdistan and Basra, to exploit their own natural resources]. The Constitution also establishes an asymmetrical form of federalism, wherein regions have greater autonomy than governorates. It created core federal institutions, but its intent seems to be that intergovernmental relationships should evolve gradually (Bishop and Shah, 2008).

Although a significant portion of the national budget is spent in the governorates, the bulk of this spending is directly controlled by the central government. Funding levels for the regional development program were initially high. For example, between 2006 and 2009, the governorates and the KRG together were allocated 35 to 45 percent of the total federal investment budget to implement projects selected and developed within the governorates (and the KRG). However, when federal budget shortfalls occur, the investment budgets of the central ministries are protected at the expense of allocations to the governorates. In the 2016 federal budget, the regional development allocation to the KRG and the governorates amounted to only 6 percent of all federal investment expenditures.

The government has given little attention to developing local capacity or to making the institutional and fiscal decisions required to successfully achieve the devolution implicit in the Constitution. Governorates have limited capacity to absorb and manage staff, resources, and responsibilities and to date have had very weak budgetary authority. The 2013 amendments to Law 21 allocated a fixed price per barrel in US dollars (or per cubic meter for natural gas) that the central government would pay for oil and gas produced or refined in the governorates, but these allocations were never fully implemented. Although the current decentralization model focuses on the governorates, the feasibility of devolving to district or municipal governments should be explored, as these governments are more directly involved in the delivery of local services than the governorates.

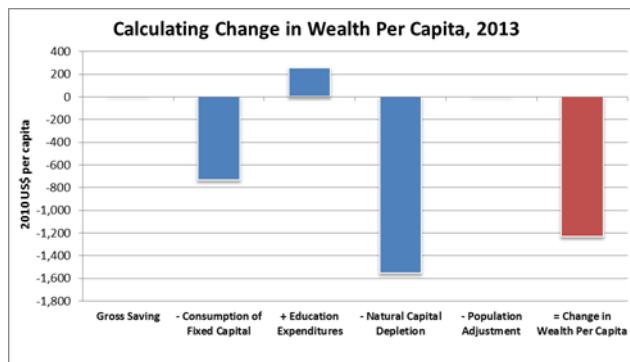
In the medium and longer term, decentralization will require: (i) taking a coordinated and sequenced strategic approach; (ii) strengthening local accountability to ensure that governorates are effective in delivering services; (iii) putting in place a transparent, predictable, and sustainable flow of resources to the governorates; (iv) developing efficient expenditure management systems for the governorates; and (vi) allowing local governments to raise their own revenue mobilization to enhance local accountability and financial sustainability (World Bank, 2016a).

B. Environmental Sustainability

222. Iraq's growth model is unsustainable in environmental terms and is depleting the country's total wealth. When measuring sustainability, all of a country's wealth, as represented by its physical, financial, natural, human, and intangible social forms are capital must be taken into consideration as they are all required to generate income. Wealth analysis helps to answer the question of whether GDP growth is sustainable or if a country is living off its capital – including its natural

capital. The adjusted net savings (ANS) method⁶⁷ measure the true savings in an economy once deductions have been made for the depletion of natural resources and the damage caused by carbon dioxide and particulate emissions are taken into consideration. This method shows that Iraq has consistently had negative adjusted net savings in the last decade or so, mainly because of energy depletion, indicating that its economy is on an unsustainable path (Figure 62). The World Bank's Per Capita Wealth database shows that Iraqis were poorer in 2013 on average than they were a year earlier and that the country was not only not accumulating any wealth but depleting it rapidly.

Figure 62. Iraq Adjusted Net Savings



Source: Change in Per Capita Wealth database, World Bank, 2015

Table 12. Annual Cost of Environmental Degradation in Iraq, 2008

	ID (billion per year)	US\$ (billion per year)	Percent of GDP
Air	1,452	1.3	1.5
Water	3,518	3.1	3.5
Land	949	0.8	1.0
Waste	381	0.3	0.4
Coastal zones	15	0.0	0.0
Sub-Total	6,316	5.6	6.4
Global Environment	685	0.6	0.7%
Total	7,091	6.2	7.1

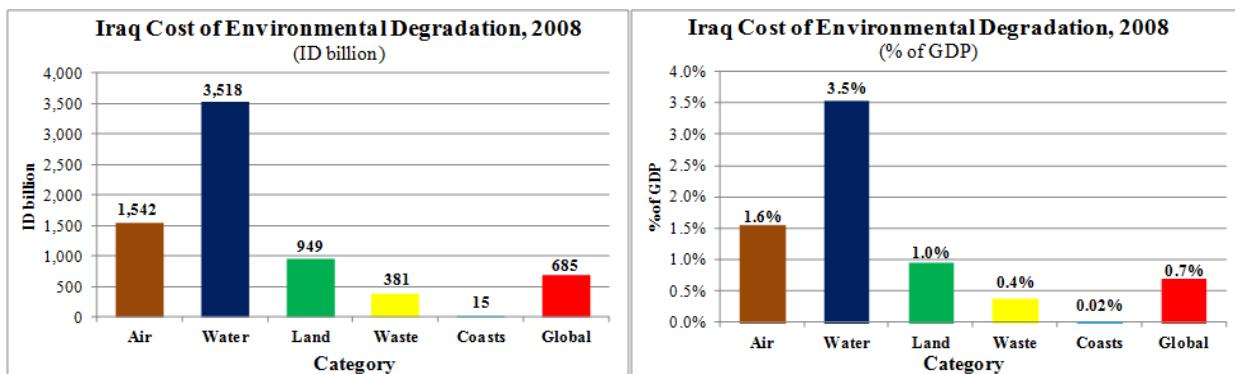
Source: World Bank, 2012c.

223. **The World Bank conducted a study of the cost of environmental degradation (COED) in Iraq in 2012** (World Bank, 2012c). The study indicated that the annual COED in Iraq (for 2008) was US\$5.6 billion, equivalent to 6.4 percent of its GDP, which placed it second in the MENA region (Table 12., Figure 63).The study attributed 56 percent of the total damage to damage to the

⁶⁷ ANS is derived from the standard national accounting measure of gross savings after making deductions for: (i) the depletion of natural resources to reflect the decline in asset values associated with extraction and depletion and (ii) the damage caused by carbon dioxide and particulate emissions.

population's health and quality of life (3.5 percent of GDP) and the remaining 44 percent to natural resource degradation (2.9 percent of GDP). The study found that the degradation of water resources was a particularly grave threat to the sustainability of livelihoods and economic activity.

Figure 63. Cost of Environmental Degradation



Source: World Bank, 2012c.

C. Fiscal Sustainability

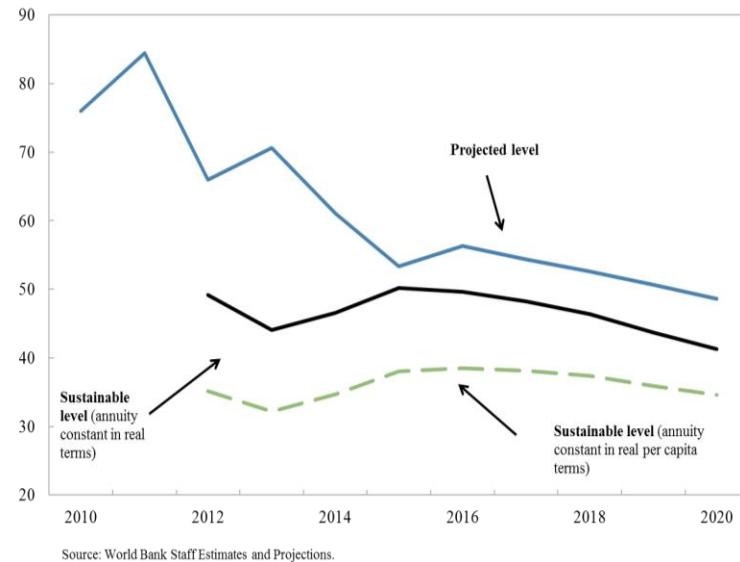
224. While Iraq has made progress towards achieving a sustainable level of fiscal spending, further efforts are needed to improve the country's structural fiscal balance. Using a permanent income hypothesis (PIH) model, it is possible to assess whether Iraq's large non-oil fiscal deficits are sustainable in light of the country's finite supply of oil and whether future generations will benefit from a similar real level of spending as today's Iraqis. Our analysis revealed that Iraq's large non-oil deficit is matched by equally large oil wealth, allowing the country to run sizable non-oil primary balance (NOPB) deficits while still maintaining a fiscal path that is consistent with intergenerational equity. While Iraq's projected medium-term fiscal path is broadly consistent with a permanently sustainable level of spending – under the assumption that major spending inefficiencies will be reduced – the NOPB is currently higher than is consistent with a permanently sustainable level of spending. The absence of effective oil wealth management has meant that Iraq is consuming its oil wealth too rapidly. As shown in Figure 64, a sustainable NOPB deficit for Iraq over the medium term would be around 42 percent of non-oil GDP.⁶⁸ In recent years, Iraq has moved towards that sustainable deficit as the NOPB shrank from 59.3 percent of non-oil GDP in 2014 to 46.8 percent in 2015.

225. The lack of an effective system for managing oil revenue has meant that the government has had to cope with the sudden decline in oil prices after the fact and in crisis mode. It has also meant that the inherent volatility of oil prices has affected the entire economy in the absence of any mechanisms to smooth their impact. International experience has shown the need to have policies in place before such price drops occur. As argued in the World Bank's Country Economic Memorandum for Iraq (World Bank, 2012a), favoring investment in public capital, while easing the short-term adjustment costs associated with a weak public investment management system,

⁶⁸ The size of the sustainable deficit declines over time in relation to non-oil GDP because the latter grows at 5 percent while the former grows at the population growth rate of 3.2 percent so as to keep per capita consumption out of oil wealth constant.

is also a potential way to manage oil revenues. Using an overseas transitional saving or “parking” fund where a portion of revenues would be set aside while the public capital stock is increased would be one means of circumventing PIM constraints until these are resolved. Investing in public capital would increase labor productivity in the economy, lift wages, and sustainably increase output and consumption.

**Figure 64. Projected and Sustainable Non-Oil Primary Deficit
PIH Approach, % of non-oil GDP**



Source: World Bank Staff Estimates and Projections.

226. Finally, as suggested throughout this report, shifting the composition of public spending towards supporting medium-term growth is key challenge for Iraq. Given the country's vast security, poverty-related, and humanitarian needs, this will not be a short-term undertaking. It will necessitate gradually shrinking the footprint of the public sector in the economy to a few core areas, thus making space for private sector growth and job creation. Spending priorities will need to be redirected towards effective and efficient transfers, the delivery of public services, and the provision of public infrastructure. Contingent liabilities such as the SOE sector will need to be resolved.

VI. Prioritization of Areas for Reform

227. **One objective of this report has been to bring together some of the lessons learned and knowledge gained from Iraq's experience and to put together a list of priority areas for reform based on those broad lessons.** The key lesson is the impossibility of achieving sustainable welfare improvements under conditions of high insecurity. Similarly, and related to this, the lack of strong, transparent, and accountable institutions critically undermines core national values such as equal sharing of resources and the effective delivery of services, thus encouraging the continuation of social fragmentation and conflict. Another lesson is the need for more equitable allocation of Iraq's oil wealth and its management in ways that promote more effective institutions and greater **resilience to shocks**. Building a stronger civil society, locally as well as nationally, is therefore critical to generating demand for accountable, inclusive institutions and more robust governance. The massive assistance to Iraq provided by the international community has shown that financial and technical resources are not sufficient, on their own, to achieve positive results in the absence of security and adequate governance. They may even be counter-productive or may postpone the resolution of underlying constraints by facilitating existing dysfunction. What is needed are interventions aimed at restoring the legitimacy of the state and building inclusive institutions.

228. **In setting priorities for Iraq in this section, we distinguish between the fundamental underlying constraints facing the country generally and narrower sectoral constraints.** The analysis and information presented in this report has identified three factors that underlie the continued instability, conflict, and violence in Iraq today – weak governance, oil dependence, and sectarianism. Any future policies need to target, or at the very least acknowledge, these underlying constraints as they represent the pre-conditions for any potentially successful reforms. Tackling these underlying constraints will be a long-term undertaking but will have high potential rewards. In the shorter term, policymakers will need to design reforms that take into account Iraq's insecurity, weak institutions, and divided political and social reality and that provide incentives to stakeholders to uphold them. Both the long-term and short-term types of reforms are essential.

229. **Our identification of governance failures as one of Iraq's underlying constraint sheds light on why previous reform efforts have often had little success.** Unless Iraq's weak institutions and governance are tackled and the implications embedded into reform design, even the best technical efforts are unlikely to prosper. Lessons of experience in Iraq and worldwide indicate that a number of principles are critical to making progress on reform:

- *Flexibility and adaptability.* The fluid conditions that prevail in Iraq today mean that there may have to be changes in course midway through the design or implementation of a policy or reform in order to reflect practical realities. This flexibility must also include the capacity to respond and innovate on at short notice and in response to changing realities.
- *Political economy considerations.* It will be essential to evaluate who will win and who will lose from the proposed reforms. This suggests that investing in and building strong knowledge base of stakeholders and there incentives is a key to success.
- *Realistic timeframes.* Reforms can be expected to take longer in countries characterized by FCV because of security constraints, limited capacity, and high turnover of staff.

- *Data collection.* Because the evidence base is weak, it will be vital to focus on collecting the data needed to build a solid knowledge base that will increase the public's confidence in reform proposals.
- *Downstream focus.* Downstream reforms and a focus on implementation are more likely to yield results than reforms of upstream laws and regulations that can be co-opted or blocked by interest groups for their own gain.

230. **An issue that affects policymaking across the board is the poor quality of the data and knowledge that is available in many sectors.** Annex 5 notes just a few of these shortcoming as they relate to national statistical databases such as the System of National Accounts and the Censuses. These deficiencies in the available data in most areas make it difficult to identify priority actions and their content with confidence. A case in point is the status of the environment and natural resources and the impact of climate change. Indications are that Iraq faces very serious environmental problems, ranging from poor water quality, soil salinity, air pollution, waste management problems, and contaminated sites to the deterioration of key ecosystems. The costs of environmental degradation are reflected in the worrying results from the World Bank's Net Adjusted Savings calculations, which show that Iraq is rapidly depleting its natural wealth. Yet there is little up-to-date or reliable information on specific environmental issues, which hinders effective policymaking. Not only do more reliable data need to be collected but they need to be collected more often in order to keep track of the rapid change in conditions in Iraq, a case in point being poverty where there have been dramatic shifts in just a few short years.

A. Priorities for Addressing Iraq's Underlying Constraints

231. **The list of important reforms in Iraq is lengthy so we will focus on those priorities that we consider to be prerequisites for making progress in other areas.** The priorities identified here and which target Iraq's underlying constraints are very much in line with the priorities outlined in the World Bank's MENA Strategy, namely: (i) renewing the social contract, (ii) strengthening regional cooperation; (iii) increasing the resilience of refugees and IDPs to shocks; and (iv) supporting recovery and reconstruction. While, as noted above, results may only become evident in the medium or longer term, these measures need to be initiated immediately given the very fragile political and social conditions that prevail in Iraq today.

1. Reestablishing Security

232. **Improving security is a pre-condition for the success of other reforms given that security is a fundamental prerequisite for development.** While many areas of Iraq continue to be relatively secure, the large pockets of violence that continue to exist undercut the legitimacy of the state and undermine development and reform efforts. The existence of powerful rival militias beyond the direct control of the government with diverse political and sectarian interests weakens the state's legitimacy, as does Daesh control of Iraqi territory. While the role that international finance institutions can play is limited, the global community and neighboring countries have a critical role to play. Iraq has become a battleground in regional power struggles, and this is reflected in its domestic political dynamics. Its neighboring countries have strong ties to factions within Iraqi politics, including many militias beyond the control and discipline of the Iraqi Armed Forces, which keeps the country's

polity divided and government weak. Tackling fragility, conflict, and violence in Iraq will require cooperation between authorities both inside and outside its borders (World Bank, 2016).

233. **The lack of security has a direct impact on Iraq's economic and social outcomes.** It reduces incentives to invest in all but the most fortified enclaves and negatively affects all aspects of human capital accumulation. In addition to its corrosive effects on trust, governance, and state legitimacy, insecurity stymies all efforts to further Iraq's development. As one example, the geographic isolation resulting from conflict and insecurity prevents all Iraqis from venturing far beyond their communities. Iraqi youth are particularly affected as their geographic location determines their social, economic, and even marital decisions. As was observed in the brief interlude of peace between 2007 and 2012, once relative security is established, society can turn its focus to other goals, including improving governance and increasing accountability. This was the case in the KRI, which has made progress in terms of its human development indicators and levels of investment.

2. Rebuilding the Social Contract and State Legitimacy

234. **Governance in Iraq is currently discredited and weak, and the population has lost faith in the ability of the state to govern fairly and effectively.** It will be essential to reverse this situation to ensure the success of any reform effort and this will require the engagement of both the government and Iraqi citizens. It will also be necessary to focus not just on reconstruction but also on promoting inclusion, social cohesion, and belief in the legitimacy of the state across the country. Doing so will require re-building trust not only between government and citizens but among all Iraqis. Iraqi public institutions are not doing enough to appeal to the most vulnerable demographic groups (youths) or to minorities, including Sunnis and Kurds. Beyond ensuring security, a primary requirement for reestablishing the legitimacy of the state will be ensuring a more equitable distribution of oil resources across the country and population. Other actions to reinforce this would include improving service delivery, increasing the effectiveness of the public sector, and successfully tackling the problems faced by Iraq's most excluded and disenfranchised groups – including IDPs and youths.

235. **Emergency rapid response reconstruction programs are an example of the kind of interventions that have been successful in rebuilding social trust.** These have had some success in Iraq and could be extended in ways that would explicitly target social exclusion. These programs could be visibly implemented in areas where the trust in state institutions is very low, where the population feels increasingly marginalized, and where radicalization is particularly worrisome. In terms of confronting exclusion and fragility, the programs should pay urgent attention to the plight of IDPs and refugees, as well as Iraqi youths. IDPs tend to be concentrated in urban areas and in a few governorates where they have little access to services, education, jobs, and social security. As noted in the World Bank's MENA Strategy (Devarajan, 2016), given that IDPs are expected to have to stay in their new communities for a long time, interventions should be oriented towards helping them to build their human, physical, and institutional capital. Helping both host and IDP communities to access service should be a top priority, especially social protection for the urban poor. In addition, interventions that support the reconstruction and repair of housing in conflict-affected areas would provide local employment opportunities, help to increase social and political stability and eventually enable IDPs to return to their homes.

236. **Iraq's young people suffer disproportionately from exclusion and poor prospects, and rebuilding the legitimacy of the state will depend upon the productive incorporation of this**

group into society and the economy. About 50 percent of Iraq's population is under 19 years old. One-third of those between the ages of 15 and 29 are illiterate or only semi-literate. Youth unemployment is very high at 34.6 percent. Rehabilitating schools in conflict areas, where one in five schools has closed, would help to encourage some of the 3.5 million children of school age who are currently not in school to return to the classroom. Schools are the best place to provide psycho-emotional support to conflict-affected children and youths, and education can play a pivotal role in promoting resilience among conflict-affected populations and eventually social cohesion. For girls in particular, particularly those in conflict zones, school attendance can combat illiteracy and exclusion, which are the key underlying reasons for the high adolescent birth rates for Iraqi girls. In consultations with stakeholders during the preparation of this SCD, many emphasized the importance of rewriting the education curriculum to combat sectarianism, reduce conflict, and build support for the basic concepts of human rights and civic engagement.

237. Iraq fails to provide jobs for the thousands of young people entering the work force each year. Between 2006 and 2014, Iraq's rate of youth unemployment never dropped below 28 percent, despite economic growth that averaged 6.3 percent annually. The benefits of growth did not accrue to young adults. Youths are underrepresented in government jobs, and the private sector is too weak to create enough employment to absorb the younger generation of Iraqis. In the near term, implementing much-needed local investment programs would create jobs at the local level. Yet as has been noted in this report, local administrations find it very difficult to implement investment programs because of their limited capacity and the lack of reliable resource flows from the central government, among many other constraints. Therefore, it is essential to resolve these constraints to greater local investment, and one way to do this might be to explore the feasibility of devolving some spending authority not only to governorates but to the districts or municipalities as they are directly involved in delivering local services.

238. Improving the delivery of public services would fortify trust and legitimacy between citizens and the state. As described in previous chapters, Iraqis have witnessed a dramatic deterioration in most basic services: electricity, water and sanitation, health, education, and transportation – and above all security. Well-targeted and effective social protection programs are needed to help the poor and near-poor to face highly volatile economic and social conditions with resilience. Iraq's social protection transfers cover only one-tenth of the poor. Fewer than 20 percent of the poor have access to pension incomes. The poor are very dependent on public transfers, particularly those in the bottom 10 percent of the consumption distribution. Transfers account for nearly 30 percent of the total income of households in this decile. While reforming the system is critical for efficiency and fiscal health, improved targeting of all public transfers will be essential to ensure that the rationalization of social protection has no negative impact on the poor, thus further undermining legitimacy. Policymakers should also ensure that these transfers target IDPs and children as particularly vulnerable populations. The current efforts to change the targeting of Iraq's Social Protection Net program from categorical targeting to proxy means testing and to establish a unified registry of beneficiaries are steps in the right direction and will enhance the government's capacity to help IDPs and improve targeting overall.

239. The rebuilding of destroyed or damaged infrastructure will be essential to enabling the effective delivery of services and to reintegrating Iraq's increasingly isolated regions in support of greater national cohesion is essential. In the energy sector, for instance, where citizens'

dissatisfaction with service levels and reliability has led to protests, increasing cost recovery through tariff reform will be essential to fund a sustained upgrading of services. However, tariff reform will need to be accompanied by visible improvements in services or users will not accept the higher prices. Users may be persuaded by the fact that any expansion in the supply of electricity via the grid can lead to cost savings for households as they will no longer have to rely on more expensive fuels. Reducing the costs of producing electricity nationwide will depend on reducing gas flaring and relying more on Iraq's massive gas supplies for electricity production. It will also be necessary to improve public investment management and governance to reduce what are thought to be enormous leakages in infrastructure spending (World Bank, 2012a).

240. **Sustainable decentralization reform may be years in the making, but given its importance to the stability of the country and the legitimacy of the state, the government should not delay building a consensus on the form of the relationship between the central and subnational governments and the most appropriate distribution of resources between them.** It is important to be clear that, in order to be effective, the decentralization of responsibilities must be accompanied by the decentralization of revenues as well. In order to ensure that greater decentralization will lead to improved service delivery and greater geographic equity, steps must be taken in the near term to increase capacity, promote accountability, and improve service delivery at the local level, including significantly strengthening local administrative and financial management capacity. Gradual asymmetric decentralization, where the level of autonomy of subnational governments (e.g. de-concentration, devolution, and decentralization) varies according to negotiated and agreed-upon criteria, may be a promising way forward but will need to be decided on the basis of a national political consensus. In the meantime, work should be done to explore the range of possibilities (formulae) in terms of the political and geographical allocation of oil revenues.

3. Oil Revenues and Economic Management

241. **A first-order priority is the need to bolster macroeconomic stability.** The implementation by Iraqi authorities of a robust program of fiscal consolidation is necessitated by the depth and duration of international oil price declines and the likelihood that a significant portion of the price shock is likely to be permanent. 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.

242. **World Bank analysis shows that allocating more oil revenues to investments in public capital would provide the broadest benefits in terms of diversification and economic transformation.** In contrast, the management of oil wealth today predominantly aims to meet short-term consumption needs and has fostered import dependence, a skewed labor market, and a crippled private sector. However, there is an important caveat to a greater allocation of oil revenues to investment, and that is Iraq's very poor record of public investment management (PIM). Therefore, the government must improve 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. Reliance on fiscal rules is unlikely to be successful in a rapidly shifting structural environment with high oil price volatility.

243. **The previous chapters argue that it has become unsustainable for the public sector to continue its traditional role as the country's main employer and provider of heavily subsidized and poor quality public services and infrastructure.** Reducing the size of the public sector is a hugely challenging undertaking as it goes to the heart of the governance, ethnic, and sectarian issues that bedevil the country. Previous chapters have highlighted the importance of re-orienting the civil service and strengthening transparency across the sector and have suggested some proposals for reform. Building adequate human resource information systems and strengthening oversight in the civil service are critical to stemming the rampant use of favoritism in hiring and promotions, often following political or sectarian lines. The civil service accounts for over 40 percent of jobs in the country and has become a de facto social safety net for many, with more generous benefits and pensions than the private sector provides. Outright layoffs are therefore 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.

244. **Gradually limiting the scope of public sector activities will also be essential to revitalizing the private sector.** A strong private sector is a prerequisite for economic diversification and for sustainable growth and the associated job creation necessary to enhance the welfare of all Iraqis. Yet outside the oil sector - and beyond a few small and micro, informal, and service-oriented enterprises - non-oil private firms have been crowded out by SOEs and by a maze of regulations that creates a hostile environment for market activity. SOEs operate in a wide range of sectors of the economy and are largely non-transparent, weakly accountable, and undertake sizeable quasi-fiscal activities that generate fiscal liabilities and risks. There is no accurate calculation of the magnitude of indirect SOE subsidies. SOE reform has been on the table for many years, but limited tangible progress has been achieved. In the medium term, it will be necessary to convert the hidden 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. 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.

B. Risks

245. **Numerous obstacles and risks lie in the way of achieving progress on the priorities identified in this Systematic Country Diagnostic.** Sectarianism and security may worsen, which would derail the progress that has been achieved to date and make it impossible to improve governance and increase the legitimacy of the state. The process of decentralization may falter, which would limit the potential for improving service delivery and increasing accountability at the local level. Macroeconomic and fiscal risks may undermine the government's economic reform efforts. Attempts to redefine the role of the public sector, which will be critical to revitalizing the private sector and to ensuring fiscal health, may face insurmountable opposition. And external shocks, to which Iraq is highly susceptible, may derail efforts to strengthen security and the rule of law.

246. **Nevertheless, Iraq's rich diversity and wealth also present numerous opportunities.** Under the right circumstances, oil and gas can be a stepping stone to diversification of the economy. Iraq has considerable agricultural resources and, unlike most of its oil-rich neighbors, has a population large enough to contemplate skills specialization. With its holy Shia cities and historical heritage, Iraq continues to attract millions of tourists – especially religious tourists – despite its difficult circumstances. When conditions – namely security – have allowed, Iraq has been able to attract significant investment. And despite its highly constrained environment, numerous improvements in welfare have been achieved, including reductions in maternal mortality, increases in safe births, increased primary enrollment rates and gender parity at primary levels, and the initiation of wholesale reforms to the social protection net. It is now time to overcome the fundamental constraints to improving security and governance and increasing social cohesion to begin to achieve Iraq's potential and to improve the welfare of all of its citizens.

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Annex 1: Multidimensional Poverty in Human Development

To benchmark poverty in human development, the report “The Unfulfilled Promise of Oil and Growth” (World Bank, 2014) creates a multidimensional measure that builds on three equally weighted dimensions of deprivation in human development: education, health and standards of living. Each dimension is composed of the following deprivation indicators (each taking the values 0 or 1):

Education

Illiterate household head: Deprived if the household head is illiterate

School attendance: Deprived if any child under 12 in the household is not currently in school

Health

Nutrition: Deprived if there is a malnourished child in the household (suffering from either stunting or wasting)

Standard of living

Electricity: Deprived if the household has less than 12 hours a day of electricity from the public network

Assets: Deprived if the household does not own more than one TV, motorbike, or fridge and does not own a car

Flooring: Deprived if the household has a brick, earth, or other flooring

Water: Deprived if the household has insufficient supply of water from the network

Sanitation: Deprived if the household does not have flush toilet or if the toilet is shared

Based on the indicators presented above, each household is assigned a deprivation score, which is the weighted sum of the number of deprivations (all three dimensions are equally weighted as is each indicator within each dimension). In computing the Multidimensional Poverty Index (MPI) for human development, the larger the number of deprivation indicators in each dimension, the smaller the weight of each indicator individually. A given household is considered MPI poor if their deprivation score lies above the poverty cutoff of 0.33.

Annex 2: Characteristics of the Poor and Non-Poor

Table A2.1: Mean Characteristics of the poor and non-poor, all IRAQ

	2007		2012	
	Poor	Non-poor	Poor	Non-poor
Urban	0.50	0.77	0.49	0.73
Household size	11.17	7.89	10.72	7.88
Number of children 0 - 6 years old	2.67	1.51	2.70	1.63
Number of children 7 - 17 years old	3.31	2.13	3.43	2.08
Number of elderly aged 60 years or more	0.43	0.40	0.41	0.40
Number of working age males employed	1.87	1.56	1.60	1.52
Age of the household head	48.04	47.36	46.46	47.92
Household head is male	0.92	0.90	0.92	0.90
Household head was born elsewhere	0.01	0.02	0.10	0.13
Household head not employed	0.32	0.29	0.33	0.28
Household head employment in agriculture and fishing	0.18	0.07	0.12	0.06
Household head employment in mining and quarrying	0.01	0.01	0.00	0.01
Household head employment in manufacturing	0.07	0.05	0.05	0.07
Household head employment in electricity, gas, and water supply	0.01	0.02	0.02	0.02
Household head employment in construction	0.09	0.07	0.12	0.06
Household head employment in commerce and retail	0.09	0.14	0.07	0.13
Household head employment in transport, storage, and communication	0.09	0.10	0.12	0.10
Household head employment in financial, insurance, and professional	0.03	0.07	0.07	0.11
Household head employment in public administration, health, and education	0.09	0.15	0.07	0.12
Household head employment in other sector/services	0.02	0.03	0.03	0.04
Illiterate	0.28	0.18	0.23	0.13
Incomplete primary	0.18	0.14	0.28	0.21
Complete primary	0.30	0.27	0.31	0.28
Intermediate	0.09	0.13	0.09	0.11
Secondary	0.06	0.10	0.05	0.09
Higher secondary	0.04	0.08	0.03	0.08
Tertiary	0.04	0.09	0.02	0.09

Source: World Bank staff calculations using data from the 2007 and 2012 IHSES

Table A2.2: Mean Characteristics of the Bottom 40 and Top 60, All of Iraq

	2007		2012	
	Bottom 40	Top 60	Bottom 40	Top 60
Urban	0.57	0.81	0.56	0.76
Household size	10.39	7.45	10.25	7.20
Number of children 0 - 6 years old	2.38	1.36	2.53	1.38
Number of children 7 - 17 years old	3.12	1.92	3.10	1.83
Number of elderly aged 60 years or more	0.40	0.41	0.41	0.40
Number of working age males employed	1.78	1.53	1.65	1.46
Age of the household head	47.64	47.43	47.03	48.05
Household head is male	0.92	0.90	0.91	0.90
Household head was born elsewhere	0.01	0.02	0.13	0.13
Household head not employed	0.33	0.28	0.32	0.26
Household head employment in agriculture and fishing	0.15	0.06	0.10	0.05
Household head employment in mining and quarrying	0.01	0.01	0.01	0.01
Household head employment in manufacturing	0.05	0.05	0.05	0.08
Household head employment in electricity, gas, and water supply	0.01	0.02	0.02	0.02
Household head employment in construction	0.09	0.06	0.10	0.06
Household head employment in commerce and retail	0.10	0.14	0.10	0.14
Household head employment in transport, storage, and communication	0.09	0.10	0.11	0.10
Household head employment in financial, insurance, and professional	0.05	0.08	0.08	0.12
Household head employment in public administration, health, and education	0.10	0.16	0.08	0.14
Household head employment in other sector/services	0.02	0.04	0.03	0.03
Illiterate	0.26	0.17	0.20	0.12
Incomplete primary	0.17	0.14	0.27	0.20
Complete primary	0.31	0.26	0.33	0.26
Intermediate	0.11	0.13	0.09	0.12
Secondary	0.07	0.11	0.05	0.10
Higher secondary	0.05	0.09	0.04	0.09
Tertiary	0.04	0.10	0.03	0.11

Source: World Bank staff calculations using data from the 2007 and 2012 IHSES

Annex 3: Iraq's Top Exports, 1980-1988/2012-2014

Table 3.1. Top 15 Non-oil Exports, 2012-2014

HS code	Product	value (US\$ million)			% non-oil exports			growth rate	
		2012	2013	2014	2012	2013	2014	12-13	13-14
710812	Gold in unwrought forms non-monetary	3,324	744	989	89.7	68.4	72.1	-77.6	33.0
80410	Dates, fresh or dried	135	118	136	3.6	10.9	9.9	-12.3	14.5
710813	Gold in other semi-manufactured forms	19	2	40	0.5	0.2	2.9	-89.9	2,030
410519	Sheep or lamb skin leather, (excl.	30	33	35	0.8	3.1	2.6	12.3	6.7
410110	Whole hides and skins of bovine ani	8	20	17	0.2	1.9	1.2	152.5	-17.9
410429	Other bovine and equine leather, ta	3	7	14	0.1	0.7	1.0	117.7	88.2
410221	Pickled skins of sheep or lambs, wi	12	17	12	0.3	1.5	0.9	36.9	-29.1
381710	Mixed alkylbenzenes, nes	29	29	10	0.8	2.7	0.7	-0.2	-66.5
711319	Art. of jewelry and pts thereof o	5	6	9	0.1	0.6	0.7	28.5	51.8
391510	Waste, parings and scrap, of polyme	2	5	7	0.0	0.5	0.5	224.7	21.5
847982	Mach for mixing/kneading/crushing/g	0	0	6			0.4	-	-
130212	Liquorice sap and extract	3	4	5	0.1	0.3	0.4	24.1	44.4
391590	Waste, parings and scrap, of other	9	7	5	0.3	0.6	0.4	-26.8	-22.7
410130	Hides and skins of bovine animals p	2	2	5	0.0	0.2	0.3	12.3	164.5
470710	Waste and scrap of unbleached kraft	3	4	4	0.1	0.4	0.3	34.8	4.7
Top 15 non-oil products		3,583.4	998.6	1,293.5	96.7	91.9	94.3	-72.1	29.5

Table A3.2. Iraq: Top Export Commodities, 1980-1988
(SITC Rev 1 Commodities, millions of U.S. dollars)

Code and Description	1980	1981	1982	1983	1984	1985	1986	1987	1988
Total All Commodities	\$27,848.3	\$9,949.8	\$9,511.9	\$9,012.8	\$10,059.4	\$11,140.4	\$7,951.2	\$10,305.0	\$10,196.9
3310 — Crude petroleum, etc	\$26,836.9	\$9,619.2	\$9,227.2	\$8,627.7	\$9,324.0	\$10,056.1	\$7,108.4	\$9,047.1	\$8,904.1
3324 — Residual fuel oils	\$17.0	\$27.3	\$8.1	\$144.6	\$337.6	\$500.9	\$256.4	\$374.3	\$211.5
3323 — Distillate fuels	\$0.0	\$0.1	\$0.0	\$15.3	\$57.7	\$127.1	\$94.2	\$252.7	\$135.1
3320 — UN special code	\$0.0	\$0.0	\$0.0	\$0.0	\$0.0	\$0.0	\$0.0	\$0.0	\$132.6
3411 — Natural Gas	\$2.1	\$0.1	\$0.0	\$0.0	\$25.6	\$28.4	\$21.4	\$71.4	\$103.9
3321 — Mtr. spirits, gasoline	\$101.5	\$11.2	\$0.0	\$0.0	\$30.5	\$125.2	\$78.7	\$72.8	\$98.3
2741 — Sulphur	\$25.3	\$1.5	\$0.0	\$7.2	\$19.9	\$26.7	\$37.3	\$29.3	\$76.3
7114 — Aircraft engines, inc jet	\$6.9	\$24.7	\$11.5	\$6.4	\$26.8	\$28.6	\$28.3	\$39.4	\$56.9
5612 — Chemicals phosphatic fertilizer	\$0.1	\$0.0	\$0.0	\$4.3	\$26.1	\$15.5	\$42.9	\$48.0	\$36.0
0520 — Dried fruit	\$25.5	\$36.6	\$23.7	\$33.8	\$20.5	\$17.7	\$24.3	\$40.1	\$32.6
9310 — Special transactions	\$2.4	\$0.6	\$14.5	\$6.2	\$6.1	\$7.6	\$6.5	\$23.6	\$30.2
6612 — Cement	\$0.2	\$0.0	\$0.0	\$2.7	\$4.0	\$5.6	\$29.0	\$17.8	\$25.8
5132 — Chemical elements	\$0.0	\$0.1	\$0.1	\$38.2	\$31.7	\$4.1	\$8.8	\$22.6	\$23.9
0012 — Sheep, lambs, goats	\$0.7	\$0.2	\$0.0	\$1.4	\$0.8	\$0.0	\$0.8	\$0.0	\$18.1
5611 — Chemicals, nitrogenous fertilizer	\$76.2	\$0.7	\$0.0	\$0.4	\$0.0	\$0.2	\$0.3	\$0.1	\$16.0
7349 — Aircraft parts, etc	\$0.5	\$1.3	\$0.8	\$2.6	\$3.1	\$1.4	\$5.9	\$4.9	\$14.7
5999 — Chemical products, preparations nes	\$0.1	\$0.0	\$0.0	\$0.0	\$0.0	\$0.0	\$0.0	\$3.1	\$12.4

Annex 4: Iraq Pension Reform

Table A4.1. Financial Design Indicators of the Current Pension Schemes, the SPF and the PSSD

	PSSD	SPF	NEW LAW 2014
	Social Security Department covers workers in the private sector (supervision shifted to NBP since January 2010)	new system for public employees who retired after on or after January 17, 2006 (within unifying umbrella of National Board of Pensions (NBP) -Law 27)	2013 Data and rules based on the new law 2014
SCHEMES DESIGN FINANCING	Defined-Benefit, PAYG	Defined-Benefit, PAYG	Defined-Benefit, PAYG
<i>For Pensions</i>			
<i>Total</i>	17.0%	19.0%	25.0%
Total Contribution Rates from (as % of covered wage)	14.0%	19.0%	25.0%
From Employees	5.0%	7.0%	10.0%
From Employer	12.0%	12.0%	15.0%
<i>For Work injury</i>	2%	Government provided	-
<i>Health, sickness, and maternity</i>	1%	Government provided	-
<i>For unemployment</i>	0.0%	0.0%	-
<i>Social services</i>	0.0%	0.0%	-

Table A4.2: Qualifying Conditions Indicators of the Current Pension Schemes, the SPF and the PSSD

Indicators	SSD (old SSS)	SPF	NEW LAW 2014
	Social Security Department covers workers in the private sector (supervision shifted to NBP since January 2010)	State Pension Fund is the new system for public employees who retired after or on or after January 17, 2006 (within unifying umbrella of National Board of Pensions (NBP) -Law 27)	2013 Data and rules based on the new law 2014
ELIGIBILITY CONDITIONS AND BENEFITS			
<i>For Pensions</i>			
Retirement Age and/or qualification	60-55 (men, women)	60 (mandatory retirement at 63)	50 (mandatory age 63)
Required Length of Service for pension	20	15	15
Rules for Early Retirement	At any age with 30 years of contributions. No penalties	50 and over, but less than 60, and with a minimum of 25 YOS	No provision for early retirement. Only disability& women taking care of children can retire earlier (without penalty)
Rules for Delayed Retirement	Individuals not meeting retirement conditions receive the average monthly wage of the last 3 years times the number of years of service	Compulsory retirement at 63	Compulsory retirement at 63 (except for some exemptions?)
Post-retirement Indexation	Adhoc	Adhoc	Not specified in the law
Survivors Pensions and Disability Allowances (as % of old-age pension)	All dependents (spouses, parents, and children..) fixed payments For 1 dependent 130,000 For 2 dependents 140,000 For 3 dependents or + 150,000	60% for one survivor (as long as it is not less than 200,000) 75% for two survivors (not less than 210,000) 100% for three survivors or more (not less than 220,000) (Max. is also 80% of salary)	80 % for one survivor 90 % of two survivors 100% for three or mor survivors
<i>Benefit determination:</i>			
Basic Replacement Rate	50%	30%-37.5%	37.5%
Incremental Replacement Rate	2.5%	2% (2.5% if retirement is at 63)	2.5%
Maximum Replacement Rate	200%	80%	100%
Number of Last Years for Wage Indexation	3	2 gradually to 40	3
<i>For Work injury</i>			
<i>Health, sickness, and maternity</i>			
<i>For unemployment</i>			

Table A4.3: Performance Indicators of the Current Pension Schemes, the SPF and the PSSD

Indicators	SSD (old SSS)	SPF	2013 Data (SPF)
	Social Security Department covers workers in the private sector (supervision shifted to NBP since January 2010)	State Pension Fund is the new system for public employees who retired after or on or after January 17, 2006 (within unifying umbrella of National Board of Pensions (NBP) -Law 27) 2010 Data	
SCHEMES DEMOGRAPHICS			
Number of Contributors (total)	130,000	3,115,422	3,875,000
Number of Beneficiaries (total)	22,131	104,217	138,652
Old-age	8,051	48,944	71,247
Disability			
Other beneficiaries (widows)	13,070	55,273	67,405
System Dependency Ratio:	17.0%	3.3%	3.6%
AVERAGE WAGES (in IQ)			
Average Monthly Wage	189,000	310,000	583,573
Average Monthly Pension			
For old-age	200,000	404,000	899,919
For survivors	150,000	87,100	96,463
Average Old Age Replacement	105.8%	130.3%	154.2%
REVENUES AND EXPENDITURES (in IQ dinars)			
Total Revenues	50,122,800,000	2,201,980,269,600	6,784,036,125,000
Total Expenditures	42,848,400,000	295,051,851,600	854,076,332
Surplus/ Deficit	7,274,400,000	1,906,928,418,000	6,783,182,048,668

Annex 5: Assessment of Iraq national statistical system

We assessed the capacity of the Iraq national statistical system by reviewing and evaluating the three dimensions of the system: (i) methodology, standards, and classifications (MSC); (ii) dissemination practices and openness (DPO); and (iii) data products (DP). Based on this assessment, we gave Iraq a total score of 32.44 out of 100, which indicated a low level of statistical capacity. This is a clear indicator that there is an urgent need to increase the capacity of the statistical system to enable it to collect the information necessary to fully inform policymaking and to monitor and evaluate the development progress over the coming years.

In terms of MSC, Iraq scored 41.18 out of 100, indicating that the capacity of the statistical system needs to be strengthened. We identified several areas that need improving including the current System of National Accounts (SNA) (the conflict in Iraq since 1990 delayed the movement from SNA 1968 to 1993), the use by the central government of a budgetary accounting method that provides an incomplete picture of central government activities, and the adoption of base years in the national accounts and the consumer price index (CPI). With regard to censuses and surveys, the MSC score indicated that timely population and housing censuses and business censuses are needed. Iraq does a relatively good job of conducting household surveys on income and expenditure with the help of international agencies. An effort was also made by the Central Statistical Organization (CSO) to conduct a labor force survey in 2008. Nonetheless, more surveys on agriculture, health, and businesses are needed.

In terms of DPO, which assesses the dissemination capacity of national statistical systems, Iraq received a score of 23.53 out of 100. The first sub-section of the assessment looked at the capacity of the CSO's website. Iraq lost points on all but one indicator. An event calendar is available on the CSO website, but it is blank. Although users can find some statistics and survey information, there is no database/data portal or survey catalogue to enable them to explore the data interactively or to download data in a reusable format (such as Excel). A user satisfaction survey is also needed to receive feedback from users. The website performs relatively well in terms of providing metadata information to statistical subjects, including the source of the data and the methods and definitions used. The second sub-section assessed Iraq's capacity in terms of its dissemination of information to the IMF. Based on the score, Iraq does a good job of meeting both the periodicity and timeliness requirements of the IMF Special Data Dissemination Standard in disseminating CPI and population statistics. More effort is needed to strengthen the capacity to disseminate data from the national accounts and labor and trade statistics.

The third dimension, data products, checks whether Iraqi statistics on selected indicators appear in international databases. The DP score showed that Iraq has disseminated data on the numbers of the population using safely managed drinking water services, on gross capital formation, on inflation, and on city data on air pollution. As a result, Iraq scored 22.22 out of 100, indicating more efforts required to report timely statistics to international agencies.

Scoring Matrix of Revised Statistical Capacity Indicator, Iraq

Methodology, Standards, and Classifications (45% of total score)						
1) Macroeconomic and financial indicators						
#	Indicator	Score 1	Score 0.5	Score 0	Weight	Score of Iraq
1	System of National Accounts in use	SNA2008/ESA 2010	SNA1993/QNA Manual 2001/ ESA 1995	Otherwise	1	0
2	National Accounts base year	Annual chain linking	Within past 10 years	Otherwise	1	0.5
3	Classification of national industry	Latest version is adopted (ISIC Rev 4, NACE Rev 2 or a compatible classification)	Previous version is used (ISIC Rev 3, NACE Rev 1 or a compatible classification)	Otherwise	1	0.5
4	CPI base year	Annual chain linking	Within past 10 years	Otherwise	1	0.5
5	Classification of household consumption	Follow Classification of Individual Consumption by Purpose (COICOP)	N.A.	Otherwise	1	1
6	Classification of status of employment	Follow International Labour Organization, International Classification of Status in Employment (ICSE-93)	N.A.	Otherwise	1	1
7	Central government accounting status	Consolidated central government accounting follows noncash recording basis	Consolidated central government accounting follows cash recording basis	Otherwise	1	0
8	Compilation of government finance statistics	Follow the latest Government Finance Statistical Manual (2014)	Previous version is used (GFSM 2001)	Otherwise	1	0.5
9	Compilation of monetary and financial statistics	Follow the latest Monetary and Finance Statistics Manual (2000) or Monetary and Finance Statistics: Compilation Guide (2008)	N.A.	Otherwise	1	1
Maximum score for sub-category: 9						
2) Censuses and Surveys						
Censuses						
#	Indicator	Score 1	Score 0.5	Score 0	Weight	Score of Iraq
10	Population & Housing census	Population census done within last 10 years	Population census done within last 20 years	Otherwise	1	0
11	Agriculture census	Agriculture census done within last 10 years	Agriculture census done within last 20 years	Otherwise	1	1
12	Business/establishment census	Business/establishment census done within last 10 years	Business/establishment census done within last 20 years	Otherwise	1	0

Surveys							
#	Indicator	Score 1	Score 0.67	Score 0.33	Score 0	Weight	Score of Iraq
13	Household Survey on income/consumption/expenditure/budget/Integrated Survey (All HHS since 2000)	3 or more household surveys done within past 10 years	2 household surveys done within past 10 years	1 household survey done within past 10 years	None within past 10 years	1	0.67
14	Agriculture survey	3 or more agriculture surveys done within past 10 years	2 agriculture surveys done within past 10 years	1 agriculture survey done within past 10 years	None within past 10 years	1	0
15	Labor Force Survey	3 or more labor force surveys done within past 10 years	2 labor force surveys done within past 10 years	1 labor force survey done within past 10 years	None within past 10 years	1	0.33
16	Health/Demographic survey	3 or more labor force surveys done within past 10 years	2 labor force surveys done within past 10 years	1 labor force survey done within past 10 years	None within past 10 years	1	0
17	Business/establishment survey	3 or more business/establishment surveys done within past 10 years	2 business/establishment surveys done within past 10 years	1 business/establishment survey done within past 10 years	None within past 10 years	1	0
Maximum score for sub-category: 8							
Maximum category score: 17							
MSC Country Score = Weighted Score of Country ÷ Maximum Category Score × 100							
MSC Score of Iraq: 41.18							

Dissemination Practices & Openness (30% of total score)							
1) Dissemination capacity of NSO							
#	Indicator	Score 1	Score 0	Weight	Score of Iraq		
1	NSO has an Advance Release Calendar and it is published	Yes	No	1	0		
2	NSO has a listing of surveys and microdata sets (or NADA)	Yes	No	1	0		
3	NSO has a data portal	Yes	No	1	0		
4	Timeseries indicators are available for download in reusable format for free	Yes	No	1	0		
5	Metadata are available providing definition, methodology, standards or classifications for existing data series	Yes	No	1	1		
6	NSO has conducted a user satisfaction survey	Yes	No	1	0		
Maximum score for sub-category: 6							
2) Periodicity and timeliness (SDDS requirements)							
#	Indicator	Score 1 - Meet Periodicity and Timeliness requirements	Score 0.5 - Meet either Periodicity or Timeliness requirement	Score 0	Weight		
7	National accounts	Yes	Yes	No	1		
8	Consumer price index	Yes	Yes	No	1		
9	Producer price index	Yes	Yes	No	1		
10	Production index	Yes	Yes	No	1		
11	Employment	Yes	Yes	No	1		
12	Unemployment	Yes	Yes	No	1		
13	Central government operations	Yes	Yes	No	1		
14	Balance of payments	Yes	Yes	No	1		
15	External debt	Yes	Yes	No	1		
16	Merchandise trade	Yes	Yes	No	1		
17	Population	Yes	Yes	No	1		
Maximum score for sub-category: 11							
3) Openness of data							
#	Indicator	Score			Weight		
18	Open Data Inventory	ODIN Score/100			0		
Maximum score for sub-category: 0							
Maximum category score: 17							
DPO Country Score = Weighted Score of Country ÷ Maximum Category Score × 100							
DPO Score of Iraq: 23.53							

Data Products (25% of total score)					
#	Indicator	Score 1 - Data available for the latest year	Score 0	Weight	Score of Iraq
1	Proportion of population living below the national poverty line	Yes	No	1	0
2	Prevalence of stunting among children under 5 years of age	Yes	No	1	0
3	Maternal mortality ratio	Yes	No	1	0
4	Proportion of births attended by skilled health personnel	Yes	No	1	0
5	Child immunization (proportion of 1-year-old children immunized against measles)	Yes	No	1	0
6	Primary completion rate, both sexes (%)	Yes	No	1	0
7	Adult literacy rate, population 15+ years, both sexes (%)	Yes	No	1	0
8	Proportion of population using safely managed drinking water services	Yes	No	1	1
9	Proportion of population with access to electricity	Yes	No	1	0
10	Unemployment, total (% of total labor force)	Yes	No	1	0
11	Manufacturing value added as a proportion of GDP	Yes	No	1	0
12	Gross capital formation (% of GDP)	Yes	No	1	0
13	GDP implicit price deflator (annual % growth)	Yes	No	1	1
14	Net trade in goods and services (BoP, current US\$)	Yes	No	1	1
15	Growth rates of household per capita expenditure or income among the bottom 40 percent of the population and the total population	Yes	No	1	0
16	Annual mean levels of fine particulate matter (e.g. PM2.5 and PM10) in cities	Yes	No	1	1
17	Proportion of children under 5 years of age whose births have been registered with a civil authority (completeness of birth registration)	Yes	No	1	0
18	Completeness of death registration with cause-of-death information	Yes	No	1	0

Maximum category score: 18

Data Products Country Score = Weighted Score of Country ÷ Maximum Category Score × 100

DP Score of Iraq: 22.22

$$\text{Total SCI score of Iraq} = \sqrt{0.45 \cdot 41.18^2 + 0.3 \cdot 23.53^2 + 0.25 \cdot 22.22^2} = 32.44$$

