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INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

PROGRAM DOCUMENT FOR A PROPOSED LOAN

IN THE AMOUNT OF US$1,200 MILLION

TO

THE REPUBLIC OF IRAQ

FOR AN EMERGENCY FISCAL STABILIZATION, ENERGY SUSTAINABILITY, AND STATE-OWNED ENTERPRISE TRANSPARENCY DEVELOPMENT POLICY FINANCING

December 17, 2015

Macroeconomics and Fiscal Management Global Practice

Middle East and North Africa Region

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REPUBLIC OF IRAQ

GOVERNMENT FISCAL YEAR
January 1 – December 31

CURRENCY EQUIVALENTS
(Exchange Rate Effective as of October 31, 2015)

Currency Unit = Iraqi Dinar (ID)
US$1 = ID1,124
ID1 = US$0.000890

ABBREVIATIONS AND ACRONYMS

ARA	Assessing Reserve Adequacy
BCM	Billion Cubic Meters
BSCFD	Billion Standard Cubic Feet per Day
CBI	Central Bank of Iraq
CCGTs	Combined-Cycle Gas Turbines
CEM	Country Economic Memorandum
CoM	Council of Ministers
CPS	Country Partnership Strategy
DEMPA	Debt Management Performance Assessment
DFI	Development Fund for Iraq
DPF	Development Policy Financing
DPL	Development Policy Loan
EIA	Environmental Impact Assessment
ESMAP	Energy Sector Management Assistance Program
FATF	Financial Action Task Force
FBSA	Federal Board of Supreme Audit
FDIs	Foreign Direct Investments
GDP	Gross Domestic Product
GRS	Grievance Redress Service
GGFR	Global Gas Flaring Reduction Partnership
GW	Gigawatt
IBRD	International Bank for Reconstruction and Development
ID	Iraqi Dinar
IDPs	Internally Displaced Persons
IEG	Independent Evaluation Group
IFMIS	Integrated Financial Management Information Systems
IHSES	Iraq Household Socio-economic Survey
IMF	International Monetary Fund
INES	Integrated National Energy Strategy
IOC	International Oil Company
ISPSR	Iraq Social Protection Strategic Roadmap
JICA	Japan International Cooperation Agency
KRG	Kurdistan Regional Government
KwH	Kilowatt-hour
LFO	Light Fuel Oil
LPG	Liquefied Petroleum Gas

MIM	Ministry of Industry and Minerals
MMscf	Millions of Standard Cubic Feet
MMscfd	Millions of Standard Cubic Feet per day
MoE	Ministry of Electricity
MoF	Ministry of Finance
MOLSA	Ministry of Labor and Social Affairs
MOP	Ministry of Planning
MTEF	Medium-Term Expenditure Framework
MW	Megawatt
MWh	Megawatt-hour
NOPB	Non-Oil Primary Balance
OPEC	Organization of Petroleum Exporting Countries
PDOs	Program Development Objectives
PDS	Public Distribution System
PFM	Public Financial Management
PIMS	Public Investment Management System
PIP	Public Investment Program
PLR	Performance and Learning Review
PER	Public Expenditure Review
PIM	Public Investment Management
PMAC	Prime Minister's Advisory Commission
PMT	Proxy-means Test
PPP	Public Private Partnership
PSSD	Pensions and Social Security Department
RFI	Rapid Financing Instrument
SBA	Stand-By Arrangement
SCGT	Simple-Cycle Gas Turbine
SDR	Special Drawing Rights
SMP	Staff-Monitored Program
SPF	State Pension Fund
SSN	Social Safety Net
SOEs	State-Owned Enterprises
WDR	World Development Report

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REPUBLIC OF IRAQ

EMERGENCY FISCAL STABILIZATION, ENERGY SUSTAINABILITY, AND STATE-OWNED ENTERPRISE TRANSPARENCY DEVELOPMENT POLICY FINANCING

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SUMMARY OF PROPOSED LOAN AND PROGRAM

REPUBLIC OF IRAQ: EMERGENCY FISCAL STABILIZATION, ENERGY SUSTAINABILITY, AND STATE-OWNED ENTERPRISE TRANSPARENCY DEVELOPMENT POLICY FINANCING

Borrower	Republic of Iraq
Implementation Agency	Ministry of Finance
Financing Data	IBRD Loan Amount : US$1,200 million Terms: IBRD variable spread loan, 16 years final maturity, including 5 years of grace period, commitment linked and annuity repayment profile. All conversion options remain available
Operation Type	Stand-alone single tranche operation
Pillars of the Operation and PDOs	The proposed operation is built around three pillars, which are also the operation's Program Development Objectives (PDOs): Improve (1) expenditure management; (2) the sustainability of energy supply; and (3) the transparency of state-owned enterprises.
Result Indicators	PDO 1. Improve expenditure management • Reduction in the basic annual salary of top public sector employees as a ratio of annual GDP per capita: Baseline (September 2015): 1.9; Target (Q1 2017): 1.7. • Percentage of capital projects valued at over US$500 million for which a feasibility study with cost-benefit analysis is done: Baseline (2015): 3 percent; Target (Q1 2017): 5 percent. • Approval and publication on the Ministry of Finance website of a public debt management strategy (DMS) in line with international best practice by Q1 2017 (Target). • Improved financial sustainability of the State Pension Fund through better governance as measured by a 5 percent nominal reduction of the cash benefit spending of the National Board of Pension by Q1 2017 (Target), as compared to end-2015 (Baseline). PDO 2. Improve the sustainability of energy supply • Reduced gas flaring—measured by the amount of additional (associated) gas processed (average MMscf per day): Baseline (2014): 656; Target (Q1 2017): 1,070. • Gas-to-Power Inter-ministerial Committee in place and an Action Plan developed by Q1 2017 (Target). • Fuel switching to generate power from petroleum products to gas—measured as total gas volume supplied to gas turbine power production (MMscf per day): Baseline (2014): 600; Target (Q1 2017): 840. • Increased tariffs for energy-intensive consumers—measured by the retail price of electricity sold (in ID per kWh): Baseline (2014): 30.74; Target (Q1 2017): 31.05 • Improved service delivery—measured by total electricity sold (in Megawatt per hour): Baseline (2014): 44 million; Target (Q1 2017): 47.6 million. PDO 3. Improve the transparency of state-owned enterprises • Publication of a consolidated annual report on financial and employment metrics of non-financial SOEs by Q1 2017 (Target). • Ratio of state deposits in private banks to state deposits in all banks: Baseline (January 2015): 0 percent; Target (Q1 2017): 5 percent. • Progress in implementing FATF action plan: Baseline (June 2015): Zero of 8 actions in FATF action plan completed to the satisfaction of FATF; Target (Q1 2017): At least 5 of 8 actions in FATF action plan completed to the satisfaction of FATF.
Overall risk rating	High
Operation ID	P155962

IBRD PROGRAM DOCUMENT FOR A PROPOSED LOAN TO THE REPUBLIC OF IRAQ

1. INTRODUCTION AND COUNTRY CONTEXT

1. **Iraq is a fragile state in the midst of a very serious confrontation with the Islamic State of Iraq and Syria (ISIS)**. The country is at a dangerous crossroads not just for the security of its people but also for the stability of the region. Since at least the early 1980s Iraq has been in a continuous state of conflict or fragility such as the war with Iran (1980-88), the Gulf war of 1990-91, the 2003 war, widespread acts of terrorism since 2003, and the 2006-08 turmoil. Between 2003 and 2012, 182,000 people were killed by violent means. Iraq was slowly emerging from this long and protracted institutional transition and political instability that had also weakened institutional capacity and the state's ability to deliver on its social contract with the Iraqi people. As a result, the country is persistently ranked around or below the 10^{th} percentile globally based on indicators of government effectiveness, rule of law, and control of corruption. Amid this already vulnerable situation, Iraq has been hit by the ISIS insurgency. This has caused a quadrupling of violent deaths compared to 2009-12, adding 42,000 to the violent death count, and causing a loss of control of about one-third of the territory to the insurgency.

2. **The ISIS insurgency has created a humanitarian crisis, put pressure on fiscal spending, and plunged the non-oil economy into a deep recession**. Expanding from Syria, ISIS has made rapid inroads into Iraq since June 2014. The group currently controls nearly one-third of Iraq's territory including major cities such as Mosul and Ramadi, as well as key international trade routes (borders with Syria, Jordan, and Turkey), and it has intermittently held some oil infrastructure such as the Baiji refinery, the country's largest. Critically, ISIS has not been able to directly and materially impact Iraq's oil production, which is predominently located in the southern part of Iraq (around Basra), and, to a lesser extent, in the northern part (the Kurdistan region).[1] The ISIS insurgency has created a large humanitarian crisis with over three million Iraqis internally displaced which, combined with the arrival of 245,000 Syrian refugees, is bringing to the fore weaknesses in service delivery. Progress in fighting ISIS has been slow and expensive. Security-related budgetary expenditure (military and police equipment and salaries) is projected to increase by over US$1.7 billion in 2016 (IMF Staff-Monitored Program, 2015). Moreover, the conflict has been a key driver of the severe contraction of the non-oil economy, by 7 percent in 2014 and by an estimated 6.7 percent in 2015. ISIS-controlled areas have particularly suffered as productive assets and infrastructure have been destroyed, trade routes have been cut or severely curtailed, and investor and consumer confidence dwindled.

3. **Compounding the country's fragility is the sharp drop in oil prices which is severely impacting Iraq's non-diversified and oil-dependent economy**. Iraq has the fifth largest proven crude oil reserves in the world with 141.4 billion barrels. With the rapid increase in production experienced in 2015, the country is now the world's third largest and OPEC's second largest oil exporter. With about 112 trillion cubic feet of proven reserves, Iraq's proven natural gas reserves

[1] For details on the strong performance of oil production in spite of the ISIS insurgency, see Box 2 of the IMF Country Report No. 15/235, 2015. For details on the deteriorating humanitarian conditions in Iraq, see Box 1 of the same report.

are the 12th largest in the world. The oil and gas sector dominates the economy, even by regional standards. The sector accounts for over 65 percent of GDP, more than 90 percent of central government revenue, and 98 percent of the country's exports. The fall in oil prices, which have dropped by over 50 percent since June 2014, has resulted in a sharp and sudden deterioration of the country's public finances and external balance. Oil revenue in the government budget fell by an estimated 19.3 percent of 2015 GDP between 2014 and 2015 and export revenue fell by a similar 19.3 percent leading to a sharp deterioration in the current account balance. The fall in oil prices from 2014 to 2015 would have resulted in a budgetary revenue loss of 24 percent of 2015 GDP (US$41 billion) were it not for the sizable increase in oil exports that the government managed to achieve. With the persistently low oil price, Iraq is expected to continue facing fiscal pressures in 2015-16.

4. **Iraq urgently needs support to help sustain the economy and protect the delivery of basic services to the Iraqi population while the government starts undertaking needed reforms**. The recently formed (September 2014) but still fragile coalition Government needs to strengthen its legitimacy and credibility and steer the country away from the current crisis. The Government has responded to the ISIS insurgency by starting to address peoples' grievances and retake areas controlled by ISIS including cities such as Tikrit, Baiji (along with its large oil refinery), and Sinjar. In those areas, the Government is implementing a number of projects—including with World Bank support through an Emergency Operation for Development approved by the Board in July 2015—aimed at restoring the ability of the State to provide basic services to the population. On public grievances, the focus is on combatting corruption and entering a path of ambitious political, economic and social reforms.[2] Mass demonstrations in August 2015 against corruption and weak public service delivery—most notably electricity—underscored the urgency of delivering on those reforms.

5. **The proposed Emergency Fiscal Stabilization, Energy Sustainability, and State-Owned Enterprise Transparency Development Policy Financing (DPF) in the amount of US$1.2 billion will be disbursed in a single tranche**. The proposed DPF is a critical part of the Bank's efforts to help address fragility and increase stability in Iraq and the broader Middle East and North Africa (MENA) region. This DPF seeks to safeguard economic stability and basic service delivery. The proposed DPF is built around three pillars, which are also its Program Development Objectives (PDOs), namely to improve: (1) expenditure management; (2) sustainability of energy supply; and (3) transparency of SOEs. The PDOs support key elements of Iraq's medium-term development priorities, as detailed by the Prime Minister during his inauguration speech to Parliament in September 2014, and in the *Strategic Priorities in Ministries: 2014-18 Action Plan* which lays out the six priorities of his new Government. These include: (1) promoting a secure and stable Iraq, (2) upgrading service to and the standard of living of citizens, (3) encouraging a shift towards the private sector, (4) increasing oil and gas production to improve financial sustainability, (5) implementing administrative and financial reform of government institutions; and (6) improving federal-local relations. The operation supports directly priorities (2) to (5) and, indirectly, priority (1) (see below). Overall, these reforms thus contribute to the World

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[2] The Government has also moved in earnest, though still not fully successfully, to develop a comprehensive dialogue with the Kurdistan Regional Government (KRG) and to give political signals to the southern governorate—home of 85 percent of the country's oil wealth, and with the highest poverty levels—and to those citizens who perceived they were previously excluded.

Bank Group's strategic goals of ending extreme poverty and boosting shared prosperity in a sustainable manner and to the World Bank Group's MENA Strategy (see paragraph 11). In addition, Bank support at this particular juncture is informed by the 2011 World Development Report (WDR) on *Conflict, Security and Development* and its operationalization.

6. **The proposed DPF is part of an international support package to Iraq**. The emergency operation is complemented by a Staff-Monitored Program (SMP) of the International Monetary Fund (IMF) on which staff-level agreement was reached on November 10, 2015 and which the Iraqi authorities expect to lead to a Stand-By Arrangement. The Bank is also sharing the financial support with the IMF and with the Japan International Cooperation Agency (JICA). The IMF moved quickly with the disbursement in July 2015 of a US$1.24 billion Rapid Financing Instrument and the Government of Japan is providing budget support through parallel financing. Beyond this financing package, the policy reforms proposed in the DPF are underpinned by an extensive and multi-year ongoing and/or planned program of technical assistance and projects provided by donors and international financial organizations (see Table 4). This comprehensive and medium-term engagement supports fast, effective, and sustainable policy implementation of structural reforms, as requested by the authorities.

7. **Even prior to the conflict with ISIS and the oil price shock, Iraq faced significant structural challenges to reduce poverty and generate inclusive growth**. In 2012, a fifth of the Iraqi population was spending less than the amount required to meet their minimum nutritional requirements and cover their basic non-food needs, such as clothing and shelter. Many more lived close to the poverty line, were vulnerable to increases in the price and availability of necessities and to the loss of assets and livelihoods. Poverty was accompanied by deprivation in other aspects of Iraqis' lives, too.[3] Jobs were not providing a pathway out of poverty. Overall, 70 percent of the poor are in households with employed heads. Even though private sector jobs make up more than 60 percent of total jobs in Iraq, the pace of new job creation in the private sector is disappointingly slow. During 2007-2012, 80 percent of new jobs were created in the public sector, a significant number of them being with low qualifications. In addition, Iraq has high numbers of people out of the labor force: a third of men and 90 percent of women are neither employed nor looking for work. The Public Distribution System (PDS), which remains the primary safety net for the poor and provides more than 60 percent of the calories consumed by the poor, suffers from severe inefficiencies,[4] despite some progress in developing transfer programs. Other safety net programs are not poverty targeted and cover a small share of the poor.

8. **Despite being an energy-rich country, Iraq suffers from a chronic and pervasive shortage of electricity, which contributed to social unrest during the summer of 2015**. Inadequate electricity is seen by Iraqis as a top concern of households. Inefficiencies in the energy sector impose a significant fiscal and economic burden on Iraq. Subsidies in Iraq are concentrated

[3] Roughly half of Iraq's population has less than primary level education; almost a third of children under five suffers from stunted growth; over 90 percent of households in Baghdad and central and southern governorates receive less than eight hours of electricity a day. Protracted violence and insecurity have directly and indirectly affected mortality rates (Infant mortality rates in Iraq are the highest in the region, barring Yemen and possibly Djibouti).

[4] The PDS is a large government program but its efficiency remains weak. The PDS management is rudimentary, making it vulnerable to waste, theft, and corruption. The PDS is affected by weak internal controls and accountability, and inefficiency in supply chain management. It is inefficient in terms of beneficiary impact relative to amount spent.

in fuel and electricity. 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. About 60 percent of the country's gas production is flared in-field. Iraq's planned significant increases in oil production could further increase its associated natural gas flaring losses unless measures are undertaken to capture, process and transport that production. Because Iraq is not capturing its associated gas to make it available for 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 and degrade the performance and useful life of generation equipment compared to natural gas.

9. **The public sector, SOEs and the financial system suffer from inefficiencies which represent a drag on government's fiscal position and private sector development**. Spending efficiency in Iraq is low in absolute terms and compared to peers, both on current and investment expenditure. Iraq's public sector human resource practices and payrolls are weak. Public investment decision processes suffer from large structural weaknesses that result in poor execution rates of the investment budget. SOEs stifle private sector development by crowding out private firms and impeding factor reallocation. For the most part, SOEs in Iraq are non-transparent, are weakly accountable, and undertake sizeable quasi-fiscal activities which generate large fiscal liabilities and risks. Many SOEs are simply an employment scheme. The banking system in Iraq is small, dominated by weak state-owned banks, and is not in compliance with key international transparency recommendations. Iraq's social insurance and pension system is fragmented, unequal, costly and financially unsustainable (pension spending in Iraq, at around 4 percent of GDP, is high by international standards—the OECD average of 23 countries is 1.8 percent of GDP; Iraq's spending exceeds that of the OECD's most expensive pension system, namely Greece at 3.7 percent of GDP).

10. **This operation aims to address the short-term emergency resulting from heightened fragility while helping lay the ground for addressing some of the structural challenges described above, and is a demonstration of the Bank's new approach to the MENA Region, as articulated in the new MENA Strategy, recently discussed by the Board of Directors**. The main objective of the new strategy is to contribute to peace and stability by addressing upfront the drivers of instability in an effort to mitigate against increased fragility and conflict. In Iraq, one of the main drivers of instability and conflict has been the weakened relationship between the Government and the people, disparities in access to services, and a perceived lack of representation and voice among various groups. The DPF program strengthens the relationship between the citizens and the state by first, helping to stabilize the macroeconomic situation without which FDI and growth would decline further, and unemployment and poverty would increase. It also contributes to improving the efficient delivery of services to the people with particular emphasis on the strategic and socially sensitive electricity sector. The Government, motivated by the current fiscal crisis, has embarked on a program of reforms which, to succeed, will require strong buy-in of the population and substantial external financing and assistance.

11. **In addition, and in line with the 2011 WDR, the Bank's response accepts the reality that engaging in Iraq means taking considered risks**. Those risks are multiple and of varying nature. They are linked to the security situation in the country, to its economic fragility, to the fall in oil prices and to the mismanagement of its public and financial sectors. They are present in the fluid and potentially unstable internal dynamics between the various governorates, the Kurdistan

Regional Government (KRG) and the central government. They have a regional and international dimension at a time of geo-strategic uncertainty around the broader Middle East. While candidly assessing those risks, the Bank is looking carefully at ways to mitigate them, through the reading of the country's political economy and the region's strategic dynamics. As argued in the *2011 World Development Report* on Conflict, Security, and Development, providing immediate and much needed financing, stability and space for reforms to take root, and adapting our ways of engaging in challenging situations and adopting a "layered approach"—multi-sectoral and with the commitment of several partners—will strongly contribute to the achievement of the World Bank Group's twin goals of eliminating extreme poverty and boosting shared prosperity in a sustainable manner. Progress toward, and achievement of the twin goals should be assessed against the counterfactual of no World Bank involvement at this time in Iraq through the proposed DPF.

2. MACROECONOMIC POLICY FRAMEWORK

2.1 RECENT ECONOMIC DEVELOPMENTS

12. **The conflict with ISIS and the oil price shock have caused economic growth to sharply decelerate over the past two years**. After growing at an average annual pace of 8.5 percent in the four years to 2013, Iraq's real GDP is estimated to have contracted by 2.2 percent in 2014 and is projected to grow by a tepid 0.4 percent in 2015 (Table 1). The weak growth performance stems from the non-oil economy which contracted by 7 percent in 2014 and is estimated to decline by an additional 6.7 percent in 2015. The crises, combined with political instability in 2014, impacted private sector consumption and investment, and limited government spending, particularly on investment projects. The oil sector, however, has continued to expand as production is located in areas firmly under Government and KRG control. After rising by 4 percent in 2014, oil production for the first 9 months of 2015 increased by 9 percent year-on-year and oil exports increased by 20 percent. Inflation has been subdued, at 1.6 percent at end-2014 and 2.1 percent at end-September 2015. Inflation is estimated to reach 3 percent by end-2015 because of disruption in imports and aggregate supply.[5]

13. **The ISIS crisis and the oil shock have also eroded the welfare gains of the 2007 to 2012 period**.[6] The economic disruption resulting from this unprecedented confluence of hardship has resulted in a marked contraction in GDP per capita, from about US$7,000 in 2013 to about US$5,000 in 2015. As stressed in the *2014 Iraq Country Economic Memorandum* (draft) and the companion *2014 Iraq Public Expenditure Review (PER)*, the country was ill-equipped to tackle these shocks given its weak institutions and an incomplete transition to a market-based economy. The shocks have increased the number of people living below the poverty line by an estimated 2.8 million and a reduction in the number of employed persons by 800,000. Internally Displaced Persons (IDPs) as a whole make up half a million of Iraq's poor in 2014, and have an estimated poverty rate of 40 percent, almost twice the national average. Not surprisingly, the largest adverse impacts of the twin shocks were experienced in the Kurdistan region and the ISIS-affected governorates (Anbar, Salahadin, and Nineveh), but for different reasons. Kurdistan experienced a quadrupling of poverty rates to 12.5 percent, due to the large influx of IDPs and the increased

[5] Official data do not cover the conflict-affected provinces, where inflation is reportedly higher due to shortages.

[6] Based on a microsimulation approach that assesses the impact of the twin shocks relative to a "Business as Usual" scenario (which assumes the 2012-13 trend in economic and sectoral growth would have been unchanged).

competition for jobs, goods and services. In the ISIS-affected governorates (accounting for 19 percent of Iraq's 2012 population), the direct impact of economic, social and security disruptions is estimated to have doubled poverty rates to 41.2 percent. While the effects were smaller in the rest of Iraq, poverty increased everywhere. Especially in the South, where poverty rates have always been high, the macro level shocks have further increased estimated poverty rates to above 30 percent.

Table 1. Iraq: Key Macroeconomic Indicators, 2012-2018

	2012	2013	2014	2015	2016	2017	2018
	Act.		Prel.	Est.		Proj.	
Economic growth and prices							
Real GDP (percentage change)	13.3	6.5	-2.2	0.4	4.3	5.6	6.2
Non-oil real GDP (percentage change)	15.0	10.2	-7.0	-6.7	0.0	2.0	3.0
GDP per capita (US$)	6,469	6,686	6,231	4,658	4,528	5,046	5,427
GDP (in US$ billion)	218.0	232.5	223.5	172.2	172.5	197.9	219.0
Oil production (mbpd)	3.0	3.0	3.1	3.4	3.8	4.1	4.5
Oil exports (mbpd)	2.4	2.4	2.5	2.9	3.6	3.8	4.0
Iraq oil export prices (US$ pb)	106.7	102.9	97.0	50.1	45.0	55.4	59.8
Consumer price inflation (percentage change; end of period)	3.6	3.1	1.6	3.0	3.0	3.0	3.0
Consumer price inflation (percentage change; average)	6.1	1.9	2.2	1.9	3.0	3.0	3.0
National Accounts			(Percent of GDP)				
Gross domestic investment	25.5	27.0	26.3	22.0	21.0	20.0	20.0
Of which: public	13.2	17.6	19.2	12.5	12.7	11.5	11.2
Gross domestic consumption	66.3	69.0	72.8	84.8	84.4	74.7	75.0
Of which: public	20.7	21.2	19.0	25.6	28.8	25.9	24.2
Gross national savings	31.8	28.8	25.0	15.0	15.4	23.2	25.0
Of which: public	17.7	12.1	13.7	-1.7	1.9	9.4	14.8
Saving - Investment balance	6.3	1.8	-1.3	-7.0	-5.6	3.2	5.0
Public Finance			(Percent of GDP, unless otherwise indicated)				
Government revenue and grants	47.0	42.6	40.1	30.7	39.7	44.3	45.6
Government oil revenue	43.0	38.4	37.8	27.5	35.8	40.7	41.9
Government non-oil revenue	4.0	4.2	2.3	3.2	3.9	3.6	3.8
Grants	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Expenditure	42.9	48.4	45.7	45.2	50.6	47.3	42.4
Current expenditure	29.8	30.9	26.5	32.7	38.0	36.0	32.3
Capital expenditure	13.2	17.6	19.2	12.5	12.7	11.2	10.1
Primary fiscal balance	4.5	-5.5	-5.3	-13.6	-9.5	-1.3	4.8
Overall fiscal balance	4.1	-5.9	-5.6	-14.5	-10.9	-3.0	3.3
Non-oil primary fiscal balance (percent of non-oil GDP)	-65.2	-69.9	-60.5	-52.1	-56.3	-54.9	-55.0
Monetary indicators							
Growth in broad money	4.2	15.9	3.6	9.7	11.6	14.3	11.9
Growth in reserve money	8.1	12.6	-9.6	0.1	2.1	8.9	10.9
Policy interest rate (end of period)	6.0	6.0	6.0	…	…	…	…
External sector			(Percent of GDP, unless otherwise indicated)				
Current account	6.3	1.8	-1.3	-7.0	-5.6	3.2	5.0
Trade balance	14.0	10.0	9.0	0.3	1.7	9.3	9.4
Exports of goods	43.2	39.0	39.7	31.3	34.5	38.6	40.1
Imports of goods	29.2	29.0	30.7	31.0	32.8	29.4	30.7
Overall external balance	4.5	-1.3	-7.1	-10.8	-7.8	3.3	6.5
Gross reserves (in US$ billion)	69.3	77.8	66.7	51.1	42.9	49.0	62.8
In months of imports of goods and services	9.8	10.3	11.5	8.4	7.3	7.2	8.0
Exchange rate (dinar per US$; period average)	1,166	1,166	1,166	1,166	…	…	…
Real effective exchange rate (percent change)	-1.7	6.5	4.6	…	…	…	…
Memorandum items							
Total government debt (in percent of GDP)	33.8	32.0	38.9	61.7	68.6	60.5	51.3
Total government debt (in US$ billion)	73.8	74.3	87.0	106.2	118.4	119.8	112.4
External government debt (in percent of GDP)	45.4	44.4	42.8	52.1	35.3	30.8	27.5
External government debt (in US$ billion)	99.0	103.1	95.6	89.7	60.8	60.8	60.3

Sources: Iraqi authorities; IMF and World Bank estimates and projections. The above framework does not materially differ from the one underlying the IMF SMP agreement of November 10, 2015.

14. **The fiscal deficit is projected to widen significantly from 5.6 percent of GDP in 2014 to 14.5 percent of GDP in 2015**. As explained above, the sharp fiscal deterioration is due to the impact of the conflict with ISIS and the fall in oil prices. However, good fiscal performance

through the first 9 months of 2015 has mitigated somewhat the deterioration (Tables 1 and 2). The initial 2015 budget approved by the Cabinet (January 2015) was highly expansionary (with a deficit of 36 percent of GDP), reflecting additional spending in response to the security and humanitarian spending pressures. However, lower than budgeted oil prices and the limited financing available put pressure on the Government to make some adjustments to the budget. To contain the deficit, on the revenue side the Government has focused on ensuring increased volumes of oil exports (e.g., through oil infrastructure—pipelines, storage facilities, maintenance—optimization). On the expenditure side, the Government undertook to sharply under-execute budget spending through cash management and stronger spending prioritization. Given the limited share of discretionary spending in the budget, most of the adjustment fell on non-oil capital spending with the postponement of non-essential projects. The Government has also focused on tightening spending by curbing corruption and tightening economic management, as evidenced by the elimination of 47,000 ghost workers from the payroll and the removal of over 30,000 non-eligible pension beneficiaries from the registry. As a result, the Government has been successful in reducing the deficit: in July, the overall fiscal deficit was projected by the IMF (2015 Article IV) to reach 18.4 percent of GDP; by November, the IMF revised the deficit for 2015 to 14.2 percent of GDP (in line with Bank staff estimate of 14.5 percent of GDP; see Table 2).

15. **Financing the large 2015 budget deficit in an environment of limited financing options has been a challenge for the government**. The widening of the deficit in 2015 and the need to repay the 2014 arrears[7] have created large financing needs. In contrast to these large financing needs, the Government has limited sources of financing: since it has historically run budget surpluses, it has not yet developed a Treasury bonds market; nor has it issued external bonds in the past decade.[8] Furthermore, because of pro-cyclical fiscal policies, by end-2014 Iraq had almost depleted its assets in its (now closed) sovereign wealth fund (the Development Fund for Iraq). Identified sources of financing for the 2015 budget include borrowing from state-owned banks, partly through a modification of the reserve requirement and indirect central bank financing, and some external financing (Table 2). Financing of the budget also included a planned US$2 billion Eurobond issuance, which was postponed in October due to the high interest rate (11.5 percent) required by investors. Arrears accumulation—with a stock of ID5 trillion at end-April 2015[9]) are also part of the financing, given the lack of sources and the scale of the deficit. The Government is undertaking a survey to assess the extent of the arrears accumulated (SMP structural benchmark).

16. **Implementation of the budget arrangements between the central Government in Baghdad and the KRG in Erbil regarding oil sales and fiscal transfers has stalled since June 2015**. The agreement, signed in December 2014, provides for the resumption of budget transfer from Baghdad to the KRG (equivalent to 17 percent of the federal budget, minus certain sovereign expenditures) in exchange for exports of 0.55 million barrels per day (mbpd) on average (0.25 mbpd from the KRG and 0.3 mbpd from the Kirkuk fields, now controlled by the KRG) through KRG sales to SOMO (Iraq's state-owned oil company). The northern oil (KRG and Kirkuk) is exported to Ceyhan through a new pipeline in the KRG that bypasses ISIS-controlled territory.

[7] Without the repayment of these arrears oil and associated natural gas production could rapidly become impacted as International Oil Companies (IOCs) would be forced to scale down their investments and operations.

[8] With the exception of a single bond issuance which was a bundling of Saddam-era commercial debt into a government guaranteed instrument.

[9] Latest available data.

Implementation of the agreement has stalled since June 2015 as oil exports from KRG (including Kirkuk) fell from the agreed 0.55 mbpd to 0.15 mbpd and have subsequently been almost nil as KRG began exporting its oil directly without going through SOMO. Erbil's resumption of direct oil exports coincides with the discontinuation of fiscal transfers from Baghdad.

Table 2. Iraq: Central Government Fiscal Accounts, 2014-18
(in trillions of IDs, unless otherwise specified)

	2014	2015	2016		2017	2018
	Prel.	Est.	Budget	Proj.	Proj.	Proj.
Revenues and grants	104.4	61.6	83.4	80.8	103.4	117.9
Revenues	104.4	61.6	83.4	80.8	103.4	117.9
Crude oil export revenues	98.5	55.1	72.8	72.8	95.0	108.3
Of which KRG	2.6	3.4	3.4	3.4	5.0	6.8
Non-oil revenues	5.9	6.5	10.7	7.9	8.4	9.7
Expenditures	119.0	90.7	103.4	103.1	110.4	109.5
Current expenditures	68.9	65.6	73.9	77.3	84.1	83.4
Investment expenditures	50.1	25.1	29.6	25.8	26.3	26.0
Balance (including grants)	-14.6	-29.1	-20.0	-22.3	-6.9	8.5
Statistical discrepancy	0.9	…	…	…	…	…
Financing	13.6	29.1	20.0	22.3	6.9	-8.5
External financing	1.5	-4.0	14.9	1.8	2.4	2.0
Assets held abroad	-0.1	0.0	0.4	0.0	0.0	0.0
Project financing	0.0	0.4	1.5	0.9	0.8	0.5
Financing from the World Bank	0.0	1.4	3.2	0.0	0.2	0.2
Eurobond	0.0	0.0	3.1	2.4	2.4	2.4
Regional and Foreign National Banks	…	…	2.1	0.6	0.0	0.0
Loans Guarantees by export agencies	0.0	0.0	5.9	0.0	0.0	0.0
Amortization	-2.6	-1.7	-1.3	-2.1	-1.0	-1.1
Arrears	4.2	-4.1	…	0.0	0.0	0.0
Domestic financing	12.1	33.0	5.1	20.5	4.5	-10.5
SDR Allocation	0.0	0.8	2.1	0.0	0.0	0.0
Commercial Banks Loans	5.7	5.3	0.0	4.0	2.5	2.5
IMF (RFI)	…	1.4	0.0	…	…	…
T-bills	5.0	21.3	4.4	15.4	5.1	-9.9
National Government Bond	…	…	…	5.0	…	…
Arrears	2.3	5.0	0.0	-2.4	-2.4	-2.4
Amortization	-0.9	-0.9	-1.4	-1.4	-0.7	-0.7
Memorandum items:						
Security-related expenditure	16.6	16.9	…	17.5	17.7	18.3
Transfers of the federal Budget to KRG	2.4	5.5	…	12.3	13.6	13.6
Primary fiscal balance (percent of GDP)	-5.3	-13.6	…	-9.5	-1.3	4.8
Non-oil primary fiscal balance (Percent of non-oil GDP)	-60.5	-54.6	…	-56.3	-54.9	-55.0
Average Iraq oil export price (US$/bbl)	91	50	45	45	55	60
Crude oil exports	2.5	2.9	3.6	3.6	3.8	4.0

Sources: Iraqi authorities; IMF and World Bank staff estimates and projections. 1/ Including bilaterals (JICA, Italy).

17. **Amid a weak banking sector, the Central Bank of Iraq (CBI) is pressing ahead with reforms and is tightening supervision**. Because of the ISIS insurgency, the physical assets of some banks and of their clients were destroyed, daily economic activity was disrupted, trade disruption led to a fall in import financing, and the risk of money laundering and terrorist financing has increased. Credit growth to the private sector is also impacted due to the decline in public investment. Credit growth to the private sector decelerated from 16 percent in 2013 to only 5 percent in 2014 and is expected to further decelerate in 2015. Credit to the private sector amounts to only 7 percent of GDP in 2014, which is among the lowest in the world. Non-performing loans

ratios, which have already increased from 6.7 percent in 2013 to 7.6 percent in March 2015,[10] are expected to continue increasing because of ISIS activities and reduced private sector activity. The challenging fiscal situation has also resulted in an increase in directed lending that the leading state-owned banks (Rasheed and Al-Rafidain) have provided to SOEs, mostly to cover current operating costs (e.g., wages), as well as financing the Government deficit. Banking supervision remains weak, including regulatory forbearance with Rasheed and Al-Rafidain banks. The CBI is strengthening banking supervision and is pushing ahead with financial sector reforms through the planned introduction of a deposit insurance scheme, and a credit information bureau. Plans are in place to audit Rasheed and Al-Rafidain according to the International Financial Reporting Standards (IMF SMP structural benchmark), with the aim to develop restructuring plans based on the audits. The authorities are also promoting growth and lower distortions in the banking sector by improving the playing field between public and private banks.

18. **The current account deficit is projected to widen to 7 percent of GDP in 2015, up from 1.3 percent of GDP in 2014, and although at comfortable levels, the sharp decline in international reserves is a concern**. As explained above, the sharp deterioration is due to the impact of the twin shocks. However, the better than expected fiscal performance through the first 9 months of 2015, and in particular the tightening of non-oil investment spending, has mitigated somewhat the deterioration as imports of goods have been subdued while oil exports have grown at a robust pace in the first 9 months of 2015. As a result, while the current account deficit was projected in July by the IMF (2015 Article IV) to reach 8.6 percent of GDP for 2015, by November, the IMF staff (SMP) has revised its deficit forecast to 7 percent (same as Table 3). Gross foreign exchange reserves of the CBI have declined from US$67 billion at end-2014 to US$59 billion at end-October 2015 but still cover a healthy 8.5 months of imports of goods and services.[11] The sharp decline in international reserves may put pressure on Iraq's currency peg. It is important to implement measures to contain the current account deficit or identify external sources of financing as a forced and disorganized departure from the peg could have implications for maintaining the social contract or the stability of the country.

2.2 MACROECONOMIC OUTLOOK AND DEBT SUSTAINABILITY

19. **Iraq's macroeconomic outlook is expected to improve on the back of rising oil exports, progress on the security side, structural reforms, and a cohesive macroeconomic framework supported by an IMF program** (Table 1). The economy is projected to recover (from a low base) in 2016 with a growth rate of 4.3 percent and to continue gradually gather pace over the subsequent years to reach 6.2 percent in 2018—about one third below the 9 percent average of the pre-twin shock decade (2004-13). Among the expected drivers of this gradual recovery are: (1) a ramp up in oil exports; (2) an increase in FDIs—oil related, including for the rehabilitation of the severely damaged Baiji refinery which has been recaptured from ISIS—and portfolio investments; (3) the positive response of domestic private consumption and investment to relatively relaxed monetary policy (given lower inflation); (4) a lessening of the incremental impact of the ISIS insurgency as

[10] The quality of NPL data is weak because of the spotty application of IFRS in banks, and because many NPLs in Rasheed and Al-Rafidain banks are reported as performing.

[11] On the exchange rate front, since August 2015 the spread between the official and the parallel foreign exchange market rate has narrowed to 2 percentage points, down from a peak of 16 percentage points in June 2015. The narrowing of the spread stemmed from the elimination of the obligation to prove customs duty and income tax payments before buying foreign exchange.

the economy adapts to the conflict situation (base effect); (5) ongoing reforms in public finances, business environment, and the financial sector; and (6) implementation of an IMF program.

20. **The improved macroeconomic outlook is predicated on conservative assumptions about Iraq's oil exports, the main driver of the country's balance of payments and public finance outturns**. Oil production in Iraq is in areas firmly under the control of the central government and KRG: the southern part of the country around Basra and the northern fields of KRG and Kirkuk. Hence, oil production and exports can remain strong and possibly grow even if progress in the fight against ISIS is slow. The projected average oil exports of 3.6 mbpd for 2016 is a level of exports that Iraq (central government and KRG) has already achieved on a monthly basis in July, August and September 2015.[12] The country has existing export capacity of 4 mbpd, which can accommodate the planned export increases over the next two years. Critical to the projected path of rising production and exports is continued investment in the sector. As Iraqi oil is technically simple to extract, the level of investment is closely related to production (in contrast, for example, with deep offshore drilling where technical risks are significant). Higher oil production in Iraq is expected because (1) arrears that the government owed to international oil companies have been cleared so as to allow them to move forward with their investments, and (2) oil-related public investment in the draft 2016 budget is set to increase from to ID14.7 trillion (7 percent of GDP), from ID13.7 trillion (6.8 percent of GDP) in 2015.

21. **The fiscal deficit is projected to improve in 2016** (Table 2). Building on the sizeable deficit containment efforts already undertaken during the second half of 2015—by reducing the projected overall fiscal deficit from an initial projection of 18.4 percent of GDP to 14.5 percent of GDP—the overall fiscal balance is projected to improve by 3.6 percentage points of GDP to 10.9 percent of GDP in 2016.[13] Most of this large fiscal consolidation will stem from improved revenue, and in particular oil-related revenues. These are driven by the projected increase in oil export volumes (detailed above) as the budgeted oil price is conservatively set at US$45 per barrel[14] and is below the expected average oil price of US$50.1 per barrel for 2015. On the expenditure side, containment of non-oil primary spending will mostly be achieved through the continued postponement of lower priority non-oil investment. Public debt dynamics will benefit from the improved fiscal outlook. Public debt is projected to peak at 68.6 percent of GDP in 2016 before trending down (Figure 1). A public debt sustainability analysis reveals that debt remains sustainable over the medium term, given the projected fiscal consolidation and improved growth prospects.[15] It is, however, sensitive to shocks, particularly GDP growth and the primary balance.

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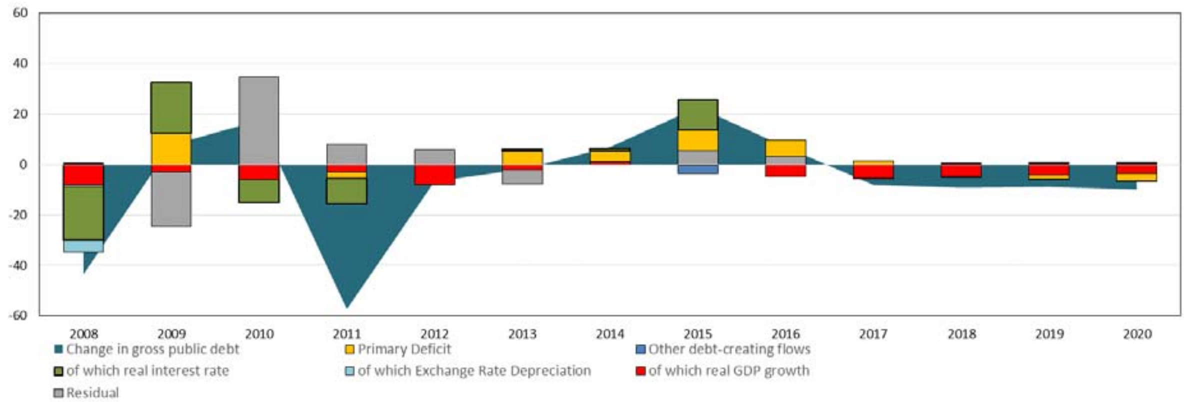
[12] The increase in oil exports shown in Table 1 from 2.9 mbpd in 2015 to 3.6 mbpd in 2016 is an overestimate as 2015 includes exports from the KRG only for the first 6 months of the year. If the Baghdad-KRG agreement had been in place throughout 2015, the average export volume for 2015 would have reached 3.2 mbpd. For 2016, based on assumption that the Baghdad-KRG agreement will be fully implemented, the 3.6mbpd projection includes KRG (and Kirkuk) exports for the whole year.

[13] The 2016 projections assume that the Baghdad-KRG agreement described in paragraph 16 is fully implemented. Should this not be the case, the impact on the central government budget would result in net fiscal savings as the transfer to the KRG amounts to US$11.8 billion while, under the budgeted oil price, KRG-related oil receipts would generate US$8 billion in revenue for the central government budget.

[14] This is below the latest IMF WEO oil price forecast—based on futures market—which is at US$48 per barrel.

[15] Permanently higher interest rates would also lead to a rising public debt path. Iraq's large gross financing needs create a rollover risk under all scenarios. Annex III of the IMF 2015 Article IV contains a detailed DSA.

Figure 1. Iraq: Public Debt Sustainability Analysis
(Contribution to growth of public debt)



Sources: IMF and World Bank staff estimates and projections

22. **The composition of the fiscal adjustment, while not optimal in light of the country's medium-term needs, is severely constrained by the current fragility and conflict context**. While the postponement of non-oil investment may seem contrary to the need to boost economic growth and service delivery in the short term, the quality and efficiency of non-oil investments has historically suffered from weak institutional capacity and governance as detailed in the *2014 Iraq Public Expenditure Review*. Thus the need to tighten non-oil investments due to fiscal pressures may be an opportunity to make these investments more selective while building the capacity of implementing agencies to take on more investments in the future. Furthermore, the wage bill—which the government aims to streamline given its very high level—is an integral part of the social contract, as is typical in many countries in the region. Changing this contract during the ongoing conflict with ISIS is highly sensitive as it risks alienating parts of the population which could potentially become more favorable to ISIS. Ultimately this could exacerbate further existing fragilities and conflict. Thus, while government remains committed to reform of the wage bill—as detailed in paragraph 41—and in particular the reform of allowances and bonuses for efficiency, equity and affordability reasons, it is undertaking more extensive consultations with stakeholders in light of the wave of demonstrations that recently took place.

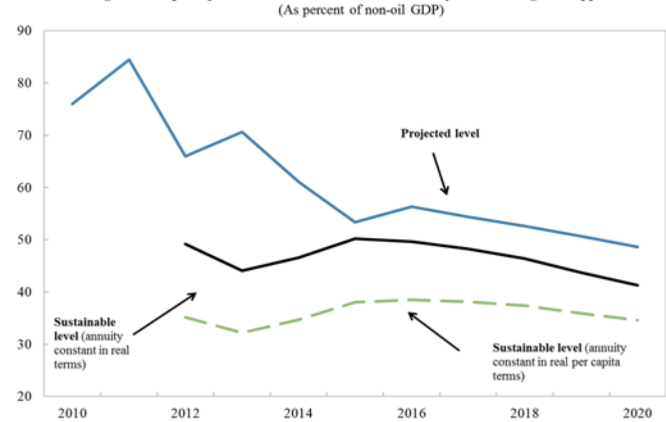
23. **Fiscal consolidation will protect much needed social spending**. Prior to the ISIS crisis and the oil price shock, social spending in Iraq was insufficient in health, inefficient in social protection, and resulted in poor human development outcomes (*2014 Iraq Public Expenditure Review*). Per capita central government health spending levels reveal a stark underspending (US$90 in Iraq against US$350 in the region and US$700 for upper-middle-income countries). This low level of spending —combined with conflict and weak spending efficiency—has led to a deterioration of health outcomes (e.g., life expectancy at birth has decreased from 70.7 in 2000 to 69 in 2013). Social protection is dominated by the Public Distribution System (PDS), which is a program whereby Government purchases imported food which are then distributed to the public. The PDS suffers from severe inefficiencies but remains the primary safety net for the poor. Other safety net programs are not poverty targeted and cover a small share of the poor. As agreed under the IMF SMP, the above fiscal consolidation will protect social spending (SMP quantitative target). Social spending is defined as budgetary allocations to health, education, and transfers in support

of the social safety net, the internally displaced and refugees, and is projected to increase from 13.2 percent of non-oil GDP in 2015 to 13.7 percent of non-oil GDP in 2016.

24. **The 2016 budget deficit does not contain any unidentified financing gap**. This stands in contrast to projections as of July 2015 which had an unidentified financing gap of 8.3 percent of GDP (IMF 2015 Article IV). Financing sources will primarily be domestic and in particular will rely extensively on indirect financing by the Central Bank of Iraq which will take the form of discounting T-bills purchased by state-owned banks. Other domestic sources include the drawdown of government deposits in the banking sector and the issuance of Treasury bills and bonds (the latter is a new instrument—the authorities have already undertaken some due diligence and market sounding and the feedback is positive). External financing sources include international financial institutions such as the Islamic Development Bank, donors such as JICA and Italy, and capital markets with a planned Eurobond issuance of US$2 billion in late 2016. The prospect for such an issuance should be significantly improved compared with the October 2015 attempt should the country have a good track record under the IMF SMP and have started an SBA by late 2016. The proposed DPF and parallel financing from JICA would also send a strong signal that Iraq is receiving broad international support for the reforms being implemented in the country, which should significantly lower the country's idiosyncratic risk premium. A possible SBA disbursement in 2016 is not assumed in the framework so it represents an upside risk to financing. The government will not resort to the accumulation of new arrears (IMF SMP structural benchmark).[16]

25. **Iraq's projected medium-term fiscal path is broadly consistent with a permanently sustainable level of spending**—this would ensure that, even after oil is exhausted, future generations will receive a similar real level of spending that current Iraqis are enjoying. Based on a Permanent Income Hypothesis (PIH) model, one can assess whether Iraq's large non-oil fiscal deficits are sustainable in light of the finite supply of oil that the country has. This analysis reveals that Iraq's large non-oil deficit is also matched by equally large oil wealth. This allows the country to run sizable non-oil primary balance (NOPB) deficits while still maintaining a fiscal path that is consistent with intergenerational equity. As shown in Figure 2 the sustainable NOPB deficit over the medium term is estimated at 42 percent of non-oil GDP.[17] Over the past years, Iraq had rapidly moved towards that sustainable deficit as

Figure 2. Iraq: Projected and Sustainable Non-oil Primary Deficit Using PIH Approach
(As percent of non-oil GDP)



Source: World Bank Staff Estimates and Projections.

[16] Securing these financing sources carries some uncertainty. The Treasury bonds are a new instrument in Iraq, and it remains to be seen how the issuance will work**.** Regarding Central Bank indirect financing of the deficit this has been a contentious issue between the Central Bank and fiscal authorities, with the Central Bank often deciding on the amount the financing. While an agreement has been reached between the two authorities as part of the IMF SMP, should there be a need for additional financing during the year, it is uncertain it could come from the Central Bank.

[17] The size of the sustainable deficit declines over time in relation to the 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 maintain per capita consumption out of oil wealth constant.

the NOPB shrank from 69.9 percent of non-oil GDP in 2013 to 60.5 percent in 2014. However, with the advent of the conflict with ISIS and the plunge in oil prices, the pace of adjustment towards the sustainable NOPB deficit has slowed with a NOPB projected to hover over 55 percent of non-oil GDP over the next three years (Table 1). The results suggest that Iraq's medium-term fiscal policies as outlined in the macroeconomic scenario are broadly consistent with long-term fiscal sustainability. The IMF analysis for the 2015 Article IV confirms this finding by extending the projections to 2025, at which point the NOPB is equal to the PIH-consistent NOPB.

Table 3. Iraq: Balance of Payments Financing Requirements and Sources, 2015-18
(In billions of US$, unless otherwise indicated)

	2015	2016	2017	2018
Gross financing requirements	13.8	10.1	-5.3	-10.7
External current account deficit	12.1	9.0	-6.2	-11.6
Debt amortization	1.7	1.1	0.9	0.9
Available Financing	16.4	10.6	-3.9	-10.5
Current official transfers	0.0	0.0	-3.6	0.0
Financial inflows	0.8	2.4	5.8	3.3
Foreign Direct Investment	1.0	2.0	3.0	4.0
public borowing	*2.2*	*3.6*	*4.0*	*0.6*
private inflows	-2.4	-3.2	-1.2	-1.3
Change in Gross International Reserves	15.6	8.2	-6.1	-13.8
Financing Gap	0.0	0.0	0.0	0.0
IMF	0.7	-0.1	0.0	-0.2
World Bank	1.3	0.0	0.2	0.2
Eurobond	0.0	2.0	2.0	2.0
Islamic Development Bank	0.0	0.3	…	…
Qatar National Bank	0.0	0.0	…	…
Project Financing	0.4	0.8	0.7	0.4
Change in arrears	-3.5	0.0	0.0	0.0
Memorandum items:				
Current account deficit	12.1	9.0	-6.2	-11.6
(In percent of GDP)	-7.0	-5.2	3.1	5.3
Fiscal Deficit (in percent of GDP)	-14.5	-10.9	-3.0	3.3
Central bank's Gross International Reserves (end of period	51.1	42.9	49.0	62.8
(in months of imports of goods and services)	8.5	7.3	7.2	8.0

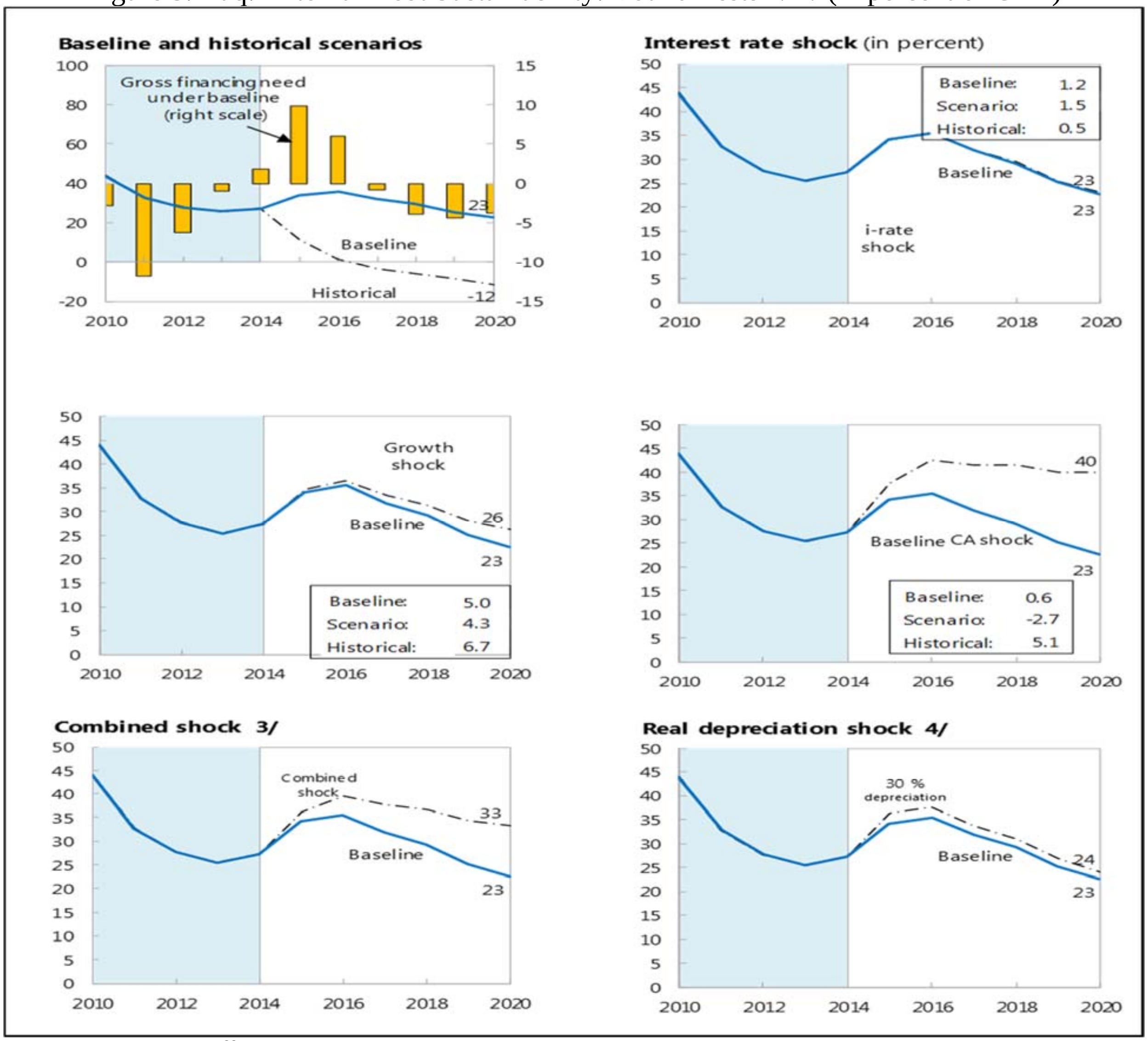
Sources: Iraqi authorities; IMF and World Bank estimates and projections.

26. **On the external side, continued improvement in oil exports and fiscal consolidation will return the country to a surplus starting in 2017** (Table 3). The current account balance, is projected to reach a surplus of 3.1 percent of GDP in 2017 and 5.3 percent of GDP in 2018. The improvement in the current account balance will help stop the dangerous erosion in international reserves observed since 2014. Foreign exchange reserves are projected to remain adequate as they are above conventional measures of reserve adequacy.[18] The projected import coverage has been revised upward by the IMF between its July 2015 Article IV consultation and its November SMP agreement (from 5.1 to 6.9 months for 2016). Reserves drawdown will be the largest financing source for the balance of payments in 2016. These will finance US$8.2 billion of the balance of

[18] Import coverage of goods and services, for example, is projected to remain above 7 months throughout the medium term—Table 1.

payments deficit, compared to US$15.6 billion in 2015. Going forward, the macroeconomic framework envisages a resumption in reserve accumulation in 2017 on the back of strong oil exports and an improved current account balance. Another important external source of financing in 2016 is the planned Eurobond issuance for an expected US$2 billion. An external debt sustainability analysis (using bound tests) indicates that Iraq's external debt is sustainable over the medium term (Figure 3).

Figure 3. Iraq: External Debt Sustainability: Bound Tests 1/ 2/ (in percent of GDP)



Sources: World Bank staff estimates and projections. 1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown (where data is available). 2/ For historical scenarios, the historical averages are calculated over the ten-year period (where data is available), and the information is used to project debt dynamics five years ahead. 3/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance. 4/ One-time real depreciation of 30 percent occurs in 2015.

27. **Based on the above, Iraq's macroeconomic policy framework is assessed to be adequate**. The IMF staff level agreement reached on an SMP in November 2015 was an input in the Bank's assessment.

28. **The macroeconomic outlook is subject to significant risks related to the global environment, social and political developments, and the ISIS insurgency**. A weaker than projected global growth or higher than expected supply of oil into the global market could put downward pressure on global oil prices and renew pressures on the twin deficits. If instead of the assumed containment of the ISIS insurgency, it were to worsen, this would materially and negatively impact Iraq's economy. Domestic political tensions could rise anew which could undermine the reform effort. The large fiscal consolidation effort could also give rise to social tensions and impact the implementation of reforms.

2.3 IMF RELATIONS

29. **Building on the Rapid Financing Instrument (RFI) and to prepare for an SBA, the authorities reached on November 10, 2015 a staff level agreement on a Staff-Monitored Program that has no financing gap**.[19] The IMF Board of Executive Directors approved on July 27, 2015 a budgetary financial assistance package under the RFI for 75 percent of quota (US$1.24 billion). The RFI is a single tranche disbursement aimed at countries that are facing urgent financing needs. It is not a program and, therefore, does not involve subsequent economic monitoring. To build a track record towards an upper tranche IMF program (e.g., an SBA), the Government reached an agreement on an SMP whose aim is to help Iraq implement a cohesive macroeconomic framework to maintain confidence through the immediate crisis by a measured use of financial buffers and the implementation of reforms to improve public financial management. Staff from the IMF and the World Bank are closely collaborating on the macroeconomic framework, policy reforms, and technical assistance.

3. THE GOVERNMENT'S PROGRAM

30. **The Government of Iraq has detailed a reform plan to build a more transparent state that delivers better services to the public, as articulated in the Prime Minister's acceptance speech to Parliament**. The main challenge for Iraq is the incremental and long-term rebuilding of state institutions that were systematically weakened over the last twenty years. The authorities are committed to implementing the Government program for 2015-18. The first strategic priority of the program is to reach security and stability by liberating cities and provinces controlled by terrorist groups, and by restoring the rule of law. The second priority is to deliver public services and upgrade standards of living. This includes delivering electricity services; improving water, health and education sector performance; and reforming the social protection system.

31. **Recent social unrest and severe financing constraints have led the Government to accelerate implementation of its economic reform agenda**. Since the August 2015 wave of demonstrations, the Government has launched a series of governance reforms (including cutting positions such as three Vice Presidents and three Deputy Prime Ministers). The Government is also working towards adopting a strategy to develop the private sector. This includes adoption of policies towards reforming SOEs and gradually increasing the share of the private sector in the economy. The Government plan calls for creating a supportive environment to hasten the transition towards a market economy, particularly through adopting legislation that stimulates investment.

[19] The SMP will be submitted to IMF management for its consideration by the beginning of next year.

The Government is also keen on improving fiscal management and budget systems which are not currently aligned with the country's priorities and Government's development programs. Long-standing structural issues of inefficient public spending hamper the efficient allocation of resources. In addition, the Government has developed an action plan to reduce power outages, which includes investments in upstream gas, electricity tariff reforms, and improving the investment climate to attract private capital in power generation. The Government's reform drive has faced some resistance, both from the public—as illustrated by the demonstrations against the cuts in allowances and bonuses of public sector employees—and from Parliament which has, for example, challenged its authority to eliminate key government positions. So while the Government is determined to move forward with reforms, it has to take into account the challenges of implementing reforms in an FCV environment with vested interests and a population that can fall pray to extremists.

32. **The Government has expressed strong interest in the Bank Group's support, both financial and advisory, to help tackle the country's economic and social challenges**. The recent Performance and Learning Review of the World Bank Group's Country Partnership Strategy (CPS) took into consideration the changes that have taken place, and the strategy is structured to help Iraq deal with fragility and conflict and move towards transformative areas to reach the twin goals of poverty reduction and shared prosperity in a sustainable manner. For the remaining period of the CPS, the partnership will be heavily inspired by the Government's development plan and will be articulated around the following two pillars: (1) deliver basic public services to reduce poverty and enhance citizen's trust in government institutions, and (2) address and help manage the country's critical fiscal situation, aggravated by the fall in oil prices and the drain on public finances caused by an inflated public sector and an inefficient banking sector.

4. THE PROPOSED OPERATION

4.1 LINK TO GOVERNMENT PROGRAM AND OPERATION DESCRIPTION

33. **The DPF is aimed at supporting Iraq's economic reforms**. The Program Development Objectives are in line with the Government's strategy which supports broader goals such as inclusive growth, efficient service delivery, and social protection measures. The operation is structured under three pillars which are also the program's development objectives aimed at improving: (1) expenditure management; (2) sustainability of energy supply; and (3) transparency of state-owned enterprises. The first pillar includes reforms aimed at improving public wage reform, public investment and debt management, and the pension system. Within the second pillar, reforms will focus on reducing gas flaring, expanding gas-to-power generation, and reducing electricity subsidies. The third pillar tackles the lack of transparency among financial and non-financial SOEs.

34. **The design of the DPF incorporates lessons learned from earlier budget support operations in Iraq** (Box 1). Iraq experienced a large fiscal shock in 2009. At that time, a World Bank-financed budget support operation alongside with an IMF SBA helped maintain fiscal sustainability. The Bank and the Fund helped Iraq at a time when the country's fiscal shock could have led to a deeper crisis. By providing just-in-time budget support, the 2010 DPL and SBA contributed to preventing further abrupt cuts in public spending. The current DPF is designed around a program of economic reform measures to address the ongoing crisis. The operation aims

to provide rapid assistance while being supported by an extensive and multi-year technical assistance program from several donors and international financial institutions that will help sustain the reform momentum and implementation beyond the immediate DPF prior actions. The policy reforms chosen aim at tackling longstanding structural issues so as to improve Iraq's structural fiscal balance (and lessen contingent liabilities).

4.2. PRIOR ACTIONS, RESULTS AND ANALYTICAL UNDERPINNINGS

35. **The DPF is supported by an extensive set of multi-year technical assistance programs from bilaterals and multilaterals to help with reform implementation**. To ensure successful implementation of the DPF-supported reforms, an extensive technical assistance program and several investment lending operations are already in place or are expected to start shortly. Importantly, many of these programs will be in place for several years so as to accompany the Government reforms that, for the most part, are structural and extend beyond the time horizon of the proposed emergency DPF. This medium-term engagement, fully in line with the World Bank Group's MENA Strategy, will help ensure that development gains achieved in this DPF are sustained over time. As detailed in Table 4, this assistance program involves and is coordinated across several international organizations and donors. The programs in brackets are envisaged but not yet approved.

Table 4. Technical Assistance and Projects Supporting Reform Implementation

Iraq DPF Pillars and Prior Actions	Technical Assistance Support by International Partners
Pillar 1. Improve expenditure management	
PIM reform	[IMF]; [DFID]; USAID
Public debt management	JICA
Pension reform	WB (financed by DFID and Japan)
Pillar 2. Improve the sustainability of energy supply	
Reduce gas flaring	U.S. Department of Energy; U.S. State Department/CLDP
Expand gas use to power generation	U.S. State Department/CLDP
Reduce electricity subsidies	ESMAP
Pillar 3. Improve SOE transparency	
Non-financial SOEs	[PPIAF]; [US Treasury]
Financial SOE and banking sector	WB (partly financed by Japan); IMF, US Treasury

Box 1. Lessons Learned from the 2010 Iraq DPL

Iraq experienced a large fiscal shock in 2009. After peaking at US$92 a barrel in 2008, oil prices plunged to US$56 a barrel in 2009, before starting a gradual recovery and reaching an average of US$107 in 2012. The impact on Iraq's total revenues—and thus on its economy—was severe. Iraq's fiscal balance worsened from a deficit of 1.3 percent of GDP in 2008 to 20.5 percent of GDP in 2009. At that time, the ability to use the Development Fund for Iraq and the multilateral finance from the IMF and World Bank closed the financing gap and by 2010 oil prices were already moving back upward.

The 2010 DPL to Iraq, leveraged by the IMF's SBA, was considered critical for fiscal sustainability. These institutions stepped in at a time when the fiscal shock could have led to a deeper crisis with unpredictable macroeconomic and political ramifications. By providing just-in-time budget support, the DPL and SBA together contributed to preventing further abrupt cuts in public spending. The DPL design was based on a programmatic approach of two operations. DPL1 disbursed in 2010 and closed in 2011. The successor DPL ultimately did not materialize, because the financing need disappeared with the rise in oil prices. The Government asked the IMF in early-2011 to convert the SBA into a precautionary arrangement.

The main objective of the DPL was to mitigate the impact of the 2009 fiscal crisis on Iraq's economy and to support its medium-term economic reform program, thereby helping the country improve fiscal sustainability and reducing its fiscal and socio-economic vulnerability to sudden drops in oil revenues. This operation supported improvements in public financial management, financial sector management, and social protection. The supported reforms in the specific policy areas were seen to be interlinked by their impact on rationalizing and prioritizing fiscal resources. The objectives were highly relevant to addressing the financial shortfall arising from the global economic crisis, PFM weaknesses, financial sector shortcomings, and weaknesses in social protection. The Government was actively involved in the design of the operation, and contributed to the achievement of most program outcomes. Yet, it was not able to generate political support for achieving 6 of 16 program outcomes.

Lessons learned from the 2010 DPL operation were significant. The IEG evaluation highlighted that the Iraqi experience demonstrated that development policy operations can work well in a high risk environment when governments are motivated by fiscal stress, but that the sustainability of achievements is uncertain once the fiscal stress is removed. It also showed the importance of a mutually reinforcing package of properly sequenced analytical work, technical assistance, development policy lending, and assistance from other donors. The design of a quick disbursing loan was found to be highly relevant, due to the uncertain fiscal scenario facing the Government at the time of approval. The combined SBA and DPL package provided significant financial support which helped to prevent abrupt spending cuts, to preserve the exchange rate peg, and to keep inflation in check: all important results in the politically fragile context.

Pillar 1. Improve expenditure management[20]

36. **Spending efficiency in Iraq is inadequate in absolute terms and compared to peers, both on current and investment expenditure** (see Annex 4 for a summary of findings and recommendations of the *2014 Iraq Public Expenditure Review*). Iraq's fiscal institutions are still ill-equipped to deal with the complexities of an oil-dominated budget. The state has been allowed to grow to a size that is unusually large, yet access to even basic services is deficient. Public spending is pro-cyclical. Much of the spending is allocated to security, wages, and subsidies, crowding out funding for services to the population and the reconstruction of infrastructure. The public investment system is deficient. The challenge for the Iraqi authorities is curbing inefficient and ineffective spending, and redirecting resources to critical public investment and basic services while protecting social spending in the context of an ongoing conflict and fiscal shock. This pillar starts to address some of these longstanding issues. Many of these reforms require a multi-year agenda for reforms to be designed, legislated and/or approved, and implemented. The proposed emergency DPF, while addressing immediate needs of the Government, is accompanied by a multi-year technical assistance program designed to support the implementation of these structural reforms (Table 4).

Public Wage Reform

37. **Iraq's public sector human resource practices and payroll management are weak** (*2014 Iraq Public Expenditure Review*). Iraq's wage bill is very high by global standards, including among oil exporters and MENA countries, and is the largest and most rapidly growing budget item. The wage bill increased from 12 percent of GDP in 2013 to 17.1 percent of GDP in

[20] See Annex 1 for an overview of the DPF Policy and Result Matrix.

2015. The increase was in large part caused by widespread hiring due to the felt need to use public sector employment to hold the country together in the face of risk of disintegration of the country. At equivalent education level, salaries in the public sector are higher than in the private sector. This gap rises by education level; individuals that have completed a secondary degree or higher earn more than 40 percent in the public sector than in the private sector, over twice the wage differential that low education workers have.[21] Beyond basic salary, allowances and bonuses are particularly large—accounting for 60 percent of total personnel compensation costs—complex and often regressive. Hiring into the public sector is non-transparent and can be politically or sectarian related rather than competency related. Audit reports indicate that significant resources are being wasted through the payroll by a variety of inappropriate practices, including "ghost workers" and workers (illegally) receiving two salaries.

38. **The DPF-supported reform measures are part of a multi-pronged approach by the Government to start addressing the high public sector wage bill**. While progress in payroll reform is a medium-term structural reform agenda, in the short term the Government has secured "quick wins." Reforms implemented target both salaries and headcount in the public sector. On the salary front, the Government adopted on October 15, 2015 a new salary scale, which replaces the 2008 scale. The new salary scale, which became effective on November 1, 2015 (Prior Action 1), provides for nominal pay cuts for the highest salary grades while maintaining salaries for middle-grade employees and increasing those of the lowest grade employees. In real terms, the pay cut for the highest grade civil servants reaches 20 percent (compared to real wage increases of 3 percent for the lowest grade employees). The cut in top public sector salary contributes, *ceteris paribus*, to reducing the wage differential between public and private sector salaries for high-skilled labor. On headcount, Government plans to eliminate ghost workers throughout public sector, and the initial phase of implementation has generated fiscal savings of about US$180 million a year.[22]

39. **The new salary scale needs to be placed in the Fragility, Conflict and Violence (FCV) context facing Iraq**. Due to the legacy of repeated and ongoing conflict, the Iraqi Government has a very limited range of effective economic instruments. Despite its distortionary effects, the public sector wage bill has played an important role as a *de facto* wealth-sharing mechanism, particularly in terms of securing social stability given that the public sector workforce is among the largest social blocs in the country. The 2011 WDR on Conflict, Security and Development, however, recommended ensuring that reforms in FCV contexts are "best-fit:" *Because of the risks of political backlash in conditions of imperfect security and weak institutions, "best-practice" technocratic reform options may not work. Less orthodox approaches that are best-fit in the context of imperfect security, institutional capacity, and competitive markets can work better—but may have "second best" implications that need to be managed* (WDR Box 3.5). Examples given by the 2011 WDR

[21] Based on the 2012 Iraq household survey. It is difficult to compute wage premiums controlling for sectors, occupation, or type of activity because of the limited overlap in occupations and sector of activity between the private and public sector in Iraq—in part reflecting the limited size of the non-oil private sector.

[22] Despite these measures, the overall wage bill is still projected to increase in 2016. This, however, reflects one-off items in both 2015 and 2016. Key among these are (1) the lack of fiscal transfer from the central government to KRG since June 2015—part of which consisted of wage payments for KRG—whereas the draft 2016 budget assumes full transfer to the KRG (as well as oil sales from KRG to SOMO); and (2) hiring of new fighters against ISIS. Adjusting for these, the underlying wage bill would have shrank from 28.1 percent of non-oil GDP in 2015 to 27.6 percent of non-oil GDP in 2016.

include increased public sector employment or security sector expenditures. Given the current difficulties in Iraq and in particular the ISIS insurgency, the already small private sector is further stressed by risks while non-oil public investment bears the brunt of the needed fiscal adjustment. Thus recurrent cash outlays play an outsized role in sustaining economic activity and maintaining social peace and stability, giving the government little room to maneuver for an overall cut in public sector pay. The government views the more compressed salary scale as an improvement in fairness. In particular, in the FCV context, the nominal wage cut at the upper tiers is seen as a confidence-building measure given the perception that these upper tiers of the public administration are comparatively insulated from the negative effects of conflict. Similarly, the nominal wage increase for the lower grades, can help retain the confidence of the public sector workforce who at this point have choices not just to join insurgency but also, increasingly, seek to migrate to Europe.[23]

Prior Action 1: *The Council of Ministers approved a new salary scale for state and public sector employees, effective November 1, 2015, in which the salaries of public sector employees in higher grades are reduced (Council of Ministers Decision No. 366 of 2015, dated October 15, 2015).*

40. *Expected results*. **The prior action contributes to increasing perceived fairness among public sector workers, and therefore to strengthening peace and stability while also helping to reduce the large wage differential of high-grade public employees** relative to equally educated counterparts in the private sector. Given the acute challenges the country is facing, the reduction in top public salaries combined with increases in lower grade salaries is expected to strengthen social cohesion within the public sector. To capture improved fairness and a reduction in the high grade wage differential, the result indicator will be a reduction in the basic annual salary of top public sector employees as a ratio of annual GDP per capita. Given that bonuses are generally indexed on base pay, the recent wage revision will reduce the value of bonuses received by the highest paid public employees.

41. *Future Steps*. **The Government intends to streamline allowances and bonuses and tighten payroll management**. On the employee compensation front, the Government aims to further improve fairness and transparency in the public sector by reviewing, streamlining, and, on aggregate, reducing allowances and bonuses. The Committee of Reform of the Salary Scale and Allowances of all Public Employees, formed under Decree No. 317 of 2015 is currently working on reforming allowances and bonuses. Significant fiscal savings could be generated from such a measure. On the size of the civil service, the Government has committed to reducing the number of public sector employees in the central government from 3.02 million in the 2015 budget to 2.98 million in the draft 2016 budget; in part this will be achieved through expanding its audit of ghost workers to other line ministries. These reforms are consistent with the Government's Federal Budget Strategy for 2016-18 which identified civil service reform as one of its priorities. Combined

[23] In a large scale civil servant survey, 72 per cent of civil servants in the lower grades say that they cannot live off their salary, while more than 60 per cent of civil servants with intermediary education and below also state that their salary is insufficient. Salary satisfaction increases with grade and educational attainment. It is lowest for workers (51.7 per cent). Job satisfaction overall is an important determinant of corruption. For details, see "Corruption and Integrity Challenges in the Public Sector of Iraq: an Evidence-based Study" (2013) by UNODC, UNDP Iraq, CSO of Iraq, KRSO, and Commission of Integrity.

with the above prior action, these measures are projected to lead to a reduction of the wage bill by about 1 percentage point of non-oil GDP every year over the next three years.

Public Investment Management (PIM) Reform

42. **Iraq's public investment decision process suffers from large structural weaknesses that result in poor execution rates of the investment budget and, in times of fiscal stress, prevent critical prioritization of needs**. Even prior to the current fiscal shock, the Government was facing challenges to prioritize and implement a capital investment program due to significant bottlenecks in public investment, and Iraq's ability to follow through on investment programs has been low. The poor planning and preparation of investment projects and inadequate control over project-related cash releases, result in low levels of utilization (in the 50-60 percent range). Poor execution rates are exacerbated by high levels of accumulated advances, funding and management complications from carryovers of budgets into subsequent financial years, a lack of adequate and working management support systems, and poor capacity of project management staff. These structural inefficiencies are a major impediment to the efficient and cost effective implementation of Iraq's large long-term reconstruction needs but also to its short-term needs to efficiently prioritize capital spending given the overall fiscal consolidation needs and the prominent contribution that is coming from cuts in the investment spending budget.

43. **The DPF-supported reforms are part of a medium-term reform aimed at ensuring that all public investment passes through a modernized PIM system thereby improving spending efficiency**. To that end, the Ministry of Planning will, for example, create and make operational within one year a Central PIM Unit in charge of project appraisal, monitoring and ex-post evaluation processes. Ultimately, the reforms would result in: (1) a national PIM system that includes a comprehensive set of concepts, techniques, standard and methodological procedures for the formulation, preparation, implementation, monitoring and evaluation of projects, and (2) PIM operational capacity within the Ministry of Planning to cover project prioritization (based on Cost-Benefit Analysis and expenditure efficiency), financing modalities (e.g., on budget or through PPPs) and continuous monitoring of the fiscal affordability of all projects. The quality of the pre-feasibility/feasibility studies is expected to improve as a result of PIM Decree No. 445 which stipulates that the Ministry of Planning is now the only federal government entity that can provide the final "seal of approval" on any public investment initiative. This will help ensure that only those capital investments that are likely to make the most efficient use of scarce economic resources are undertaken.

DPF Prior Action 2: *The Borrower's Prime Minister adopted the Public Investment Management Framework which covers project feasibility, implementation, operation, and ex-post evaluation phases (Decree No. 445, dated October 18, 2015).*

44. *Expected results.* **Efficiency improvements of investment expenditures** will be measured by the percentage of capital projects valued at over US$500 million having a pre-feasibility/feasibility study with Cost-Benefit Analysis and being selected according to a clearly defined project selection criteria methodology.

45. *Future steps*. By end-2016, the Ministry of Planning aims to create and make operational a "Central PIM Unit" at the ministry that will be in charge of project appraisal and monitoring processes. By end-2017, the Ministry of Planning aims to create and make operational a specialized monitoring and ex-post evaluation team, within the Central PIM Unit of the ministry in charge of ex post evaluation.

Public Debt Management

46. **Given Iraq's rapid public debt accumulation, limited experience with key debt products and large financing needs, strengthening the Ministry of Finance's debt management capacity is critical**. At a projected 61.7 percent of GDP in 2015, Iraq's gross public debt-to-GDP ratio is high. As the country has historically run surpluses on its overall fiscal balance, it has not developed financing instruments that countries often rely on, such as a domestic bond market (only Treasury bills exist) or access to external bonds,[24] such as Eurobonds. As the country's recent unsuccessful attempt to raise US$2 billion through a Eurobond issuance illustrates, a strengthening of capacity in the debt management area is urgently needed.

47. **The capacity of the Public Debt Directorate will be strengthened with the technical assistance support from JICA, one of the largest bilateral and concessional lenders to Iraq**. Starting in October 2015, a workshop was held with support from a debt management expert from JICA. This will be followed by a package of training programs consisting of a series of seminars and practical trainings for strengthening the capacity of the Public Debt Directorate. Some training courses may be held in cooperation with neighboring countries and international financial institutions.

48. **The establishment of a Debt Management section (Prior Action 3) in line with best practices would enhance a number of debt functions**. These include: (i) supervision of the other four divisions of the Public Debt Directorate with research and analytical assistance; (ii) production of the debt service projections and debt sustainability analysis; (iii) establishment of strategies for the new borrowings and the repayments in accordance with the debt service projections, including the necessities of currency and interest risk hedging; (iv) supervision of: (a) monthly statistical bulletins to be produced in accordance with international standards; (b) medium-term debt management strategy with assessment and risk analysis of existing portfolio; and (c) coordination on macroeconomic policies with key departments in charge of fiscal policy and the Central Bank of Iraq; and (v) reporting outcomes of the above activities to the higher level management at the Ministry of Finance. A legislative framework to issue new instruments as identified in the debt strategy would allow borrowing and related financing activities to implement the strategy.

DPF Prior Action 3*: The Borrower's Minister of Finance established a debt management section within the Ministry of Finance (Ministerial Order No. 4340, dated October 19, 2015).*

49. *Expected results.* **The reforms will strengthen debt management capacity at the Ministry of Finance**. It would also support stronger governance in debt management. Enhanced

[24] With the exception of a single bond issuance which was a bundling of Saddam-era commercial debt into a government guaranteed instrument.

debt management would lead to more comprehensive data recording and reporting, which will be the responsibility of the newly established (October 2015) Debt Management section. The latter will act as the leading division of the existing Public Debt Directorate in order to improve the management of existing obligations through improved cash management which can result in fiscal savings and reduce operational risks. This capacity strengthening will be measured by the approval of a public debt management strategy in line with international best practice and its publication on the Ministry of Finance website.

50. *Future steps*. By end-2016, the Ministry of Finance aims to approve and publish the results of a Debt Management Performance Assessment (DEMPA). In subsequent year, the Ministry of Finance will prepare the necessary legislative framework for issuing new debt instruments so as to diversify its funding sources, in accordance with the approved debt management strategy.

Social Insurance and Pensions

51. **Iraq's social insurance and pension system is fragmented, lacks fairness, and is costly and financially unsustainable**. Pension spending in Iraq, at around 4 percent of GDP, is high by international standards (the OECD average of 23 countries is 1.8 percent of GDP; Iraq's spending exceeds that of the OECD's most expensive pension system, namely Greece at 3.7 percent of GDP). Despite such a high cost, the system, which consists of two mandatory pension schemes covering public and private sector employees, suffers from large coverage gaps and overly generous benefits. Regarding the former, only about 48 percent of the total labor force is currently contributing to and is covered by the pension system; most of the covered employees are in the public sector under the State Pensions Fund (SPF) while less than 3 percent of the private sector employees are covered through the Pensions and Social Security Department (PSSD).[25] Both schemes are contributory and designed as pay-as-you-go, defined-benefit schemes. Regarding the latter—the high generosity—can be seen through its high accrual rate of 2.5 percent (corresponding to an implicit real rate of return on contributions that ranges from 5 to 8 percent at age 60) or through the extremely high benefit ratio (i.e., the average pension as a percentage of average earnings) which in Iraq nears 100 percent, against 57 percent in Spain and below 50 percent for most OECD countries.

52. **Restoring the medium-term financial viability of the SPF through good pension design principles is urgently needed given Iraq's population age dynamics and would generate large fiscal savings**. The World Bank has a long-term engagement with the Iraqi Government on the reform of the pension system. Moreover, modernizing the social protection system is one of the targets of improving quality of services under the 'Renewing the Social Contract' pillar of the World Bank Group's MENA Strategy. Iraq's pensions reform can be achieved through amendments of the pension law 9/2014 that would, for example: (1) decrease the accrual rate from 2.5 percent to 1.5 percent; (2) increase the minimum length of service from 15 years to 20 years for pension salary eligibility; (3) change the base wage for pension calculation from the last three years to the last seven years; and (4) reduce the qualifying conditions for survivorship pensions to only spouses, parents, and children. Such reforms would generate cumulative savings of over ID1 trillion through 2018 and ID31 trillion through 2028. While these

[25] The SPF currently has more than 3 million contributors against less than 200,000 for the private pension scheme.

reforms take time to be properly designed, the National Board of Pension has undertaken the necessary governance and fiscal savings measures resulting in the removal of non-eligible retirees.

DPF Prior Action 4: *The National Board of Pensions implemented a campaign to clean its retiree data registry resulting in the removal of at least 30,000 non-eligible retirees.*

53. *Expected results.* **The strengthening of the governance of the National Board of Pension (NBP) is expected to improve the financial sustainability of the SPF**. The removal of over 30,000 ineligible beneficiaries—accounting for about 10 percent of beneficiaries—shows the NBP's commitment to apply the law in a transparent manner, and signals to stakeholders (including contributors and other beneficiaries) that the pension system is operating in an environment of robust monitoring and controls. Another benefit is that it reveals the resolve and credibility of the NBP to kick start medium-term reforms of Iraq's pension systems. Such action will help protect the pension fund from future political influence. This measure is expected to improve the financial sustainability of the SPF by leading to a reduction of 5 percent in the total cash benefit spending of the NBP by Q1 2017, as compared to end-2015.

54. *Future steps*. **The Government's medium-term reforms aim to improve the efficiency, coverage and sustainability of Iraq's pension fund**. Specifically, by end-2016, the Government, with technical assistance from the World Bank, aims to amend the pension law so as to restore the medium-term financial viability of the SPF through good pension design principles. By end-2017, the Government will work on the unification of the pension system. This is expected to result in an extension of the financial viability horizon of the pension from 2028 to 2044. This would remove large liabilities for the budget. Specific improvements in Iraq's pension system are expected to include:

- **Reform**: The public sector scheme (SPF) is expected to become self-financed or at least rely only lightly on the general budget. For this purpose, qualifying conditions and benefit formulas of the scheme as described in Law 9/2014 will need to be reviewed (and adjusted) in order to guarantee such financial sustainability or, at the very least, provide a clear understanding of the future financial needs to maintain such a scheme.

- **Integration**: Private and public sector employees will be covered by the same national pension scheme. PSSD will need to be integrated into SPF, and such integration will be full (not only administrative integration, but also the same rules will be applied to all employees), and rapid (not only new, but current employees will all be subject to the same rules of the new integrated pension scheme).

- **Expansion of coverage of active workers (labor force)**: Incentives and enforcement mechanisms to expand coverage will be put in place once the new integrated and reformed scheme is completed. The specific characteristics of the Iraqi labor force will need to be assessed in order to identify potential alternative mechanisms to cover specific income groups such as the self-employed, and/or low income, and/or informal employees, which are usually groups that are not easy to cover by traditional contributory earnings-related pension scheme. This is consistent with the resilience-based developmental approach of the MENA Strategy.

Pillar 2. Improve the sustainability of energy supply

55. **Inefficiencies in the energy sector impose a significant fiscal and economic burden on Iraq**. Despite being an energy rich country, Iraq faces severe shortages of energy supply for its people. Success in developing Iraq's energy potential and effective management of the resulting revenues can fuel Iraq's social and economic development. Currently, the oil sector makes little contribution to economic diversification and jobs growth. Since the beginning of the 1990s, Iraq has been experiencing severe energy supply outages which had a significant impact on growth. These have been driven by deficiencies in damaged and old energy infrastructure, distortions in the energy supply chain arising from persistent fuel and electricity subsidies and inadequate supply in natural gas, oil and petroleum products as feedstock for power generation. In response to the inefficiencies in electricity supply, people have come to rely on a parallel and informal network of privately-owned diesel generators, which itself is highly inefficient and relies on a highly subsidized fuel. The Bank-supported Iraq Integrated National Energy Strategy[26] (INES) underlines the importance of Iraq's energy sectors as a significant contributor to economic growth and outlines over US$600 billion in reforms and investments in the oil, gas, electricity and industrial sectors, which it forecasts could realize over US$6 trillion in revenues, and up to 10 million new jobs by 2030.

56. **Subsidies in Iraq (over 12 percent of GDP in 2013) are concentrated in fuel and electricity**. The structure of fuel subsidies is complex, spanning the entire chain of production, refinery, and distribution phases. According to the Ministry of Oil, direct costs of energy subsidies for fuel products are roughly ID5 trillion a year (2.5 percent of GDP). A system of subsidies and cross subsidies governs the electricity sector, benefiting mostly households and the government (pricing is progressive). Subsidization contributes to problems such as limited service hours due to technical losses in distribution, high import content, rigidities in structure of production costs, and intra-agency debts. These factors partly explain the rampant nonpayment by the public, which in turn increases the government electricity subsidy bill, estimated at roughly ID10 trillion (5 percent of GDP). Potential medium/long-term improvements and reform programs in the energy sector could bring significant savings (6 percent of GDP) for the state budget and macroeconomic sustainability in Iraq.[27]

57. **In addition to the fiscal burden of subsidies, the inefficient allocation of budgetary resources towards least cost fuel options is a major issue in the Iraqi energy sector**. Given emergency needs and lack of efficient coordination among sector stakeholders, the Government is often obliged to allocate significant budgetary resources to use expensive fuels (crude, heavy fuel oil, and diesel for power generation), while cheaper domestic gas production output cannot be oriented towards the power plants. Iraq has even reverted to import alternative fuels from Iran and elsewhere. The proposed DPF aims to promote the shift towards the use of domestic gas resources instead of expensive imported fuels and hence contribute to the rationalization of the sector operations and trigger structural changes and reform.

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[26] The 2013 INES defines a vision for Iraq's energy future, assesses the energy resources available to Iraq, and considers options for deploying those resources. On that basis it proposes a long-term plan of investment, infrastructure development, and institutional reform. The strategy covers a time span extending to 2030. It includes all the major components of Iraq's energy sector: upstream and downstream oil, natural gas, power, and linked industries.

[27] IMF Country Report No. 15/235, August 2015.

58. **Consistent with global best practice, government is seeking to improve service delivery alongside increasing tariffs**. Recent experience within the region, such as Jordan, Egypt and Morocco, indicates that successful energy subsidy reforms are predicated on a credible promise of better supply and quality of service. This is consistent with international experience in Turkey and India, where a lesson is that changing the social compact of providing cheap electricity to market-priced tariffs hinges on improving the quality of service. This will be particularly difficult in Iraq, which has a significant capacity shortfall in installed generation capacity and transmission and distribution infrastructure. It is also critical that mitigation measures are implemented for the poor, and to secure buy-in from the middle-class and industry. In the case of Iraq, a long-term fuel supply for power generation will need to be secured. Iraq has sufficient quantities of gas, which is the economic fuel of choice for the power sector.

Reduce Gas Flaring

59. **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**. Shortages of natural gas are especially acute for power generation. Close to 60 percent of the country's gas production is flared in-field. This share is expected to increase in the absence of effective measures to capture this gas and support increased gas utilization.[28] Flaring generates significant air pollution and carbon release. The shortage of delivered gas imposes significant economic and fiscal costs and precludes the introduction of efficient combined-cycle power plants and the development of industries that depend on gas feedstock and gas fuel. The amount of gas currently flared would be sufficient to meet most of Iraq's unmet gas demand. Current production and gas flaring volumes amount to roughly 2 Bscfd (billion standard cubic feet per day) and 1.2 Bscfd, respectively. Shortage of natural gas requires the use of (expensive and for some parts imported) fuel, which costs the country an estimated US$6-8 billion per year.

60. **Iraq's planned significant increases in oil production would further increase its associated natural gas flaring losses unless measures are undertaken to capture, process and transport that production**. The DPF is expected to help internalize the costs and capture the economic and social benefits that can accrue from reduced waste and increased electricity generation that would otherwise be lost. Iraq joined the Global Gas Flaring Reduction Initiative in 2011 (the second country in the world after Qatar) and created the Basra Gas Company (BGC) in 2013 to capture, treat and monetize the flared associated natural gas in certain oil fields. The BGC has recently attained a processing record of 500 MMscfd of gas and an LPG production record of 2,650 tons per day. It is estimated that currently flared gas volumes would be sufficient to support an incremental generation capacity of roughly 6.5 GW, sufficient to supply about three million homes (equivalent to around a US$3.5 billion injection into Iraq's economy). Iraq's natural gas has a significant LPG content which can be compressed and bottled for distribution for household use in cooking and heating. Given existing shortages in Iraq, the expected increase in supply would likely drive prices down with positive welfare impact on the middle class and the poor.

[28] Flaring may grow two or three fold as oil production increases. A satellite survey performed by National Oceanic and Atmospheric Administration on the account of Global Gas Flaring Reduction Initiative shows a sharp increase in flaring from 7 to 10 billion cubic meters per year (bcm/y) from 2007 to 2012, linked to the recent growth in oil production from the Southern fields.

Furthermore, reductions in flaring could decrease greenhouse gas emissions which currently stand at around 20 million tons per year, equivalent to Croatia's total emissions.

61. **Iraq's progress in reducing gas flaring is critically dependent on the projected increases in processing capacity around the Basra petroleum hub in the south** (due to security concerns in the north). Investment plans in the Government budget need to be consistent with the above CoM-approved commitments.

DPF Prior Action 5: *The Energy Committee of the Council of Ministers approved the implementation plan proposed by the Ministry of Oil setting forth targets for the reduction of gas flaring for the period 2015-2018, in support of the objective of achieving zero gas flaring by 2030 (Energy Committee Decision No. 17, dated November 9, 2015).*

62. *Expected results*. **These commitments are expected to result in a sharp expansion in natural gas processing capacity and a significant reduction in natural gas flaring in both absolute and relative terms**. It is expected that expansions in processing capacity would yield an additional 414 MMscfd of usable natural gas by Q1 2017 (compared to 656 MMscfd in 2014) with a current monetary value of US$1.2 billion as fiscal savings. It should be noted that, under current oil production plans and without expansion of the country's capacity to capture, process and transport associated natural gas production, gas flaring is set to increase substantially in absolute and relative terms, reaching 1.4 Bscfd and 68.7 percent of production by the end of 2016. Instead, because of the above commitments, flaring is expected to reach about 1.0 Bscfd in Q1 2017 and its share is projected to significantly decrease from 65.4 percent of production in 2014 to 49.0 percent in Q1 2017. Combined with the strengthening of gas-to-power supply (see reform below) the resulting increase in gas supply is expected to generate significant fiscal and balance of payments savings, reduce CO2 emissions and improve welfare impact for the middle class and the poor.

63. *Future steps*. In order to sustain the initial reform over the coming years, the Government is planning to adopt a Gas Pricing Policy and to start its implementation by end-2016. The Policy will include targets for annual natural gas processing over the period 2016-18, the inclusion of the necessary and timely budget support required for the achievement of the projected natural gas processing targets, and the objective of achieving zero gas flaring by 2030.

Strengthening Gas-to-Power Strategy

64. **To fully realize the benefits of reducing gas flaring, Iraq needs to ensure that the additional gas captured can be used for its power generation needs**. There is a close link between electricity sector performance and availability of gas supply for power generation in Iraq. As the power sector is the main consumer (85 percent) of natural gas (produced through gas flaring reduction from associated oil fields) the cost recovery and pricing at which the natural gas is transferred to the electricity sector affects the overall electricity sector performance and subsidies Iraq's natural gas-based generation has recently oscillated around a 15-20 percent range of total power generation capacity of 12,500 MW. 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 and degrade the performance and useful life of generation equipment compared to natural gas. Moving towards

gas-fired generation would enable Iraq to increasingly switch to both gas turbines and more efficient combined-cycle gas turbines (CCGTs). Such a transition would reduce domestic oil demand by an estimated 1.2 mb/d by 2035 which would result in additional cumulative oil exports of US$520 billion. Iraq's current Energy Master Plan projects to achieve a total installed capacity of 24,400 MW by 2020 including 13,000 MW of gas-fired capacity, equivalent to a requirement of roughly 2.5 Bscfd of natural gas feedstock. A further 4,000 MW (equivalent to approximately 0.8 Bscfd) is being added by the conversion of open-cycle gas turbine (OCGT) power plants to CCGT technology. Overall, a total of about 3.3 Bscfd of natural gas will be required solely for power generation purposes by 2020.

65. **Planning, implementation and monitoring of gas-to-power interventions requires close inter-ministerial coordination**. The planning, prioritization and financing of investments needed in power generation, natural gas processing and transport will require a dedicated "gas-to-power" strategy for the short and medium term. This activity will, in turn, require strong coordination among the Ministries of Electricity, Oil, and Finance to identify, finance, implement and monitor projects as well as regular maintenance operations. An explicit organizational structure that facilitates such coordination can help expedite gas-to-power projects, as well as address bottlenecks in optimal utilization of existing assets. The World Bank's Reimbursable Advisory Service (RAS) on natural gas value chain restructuring and marketing will also assist the Government in preparing and implementing gas-to-power plans.

DPF Prior Action 6: *The Council of Ministers approved the establishment of an inter-ministerial committee, including the Ministers of Oil, Electricity, and Finance, which shall be tasked with developing an action plan to utilize gas in electric power generation (Council of Ministers Decision No. 370 of 2015, dated October 19, 2015).*

66. *Expected results.* **The above measures are expected to promote fuel switching in power generation from petroleum products to gas** and increase total gas volume supplied to gas turbine power production from 600 MMscfd in 2014 to 840 MMscfd in Q1 2017.

67. *Future steps*. The authorities are planning to adopt by end-2016 the proposed Gas-to-Power Action Plan (2016-21), and launch implementation and allocate the necessary resources for its implementation. By end-2017, the Inter-Ministerial Committee will prepare and submit for approval by the Council of Ministers an interim assessment report on the implementation of the 2016-21 Gas-to-Power Action Plan along with an updated timeline and investment plan of implementation to achieve the 2021 targets. In the longer term, this will lead to substantial improvements in service delivery and the reduction of the fiscal burden of the energy sector and improved balance of payments. This will be measured by the conversion of existing crude, heavy crude, and LFO-based generation to gas-powered SCGT and CCGT capacity. Crude, heavy crude, and LFO will be phased out as power generation fuels, redeployed for export, petroleum refining and industrial use, and replaced by gas-powered generation which is expected to comprise four-fifths of total capacity by 2030.

Reduce Electricity Subsidies

68. **Despite being an energy-rich country, Iraq suffers from a chronic and pervasive shortage of electricity, which contributed to social unrest during the summer of 2015**. The electricity deficit in Iraq is estimated at 6 to 7 GW of electricity, or 50 percent of the installed generation capacity. Iraqi households and consumers receive an average of 14.6 hours of electricity per day, of which 7.6 hours per day is provided by the electricity grid. To make up the shortfall, Iraqi consumers rely on a parallel informal network[29] that relies on highly subsidized diesel, which offers more reliability, but at a significantly higher cost differential – as much as 40 times the cost of grid-connected electricity. Only 3 percent of households in Baghdad, and around a tenth of households in the Center and the South receive power for more than 12 hours. Baghdad is by far the worst hit in terms of electricity shortages, with more than three-quarters of all households in the capital receiving less than 8 hours of electricity a day. During the heatwave of 2015, mass protests erupted in major metropolitan areas of Iraq over a number of weeks, as power cuts eclipsed other concerns. Increasingly, Iraqi citizens are demanding the provision of electricity and other basic services as critical components of renewing the social contract.

69. **Electricity shortages have a significant cost to the Iraqi economy, and if not addressed, will exacerbate Iraq's deficit**. The energy sector is a burden on Iraq's budget. The *2014 Iraq Public Expenditure Review* estimated that explicit subsidies for electricity use alone constituted 65 percent of all subsidies in the budget. However, the true cost of energy subsidies is higher than what is reflected in the budget; 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. Natural gas is the least cost option in Iraq to generate electricity, but it is not available in the market primarily due to the inability to price it at its economic opportunity cost, and inadequate measures to make productive use of gas resources. Paradoxically, the amount of gas currently flared would be sufficient to meet most of Iraq's unmet gas demand in the power and industrial sectors. Instead, the Iraqi electricity sector relies on more expensive and less efficient substitutes like crude oil and heavy fuel oil, and increasingly imported diesel, which increases costs of generating electricity by a factor of five compared to domestic natural gas. Iraq's Integrated Energy Strategy (2013) estimated the cost of power outages at US$40 billion per year, taking into account production losses, cost of imported alternate fuels for electricity generation (currently at US$6-8 billion per year), and loss revenues and royalties from domestic gas production.

70. **Inadequate electricity is seen by Iraqis as a top concern of households**. Lack of sanitation, inadequate electricity and poor nutrition are the most prevalent deprivations in Iraq, followed by water and school attendance (2012 Household Survey). On the business side, respondents to the 2012 Enterprise Survey listed electricity, instability, and corruption as the three most severe obstacles to doing business in Iraq. The average firm suffered nearly 600 power interruptions per year, with some firms reporting three outages per day. This unstable power supply results in significant sales losses. Extremely high technical and non-technical losses (around 40 percent of electricity demand) significantly affect the Ministry of Electricity's ability to meet electricity demand. The current supply situation is exacerbated by low tariffs (these have been

[29] The informal network is a network connecting the end user (households) to the private generators. It is not connected to the national grid. It is a simple form of wiring usually created by either the household or the owner of the generator using single wires to connect.

frozen below cost recovery since the 1990s), weak collection rate (due to a lack of metering and efficient payment collection) and poor revenue management with per-kWh tariffs set at levels that, even if fully billed and collected, would cover only 10 percent of fuel and operating costs. Low tariffs have meant that Iraqis have little incentive to use electricity efficiently and electricity consumption is high by regional standards with demand growing at more than 8 percent per year. Low tariffs, excessive losses and poor billing and collection practices in the power sector have resulted in a heavy reliance on government funding.

71. **Rationalization of the tariff structures is critical to reduce the fiscal burden, increase investment, and improve demand efficiency in the sector**. As such, rationalization of tariffs has been identified by the Government as a key sector priority. The tariff structure is, however, a socially sensitive issue. To strengthen implementation capacity, Energy Sector Management Assistance Program (ESMAP) is currently supporting a technical assistance program that incorporates analysis of the magnitude of current energy (oil, gas and electricity) subsidies in Iraq, their distribution across sectors, and, for residential/household users, across different income levels. It will, in particular, assess the distributional impact of potential changes in fuel and power tariffs; undertake a qualitative assessment of public perceptions with a view towards supporting the Government in communicating the tariff reform strategy to consumers; and recommend ways of mitigating the impact of tariff increases on vulnerable sections of the population. In addition, the Bank has recently approved an Emergency for Development Operation, including reconstruction of the damaged electricity transmission and distribution network in seven ISIS-liberated areas.

72. **The Government has started implementing reforms of electricity subsidies**. As a first step, the Government would apply full-cost-recovery tariffs to consumers who are currently availing 24x7 supply as an exception to the prevailing supply curtailments faced by other consumers. Currently, around 1,600 MW of electricity is being supplied to large consumers on an exceptional 24x7 basis under highly subsidized tariffs. With the removal of these exceptions and implementation of full-cost-recovery tariffs, it is expected that the subsidy burden would be reduced, some wasteful consumption would be curtailed, and a signal of the Government's intentions to rationalize tariffs for all consumers would be sent out. The Prime Minister's Office is also working on a parallel track, with the technical assistance of the World Bank, on a robust program of tariff reforms and emergency actions to reduce power cuts in the short term.

DPF Prior Action 7: *The Energy Committee of the Council of Ministers approved the implementation of a new unsubsidized commercial tariff for large commercial consumers (except hospitals) that choose to avail themselves of continuous (twenty four (24) hours, seven (7) days a week) electricity supply under bilateral contracts with the Ministry of Electricity (Energy Committee Decision No. 6, dated May 25, 2015).*

73. *Expected results*. **The above reforms are expected to increase electricity tariffs for energy-intensive consumers and improve service delivery measured by total electricity sold**. Rationalizing the pricing of fuels and electricity and restructuring the existing tariffs by reducing broad subsidies and improving targeting is expected to generate funds for investment in the system and to stem physical and commercial losses. Reduced fiscal losses are measured by the increase in average retail tariffs for electricity sold. Although the implementation of the current Ministry of

Electricity initiative (24X7 electricity supply under bilateral contracts) only covers, as a first step, 40-50 major commercial consumers with relatively small fiscal savings, the proposed DPF prior action moves Iraq towards institutionalizing tariff increases, while incorporating implementation lessons on affordability, communications and sequencing from the energy subsidies reform experience worldwide.

74. *Future steps*. The low level of Iraqi tariffs means that moving to cost recovery will require a phased approach, particularly since earlier initiatives to reduce subsidies for energy did not take off for fear of the public reaction amid widespread dissatisfaction with service reliability, pointing to the need for tariff reform to go hand-in-hand with visible improvements in service to improve acceptability. Envisaged actions will gradually move Iraq towards institutionalizing tariff increases, while incorporating implementation lessons on affordability, communications and sequencing from the energy subsidies reform experience worldwide. By end-2016, the Council of Ministers aims to approve the implementation of a progressive electricity tariff adjustments to improve revenues and reduce subsidies. In parallel, the Government aims to approve a progressive multi-year electricity tariff recovery plan taking into consideration consumers' affordability and implement the annual electricity tariff adjustments in accordance with the recovery plan over 2017 and 2018.

Pillar 3. Improve transparency of State-Owned Enterprises (SOEs)

75. **Iraq's economy suffers from the presence of a large number of financial and non-financial SOEs**. A pervasive network of non-financial SOEs that operate in a wide range of sectors of the economy and, given their privileged status, prevent and stifle private sector growth in many of these sectors. Non-financial SOEs in Iraq include a large variety of public entities, including ministries' directorates/departments, and bodies. There are 176 SOEs in Iraq, with over 550,000 employees, of whom 30 to 50 percent are estimated to represent excess labor. The financial sector is dominated by a few large state-owned banks. As with non-financial SOEs, these banks receive significant privileges compared to private sector banks, thereby stifling competition but also innovation and growth of the overall sector. The banking system in Iraq is small; its assets-to-GDP ratio is equivalent to 73 percent compared to 130 percent for MENA countries. Credit expansion is also very low at 7 percent of GDP, compared to 55 percent on average for MENA countries.

76. **For the most part, SOEs in Iraq are non-transparent, are weakly accountable, and undertake sizeable quasi-fiscal activities which generate large fiscal liabilities and risks**. Many SOEs in Iraq are seriously decapitalized, asset-starved, inefficient, saddled with high production costs, over-staffed, and in a state of physical degradation (World Bank, 2004). Many of these SOEs have limited rationale beyond providing public employment. As a result, they are structurally loss-making and present a large burden for public finances (IMF, 2015). The exact scope and scale of the economic, financial and fiscal cost that SOEs represent in Iraq is, however, unknown due to poor reporting of key financial and economic statistics on the 176 non-financial SOEs. Similarly, the transparency of financial SOEs is limited. For example, the last accounts of Rasheed and Al-Rafidain—Iraq's largest (state-owned) banks—to have been audited by an international company relate to their 2006 accounts. Most of the budget and off-budget (through state-owned banks) funding for SOEs goes towards employee wages. Improving fiscal

transparency, accountability, and reporting of SOEs, and leveling the playing field with the private sector, including through SOE restructuring, would promote sustainable and inclusive growth.

Non-Financial SOE reform

77. **Iraq's management of the SOE sector is structurally weak**. It is currently decentralized in various ministries and coordination with Ministry of Finance beyond providing financial statements is ad hoc.[30] Given the lack of a comprehensive, accurate and timely statistical repository of information on SOEs, strategic monitoring, restructuring, or fiscal risk management of SOEs is challenging. Given the magnitude of the sector and its structural and cyclical problems, this represents a major gap to fill. Ensuring the collection, compilation, and reporting data at a central level will facilitate the mandate of the High Committee and will enable SOE restructuring to be better informed and designed.[31] It will, for example, inform decisions of interventions for liquidation and restructuring, promote a culture of openness through data collection, reporting, and publication. This, in turn, is expected to strengthen accountability and to enable fiscal risks stemming from SOEs to be monitored and managed.[32]

DPF Prior Action 8: The Prime Minister established a committee to set up, operate, and supervise a database to monitor the fiscal risks of non-financial SOEs, and update and publish the financial and employment data of said non-financial SOEs (Decree No. 446, dated October 18, 2015).

78. *Expected results.* **The prior action aims to strengthen transparency and help improve the monitoring of SOEs' performance and their associated fiscal risks**. It will also improve the monitoring of the liabilities and risks to public finances stemming from SOEs. To do so, improving transparency of SOEs' performance is the basis of reform. The MENA Strategy puts a strong emphasis on strengthening public institutions for more efficient and effective service delivery. While this pillar is not expected to contribute to the Government's short-term fiscal consolidation efforts, it will improve transparency and monitoring of non-financial SOEs as measured by the publication of consolidated annual reports on financial and employment metrics of non-financial SOEs relevant for fiscal risk monitoring, assessment, and management. By Q1 2017, it is expected that information will cover at least 75 percent of the SOEs (excluding SOEs operating in ISIS-controlled areas and in the KRG).

79. *Future steps.* In 2017, the authorities plan to collect financial and employment data for 100 percent of non-financial SOEs (still excluding SOEs operating in ISIS-controlled areas) into

[30] Selective data has been collected for studies on SOE restructuring by the Prime Minister's Advisory Committee (PMAC), the Ministry of Industry and Minerals (MIM), and the Asset Valuation Department of the MoF.

[31] Preliminary government studies have identified 17 non-financial SOEs as "very unviable."

[32] Information from SOEs that are operating in areas controlled by ISIS is not expected to be included in the analysis because of information availability or quality. Currently, for example, 22 of the 70 SOEs monitored by MIM are in ISIS-controlled territories.

the database and publish quarterly reports on the Council of Ministers' website, highlighting key metrics and in particular fiscal risks of non-financial SOEs.[33]

Financial SOE Reform

80. **The banking system in Iraq is small, dominated by weak state-owned banks, and is not in compliance with key international transparency recommendations**. Iraq's seven state-owned banks dominate the banking sector in part due to restrictions placed on private banks and also due to the perception of a de facto deposit insurance in public banks, while no deposit insurance exists for private banks. For example, by virtue of a series of MoF instructions since 2008, SOEs, ministries, and government agencies have not been allowed to (1) open accounts or deposit money in private banks; (2) pay staff salaries through private banks; (3) accept certified checks from private banks; (4) accept letters of credit issued by private banks; or (5) use transaction accounts in private banks to finance investment projects. A renewed push for directed lending to SOEs has further weakened state-owned banks. Under political and social pressures, state-owned banks are required to finance national priorities and public spending. At times, as a result of workers' demonstrations, state-owned banks have provided 'loans' to pay staff salaries of non-performing SOEs. Iraq's two largest state-owned banks, Rasheed and Al-Rafidain, hold 71 percent of the system's deposits. Private banks are generally quite small, accounting for only 11 percent of the system. Seven of the 36 private banks have foreign participation, and eight operate according to Islamic principles. In 2012, the Middle East and North Africa Financial Action Task Force regional body (MENA FATF) assessed Iraq as being either noncompliant or only partially compliant with 35 of FATF's 40 core recommendations (two were considered not applicable) and with all nine special recommendations. On the basis of this assessment, the FATF put Iraq on its list of countries presenting strategic AML/CFT deficiencies, and asked Iraq to prepare an action plan, consisting of eight actions, to address the issues of highest priority. In June 2015, Iraq had made progress, but had not sufficiently delivered on this action plan. As a result, FATF gave Iraq a deadline of October 19, 2015, to address delays or risk being blacklisted. The persistence of this situation would have been very negative to the country's financial system and economy as it would have raised Iraq's AML/CFT risk profile, potentially leading to significant difficulties in accessing the international financial system. To address some of these issues, the following reforms have been undertaken:

DPF Prior Action 9: *The Council of Ministers issued a decision aimed at leveling the playing field between public and private banking institutions by expanding the range of financial services that private banks are allowed to provide to government ministries and SOEs (Council of Ministers Decision No. 370 of 2015, dated October 19, 2015).*

DPF Prior Action 10: *The Borrower passed the Combatting of Money Laundering and the Financing of Terrorism Law No. 39 of 2015, aimed at reducing money laundering activities and the financing of terrorism.*

[33] In 2017, data collection of non-financial SOEs at 100 percent will exclude SOEs operating in ISIS-controlled areas and is contingent upon changes in the territorial control that the central government has in the areas where SOEs operate. In 2017, data collection efforts will also include non-financial SOEs in the KRG.

81. *Expected results*. **The above reforms are aimed at leveling the playing field between state-owned and private banks and ensuring the resiliency of the financial system so that private sector credit can continue to expand**. Promoting broad-based private sector development is one of the opportunities of renewing the social contract discussed under the MENA Strategy. Allowing the state institutions to conduct transactions with private banks will be a first step in leveling the playing field between private and state-owned banks. The completion of Prior Action 10 ensured that Iraq avoided being blacklisted and that progress can be made in implementing the FATF action plan. It is expected that such progress will result in at least five out of eight actions in the FATF action plan completed to the satisfaction of FATF by Q1 2017, against zero as of June 2015. AML/CFT reforms and advice are coordinated with the IMF (as part of the SMP) and with the US Treasury that is providing technical assistance.

82. *Future steps*. **The DPF-supported reforms are part of a medium-term reform plan that aims to strengthen the resiliency of the banking system**. Following Prior Action 9, the authorities aim to address the de facto exemption of Iraq's state-owned banks from meeting prudential requirements. Iraq's two largest state-owned banks, Rasheed and Al-Rafidain, have not been audited according to the International Financial Reporting Standards (IFRS). As a result, the scope of the problem that these banks have on their balance sheet is difficult to assess. This is a critical first step prior to preparing and implementing any restructuring plans. The authorities are therefore planning to prepare in agreement with the World Bank and the IMF, terms of reference for an audit of the Rasheed and Al-Rafidain's balance sheets by an internationally reputable audit firm according to IFRS (IMF SPM structural benchmark), and contract, complete and publish the audit by the end of 2016. Based on the results of the audit, the authorities plan to formulate and start implementation of a restructuring plan for Rasheed and Al-Rafidain in 2017. On the AML/CFT front (Prior Action 10), the CBI is planning to issue implementing regulations in line with the FATF recommendation by end-2016, and, by end-2017, a Financial Intelligence Unit hosted by the CBI is expected to be fully operational and enforcing the legal and regulatory framework for AML/CFT, in close coordination with the financial sector prudential regulators.

Table 5. DPF Prior Actions and Analytical Underpinnings

Prior Action	Analytical Underpinnings
Prior Action 1: Public wage reform	Iraq Public Expenditure Review. World Bank. 2014.
Prior Action 2: PIM reform	"2014 Iraqi Public Investment Management System (I-PIMS) Assessment," World Bank, 2015. "Action Plan to Develop an Efficient Iraqi Public Investment Management System (I-PIMS) over the Period 2016-2018," World Bank, May 2015. "PIM Framework for Iraq," World Bank, September 2015. "Simplified Methodology for Economic Appraisal of Projects in Iraq," World Bank, 2015. "PIM Iraq: Financial and Economic Analysis Template (Excel Spreadsheet)," World Bank, 2015. "The Role of Key Performance Indicators in Public Investment Management," World Bank, 2015. "Manual for Public Investment Project Selection and Prioritization," World Bank, 2015. "PIM Capacity Building in Project Design, Appraisal, Selection and Budgeting: The Iraqi Case," World Bank, September 2015.
Prior Action 3: Public debt management	IMF 2015 Article IV Consultations: Debt Sustainability Analysis.
Prior Action 4: Pension reform	"A Stocktaking of Social Assistance Programs in the Republic of Iraq," World Bank, Dec. 2014.

<u>Prior Actions 5 and 6:</u> Gas flaring and gas-to-power	Iraq: Petroleum Products Distribution and Retail Market Reform, World Bank, 2015. Iraq: Electricity Distribution Sector Reform Study, CPCS, 2015. Energy Information Administration, Iraq Factsheet, 2015. Iraq: Gas to Petrochemicals Study, World Bank GGFR – Nexant, 2014. Iraq: Gas Pricing Study, World Bank, 2014. Iraq Integrated National Energy Strategy Report, the World Bank, 2013. Report: International Energy Agency, Iraq Energy Outlook, October 2012Report: Iraq Electricity Master Plan, Parsons Brinckerhoff: Iraq Electricity Master Plan, 2011.
<u>Prior Action 7:</u> Electricity tariff	Iraq: Electricity Distribution Sector Reform Study, World Bank - CPCS, 2015. "Energy Subsidy Reform: Lessons and Implications," by Clements, Coady, Fabrizio, Gupta, Alleyne, and Sdralevich, eds. 2013, Washington, DC: IMF. Iraq: Integrated National Energy Strategy Report, World Bank, 2013. International Energy Agency, Iraq Energy Outlook Report, October 2012. Iraq Electricity Master Plan, Parsons Brinckerhoff, 2011.
<u>Prior Action 8:</u> Non-financial SOEs reform	"Restructuring of Public Companies: Vision toward Reform," Prime Minister Advisory Commission, Public Companies Restructuring Team, February 2015. "State-Owned Enterprises Reform in Iraq" Reconstructing Iraq WP No 2, World Bank, 2004. "Governance Reforms of State-Owned Enterprises in MENA," World Bank, August 2015. "Iraq Economic Monitoring Report," World Bank, Spring 2015. Republic of Iraq Ministry of Industry and Minerals, 2015-2017 Budget Strategic Plan, 2014. "Iraq: 2015 Article IV Consultation and Request for Disbursement Under the Rapid Financing Instrument," IMF, July 2015. "Reform of SOEs and PPPs in Iraq," S. Rimmer and M. Wafaa Al-Ani, World Bank, Nov. 2012.
<u>Prior Actions 9-10:</u> Financial SOEs and banking sector reform	Iraq: Financial Sector Review, 2012. Iraq: Mutual Evaluation Report – Anti-Money Laundering and Combating the Financing of Terrorism, Middle East and North Africa Financial Action Task Force, 2012 (and 2015 update).

4.3 LINK TO CPS, OTHER BANK OPERATIONS AND THE WBG STRATEGY

83. **The operation builds on the Iraq Country Partnership Strategy (CPS) (FY13-FY16) as revised through the Performance and Learning Review (PLR) discussed by the Board on July 7, 2015**. The CPS, which builds on the National Development Plan 2010-14 (now updated to 2013-17) is structured around three pillars: (1) improving governance; (2) supporting economic diversification; and (3) improving social inclusion and reducing poverty. The CPS envisaged a calibrated engagement depending on the pace and strength of reforms, and on the political and security environment. This engagement has taken several forms, including a 2010 DPL—which closed with an IEG rating of Moderately Satisfactory—and several recent reports such as the above-mentioned 2014 CEM and PER, a 2012 Poverty Assessment, and a 2011 Financial Sector Review. This DPF builds on this long-standing engagement. The revised objectives of the CPS recognizes the challenges Iraq is facing in rebuilding and strengthening the relationship between the citizens and the State. For the remaining period of the CPS, the PLR introduces two objectives: (1) restoring and improving basic service delivery, especially in those areas affected by ISIS, to help reinforce the legitimacy of the State; and (2) managing the country's critical fiscal situation and increasing opportunities for the private sector. The first objective is supported by a US$350 million Emergency Operation for Development approved by the Board on July 7, 2015 and declared effective in August. It supports the resumption of basic services in seven cities that have been regained from ISIS control. The DPF operation aligns with the second objective and support Iraq's efforts towards economic stabilization, rebuilding state institutions and putting the economy on a sustainable path towards ending extreme poverty and promoting shared prosperity.

84. **The DPF operation is fully aligned with the MENA Regional Strategy**. The new MENA Strategy aims at promoting peace and stability in the region, thereby establishing the conditions for inclusive growth. The Strategy acknowledges that conflict and violence in MENA have huge spill-over effects, and confronting them through development initiatives that promote peace and stability is therefore a global public good, which requires a global coalition to achieve. Without concerted action to promote economic and social inclusion for peace and stability, violence and conflict will continue to corrode the economies, societies, and lives of the people in the MENA region and beyond. This DPF operation is consistent with the four pillars of the MENA regional strategy: (1) Renewing the Social Contract; (2) Regional Cooperation; (3) Resilience; and (4) Recovery and Reconstruction.

4.4 CONSULTATIONS, COLLABORATION WITH DEVELOPMENT PARTNERS

85. **In-country consultations are constrained by the security situation, but stakeholder consultation has already taken place**. Despite limited consultation opportunities because of the security situation in Iraq, consultations on reform actions with key government officials and with donors have taken place since the early stage of the DPF preparation. Based on the Minister of Finance's initiative, the Government program actions, supported by the DPF, have received significant media coverage, as the Minister invited a wide range of media to cover the program preparation. The Minister has also put on his Facebook page key elements of the proposed program. As described in Section 1, the proposed operation and its prior actions are closely aligned with five of the six development priorities of the new Government, so the operation is benefiting from the consultations that the Government conducted and the mandate it has received.

86. **The operation is part of a package of coordinated financial assistance from international partners to help Iraq**. The proposed DPF operation is closely coordinated with other donors and the IMF. The IMF supported Iraq through a US$1.24 billion Rapid Financing Instrument in July 2015 and a staff level agreement was reached on November 10, 2015 on a fully financed Staff-Monitored Program. Bank staff have joined both the RFI and SMP missions. JICA is providing parallel financing to the proposed DPF and has participated in the discussions on the DPF prior actions. The reform areas included under the DPF are supported by a number of ongoing or starting technical assistance programs and investment lending operations, some of which are supported by donors (Table 4).

5. OTHER DESIGN AND APPRAISAL ISSUES

5.1 POVERTY AND SOCIAL IMPACT

87. **Overall, the macro-level reforms proposed in the DPF are unlikely to adversely impact welfare**. While it is difficult to assess the direct impact of some of the broader reforms on poverty and shared prosperity, insofar as the proposed reforms prove effective in improving the efficiency of public spending, reforming SOEs and improving the sustainability of energy supply, they will free up resources that could be potentially reoriented for welfare-improving expenditure. A gender-neutral expansion in social services and essential infrastructure, if forthcoming, will likely disproportionately benefit women and girls, and help address existing gender gaps in access

to health and education infrastructure.[34] Any expansion in the supply of electricity to households (consequent to the proposed reforms) can lead to cost savings for households—preliminary analysis comparing 2012 and 2014 data suggests that when power supply through the public grid increased, household expenditures on energy declined, as a result of substitution away from more expensive fuel sources.

88. **The proposed civil service wage reform which is cutting nominal wages of top public sector employees is unlikely to adversely affect the poor or bottom 40 percent of the population**. The measure that the Government has taken to also reform wages at the lower levels of the public sector salary scale is also unlikely to adversely affect the poor or bottom 40 percent of the population as nominal wages are kept constant or increased. It is important to note that between 2007 and 2012, almost 80 percent of the new jobs were created in the public sector, and primarily absorbed less-educated men. Anecdotal evidence (which was also confirmed in consultations with Government during the poverty assessment) suggests that many of these types of jobs were in the security sector.

Reduce electricity subsidies

89. **The proposed service improvement which guarantees 30-40 commercial and industrial entities 24X7 electricity supply conditional on a tariff increase is unlikely to adversely impact household welfare**. Given the unpredictability and paucity in supply from the public grid, and the higher costs associated with private substitutes such as generators, these entities may be able to lower costs while increasing output and productivity. It is unlikely therefore that the higher tariffs will be passed on to consumers; instead, insofar as these firms and businesses are able to expand, there may be a positive welfare impact through the creation of jobs.

90. **While connection to the grid is almost universal in Iraq, actual electricity supply is scarce and depends on geography**. In 2012, almost all households reported being connected to the public electricity grid. Electricity supply, however, is rarely higher than 12 hours on average, with the exception of KRG, where 93 percent of households receive electricity for more than 12 hours. In sharp contrast, only 3 percent of households in Baghdad, and around a tenth of households in the Center and the South receive power for more than 12 hours. Baghdad is by far the worst hit in terms of electricity, with more than three-quarters of all households in the capital receiving less

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[34] See World Bank MENA Development Report (2013) "Opening Doors: Gender Equality in the Middle East and North Africa" and the World Bank Iraq Poverty and Inclusion Assessment (2015) "The Unfulfilled Promise of Oil and Growth: Poverty, Inclusion and Welfare in Iraq, 2007-2012". In countries such as Iraq, where gender gaps in outcomes in health and education are partly driven by lack of physical access or by financial constraints, easing these constraints can disproportionately benefit girls and women, who start out from a lower base. In 2012, 18 percent of female aged 7–25 who never attended school reported the lack of access as the main reason, while 11 percent report that their households could not afford the costs of schooling. Despite lower odds of being in school relative to boys, among the girls who make it to secondary and tertiary level, net enrollment rates are slightly higher among girls than among boys. This suggests that while girls are less likely than boys to make it to higher education (because of gender gaps that begin early in the education process), once they reach a higher level, girls are slightly better in completing each level on time and tend to lag behind less. While closing education and skills gap for women is an important policy priority, complementary efforts to unleash private sector led job creation that offers a diverse set of job opportunities is a critical and necessary step for both youth and women in Iraq. International evidence suggests that economic growth created new opportunities for women in countries like Spain, Ireland and Greece: labor force participation which was low in the 1980s grew by 20 percent in recent decades mainly spurred by private sector led job creation.

than 8 hours of electricity a day. Variation in electricity supply across space seems to be the relevant metric of unequal access. Irrespective of household wealth, few receive more than 12 hours of electricity on average per day. While only 15 percent of the poorest quintile get more than half a day of power, even among the richest quintile, less than 40 percent receive the same. Similarly, around a third of all households receive less than 8 hours of electricity per day (IHSES 2012, staff calculations).

91. **A comprehensive analysis of the system of energy subsidies and alternate reform scenarios is also underway, supported by ESMAP**. In addition, a comprehensive poverty and social impact analysis of reforms to the system of energy subsidies will be undertaken in 2016 that will take into account the presence of alternate sources of energy to households, both publicly and privately provided. This technical assistance includes an assessment of the magnitude and distribution of subsidies in energy; the economy-wide, sectoral and distributional impacts of tariff increases; and assistance in communicating this reform agenda to the public.

5.2 ENVIRONMENTAL ASPECTS

92. **The reforms supported by the proposed DPF are not likely to have significant negative effects on the country's environment, forests or other natural resources**. Despite the instability and civil strife, the government has handled the issue of environmental sustainability with relative success, starting with law no. 37 of 2008 establishing the Ministry of Environment (MoE), and then the environmental protection and improvement law No. 27 of 2009 that clearly defines the process, procedures and requirements for environmental assessment, under the overall supervision of the EIA department in the Ministry of Environment.[35]

93. **As per OP 8.60, the World Bank assessed whether specific country policies supported by the DPF are likely to cause significant effects on the country's environment, forests, and other natural resources**. The assessment concluded that the policies supported by the proposed DPF are not likely to have negative impacts on the country's natural assets. The reform programs supported under the energy objective would help in the reduction of gas flaring, thereby reducing climate change effects, as there will be reduction of methane to the atmosphere resulting in less environmental degradation. The natural gas processing targets supported under the energy objective would result in equivalent volume reductions in gas flaring, thereby reducing the emission of greenhouse gasses to the atmosphere. Similarly, the implementation of the gas-to-power strategy under this same objective is intended to promote the use of natural gas in power generation by displacing the use of more polluting fuel oil and diesel. This would improve air quality by reducing energy-related GHG emissions that lead to air pollution, reducing the related impact on human health. According to the Bank team's calculations, the GHG emissions from power generation in Iraq will drop up to 6.9 million tons between 2014 and 2016 as a result of the displacement of HFO/LFO/Diesel by cleaner natural gas and 2.4 million tons as a result of the reduction in flaring in the same period.

[35] Many features of the Iraqi EA system are comparable with the World Bank Environmental Assessment Policy (OP/BP 4.01). Environmental Impact Assessment is required for all new establishments and for a change of an existing establishment in accordance with Annex I of the environmental assessment regulations. The MoE reviews EIA reports and issues an environmental compliance certificate, and consultations are held with the concerned public, stakeholders, municipalities and ministries. The MoE may request the project developer to submit an environmental audit report on the harm or suspected harm to the environment or on any specific matter determined by the ministry.

94. **With respect to the reforms, any significant negative environmental effect is likely to be avoided or mitigated**. The EIA department at the Ministry of Environment has capacity to implement, monitor and report on mitigating measures and/or environmental and social management plans (ESMPs) as the case maybe; and is presently working with the Bank in the preparation of environmental safeguards instruments for the proposed electricity distribution reform and investment project.

5.3 PFM, DISBURSEMENT AND AUDITING ASPECTS

95. **Public Financial Management (PFM)**: The Government of Iraq continues to place priority on PFM reforms and places PFM at the heart of the *General framework of Government Program 2014-2018* that aims to achieve economic and financial reforms. Some progress in reforming PFM has been made, including: (1) preparation of a revised PFM draft law; (2) improvement in the budget preparation process with: detailed policy focus during budget strategy discussions, an MTEF developed and operational; and budget formulation and execution based on administrative and economic classification using GFS standards; (3) development of a new budget classification (BC) and a new Chart of Accounts (CoA) with separate segments for administrative, economic, type, functional, and geographical;[36] (4) general information on the federal budget of 2015 is published on the MOF website; and (5) development of IFMIS implementation plan (2016-2020) with a System Requirement Study (SRS) was conducted, and the design and specifications of the needed IFMIS for budget preparation and execution with the support of the World Bank. Standard bidding documents and national implementation manual were prepared, piloted and disseminated for use by different implementing agencies, and complemented by development and adoption of public procurement national training strategy. The revised Federal Board of Supreme Audit (FBSA) law no 31, promulgated in September 30, 2011, reinforces its financial and administrative independence, its position in the governance system, and its role in forensic audit.[37] A new organizational structure with new roles and responsibilities for internal auditors, new internal audit charter, and new audit methodology based on risks were developed for the internal audit department at MoF with the support of the World Bank.

96. **Notwithstanding the latter improvements, a number of issues need to be addressed**. These include: (1) Iraq's score on the Open Budget Index declined from 4 in 2012 to 3 in the 2015 (last round); (2) while progress has been made on the development of a revised PFM law, considerable additional work remains to further strengthen the framework;[38] (3) in 2014, Iraq

[36] The last two classification segments are yet to be developed prior to the implementation of the Iraqi financial management Information System (IFMIS). The accounting manual describing the accounting framework, the new budget classification (BC), and the new Chart of Accounts (CoA) has been developed as well.

[37] This is complemented by a capacity development program initiated during the last few years with the support of the World Bank, where it had trained hundreds of its staff, developed and revamped its methodology in risk-based audit, performance audit, procurement audit, and forensic audit. FBSA had been subject to peer and independent reviews that showed positive improvements in complying with ISSAIs standards. The FBSA stepped up its transparency efforts in sharing most of the periodical and annual audit reports on its website, including its activities reports (the FBSA 2014 annual report is already online) and financial statements.

[38] Key provisions that need to be further developed, such as and not limited to: (1) the roles and responsibilities of the key stakeholders, (2) key principles related to fiscal responsibility, budget formulation, budget execution accounting

operated without an approved budget; (4) the published Federal Government budget on the MOF website does not provide sufficient information, and the public has limited information on the Federal Government budget and financial activities during the course of the budget year;[39] and (5) the CPA Order 87 of 2004, imposed by the transitional authority, is not generally regarded as applicable and is for the most part ignored by practitioners. The CoM in 2009 decided to abolish the CPA order 87 leaving the system without the pinnacle hierarchical legislative instrument found in a normal legal framework for public procurement. In place of a procurement law, the main legal framework for public procurement consists of regulations of 2007 revised in 2008 and 2014 and other instruments such as instructions by CoM and MoF. The internal controls within the entire public administration, including the roles of internal auditors and Inspectors General (IGs) need a holistic reform.[40] The implementation of IFMIS is going slowly. The timeliness of the completion of the final accounts by MoF and submission to the FBSA for auditing and the timeliness of the MoF response to the FBSA inquiries needed to complete the audit requires improvements.[41]

97. **To address some of these issues, the World Bank is working with the Iraqi authorities on a multi-year engagement on PFM**. A new proposed PFM loan would aim at strengthening budgetary systems, internal controls and audit functions, as well as public investment management capacity and procurement reforms. Furthermore, the Bank will provide advisory services through its "Public Management, Transparency, and Regulatory Reform Technical Assistance," funded by the Externally-Financed Output (EFO) agreement signed with the UK DFID, with the following main objectives: (1) improve MOF on-line information and transparency; (2) provide MOF with a relevant instrument to benchmark PFM performance against international practices by assessing its PFM systems using the new PEFA framework of 2015; (3) assess MOF capacity building needs; (4) enhance the Federal Board of Supreme Audit (FBSA) oversight capacity; and (5) improve the regulatory governance and simplification.

98. **Foreign exchange**. The CBI was subject to the IMF safeguards assessment in June 2010. The assessment shows significant safeguards risks at the CBI, including structural deficiencies in the control framework of the CBI, concerns with the operational controls, and heavily qualified audit opinions by the external audits. The CBI has been already engaged towards important steps to strengthen its safeguard framework and the progress on those steps is monitored by the IMF.

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and financial reporting, and fiscal risk analysis; and (3) Delegation to Head of Ministries/Executing Authorities, Heads of MoF and MoP Departments, etc.

[39] This makes it challenging for citizens to hold the government accountable on fiscal management. Only the enacted budget and the year-end budget reports are published. The other documents (Pre-Budget Statement; Executive's Budget Proposal; In-Year Reports, Mid-Year Review; and Audit Report) are being produced only for internal use. The Citizens Budget is not produced for now. The modernization of the website of the Ministry of Finance, to be completed in 2016 with an Open Budget window requested by the government, should be the visible result of such an initiative.

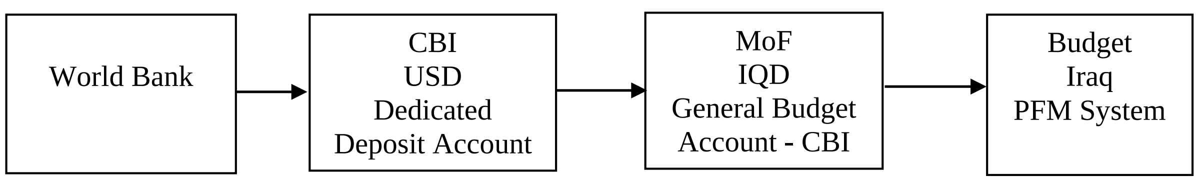
[40] The internal audit function is almost exclusively restricted to the compliance and regularity of transactions. Internal auditors do not produce a regular report highlighting the findings and conclusions during the period of review or the identified issues and risks except when they are requested specifically to provide assurance on certain issues. On the other hand, the IGs appears to provide integrity review functions with no defined methodology or set of comprehensive policies and procedures to provide guidance and lead to consistency and standardization of activities in the Office and provide evidence of the use or existence of a systematic and disciplined approach. See "Internal Financial Controls." ITF-PFM reforms Project, 2013.

[41] This delay, added to the time required by the Parliament to approve the accounts, affects the validity and relevance of the financial information. For example, the 2011 audited final accounts were approved by the Parliament in June 2014. The last accounts audited by the FBSA were that of 2013. The final accounts are not published.

The CBI financial statements are annually audited by a private independent auditor. The auditor issued a "qualified" audit opinion on CBI's financial statements for the year ended December 31, 2014. The basis of the qualified opinion is the same as that of 2011 and 2012 and relates to old outstanding balances at foreign banks, funds owed to the CBI from the MoF that have not yet been returned to the CBI, and lawsuits in different countries against the CBI for past due debts.

99. **Disbursement arrangements**. The proposed loan will follow the Bank's disbursement procedures for DPF and will be disbursed in a single installment. Once the loan is approved by the World Bank's Board and becomes effective, the proceeds of the loan will be disbursed in compliance with the stipulated release conditions and deposited by the IBRD in an account designated by the Borrower and acceptable to the World Bank at the CBI. The Borrower should ensure that upon the deposit of the loan into the said account, an equivalent amount is credited in the general budget account at the CBI. The administration of this loan will be the responsibility of MoF. If the Bank determines at any time that an amount of the loan was used to make payment for excluded expenditures, the Borrower shall refund an equal amount of such payment to the Bank and such amount refunded to the Bank shall be cancelled from the loan.

100. The total amount of time between disbursement by the World Bank of the loan proceeds in US Dollar and the credit into the general budget account should not exceed 30 days. MoF will provide to the Bank, within 30 days, a confirmation of this transfer; advising that the total sum of the loan has been received. The diagram below depicts the envisaged flow of funds arrangements:



101. **Auditing arrangements**. An independent external auditor, acceptable to the Bank, will be hired by MoF to verify the accuracy of the transactions of the dedicated deposit account, including accuracy of exchange rate conversions; that the dedicated deposit account was used only for the purposes of the operation and no other amounts have been deposited into the account. Also the auditor will have to obtain confirmation from the corresponding bank(s) involved in the funds flow regarding the transaction. The time period for submission of the audit report to the Bank is no later than six months after the date of the deposit of loan proceeds into the dedicated deposit account.

5.4 MONITORING, EVALUATION AND ACCOUNTABILITY

102. **The responsibility for implementing the program in Government rests with the Ministry of Finance**. The MoF is responsible for the implementation of the DPF-supported program as well as for coordinating the actions among the concerned institutions. Together with the MoF, line ministries and agencies engaged in DPF-supported reforms will collect the necessary data for the identified monitoring indicators. Given the multi-sector and multi-agency nature of the DPF reforms, the Prime Minister's Office has also committed to continuously monitor implementation of the reforms against agreed plans and timelines and will work closely with the World Bank and the Ministry of Finance to address any slippages.

103. **Overall, data availability and quality to monitor progress is sufficient for reform monitoring although some institutions have difficulty in providing some data**. While most of the data required for monitoring progress towards the achievement of the DPF results are available, data for some indicators have so far been difficult to obtain. As noted in the 2015 IMF Article IV staff report, the quality and availability of some statistics needs improvement. Specifically, "statistics, in particular in the fiscal and balance of payments areas, are barely adequate for analyzing macro-economic developments."

104. **Grievance Redress**. Communities and individuals who believe that they are adversely affected by specific country policies supported as prior actions or tranche release conditions under a World Bank Development Policy Operation may submit complaints to the responsible country authorities, appropriate local/national grievance redress mechanisms, or the WB's Grievance Redress Service (GRS). The GRS ensures that complaints received are promptly reviewed in order to address pertinent concerns. Affected communities and individuals may submit their complaint to the WB's independent Inspection Panel which determines whether harm occurred, or could occur, as a result of WB non-compliance with its policies and procedures. Complaints may be submitted at any time after concerns have been brought directly to the World Bank's attention, and Bank Management has been given an opportunity to respond. For information on how to submit complaints to the World Bank's corporate Grievance Redress Service (GRS), please visit http://www.worldbank.org/GRS ; for information on how to submit complaints to the World Bank Inspection Panel, please visit www.inspectionpanel.org.

6. SUMMARY OF RISKS AND MITIGATION

105. **The overall risk rating of this operation is high**. Major risks that could prevent the operation from achieving its development objectives include: political and governance risks, macroeconomic risks, fragility, conflict and violence risks, fiduciary risks, and stakeholder risks (Table 6).

- **Political and governance risks are high**. The crisis and the fact that Parliamentary elections are not due till 2018 present an opportunity and a long time horizon to tackle long standing decisions. The reform drive, however, could be undermined by a number of factors, including the further weakening of the security situation, social unrest due to low quality and availability of basic public services (such as electricity), [42] perception of widespread corruption, disagreements between the central government and KRG which could escalate into a political crisis and governmental deadlock, or by capture by vested interests. On the latter, Iraq ranks poorly on international comparisons regarding perception and control of corruption. A mitigating factor is that political will shown so far is an indication that the country's leadership realizes that they are on the brink of a major setback. All signals and political discourses indicate that this government understands that backsliding on the reform agenda could endanger its

[42] In August 2015, a wave of anti-establishment protests took place in Baghdad and southern provinces over corruption and systematic inadequacy of service delivery. The power grid's failure during extreme summer heat was the trigger that turned general discontent into anger about governance and the political class. The reform agenda cannot be surmounted in a few weeks or months, and if recent history is any indication, the current protests could further destabilize the country if militia groups are able to capitalize on the current discontent. At such a sensitive juncture, immediate and large external financial support is critical to generate the short-term stability required to further advance the reform agenda before the anti-establishment mood benefits militias and other radical alternatives.

macroeconomic framework, and almost irreparably damage the country's standing.

- **Macroeconomic risks are high**. The risks outlined in paragraph 28 could affect implementation, impact and sustainability of the reforms supported by this DPF. There is a risk that the adjustment and financing needs may be greater than anticipated, especially in case of a further decline in global oil prices, and further escalation of the ISIS insurgency. Both of these shocks would put further strain on the budget and on the state's capacity to finance the additional deficit which would undermine the adequacy of the macroeconomic framework that underpins this operation. Pressures on financing could also result in renewed arrears to IOCs, which would endanger the projected increase in oil production and exports as well as investment needed for capturing flared gas, which is critical to achieving the gas flaring reduction target. A rise in global interest rates could also tighten Iraq's access. These risks would be partially mitigated once the Government enters into an upper tranche program with the IMF (as it currently intends). Acceleration of some of the fiscal savings measures included in this operation (e.g., parametric pension reform) would also help mitigate some of the downside risks by reducing the structural fiscal deficit.

- **Fragility, conflict and violence risks are high**. The main risk is related to ISIS which has proven to be a strong military force and has at times expanded quickly and unpredictably. To prepare to respond to future ISIS attacks, there could be higher military costs for the Iraqi Government and further strains on the state budget and capacity. To defeat ISIS, the Government may, at some point, decide to focus on security at the expense of longer-term development goals, which could lead to the de-prioritization of policies supported by this DPF. The international response to ISIS may also strengthen or subside, also with impacts on Iraqi state capacity to address conflict and the perception that the Government is able to secure the population in its borders. Escalation or widening of ISIS control in Iraq could have serious implications on the implementation of the macroeconomic framework (particularly if the south of Iraq where most of the country's oil production originates is affected) and also for parts of the DPF-supported reforms, such as data collection of non-financial SOEs and any subsequent restructuring.

- **Fiduciary risks related to this operation are high**. This is the general conclusion of a number of diagnostic reports.[43] The fiduciary risks in this operation cannot be mitigated in the short term. In the longer term, the Bank will be supporting the Iraqi Government in strengthening its PFM system through a PFM Institutional Development and Capacity Building Project (under preparation). This new project is expected to contribute to better information for fiscal management and strategic allocation of resources, more efficient service delivery, and public finance transparency. It will pursue this objective by supporting capacity development and foundational systems (IFMIS, Public Investment Management System, Public Procurement and Financial Controls).[44] Furthermore, the latter will be complemented by the World Bank

[43] The World Bank, Financial Management Accountability Assessment Report issued on June 2007 and Report on the Assessment Fiduciary Risk; in Iraq issued in November 2009, The World Bank, *Public Expenditure and Institutional Assessment* (2 volumes, including PEFA assessment), February 5, 2009.

[44] Under this PFM project (under preparation), the Bank will continue supporting the Government in public procurement reforms, including: implementation of the e-single portal; improve transparency and accountability of the procurement system, including collection and dissemination of information on procurement activities to all

advisory services under its “Public Management, Transparency, and Regulatory Reform Technical Assistance (DFID financed).

- **Stakeholder risks are high**. Incomplete implementation either due to the lack of resources, capacity constraints, resistance from special interest groups, changes in reform directions due to political and social pressures could undermine the impact of these reforms. For example, pensions have always been politically influenced in Iraq. That is why parametric reforms will threaten the political interests some have in the pension program. The main risk remains the political intervention against the suggested reform steps. In addition, the possible referral of the long lists of victims and martyrs of terrorism or casualties of incidents to pension will jeopardize any efforts undertaken to sustain the system financially. Approving the amended law and removing the exemptions that have been introduced earlier would be an achievement, yet that would require a political consensus and firm political support. Mitigation factors include the current financial situation and particularly the lack of resources and the threat of closing down the pension system in the near future, backed up by accurate forecasting estimation, should be the drive to mitigate the highly visible political risk.

Table 6. Iraq DPF Risk Rating by Categories

Risk Categories	**Rating (H, S, M or L)**
1. Political and governance	H
2. Macroeconomic	H
3. Sector strategies and policies	S
4. Technical design of project or program	M
5. Institutional capacity for implementation and Sustainability	S
6. Fiduciary	H
7. Environment and social	M
8. Stakeholders	H
9. Other: Fragility, Conflict, and Security	H
Overall	**H**

106. **While risks to this DPF are high, they should be weighed against the counterfactual: the risks of inaction and absence of support from the Bank to the current reform momentum**. By not engaging now with the proposed operation, Iraq’s financing position—already challenging as revealed by the large accumulation of arrears and the difficulty in accessing external markets at a reasonable cost—would become even more binding since: (1) the budgeted financing support from the World Bank and JICA would not be forthcoming; and (2) the absence of any international support package would negatively affect Iraq’s prospects of raising funds externally. Similarly this would weaken the macroeconomic framework underpinning the IMF SMP because of lower financing and weaker implementation of structural reforms jointly supported by the IMF and the Bank. Not engaging through this DPF would result in fewer opportunities for technical assistance, thereby affecting the quality of reform design, implementation, and impact. A weaker ability to

stakeholders; capacity building and professionalization of the procurement workforce for the implementing agencies (Ministries and Governorates); and capacity building for Parliamentary oversight of public procurement.

access international capital market may result in Iraq having to finance its deficit through reserves draw down and/or further cuts in investment and current expenditures in a way that would curtail the State's ability to provide basic social and economic services and ultimately weaken its ability to fight ISIS and contribute to peace and stability in the region. Regarding the timing of the DPF, the Bank is playing an important role by providing financing now, to complement the financing that the IMF provided in July through the RFI. The Bank can, therefore, seize the opportunity of supporting the government reform effort at this critical juncture. The implementation of reforms supported by this DPF will not only help prevent the economy from going into a deeper crisis but will also play a catalytic role in laying the foundations for a stronger economy and a better financing outlook for Iraq in 2016 even without further budget support from the Bank.

ANNEX 1: DPF POLICY MATRIX: PRIOR ACTIONS AND RESULTS FRAMEWORK

Prior Action DPF		Result Framework		
		Indicator	Baseline	Target
Pillar 1. Improve expenditure management				
Public Wage Reform:	1. The Council of Ministers approved a new salary scale for state and public sector employees, effective November 1, 2015, in which the salaries of public sector employees in higher grades are reduced (Council of Ministers Decision No. 366 of 2015, dated October 15, 2015).	Reduction in the basic annual salary of top public sector employees as a ratio of annual GDP per capita (defined at grade 3 with 11 years of experience).	September 2015: 1.9	Q1 2017: 1.7
PIM reform:	2. The Borrower's Prime Minister adopted the Public Investment Management Framework which covers project feasibility, implementation, operation, and ex-post evaluation phases (Decree No. 445, dated October 18, 2015).	Percentage of capital projects valued at over US$500 million for which a feasibility study with cost-benefit analysis is done.	2015: 3 percent of the total number of projects.	Q1 2017: 5 percent of the total number of projects.
Public Debt Management	3. The Borrower's Minister of Finance established a debt management section within the Ministry of Finance (Ministerial Order No. 4340, dated October 19, 2015).	Approval and publication on the ministry of finance website of a public debt management strategy in line with international best practice.	2015: No debt management strategy	Q1 2017: Debt management strategy approved and published
Pension reform:	4. The National Board of Pensions implemented a campaign to clean its retiree data registry resulting in the removal of at least 30,000 non-eligible retirees.	Improved financial sustainability of the State Pension Fund through better governance as measured by a reduction of the cash benefit spending of the National Board of Pension.	2015: To be determined at end-2015	Q1 2017: a 5 percent nominal reduction compared to end-2015.
Pillar 2. Improve the sustainability of energy supply				
Reduce gas flaring:	5. The Energy Committee of the Council of Ministers approved the implementation plan proposed by the Ministry of Oil setting forth targets for the reduction of gas flaring for the period 2015-2018, in support of the objective of achieving zero gas flaring by 2030 (Energy Committee Decision No. 17, dated November 9, 2015).	Reduced gas flaring—measured by the amount of additional (associated) gas processed (measured as the average MMscf/day).	2014: MMscf/day: 656	Q1 2017: MMscf/day: 1,070
Expand gas use to power generation:	6. The Council of Ministers approved the establishment of an inter-ministerial committee, including the Ministers of Oil, Electricity, and Finance, which shall be tasked with developing an action plan to utilize gas in electric power generation (Council of Ministers Decision No. 370 of 2015, dated October 19, 2015).	1) Establishment of an inter-ministerial committee and development of an action plan for gas-to-power; 2) Fuel switching to generate power from petroleum products to gas—measured as total volume of gas supplied to GT power production (MMscf/day).	1) 2014: No specific Committee in place and no Action Plan for Gas-to-Power developed; 2) 2014 = 600 MMscf/day	1) Q1 2017: Specific inter-ministerial committee in place and an Action Plan developed; 2) Q1 2017 = 840 MMscf/day
Reduce electricity subsidies:	7. The Energy Committee of the Council of Ministers approved the implementation of a new unsubsidized commercial tariff for large commercial consumers (except hospitals) that choose to avail themselves of continuous (twenty four (24) hours, seven (7) days a week) electricity supply under bilateral contracts with the Ministry of Electricity (Energy Committee Decision No. 6, dated May 25, 2015).	1) Increased tariffs for energy-intensive consumers--measured by the retail price of electricity sold (in ID per kWh); 2) Improved service delivery--measured by total electricity sold (in MWh)	1) 2014: 30.74 ID/kWh 2) 2014: 44 million MWh	1) Q1 2017: 31.05 ID / KWh 2) Q1 2017: 47.6 million MWh

ANNEX 1. DPF POLICY MATRIX: PRIOR ACTION AND RESULT FRAMEWORK (CONTINUED)

	Prior Action DPF	Result Framework		
		Indicator	Baseline	Target
Pillar 3. Improve the transparency of state-owned enterprises				
Non-financial SOEs reform:	8. The Prime Minister established a committee to set up, operate, and supervise a database to monitor the fiscal risks of non-financial SOEs, and update and publish the financial and employment data of said non-financial SOEs (Decree No. 446, dated October 18, 2015).	Improved transparency, reporting, accountability, and assessment of fiscal risks stemming from non-financial SOEs as measured by the publication of consolidated annual reports on financial and employment metrics of non-financial SOEs relevant for fiscal risk monitoring, assessment, and management.	2014: No report published	Q1 2017: Annual report published.
Financial SOE and banking sector reforms				
	9. The Council of Ministers issued a decision aimed at leveling the playing field between public and private banking institutions by expanding the range of financial services that private banks are allowed to provide to government ministries and SOEs (Council of Ministers Decision No. 370 of 2015, dated October 19, 2015).	Ratio of state deposits in private banks to state deposits in all banks	January 2015: zero percent	Q1 2017: 5 percent
	10. The Borrower passed the Combatting of Money Laundering and the Financing of Terrorism Law No. 39 of 2015, aimed at reducing money laundering activities and the financing of terrorism.	Progress in implementing FATF action plan.	June 2015: Zero of 8 actions in FATF action plan completed to the satisfaction of FATF	Q1 2017: At least 5 of 8 actions in FATF action plan completed to the satisfaction of FATF.

ANNEX 2: LETTER OF DEVELOPMENT POLICY

بسم الله الرحمن الرحيم

Republic of Iraq

Ministry of Finance

The Minister

جمهورية العراق

وزارة المالية

الوزير

December 1, 2015

Mr. Jim Yong Kim
President of the World Bank Group
World Bank
1818 H Street, N.W.
Washington D.C. 20433
U.S.A.

Ref: Letter of Development Policy

Iraq: EmergencyFiscal Stabilization, Energy Sustainability and State-Owned Enterprise Transparency Development Policy Financing

Dear Mr. Kim,

1. While Iraq's recent history has been painfully marred by security, economic and human development challenges, today Iraq finds itself at a particularly critical juncture and facing two exogenous shocks. We are battling an existential fight against the so-called Islamic State group (Daesh) and grappling with a potential economic and social crisis as a result of the sharp downturn in the price of oil affecting our main export and source of revenues. Yet, for the sake of our country and its unity, we are determined to overcome these formidable challenges through strategic vision, security-focus, and the implementation of necessary reforms with the support of bilateral and multilateral partners.

Background

2. The incursion of Daesh into Iraq has been brutal including on the humanitarian and economic fronts. We have launched a concerted and ongoing military campaign against Daesh. This campaign has already produced important victories, as shown by regaining the control of large cities such as Tikrit, Dyala, and Baiji, and we are currently working on reinstating the presence of the State in these areas (we are doing so in partnership with the World Bank through theUS$350 million Emergency Operation for Development).Despite these gains, large parts of Iraq's territory still remain under Daesh control. In addition to the lives lost as a result of terrorist activity, we are witnessing the unfolding of a humanitarian crisis: over 3 million Iraqi citizens are internally displaced and 245,000 Syrian refugees that have fled the conflict in their country are placing a large burden on our already stressed public services. The conflict is also leading to large destruction in physical assets.

3. The oil economy, the main driver of our economy, has also been severely hit by the sharp reduction in oil prices since 2014. While we have been able to mitigate this shock by increasing the supply of exported oil (with oil production in 2015 forecast to increase to 3.4 million barrels per day (mbpd) from 3.1 mbpd in 2014), the economy, public finances, external balance and oil wealth have been negatively impacted by this second shock.

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4. As a result, advances we had made in some development indicators have reversed and poverty has been increasing. As estimated by the World Bank, employment has been drastically cut, by 800,000 jobs. The shocks have also pushed an additional 2.8 million Iraqis into poverty.Beyond the human suffering and tragedy, IDPs are under particularly difficult economic circumstances; about 500,000 of them are poor and the poverty rate among IDPs is a staggering 40 percent, almost twice Iraq's national average. For the population as a whole, the twin shocks have, in a very short period of time, resulted in a sharp reduction in our GDP per capita, from about $7,000 in 2013 to about $5,000 in 2015.

Macroeconomic, external and fiscal sectors, current and outlook

5. The economy, public finances and the external sector have been severely affected by the two exogenous shocks facing Iraq. The economy rebounded sharply after the global recession, and was able to grow in real terms by double digit rates over 2012 and 2013. By contrast, in 2014 the economy contracted by 2.2 percent. The persistence of the shocks continue to weigh heavily on 2015, with growth projected to reach 1.5 percent. These numbers mask an even more dire economic and social situation. Given the non-diversified nature of our economy, oil-sector growth—which has a relatively low labor intensity—provided the impetus for the tepid economic activity we are observing. The non-oil economy is, however, facing a brutal recession with a collapse in growth from an expansion of 10.2 percent in 2013 to a contraction of7 percent in 2014 and a further contraction of 6.7 percent projected for 2015. This dire non-oil economic situation has led to the loss of 800,000 jobs mentioned above. Inflation remains restrained reaching 1.6 percent on an end-of-period basis at the end of 2014 and is expected to reach 3.0 percent end-2015, although we are concerned about potentially higher inflation rates in areas within Daesh control.

6. On the external front, the current account balance is forecast to reach a deficit of7 percent of GDP by end 2015 compared to a deficit of 1.3 percent in 2014, when it first turned negative. This deterioration is led by the plunging of oil prices since 2014 which negatively affects revenues from oil exports. The latter are expected to fall by 25 percent in 2015 compared to 2014 when they had already contracted by 7 percent compared to the previous year. With these balance of payment pressures, our gross reserves have been on a downward path since 2013, estimated to reach US$51.1 billion by end-2015. This level of reserves is comfortable to maintain our peg, as recently assessed in the 2015 IMF Article IV consultations published on August 2015.

7. On the fiscal front, the fall in oil prices has abruptly reduced our revenue while the Daesh shock has necessitated an increase in spending thereby pushing our fiscal balance into a large deficit. Our initial budget envisaged a high fiscal deficit which, given our limited sources of financing and instruments available would have been very challenging to finance. Cognizant of this, we revised the 2015 budget law by introducing new revenue and expenditure measures worth ID 13 trillion. Unfortunately, passage of our revenue measures was not approved by Parliament. As a result, most of the brunt of the adjustment is falling on the expenditure side, and in particular on investment spending which is one of the few large discretionary items in the budget. We are also taking measures to ensure that the country can boost its oil exports, so as to limit the impact of the subdued international oil prices on our budgetary revenues. Thanks to these steps, our fiscal deficit for 2015 is projected to be contained to 14.5 percent of GDPaccording to the IMF and the World Bank. As a result, our public debt-to-GDP ratio is forecast to reach 61.7 percent by end-2015 up from 38.9 percent at end-2014. We are mindful of this sharp increase and we are committed to sound and improved debt management to manage the debt and to fiscal consolidation to narrow the deficit.

8. The large widening of the deficit coupled with our limited sources of financing have made it difficult to finance the deficit in 2015. We have sought to diversify the sources of funding to close our remaining financing needs. Yet, given our underdeveloped domestic debt market and no previous tapping of international bond markets, we are resorting to Treasury Bill issuances and borrowing from state-owned banks, the Central Bank of Iraq (CBI), and multilateral partners. As these sources were not sufficient to meet our financing needs, we have been forced to delay the payment of some of our domestic expenditure. We do not, however, have payment arrears with the international oil companies operating in Iraq so as to avoid jeopardizing any crucial investments and operations on their part.

9. In 2015,our external arrears were primarily towards international oil companies, and these arrears have been substantially paid. In 2016, we will not resort to the accumulation of new arrears.We have committed to pay US$12 billion in 2016 to international oil companies.With regards to domestic arrears,at end-April 2015, the government identified ID7.3 trillion in domestic arrears, out of which ID 5 trillion accumulated in 2015. We envisage the payment of ID 2.4 trillion of domestic arrears in 2016. As an IMF SMP structural benchmark, we have agreed to undertake a survey to assess the extent of the arrears accumulated. As a first step, the Ministry of Planning will complete, by end-February 2016, a survey of domestic arrears on investment spending accumulated by all ministries, and the Ministry of Finance will complete a survey on current spending accumulated by the same units. On the basis of these surveys, we will prepare a plan for the orderly payment of these arrears, which will include an independent audit of these arrears and a repayment schedule in line with our financing capacity.

10. Despite challenges and a continued low oil price which we conservatively set at US$45/barrel for our 2016 draft budget, we expect some improvement over the next year although the situation remains challenging. With increased oil production projected at4.2mbpd in 2016, we expect overall growth to pick up with a return to positive/flat growth in the non-oil economy on the back of a projected improvement in the security situation. With higher oil exports, we envisage an improved trade and current account balances in 2016. Given fiscal consolidation efforts, we expect the fiscal deficit to narrow by 3.6 percent of GDP in 2016 to reach 10.9 percent of GDP. We also expect that the fiscal deficit will be fully financed through multiple funding sources both domestically and externally from international financial institutions, donors and capital markets.

The Government's reform focus

11. The Government of Iraq is steadfast in pursuing reforms despite challenges and we are committed to implement our 2014-18 Action Plan (*Action Plan* thereafter). The priority of this program is security and stability for all of Iraq, liberating Daesh-controlled areas and reinstating rule and order, a prerequisite for an improved economy and for development. The second priority is to step up the level of public services including provisioning of electricity, water, health, education and ameliorating the social protection system. The August 2015 protests from citizens were a call to speed up our reform efforts. The Government listened to the people's demands and launched a series of reforms in governance in addition to other social and economic reforms towards inclusive growth, improved fiscal management, augmented electricity provision and enhanced investment environment and movement towards a market economy.

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12. On the fiscal management front, we are eager to improve the efficiency of our current and investment expenditures. We recognize that this will require difficult and socially-sensitive measures. In line with our commitment to fiscal sustainability and sound macroeconomic policies, we commit to implementing such measures as we did in 2007 when eliminating direct budgetary fuel subsidies.

    a. At an estimated 17.1 percent of GDP, our wage bill, the largest expenditure item, is high compared to international standards and still growing. With a comparatively high salaries for top public sector employees (when compared to similarly educated private sector workers), large bonuses and allowances, non-transparent recruiting into the public sector, and weak payrolls and disbursement process, there is much scope to improve auditing, efficiency, and fairness. As such, the Government has prepared and endorsed a new salary scale for state and public sector employees. This new scale reduces the nominal salary of top public sector employees while also, for fairness and social cohesion in the public sector, increases the nominal wage of lower grade public sector employees.

    b. The rationalization and prioritization of investment projects is urgently needed. Our investment projects currently suffer from a number of structural inefficiencies, low execution and low utilization rates. Improvement is needed not only to prioritize and effectively and efficiently implement the limited investment spending that is feasible for 2016, but also to be able, over the medium term to afford to undertake the large investment projects required for rebuilding the country. To address this, the Prime Minister has issued a decree to adopt a Public Investment Management (PIM) Framework. This framework covers the public investment cycle from project feasibility to post evaluation phases of a project, including preparation of a Cost-Benefit analysis for capital projects. To further support the implementation of the framework, the Ministry of Planning will set up and host the Central PIM Unit which is expected to be operational by end-2016 to oversee project appraisal and monitoring. Additionally, by the end of the following year, we aim to make a specialized monitoring and ex-post evaluation team within this unit.

    c. With a debt-to-GDP ratio that has almost doubled in the last two years and is forecast to reach 69 percent by end-2016, embarking on improvements in our debt management is key. As such, I have established a Debt Management Section within the Ministry of Finance to improve our capacity to record and report on the debt in line with international best practice, improve management of the debt, prepare medium-term debt strategies, coordinate with the Central Bank of Iraq on issues of debt management and develop the legal framework to introduce new instruments in line with diversifying our funding sources. Building capacity in this unit will also be crucial to explore new financing instruments, develop our nascent domestic debt market and improve our access to international capital markets having learned from our recent unfruitful Eurobond issue attempt. We have already secured the assistance of JICA for the purpose of building capacity in this unit. By end-2016, we aim to adopt a medium-term debt strategy which will support increasing the average debt maturity of domestic public debt from the current short average duration of 0.6 years—which exposes public finances to large debt rollover risks—to an average duration of 1 year by end-2016. We shall also undertake and publish the results of a DEMPA by this time. This will provide us with a comprehensive and candid assessment of our public debt management, assessed against international best practices.

d. At about 4 percent of GDP, our pension spending is high compared to international standards. It is fragmented, suffers from coverage gaps and is unsustainable. In line with efforts to reform pensions, the National Board of Pension is removing at least 30,000 non-eligible retirees from the data registry—these represent about 10 percent of the Fund's current beneficiaries—leading to a reduced budget of the National Pension Board in 2016. Additionally, we aim to continue medium-term reforms on this front with planned amendments to the pension law by end-2016, through unification of the State and private sector pension systems into the same national scheme the following year and through more comprehensive coverage of active workers.

13. On the energy supply front, we are striving to improve the sustainability of supply particularly given that this is a priority concern for our citizens and in line with the fourth strategic priority of our *Action Plan*. To reduce our chronic 6-7 GW electricity shortage which generates a significant cost to our economy, we need to make better use of domestic gas, which is our least cost option, and reduce our dependency on more expensive crude and heavy fuel oil and imported diesel. Despite being one of the world's most gas-rich countries in terms of proven reserves, inefficiencies mean that almost 60 percent of our associated gas is flared in-field rendering Iraq the fourth largest gas flaring country in the world. This generates large economic and fiscal costs which can be reversed, through capturing flared gas, ensuring it is transmitted to markets, and promoting the efficient use of domestic gas, for instance by introducing combined-cycle power plants (CCGT)) and supporting industries that depend on gas feedstock and gas fuel.

a. In line with our 2013 Integrated National Strategy of Energy, the Ministry of Oil has committed to reducing gas flaring to zero by 2030. The projected reduction is expected to result in the capture of US$2.1 billion worth of associated gas by end-2016. Absent this measure, our otherwise planned increase in oil production would result in even larger quantities of flared gas. With this commitment, the expected increase in supply from capturing, processing and the transportation of the natural gas produced, would provide a long term fuel supply for the additional generation capacity required to meet the growing electricity demand in Iraq, resulting in economic and social benefits and the reduction of air pollution and CO_2 emissions. As an important first step, we have committed to increase the processing of flared gas, and we are committed to pay $236 million in arrears to the Basra Gas Company by end-January 2016, which will enable us to significantly increase gas available to the power grid within one year. By end-2016, we are also planning to adopt and begin implementation of a Gas Pricing Policy, which will increase the value of flared gas. The following year we also aim to implement a fuel pricing plan for the reduction in fuel subsidies to domestic, industrial, commercial and retail consumers.

b. Today, about 80 percent of the fuel used in power generation consists of fuels that are heavy and costlier than natural gas, and that degrade power generation equipment faster. In order to shift power generation to natural gas, and reduce the fiscal burden of the power sector, the Council of Ministers set up an inter-ministerial committee to develop a five-year "Gas to Power Action Plan." This will address such issues as the sequencing of conversion of power plants to Combined Cycle Gas Turbines (CCGT) and the sequencing of construction of gas and electricity transmission. We expect to launch the plan's implementation by end-2016 and evaluate and update it in line with achieving its targets by end-2017. These measures, coupled with our plan to reduce the share of gas flared, are intended to enhance the share of natural gas in the power sector ultimately resulting in large fiscal and balance of payment savings.

c. One of the impediments in attracting much needed investments in the power sector has been low electricity tariffs that have been frozen at below cost recovery levels since the 1990s. This has put pressure on Government funding when coupled with technical losses in transmission and distribution and weak billing and collection. To reduce this fiscal burden and improve service delivery, we realize the need to rationalize the tariff structure. As such, we have approved the implementation of a new (unsubsidized) commercial tariff for large commercial consumers (except for hospitals) who would like a continuous supply of electricity via contracts with the Ministry of Electricity. This scheme targets commercial users, and does not impact households. We are aware that Iraqis rely on private diesel generators to complement power supply available from the grid, and they pay significantly higher prices forthis. . We are planning a phased approach towards cost recovery in power generation and fiscal savings though progressive electricity tariff adjustments, which will be implemented while we are improving the quantity of power available in the grid. However, we are mindful of the impact this could have on vulnerable parts of our population and we are working to ensure that the planned tariff increases are mitigated for these citizens. By the end of 2016 we aim to approve such tariff adjustments and by the end of the following year, we aim to implement the plan in line with a progressive electricity tariff recovery plan that will carefully consider affordability for consumers.

14. In line with efforts to improve governance, we are committed to improving the transparency of State-Owned Enterprises (SOEs). At the moment, SOEs are largely weakly accountable, overstaffed, generating fiscal costs and posing a liability for the Government. Given poor reporting from the 176 non-financial SOEs, it is challenging to quantify these potential liabilities. Addressing enhanced transparency of these SOEs would also contribute towards transitioning our economy to a market-based economy that supports private sector development and is able to generate the jobs needed for our population, both in quantity and in quality. This is consistent with the third and fifth strategic priorities of our *Action Plan* calling for a shift towards the private sector and implementing administrative and financial reform of Government institutions.

a. In order to better inform decisions in monitoring and managing the large number of SOEs, support enhanced accountability, and mitigate the fiscal risks they pose, we are undertaking measures to improve the information collected on SOEs in a central repository. To this end, the Prime Minister has issued a decree stipulating the establishment of a committee to establish, operate and supervise a database to monitor the fiscal risks of non-financial SOEs. The committee has also been tasked with updating and publishing the financial and employment data of these SOEs, in a first stage, on an annual basis on the Council of Ministers website. We aim for this information to be available for 75 percent of SOEs (outside of Daesh-controlled areas and the KRG) by end-2016. By the end of 2017, we expect that SOE coverage will be complete for all SOEs (outside of Daesh-controlled areas).

b. Also in line with enhanced transparency and stimulating the private sector towards financial intermediation, we are implementing actions that support the development of private banks which currently account for only 11 percent of the banking system's deposits. Given the dominance of our seven state-owned banks, and the Financial Action Task Force's (FATF) assessment of Iraq as being noncompliant or partially compliant with core recommendations, we have adopted two measures to level the playing field between state-owned and private banks by allowing for a wider range of financial services that private banks may provide to Government ministries and SOEs as stipulated by a Council of Ministers decision. We are also removing the risk of Iraq being blacklisted by FATF, which would be detrimental to the Iraqi economy. This was done through the passage of the Combatting of Money Laundering and the Financing of Terrorism Law, No 39 in 2015. These reforms are part of a medium-term plan to strengthen the banking sector's resiliency. Under this plan the CBI is planning to issue further regulations in line with FATF recommendations by end-2016. We are committed to prepare terms of reference for an audit of the Rasheed and Al-Rafidain's balance sheets by a reputable audit firm, contract the audit, and complete and publish the audit by the end of 2016. We plan to prepare these terms of reference along international standards and to reach agreement with the IMF and the World Bank on the terms of reference by end-February 2016. Based on the results of the audit, weare committed to formulate and start implementation of a restructuring plan for these two state banks in 2017. Also on the AML/CFT front, we expect a Financial Intelligence Unit at the CBI to be fully operational by end-2017.

Partnership with international partners including the World Bank

15. The Government of Iraq is working hand in hand with international partners to garner financial support and technical assistance to implement the reforms to which we have committed. Following the Rapid Financing Instrument (RFI) and subsequently approved Staff-Monitored Program (SMP) with the IMF on November 10, 2015, we expect negotiations on a Stand-By Arrangement (SBA) to start around July to September 2016. In spite of the challenging times the country is facing, the agreed fully-financed SMP requires a firm and resolute implementation of policies but the proposed adjustment is realistic and we are committed to diligently implementing it and successfully demonstrating a good performance track record on the SMP. We are looking at the Fund SBA, the proposed World Bank Development Policy Financing (the DPF) and JICA budget support to be catalytic in sending a strong signal to international financial markets that Iraq is undertaking strong short-term and structural reforms with international partners. We expect this signal to enable us to access such markets on financial terms and conditions that are acceptable for the Republic of Iraq. We have also engaged into a comprehensive medium-term technical assistance program with partner countries and institutions. In particular, we have a program with JICA on public debt management (as mentioned), another one with the Energy Sector Management Assistance Program (ESMAP)on the reduction of electricity subsidies,a third one on improving the transparency of financial SOEs and banking sector reformswhichis supported by the World Bank and financed by Japan. We also have other envisaged technical assistance support by other international partners such as DFID and USAID that are in the process of being finalized in the areas of public financial management, pension reform, reduction of gas flaring, expanding gas use to power generation and improving the transparency of non-financial SOEs.

16. The World Bank is a trusted partner in this quest. We value the partnership and support from the Bank when Iraq was hit by a similar oil price crash-induced fiscal shock in 2009—but at that time without the security shock that Daesh is currently presenting. At that time we embarked on a Development Policy Loan to mitigate the impact of this shock and support Iraq's medium-term reform program. Most recently, the Bank's Board approved the US$350 million Emergency Operation for Development in July 2015 for rapid assistance to

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resume basic services in areas reclaimed from Daesh, including in improving damaged electricity transmission and distribution networks. In addition to these lending operations, we continue to appreciate advisory support from the Bank on a range of development areas including PIM, pension reform, tariff reforms, pricing of natural gas flared, and short-term actions to reduce power cuts.

17. The Government of Iraq expresses its full commitment to the implementation of the reform plan outlined above. To this end, we seize the opportunity to request continuing support from the World Bank for its implementation through the proposed DPF. The proposed DPF is aligned with the Government's priorities and is a welcome and important element of our strategy towards the successful achievement of specific reform actions and financing support. Particularly, the DPF will support us to improve our budgetary spending through reforms in the wage bill, PIM, public debt management and pensions. It will also support another objective to develop the sustainability of energy supply through reduced gas flaring, the expanded gas use to power generation and reduced electricity subsidies. And finally, the operation will sustain enhanced transparency of state-owned enterprises in line with our goal to improve governance, through reforms in SOEs, both financial and non-financial, and banking sector reforms.

18. In closing, we appreciate the World Bank's support of Iraq's reform agenda over the past critical years across lending and advisory roles. The Government of Iraq requests the approval of the World Bank support of our most recent program as outlined above during these utmost challenging times.

Yours sincerely,

Hoshyar Zebari

Minister of Finance

ANNEX 3: POLICY RECOMMENDATIONS OF THE 2014 IRAQ PUBLIC EXPENDITURE REVIEW

107. **Iraq's 2014 Public Expenditure Review (PER) provided an integrated perspective on how the country needs to provide better public service delivery while maintaining macroeconomic stability and fiscal discipline**. These goals exist amid a challenging context of revenue volatility, the need to diversify the economy, weak accountability mechanisms, and residual conflict. Reflecting these challenges, key socioeconomic developmental indicators are stalled. Public spending has not been matched by absorptive capacity, let alone improved outcomes. The difficult task of encouraging fiscal institutions to embed practices of good economic management remains a work in progress.

108. **An overarching message of the PER is that fiscal institutions are ill-equipped to deal with the complexities of an oil-dominated budget**. Fiscal aggregates are characterized by pronounced volatility because of the absence of smoothing mechanisms. Iraq also faces several challenges that arise from this situation in the form of "resource curse," "Dutch disease," and tensions over who controls these resources. Economic policies are needed to address social and economic development issues and to avoid a resource curse. Economic diversification is imperative for the goals of creating jobs and promoting income-generating opportunities for the Iraqi population. The PER identified the following key challenges: to remove constraints to non-oil economic activities; to ensure the efficient use of oil revenue; and to restrain the growth of current spending to free up resources for public investment, while maintaining essential safety nets and social support for the poor.

109. **Iraq is facing a number of fundamental challenges related to the level and distribution of its public spending**. The state has been allowed to grow to a size that is unusually large by any standard, yet access to even basic services is deficient. If successfully executed, reforms in areas such as subsidies and safety nets, employment in SOEs, and size and composition of the civil service will increase public spending efficiency. Amidst fiscal and security issues, the Government should lay the foundations of a broadly diversified economy, with a reasonable footprint that provides decent public services and security while facilitating adequate economic freedom. Ensuring that resources are used judiciously and for the benefit of the people is critical.

110. **The PER provided a number of recommendations to reach fiscal discipline for effective service delivery**. To manage oil revenues better, it suggested to create a sovereign "parking fund" and a fiscal stabilization fund to minimize the impact of oil revenue volatility on expenditure policy. Oil revenues could be housed under these funds until spending efficiency improves, but withdrawals would be guided by a medium-term macro-fiscal policy framework, designed to provide support for a sustainable economic growth. The PER also discussed achieving greater fiscal consolidation and reorienting spending to capital investment, particularly through better control of the wage bill and reform of social benefits and subsidies. Increasing the productivity and efficiency of capital expenditure was one of the focus topics of the PER.

111. **The PER further advised that the strategic orientation and alignment of public expenditure should be improved by strengthening medium-term planning and fiscal**

framework. Linking macro-fiscal policies to actual resource allocation decision making is critical. The PER discussed strategic planning and budget execution issues, in order to have the greatest impact consistent with good and well-articulated Government policy. It highlighted the need align national development planning and the poverty reduction strategy, to help decide resource allocation, and also highlighted the importance of fiscal rules that bring the discipline required for medium-term policies to be followed. The authorities will need to create mechanisms to break the vicious circle of lack of accountability, the root cause of wasteful spending and weak institutions. This is the toughest challenge for the authorities, but there is much that Iraq can learn from other resource-rich countries that have been successful in avoiding a resource curse.