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INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

PROGRAM DOCUMENT FOR A PROPOSED LOAN

IN THE PROPOSED AMOUNT OF US$1,443.82 MILLION

TO

THE REPUBLIC OF IRAQ

FOR THE SECOND EXPENDITURE RATIONALIZATION, ENERGY EFFICIENCY AND STATE-OWNED ENTERPRISE GOVERNANCE
PROGRAMMATIC DEVELOPMENT POLICY FINANCING

December 1, 2016

Global Practice for Macroeconomics and Fiscal Management (GMFDR)
Middle East and North Africa Region

REPUBLIC OF IRAQ

GOVERNMENT FISCAL YEAR

January 1 – December 31

CURRENCY EQUIVALENTS

(Exchange Rate Effective as of December 1, 2016)

Currency Unit = Iraqi Dinar (ID)
US$1 = ID1,182
ID1 = US$0.000864

ABBREVIATIONS AND ACRONYMS

BCM	Billion Cubic Meters
BSCFD	Billion Standard Cubic Feet per Day
CBI	Central Bank of Iraq
CCGT	Combined-Cycle Gas Turbine
CEM	Country Economic Memorandum
CPA	Coalition Provisional Authority
CPS	Country Partnership Strategy
DEMPA	Debt Management Performance Assessment
DFI	Development Fund for Iraq
DPF	Development Policy Financing
DPL	Development Policy Lending
EIA	Environmental Impact Assessment
ESMAP	Energy Sector Management Assistance Program
ESMP	Environmental and Social Management Plan
FATF	Financial Action Task Force
FBSA	Federal Board of Supreme Audit
FDI	Foreign Direct Investment
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
IDMS	Iraqi Development Management System
IDP	Internally Displaced Person
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
JICA	Japan International Cooperation Agency
KRG	Kurdistan Regional Government
KWh	Kilowatt-hour
LDP	Letter of Development Policy
LFO	Light Fuel Oil
LPG	Liquefied Petroleum Gas

MIM	Ministry of Industry and Minerals
MMSCF	Millions of Standard Cubic Feet
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
NHPB	Non-hydrocarbon Primary Balance
OPEC	Organization of the Petroleum Exporting Countries
PDO	Program Development Objective
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 (IMF)
SBA	Stand-By Arrangement (IMF)
SCGT	Simple-Cycle Gas Turbine
SDR	Special Drawing Rights
SPF	State Pension Fund
SSN	Social Safety Net
SOE	State-Owned Enterprise

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REPUBLIC OF IRAQ

THE SECOND EXPENDITURE RATIONALIZATION, ENERGY EFFICIENCY AND STATE-OWNED ENTERPRISE GOVERNANCE
PROGRAMMATIC DEVELOPMENT POLICY FINANCING

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SUMMARY OF PROPOSED LOAN AND PROGRAM

Borrower	Republic of Iraq
Implementing Agency	Ministry of Finance
Financing Data	IBRD Loan Amount : US$1.443.82 million; Terms: IBRD variable spread loan, 18 years final maturity, including 5 years of grace period, commitment linked and level repayment profile. All conversion options remain available.
Operation Type	First single tranche operation of a programmatic series of two DPFs.
Pillars of the Operation and PDOs	The proposed operation aims to achieve economic stabilization and lay the ground for structural reforms around three pillars, which form the operation's Program Development Objectives (PDOs): Improve (1) expenditure rationalization; (2) energy efficiency; and (3) the transparency and governance of state-owned enterprises.
Result Indicators	• Strengthened payroll expenditure control as measured by the percentage of verified central government civil servants whose compensation and daily attendance is tracked electronically (minimum of the two variables). Baseline (2015): 0% ; Target (2018): > 30%. • Improved selection and assessment of public investment projects as measured by the percentage of capital projects that exceed ID100,000 billion (about US$85 million) for which a feasibility study with cost-benefit analysis was conducted. Baseline (2013): 5% ; Target (2018): above 20%. • Share of the domestic debt in total public debt. Baseline (2015): 34.3% ; Target (2018): at least 35%. • Improved social insurance efficiency, coverage, and sustainability as measured by the expected actuarial deficit period (years until going into deficit from 2015). Baseline (2015): 13 years ; Target (2018): above 28 years. • Improved social safety net efficiency as measured by: (1) coverage ratio of the poor; and (2) inclusion error. Baseline (2015): (1) 11%, (2) 43% ; Target (2018): (1) at least 50%, (2) at 20% or below. • Reduction in gas flared as measured by (1) the expansion in Iraq's gas processing capacity (in MMscfd); and (2) the amount of locally produced gas-to-power allocation. Baseline (2015): (1) 671; (2) 570.9; Target (2018): (1) 1,300 or above; (2) 1,200 or above. • Improve electricity generation efficiency, cost, and environmental impact through increased share of gas used in the power generation mix. Baseline (2015): 42%; Target (2018): 70% or above. • Reduced electricity subsidies, as measured by improved revenue collection as a percentage of generation. Baseline (2015): 30%; Target (2018): above 50%. • Improved non-financial SOEs transparency and governance as measured by the ISAR Benchmark of Corporate Governance Disclosures to measure corporate governance disclosure changes at a regulatory level as well as the disclosure of key financial information at a company level. Baseline (2015): 0%; Target (2018): above 15%. • Reduction of state-owned banks' exposure to non-financial SOEs, as measured by the share of state-owned banks' outstanding stock of lending to non-financial SOEs in their total lending. Baseline and target to be determined following completion of the audit of Rasheed and Rafidain banks.
Overall risk rating	High
Climate and Disaster Risks	(i) Are there short and long-term climate and disaster risks relevant to the operation (as identified as part of the SORT environmental and social risk rating)? Yes ☐ No ☒ If yes, (ii) summarize briefly these risks in the risk section and what resilience measures may help address them?

Operation ID	P161167

PROGRAM DOCUMENT FOR A PROPOSED LOAN TO THE REPUBLIC OF IRAQ

1. INTRODUCTION AND COUNTRY CONTEXT

1. **This Program Document proposes a Second Expenditure Rationalization, Energy Efficiency, and State-Owned Enterprise (SOE) Governance Development Policy Financing for the Republic of Iraq, in the amount of US$1,443.82 million to be disbursed in a single tranche. This operation comes at a time of unprecedented stress for Iraq. The country is facing the dual shock of a fiscally, socially, and politically costly brutal war waged by the Islamic State of Iraq and Syria (ISIS), and the sharp fall of the price of oil.** This operation is part of the international community's support to government's effort to bring peace and stability to Iraq through the provision of timely and large external financing, and the support to measured structural reforms. It comes at a time when the country is undergoing a large fiscal shock that could lead to a much deeper economic and social crisis that would disproportionately hurt the poor and further delay the reconstruction of Iraq. The proposed operation is the first in a programmatic DPF series of two operations that builds on the structural reforms initiated as part of the US$1.2 billion development policy operation approved in December 2015.[1] Building on that operation, this DPF series aims to help safeguard economic stability and lay the foundations for longer-term structural reforms that would support private sector development and inclusive growth. The operation is aligned with the government objectives of, and mounting demand of citizens for, improving governance, transparency, and reducing corruption through increased expenditure rationalization. These reforms aim to provide the necessary enabling environment for subsequent reforms that would support private sector development and inclusive growth. These reform efforts are deployed in parallel to the internationally supported war effort in what is to be construed as a quasi-unique case of the international community rallying around a country engaged in a transformational economic reform program, all the while waging a war against a deeply disruptive force threatening the whole Middle East region and beyond.

2. **Since mid-2014, Iraq has been facing the war waged by ISIS, which has increased violence and destroyed infrastructure.** Expanding from Syria, ISIS initially made rapid inroads into Iraq starting in June 2014. The group quickly seized control of nearly one third of Iraq's territory including major cities. During 2015 and 2016, the federal government and the *Peshmerga* military forces of the Kurdistan Region of Iraq (KRI) were able to regain key parts of the country. The federal government is presently engaged in a battle to liberate Mosul, the last large ISIS-controlled city in Iraq. Critically, ISIS has not been able to directly and materially impact Iraq's oil production, which is predominantly located in the southern part of Iraq (around Basra), and, to a lesser extent, in the northern part (the Kurdistan region).[2]

3. **The ISIS war has created a humanitarian crisis, put pressure on fiscal spending, and plunged the non-oil economy into a deep recession**. The combination of 3.4 million Iraqis internally displaced

[1] For details, see "Republic of Iraq: Emergency Fiscal Stabilization, Energy Sustainability, and State-Owned Enterprise Transparency Development Policy Financing", World Bank, December 17, 2015.

[2] For details on the strong performance of oil production in spite of the ISIS war, 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.

and the arrival of 245,000 Syrian refugees has put enormous pressure on an already weak public service delivery system. The United Nations estimates that 10 million people are in need of assistance. Fighting ISIS has been expensive. Security-related budgetary expenditure (military and police equipment and salaries) is expected to reach US$14.8 billion in 2016[3] (8 percent of GDP, which accounts for 18.3 percent of 2016 total government spending and two-thirds of the 2016 fiscal deficit). Moreover, the conflict has been a key driver of the severe negative hit on the non-oil economy, which has contracted cumulatively by 29.5 percent in 2014-16. ISIS-controlled areas have particularly suffered as productive assets and infrastructure have been destroyed, trade routes have been cut off or severely curtailed, and investor and consumer confidence has dwindled.

4. **Compounding the country's fragility is the sharp and sustained drop in oil prices that has severely impacted 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 in 2015 and 2016, the country is now the world's third largest and OPEC's second largest oil exporter. With 112 trillion cubic feet of proven reserves, Iraq's proven and largely untapped natural gas reserves are the twelfth 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 to between one third and one half of their June 2014 level, has resulted in a sharp and large deterioration of the country's public finances and external balance. With oil prices expected to remain persistently low to moderate, the government and the economy will need to gradually adjust to a new level of permanently lower oil revenue. This requires reforms that materially and sustainably improve the structural fiscal balance—an endeavor this DPL series is supporting.

5. **The ISIS war and the oil price shock have exacerbated existing vulnerabilities and structural weaknesses that have decreased productivity, prevented inclusive development, and undermined State legitimacy.** The country is persistently ranked around or below the tenth percentile globally based on indicators of government effectiveness, rule of law, and control of corruption. Mass demonstrations against corruption and weak public service delivery that started in August 2015 and in early 2016 saw demonstrators enter Parliament inside the Green Zone in Baghdad; these underscore the urgency of delivering on those reforms, a task that is complicated by an ongoing political crisis. Recent attempts by the Prime Minister to reshuffle his cabinet by appointing technocrats were blocked by Parliament, which, through a series of no-confidence votes, forced out key ministers.[4] The persistent challenges to carry out critical reforms are threatening the very foundation of the Iraqi State, as fragmentation across different groups and regions grows. Furthermore, the formal economy is dominated by a large number of inefficient state-owned enterprises (SOEs), which have dragged productivity down. Many of these have limited economic rationale and *de facto* function as large off-budget employment programs, the financing of which is complex and non-transparent but raises significant fiscal risks. The presence of SOEs (with privileged access, including to finance and government contracts) in many key economic sectors also crowds out private firms and impedes factors' reallocation, ultimately curbing private sector job creation. Productivity of Iraq's firms is generally lower than that of firms in other countries in the region. The limited growth of the private sector has not generated significant employment opportunities, especially for young Iraqis.

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[3] IMF SBA staff report, (Forthcoming) December 2016.

[4] At end-September 2016, the Ministers of Defense, Interior, and Finance were dismissed and not yet replaced.

6. **Decades of irrational management, international sanctions, internal conflict, and, most recently, the ISIS invasion of large swaths of the Iraqi territory, have challenged the authority and presence of the State and its credibility. They have undermined the provision of basic services to the Iraqi population and have worsened social indicators, especially for women.** Iraq has been in a continuous state of conflict and fragility since the early 1980s.[5] In 2012, one 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, vulnerable to increases in prices and loss of assets and livelihoods. Poverty was accompanied by deprivation in other aspects of Iraqis' lives too.[6] Jobs were not providing a pathway out of poverty. Overall, 70 percent of the poor are in households with employed heads. Gross enrollment rates are much lower for girls than for boys and illiteracy among adult women, at 24 percent, is more than double that among Iraqi men. Low educational attainment among women is correlated with a lack of awareness of health issues and difficulties in accessing professional medical care, particularly low labor force participation, the lowest in the region, and high unemployment, and an increased likelihood of early marriage – setting in motion a vicious cycle of exclusion and lack of opportunity. 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,[7] despite some progress in developing transfer programs. Other safety net programs are not poverty targeted and cover a small share of the poor.[8] After coming to power in September 2014, the Abadi government immediately engaged in the war effort to militarily retake the areas under ISIS control including the cities of Tikrit, Falluja, Baiji, and Sinjar, to re-establish the credibility of the State by starting to address people's grievances and calls for the provision of basic services. 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.

7. **The social cost of the crisis runs deep.** Poverty increased sharply in 2014 nationwide, from 12.9 before the crisis to 22.5 percent after the crisis, but with wide variations across regions. The KRI experienced a quadrupling of poverty rates to 12.5 percent, due to the large influx of IDPs. In the ISIS-affected governorates, the poverty rate is estimated to have doubled to 41.2 percent. In the South, where poverty rates have always been high, poverty rates increased to above 30 percent. The ISIS war destroyed physical assets and disrupted economic activity further limiting opportunities for a sustainable livelihood. The government had to sharply reduce some non-security related expenditures to prioritize the war against ISIS amid a sharp drop in (oil) revenues, further reducing the government capacity to deliver services and cater to the needs of the growing numbers of internally displaced persons (IDPs). Women have been particularly affected by increased insecurity, which imposed

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5 See World Bank. "Republic of Iraq: A Systematic Country Diagnostic" (December 2016).

6 About half of Iraq's population has less than primary level education; almost a third of children under five suffer 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 affected mortality rates—See "The Unfulfilled Promise of Oil and Growth Poverty, Inclusion and Welfare in Iraq 2007–2012", The World Bank, 2014.

7 The PDS is a large government program but its efficiency is 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—World Bank (2013) *Iraq Public Expenditure Review*.

8 See World Bank. "Republic of Iraq: A Systematic Country Diagnostic" (December 2016).

restrictions on movement that affected access to education, health, and jobs. A feature of post-conflict settings with high unemployment and poor overall security is often a high incidence of gender-based violence. Additionally, youth exclusion (due to lack of education, employment, trauma, discrimination, and neglect) coupled with mistrust of government authorities has fostered radicalization and facilitated recruitment by militias and violent groups.

8. **This DPF series aims to support the government's effort to safeguard economic stability and lay the foundations for longer-term structural reforms that would support private sector development and inclusive growth.** This would be achieved through reforms built around three pillars, which are also its Program Development Objectives (PDOs), namely to improve: (1) expenditure rationalization; (2) energy efficiency; and (3) the transparency and governance of SOEs. The PDOs support directly a package of reforms announced by the Prime Minister in August 2015 to combat corruption, eliminate ineffective governance, improve basic services delivery, and support economic reforms. The proposed operation is also aligned with 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* that lays out the six priorities of his 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 toward 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). Overall, these reforms contribute to the World Bank Group's strategic goals of ending extreme poverty and boosting shared prosperity in a sustainable manner.

9. **This operation is a critical part of the World Bank's Middle East and North Africa (MENA) Region strategy to support peace and stability for economic and social inclusion.** The main objective of the MENA strategy is to contribute to peace and stability by addressing the underlying causes of fragility and conflict and renewing a social contract between governments and citizens across the region. In Iraq, the main drivers of instability and conflict have 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.[9] Groups like ISIS have exploited the lack of trust in government and attempted to challenge its very legitimacy. While a military solution is the first step to liberate the country, the challenge ahead will be to establish a new social contract that can allow the country to prosper going forward. The DPF series offers an important contribution in this effort by removing immediate pressures on the economy that could otherwise breed further radicalization through increased youth unemployment and poverty. It also contributes to improving the efficient delivery of services to the people with particular emphasis on the strategic and socially sensitive electricity sector.

10. **Other World Bank-financed operations are also helping address Iraq's sources of conflict and fragility.** These include the 2015 *Emergency Operation for Development Project* (P155732) and the proposed *Modernization of Public Financial Management Systems Project* (P151357). The former is a US$350 million investment operation to support the reconstruction of infrastructure and restoration of public services in municipal areas taken back from ISIS by the government. These are predominantly areas that felt marginalized and provided a fertile ground for ISIS to expand. In its first year, the project supported the repair and reconstruction of damaged power, water, and sanitation networks as well

[9] World Bank. "Republic of Iraq: A Systematic Country Diagnostic." (December 2016)

roads and bridges. It aims to improve healthcare services by supporting mobile hospitals and clinics, medical equipment and ambulances. These activities aim to promote trust between citizens and the State, and generate local jobs, including for youth. The US$41.5 million Modernization of Public Financial Management Systems Project aims, *inter alia*, to strengthen the PFM systems and capacities in two pilot governorates (Baghdad and Babil) in order to enable governorates to shoulder the service delivery responsibilities devolved to them by the federal government. Strengthening local accountability, transparency, and subnational PFM systems is key to strengthening the service delivery performance of the governorates as it renews the social contract between the citizens and the State.

11. **In line with the *2011 World Development Report (WDR)*, the proposed DPF series in Iraq acknowledges the existence of risks that can undermine the reform effort**. Risks are multiple and of varied nature. They include the country's security situation, its economic fragility, the fall in oil prices, the poor management of its public and financial sectors, the fluid and potentially unstable dynamics between the various governorates, the KRG, and the central government, but also between the Parliament and the executive (as the various successful votes of no confidence on the key ministers have shown in 2016). Risks of social unrest could easily reemerge. These risks also have a regional and international dimension at a time of geo-strategic uncertainty around the broader Middle East. While candidly assessing those risks, the World Bank has tried to manage them, through the reading of the country's political economy and the region's strategic dynamics and the design of the DPF series, including the selection, prioritization, and sequencing of supported reforms. As argued in the *2011 WDR* on Conflict, Security, and Development, providing 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"—multisectoral and with the commitment of several partners—will strongly contribute to the achievement of the World Bank Group's twin goals. These risks need to be contrasted with those which could stem from allowing Iraq to slide from in-conflict and fragile, to a failed State, in a volatile and sensitive region, at a crucial time in history.

12. **Engaging in this risky environment should also be weighed against the counterfactual of no World Bank engagement.** Progress toward a more stable Iraq, one that could restart its journey toward a sustainable path to development, and the achievement of the twin goals is likely to be slow and suffer from setbacks. The DPF, while supporting Iraq on this journey, recognizes the risk of not fully achieving its development objectives, but this risk should be assessed against the counterfactual of no World Bank involvement at this time in Iraq through the proposed DPF series. Iraq's macroeconomic, social, and political outlook remain very uncertain. In the absence of budget support, the government will be bound to implement further expenditure reductions, accumulate arrears, or further increase domestic financing and reduce international reserves, with the risk of undermining the macroeconomic stability maintained so far. The fiscal space for the implementation of reforms would also be more limited and would not decrease the vulnerability of Iraq in the event of future shocks.

13. **The proposed programmatic DPF series is part of an international support package to Iraq**. The DPF series will be implemented during a period when Iraq and the IMF have an ongoing three-year Stand-By Arrangement (SBA) in place (see Section 2.3. for details). The Japan International Cooperation Agency (JICA) is also planning to provide parallel financing to the proposed operation. The US intends to guarantee the issuance of a US$1 billion Eurobond by Iraq in early 2017, and Franceintends to provide a US$450 million loan to Iraq in the first half of 2017. The reform measures supported by the U.S. guarantee and the French loan are closely coordinated and aligned with the reforms supported by both the IMF SBA and the proposed DPF series. In 2016, a donor conference was co-hosted by the U.S. government—together with Canada, Germany, Kuwait, the Netherlands, and Japan—with the aim of

securing financial support for Iraq in response to the humanitarian crisis resulting from the ISIS war. Donors pledged a total of US$2.1 billion for 2016-2018. Beyond this financing package, the policy reforms supported by the DPF series are implemented with help from an extensive and multiyear ongoing and/or planned program of technical assistance and projects provided by donors and international financial organizations (see Table 4 for details). This comprehensive and medium-term engagement supports fast, effective, and sustainable implementation of structural reforms, as requested by the authorities.

14. **Guarantees to be provided to IBRD by the United Kingdom and Canada are a critical component of the financing.** The sizing of IBRD's loan in the amount of US$1,443.82 million depends on US$443.82 million in total guarantee coverage expected to be provided to the IBRD as part of the overall international support package for Iraq. The United Kingdom and Canada have each committed in principle to execute a guarantee agreement for the benefit of the IBRD, under which they will each guarantee pro rata portions of the repayment of the loan by Iraq. The guarantee from the United Kingdom will enable a portion of the loan equal to US$371.82 million while the guarantee from Canada will enable a portion of the loan equal to US$72 million.[10] In each case, the guarantor will make payment to IBRD if Iraq fails to make a repayment and such failure continues for at least six months. In the event that a guarantor makes a guarantee payment to the IBRD, then the guarantor will have the right to pursue recovery from Iraq bilaterally. The guarantees are expected to be executed and delivered prior to discussion of the proposed DPF by the IBRD Board of Executive Directors scheduled on December 20, 2016.

2. MACROECONOMIC POLICY FRAMEWORK

2.1 RECENT ECONOMIC DEVELOPMENTS

15. **The ISIS war and the drop in oil prices caused growth to sharply decelerate in 2014-2015**. After strong growth in the four years prior to 2013 (averaging 8 percent), Iraq's economy decelerated to 0.1 percent in 2014 and grew at 2.9 percent in 2015 on the back of an 18.4 percent increase in oil production (this also includes KRG's oil production share). The non-oil economy sharply contracted because of the disruption of trade, destruction of infrastructure, impeded access to fuel and electricity, and low business confidence (Table 1). The security and oil shocks impacted private sector consumption and investments, and limited government spending, particularly for investment projects. Given the sharp deceleration in economic activity and low private sector consumption, inflation was subdued, averaging 1.4 percent in 2015 and is expected to remain at 2 percent in 2016.[11]

16. **Pushed by a strong increase in oil production, growth is expected to reach 10.2 percent in 2016.** Oil production is expected to further increase by 20.4 percent in 2016, reaching an average of 4.5 million barrels per day (mbpd), a level already reached in August 2016. The rebound in overall growth

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[10] The World Bank has received (1) a Letter of Commitment signed by the General Director for International Trade and Finance at the Canadian Department of Finance; and (2) a letter from the U.K. Secretary of State to the World Bank President, in each case committing in principle to provide the above-mentioned guarantees, subject only to final internal approvals by the Cabinet of Canada and parliamentary approval by the United Kingdom, respectively.

[11] Official data do not cover the four conflict-affected provinces, where inflation is reportedly higher due to shortages in fuel and goods.

masks a continued contraction in the non-oil economy, which in 2016 is expected to contract for the third consecutive year following the continued insecurity and fiscal consolidation efforts.

Table 1. Iraq: Key Macroeconomic Indicators, 2013-2019

	2013	2014	2015	2016	2017	2018	2019
				Est.		Proj.	
Economic growth and prices							
Real GDP (percentage change)	7.6	0.1	2.9	10.2	1.1	0.7	1.1
Non-oil real GDP (percentage change)	12.4	-5.1	-13.9	-5.0	3.0	2.0	3.0
GDP deflator (percentage change)	0.0	-2.6	-23.4	-11.5	9.7	6.4	4.7
GDP per capita (US$)	7,021.0	6,672.0	5,127.0	4,818.0	5,200.0	5,434.0	5,608
GDP (in ID trillion)	273.6	266.7	210.2	205.1	227.4	243.8	258.0
Non-oil GDP (in ID trillion)	148.0	142.6	140.3	139.0	149.3	158.8	170.6
GDP (in US$ billion)	234.6	228.7	180.3	173.8	192.4	206.2	218.3
Oil production (mbpd) 1/	3.0	3.1	3.7	4.5	4.5	4.5	4.5
Oil exports (mbpd) 2/	2.4	2.6	3.4	3.8	3.8	3.8	3.8
Iraq oil export prices (US$ pb)	102.9	96.5	45.9	35.5	42.0	45.7	47.0
Consumer price inflation (percentage change; average)	1.9	2.2	1.4	2.0	2.0	2.0	2.0
	(In percent of GDP)						
National Accounts							
Gross domestic investment	26.9	25.9	24.3	17.4	20.2	18.7	18.2
of which: public	17.4	18.4	15.1	8.1	11.2	9.9	9.2
Gross domestic consumption	69.5	69.6	81.7	89.3	86.6	85.0	84.5
Of which: public	21.0	18.5	22.3	25.7	23.5	21.7	20.3
Gross national savings	28.1	28.6	18.2	10.6	13.4	12.5	15.3
Of which: public	11.2	13.1	2.8	-0.1	4.4	4.5	7.7
Saving - Investment balance	1.1	2.7	-6.1	-6.8	-6.8	-6.2	-2.9
	(In percent of GDP, unless otherwise indicated)						
Public Finance							
Government revenue and grants	42.2	39.1	30.2	32.2	34.8	35.1	34.3
Government oil revenue	38.6	36.9	27.4	28.3	30.1	30.6	29.7
Government non-oil revenue	3.5	2.2	2.8	3.9	4.6	4.5	4.6
Expenditure, of which:	48.0	44.9	42.5	40.4	41.8	40.5	36.0
Current expenditure	30.6	26.1	27.4	32.3	30.6	30.6	26.8
Capital expenditure	17.4	18.4	15.1	8.1	11.2	9.9	9.2
Overall fiscal balance (including grants)	-5.8	-5.4	-12.3	-8.2	-7.0	-5.3	-1.7
Non-oil primary fiscal balance (percent of non-oil GDP)	-67.6	-58.6	-45.0	-43.1	-45.4	-41.2	-37.6
Memorandum items:							
Total government debt (in percent of GDP) 3/	31.2	32.6	54.9	61.3	61.9	63.1	61.3
Total government debt (in US$ billion) 3/	73.1	74.6	97.8	106.6	119.1	130.1	133.9
External government debt (in percent of GDP)	25.3	25.2	36.7	37.8	38.2	40.3	38.7
External government debt (in US$ billion)	59.3	57.6	66.1	65.7	73.5	83.2	84.5
	(In percent, unless otherwise indicated)						
Monetary indicators							
Growth in reserve money	12.6	-9.6	-12.6	2.2	-0.2	7.2	6.8
Growth in broad money	15.9	3.6	-9.0	5.1	4.9	7.2	7.5
Policy interest rate (end of period)	6.0	6.0	6.0	…	…	…	…
	(In percent of GDP, unless otherwise indicated)						
External sector							
Current account	1.1	2.7	-6.1	-6.8	-6.8	-6.2	-2.9
Trade balance	9.9	11.2	-0.1	-0.8	-0.4	1.8	2.4
Exports of goods	38.3	40.6	31.3	28.3	30.1	30.5	29.7
Imports of goods	-28.4	-29.4	-31.5	-29.0	-30.5	-28.8	-27.3
Overall external balance	-1.3	-10.3	-7.1	-3.5	-2.3	-3.3	-0.3
Gross reserves (in US$ billion)	77.8	66.7	53.7	43.0	38.5	38.1	37.3
In months of imports of goods and services	10.8	10.9	9.6	6.7	5.9	5.8	5.6
Exchange rate (dinar per US$; period average)	1166.0	1166.0	1167.0	…	…	…	…
Real effective exchange rate (percent change, end of period) 4/	6.5	4.6	7.5	…	…	…	…
Financing gap (US$ billion)	0.0	0.0	0.0	0.0	0.0	6.5	0.6

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

1/ Does not reflect KRG production during 2013 and 2014.
2/ Reflects KRG exports through State Organization for Marketing Oil (SOMO).
3/ Includes arrears.
4/ Positive means appreciation.

Table 2. Iraq: Central Government Fiscal Accounts, 2013-2019

(In percent of GDP)

	2013	2014	2015	2016	2017	2018	2019
				Est.		Proj.	
Revenues and grants	42.2	39.1	30.2	32.2	34.8	35.1	34.3
Revenues	42.2	39.1	30.2	32.2	34.7	35.1	34.3
Oil	38.6	36.9	27.4	28.3	30.1	30.6	29.7
Non-oil	3.5	2.2	2.8	3.9	4.6	4.5	4.6
Grants	0.0	0.0	0.0	0.0	0.1	0.0	0.0
Expenditures	48.0	44.5	42.5	40.4	41.8	40.4	36.0
Current expenditures	30.6	26.1	27.4	32.3	30.6	30.6	26.8
Salary and pension	15.0	15.1	20.1	22.6	20.3	18.6	17.4
Salary	11.9	11.9	15.8	17.6	15.7	14.4	13.4
Pension	3.1	3.2	4.3	5.0	4.5	4.2	4.0
Goods and services	6.0	3.4	2.2	3.1	3.2	3.1	2.9
Transfers	7.3	5.5	4.5	5.5	5.9	5.5	5.2
Interest payments	0.4	0.3	0.6	1.1	1.3	1.2	1.3
War reparations 1/	1.9	1.8	0.0	0.0	0.0	2.2	0.0
Investment expenditures	17.4	18.4	15.1	8.1	11.2	9.9	9.2
Non-oil investment expenditures	11.8	9.5	6.0	1.9	5.1	4.2	3.9
Oil investment expenditures	5.6	8.9	9.1	6.1	6.0	5.6	5.3
Overall balance	-5.8	-5.4	-12.3	-8.2	-7.0	-5.3	-1.7
Statistical discrepancy	-0.5	-1.6	0.1	…	…	…	…
Financing gap							
Financing	6.3	7.0	12.2	8.2	7.0	5.3	1.7
External financing	4.6	2.2	2.0	-0.8	4.0	1.4	0.3
Budget Loans	0.0	0.0	1.4	1.7	2.8	0.9	0.4
International Financial Institutions	0.0	0.0	1.4	1.6	1.5	0.9	0.4
Bilateral	0.0	0.0	0.0	0.1	0.2	0.0	0.0
Eurobond	0.0	0.0	0.0	0.0	1.0	0.0	0.0
Project Loans	0.0	0.0	0.1	1.2	1.9	1.2	1.0
Amortization	-0.4	-0.7	-0.8	-1.0	-0.6	-0.7	-1.0
Assets held abroad	5.0	0.0	0.0	0.0	0.0	0.0	0.0
SDR Holding	0.0	0.0	1.0	0.0	0.0	0.0	0.0
Account payables	0.0	2.9	-2.3	-0.1	0.0	0.0	0.0
Arrears	0.0	0.0	2.5	-2.6	0.0	0.0	0.0
Domestic financing	1.7	4.8	10.2	9.0	3.0	0.8	1.1
Bank financing	1.7	1.8	8.6	9.3	3.0	0.8	1.1
CBI	1.5	1.3	4.8	6.1	2.4	0.8	0.7
Commercial banks	0.1	0.4	3.8	3.1	0.6	0.0	0.4
Loans	0.1	0.4	3.8	0.0	0.4	0.0	0.4
Deposits	0.0	0.0	0.0	3.1	0.2	0.0	0.0
Non-bank financing	0.0	0.0	0.0	0.3	0.6	0.7	0.6
Account payables	0.0	0.0	-0.1	0.0	0.0	0.0	0.0
Arrears	0.0	0.8	1.7	-0.6	-0.6	-0.7	-0.6
Financing gap	0.0	0.0	0.0	0.0	0.0	3.1	0.3
Memorandum items:							
Security-related expenditure	6.0	6.2	7.1	8.1	7.6	7.0	6.5
Current expenditures (percent of GDP)	30.6	26.1	27.4	32.3	30.6	30.6	26.8
Non-oil primary expenditure (percent of GDP)	40.1	33.5	32.8	33.1	34.5	31.4	29.4
Adjusted non-oil primary expenditure (percent of GDP) 2/	40.1	38.0	34.0	33.1	34.5	31.4	29.4
Adjusted non-oil primary expenditure (percent of non-oil GDP) 2/	74.1	71.1	50.9	48.9	52.5	48.2	44.5
Non-oil primary fiscal balance (percent of GDP)	-36.5	-31.3	-30.0	-29.2	-29.8	-26.9	-24.8
Adjusted non-oil primary fiscal balance (percent of GDP) 2/	-36.5	-35.8	-31.2	-29.2	-29.8	-26.9	-24.8
Adjusted non-oil primary fiscal balance (percent of non-oil GDP) 2/	-67.6	-67.0	-46.8	-43.1	-45.4	-41.2	-37.6

Sources: Iraqi authorities; and IMF and World Bank staff estimates and projections.
1/ Calculated as 5 percent of oil exports as per U.N. Security Council Resolution 1483 to finance war reparations to Kuwait.
2/ Adjusted to account for a full year estimate of federal government transfers to the Kurdistan Regional Government in 2014 and 2015, for which actual transfers were made for only 2 and 5 months, respectively.

17. **Lower oil receipts have considerably widened the budget deficit in 2015 and 2016** (**Table 2**). The budget deficit increased sharply from an average of 5.6 percent of GDP in 2013 and 2014 to 12.3 percent and 8.2 percent in 2015 and 2016, respectively. This came as a result of the sharp reduction in oil prices, which decreased from an annual average of US$96.5 per barrel in 2014 to US$45.9 in 2015 and US$35.5 in 2016. Oil revenues decreased by US$35 billion in 2015 (a 41 percent reduction). Increased oil production and exports in 2016 have slightly increased oil revenue, despite continued low oil prices. The limited financing available forced the government to make some adjustments to contain the deficit in both 2015 and 2016. On the revenue side, these focused on ensuring increased volumes of oil exports (e.g., through oil infrastructure—pipelines, storage facilities, maintenance—optimization). On the expenditure side, the government prioritized payments of wages, pensions, debt service and oil-related investments and sharply under-executed non-oil capital investment.

18. **Fiscal consolidation has been frontloaded in 2016, but the composition of public expenditure does not yet support medium-term growth.** In 2015-2016, non-oil-related expenditures and the non-oil primary deficit decreased by a cumulative 22 and 24 percentage points of non-oil GDP compared to 2014.[12] Non-oil investment expenditure, which is vastly unproductive in the absence of an appropriate public investment management system,[13]recorded the bulk of the adjustment. The government protected salary expenditure for the 3 million civil servants (accounting for over 40 percent of Iraq's employment, and for almost all of its formal jobs[14]), including the defense and security forces, transfers to SOEs (mainly to pay salaries), and the very large and generous pension payments. While the overall size of the expenditure adjustment was necessary to maintain macroeconomic stability, public expenditures require further reductions and re-direction toward the delivery of public services and the provision of public infrastructure. The oversized wage bill and pension spending (87 percent of total non-oil primary spending in 2016)—which is not positively correlated with the quality of public service delivery—is not sustainable as it crowds out other current and capital spending vital for medium-term growth. Subsidies for electricity[15] services and transfers to SOEs (mainly to pay salaries) in 2016 are estimated to exceed 6 percent of GDP.

19. **Implementation of the budget arrangements between the central government in Baghdad and the KRG, stalled since June 2015, has partly resumed in August 2016**. The Baghdad agreement, reached on December 2014, provided for Baghdad to transfer to KRG 17 percent of the federal budget (minus certain sovereign expenditures) in exchange for exports of 0.55 mbpd on average from oil production areas controlled by the KRG in the northern areas of Iraq. The northern oil (KRG and Kirkuk) is exported to Ceyhan, in Turkey, through a new pipeline in the KRG that bypasses ISIS-controlled territory. Implementation of the agreement stalled from June 2015 to July 2016 as (1) 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; and (2) transfers from Baghdad to Erbil were below the agreed 17 percent. In August 2016, the parties agreed to resume oil exports and divide equally the

[12] Assuming that the agreed transfers to KRG would have been fully implemented in 2015 and 2016.
[13] See Iraq Public Expenditure Review, The World Bank, 2014.
[14] See World Bank. "Iraq Systematic Country Diagnostic",(December 2016).
[15] Calculated as the difference between the cost of service and collected revenues.

revenue until end-2016.[16] As mutually beneficial, both governments are discussing a successor agreement for 2017.

20. **The government has partly financed its budget deficits through arrears accumulation, with external arrears expected to be cleared by end-2016**. In addition to the overall 2016 fiscal deficit of (ID16.6 trillion), the government needs to repay domestic and external arrears accumulated since 2014. Total arrears at end-June 2015 are estimated at ID12.5 trillion (US$10.6 billion), equivalent to 6.1 percent of GDP. Even through partial payments were made in the first half of 2016, external arrears accumulated toward international oil companies (IOCs) and for associated natural gas production at end-June 2016 amounted to US$3.7 billion and US$225 million respectively. Under the IMF SBA program, the government committed to repay these arrears by year-end (a performance criterion) to avoid the forced scale down of investments and operations by firms in the energy sector. Payment of domestic arrears, including payment for non-oil investment and purchase for goods and services, would require first a complete government identification, auditing of these arrears, and the formulation of a repayment plan.

21. **The country has limited sources of domestic and external financing.** The 2016 fiscal deficit is being mostly financed by domestic bank financing, most of which is being refinanced at the discount window of the Central Bank of Iraq (CBI) because banks' liquidity is constrained. The attempted 2016 issuance of ID5 trillion five-year bonds aimed at the general public mobilized only ID0.6 billion, because the interest rate (8 percent) was not considered attractive enough. Since it has historically run budget surpluses, Iraq has not developed a Treasury bonds market, nor has it successfully issued external bonds in the past decade.[17] External financing for the 2016 budget includes the proposed US$1,443.82 million World Bank DPF and US$1.2 billion financing under the IMF SBA. Increased domestic financing in 2014-2015 has led to a sharp increase of public debt and contributed to a large foreign exchange reserves drawdown to finance government imports.

22. **To protect the (already weak) banking sector from ISIS spillovers, the CBI is tightening supervision and plans to adopt Anti-Money Laundering (AML) and Combating Financing of Terrorism (CFT) regulations.** Because of the ISIS war, physical assets of some banks and 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. In 2012, the Financial Action Task Force (FATF) assessed Iraq as being either noncompliant or only partially compliant with 35 of FATF's 40 core recommendations and with all nine special recommendations. The government issued a new AML/CFT Law in October 2015 (2015 DPF-supported reform), which kept Iraq off FATF's black list. By end-2016, Iraq is expected to adopt relevant AML/CFT regulation that would strengthen banking supervision and help the development of the financial sector in Iraq.

23. **In the face of low oil prices, the current account balance has turned into a deficit, which is being partly financed by a large reduction in reserves.** Oil export revenues decreased to about US$49 billion in 2015, down from US$84 billion in 2014. As a result, the current account turned into a deficit of 6.1 percent of GDP in 2015 down from a surplus of 2.7 percent of GDP in 2014. The deficit is estimated to further worsen to 7.1 percent in 2016. To partly finance this deficit, total international reserves have

[16] In August 2016 the North Oil Company has provided to the KRG 50 percent of its export amounting to 640,329 barrels, as reported by the KRG's Ministry of Natural Resources.

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

declined from about US$67 billion at end-2014 to US$54 billion by end-2015 and to US$48 billion at end-June 2016, still more than seven months of imports. The strong reserve accumulation during the period 2010-2013, has helped smoothen the needed pace of contraction in domestic demand, and in fiscal policy in particular.

2.2 MACROECONOMIC OUTLOOK AND DEBT SUSTAINABILITY

24. **Iraq's economic outlook is expected to improve under the assumption of a more favorable, but still challenging, security environment which, combined with continued fiscal consolidation, would result in subdued growth over the coming years.** With oil prices on the futures market indicating a gradual recovery of Iraq oil export prices to US$50 per barrel by 2021, less than half the pre-crisis level, the government is expected to continue implementing its SBA-supported program of fiscal consolidation. Oil production, including KRG, is expected to remain at 4.5 mbpd given the expected level of oil investment. The non-oil economy after three years of contraction is conservatively projected to grow by 3 percent in 2017 due to higher level of non-oil domestic-financed investment and higher donor-financed spending, which was delayed from 2016 to 2017. This projection assumes that in 2017, the war against ISIS would continue and the security situation would not significantly improve. For this reason, the growth rate of non-oil GDP is expected to remain lower than implied by historical elasticities (a more detailed discussion of the uncertain macroeconomic outlook is reported in Box 2).[18] Higher oil prices are projected to increase the GDP deflator by 9.7 percent in 2017, pushing nominal GDP growth to 10.9 percent in 2017. However, inflation measured by the Consumer Price Index is projected to remain stable at 2 percent over the projection period, as consumers' spending remains largely insulated from higher oil prices.

25. **Significant improvement in the non-oil economy cannot be achieved unless the government is able to regain control of ISIS-controlled territory, reduce violence, and restore confidence.** Over the medium term, non-oil GDP is conservatively projected to recover to 4 percent or about half its pre-2014 average growth, as elevated uncertainty and recurrent violence, including continuation of the ISIS war, could delay investment and development. [19] Growth will be sustained by agriculture and construction, but the low level of government expenditure would result in low growth of services. On the demand side, the high level of displacement and insecurity would initially limit private consumption and investment, which are expected then to increase also thanks to the availability of credit to the private sector. The outlook for 2017-2019 incorporates the effect of ongoing reforms, supported by the World Bank and the IMF, in public finances, service delivery, business environment, and the financial sector.

26. **The improved macroeconomic outlook is predicated on conservative assumptions about Iraq's oil exports**. Oil production in Iraq is in areas firmly under the control of the central government and the KRG: the southern part of the country around Basra and the northern fields of the KRG and Kirkuk. Hence, oil production and exports can remain strong and growing even if progress in the fight against ISIS is slow. The projected average oil exports of 3.8 mbpd for 2017 and beyond is a level of

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[18] Since 2013, the average fiscal multiplier, measured by the ratio of real non-oil GDP growth to the growth rate of the real non-oil primary expenditure, has been 0.59. Using this fiscal multiplier, non-oil GDP growth would have reached 7.8 percent in 2017.

[19] It is well documented that persistent fragility and violence slows post-conflict recovery. A growth rate of 4.5 percent, for example, corresponds to the average growth rate of a large number of post-conflict countries over the 1970-2014 that maintained peace for at least 10 years after the conflict has ended (see "The Economic Impact of Conflicts and the Refugee Crisis in the Middle East and North Africa", IMF Staff Discussion Note, Sept. 2016).

exports that Iraq (central government and the KRG) has already achieved in August 2016. The country has existing exports capacity of 4 mbpd, which can accommodate the planned export increases. Oil companies indicated that the government should double its investment expenditure to allow oil production and exports remain on an upward trend.

27. **In the medium term, the government will continue to implement a program of fiscal consolidation to contain the increase in total public debt and maintain gross foreign exchange reserves at a sustainable level** (Table 2). Building on the deficit containment efforts undertaken in 2015 and 2016, also forced by lower external financing than expected, and the gradual increase in oil prices, the overall fiscal deficit is projected to decrease to 1.7 percent of GDP in 2019. Part of this large fiscal consolidation will stem from the revenue side from improved oil revenues and efforts to increase personal income tax revenues through broadening the tax base and the application of a 4.8 percent flat tax to salaries and pensions of all civil servants and, increasing the very low effective tax rate.[20] Customs revenues are also expected to increase as the government re-gains control of some border areas currently under ISIS control and efficiency gains. On the expenditure side, containment of non-oil primary spending will mostly be achieved through reduction of the wage bill through natural attrition, rigorous controls over pension beneficiaries and continued postponement of lower priority non-oil investment. The government would reduce the wage bill by replacing only one employee for every six who retire. Civil servants and military and security personnel amount to almost 3 million people. The number of retirees is projected to increase from 50,000 in 2017 to 80,000 a year by 2020. The government also intends to encourage leave through partial pay and early retirement. These measures would result in a decrease of the wage bill in nominal terms by 1 percent in 2017 and 2 percent in 2018 and 2019. The government intends to cap the level of non-contributory pensions paid through the budget[21] at ID10.3 trillion (the 2016 level), thanks to the gradual reduction of beneficiaries and the enforcement of the existing rules preventing collection of multiple pensions or collecting pensions without minimum contribution period or below legal pensionable age. Reforms supported by the proposed DPF operation (see Section 4.2) are expected to contribute to the containment and increased efficiency of the public expenditure.

28. **Public debt is projected to peak at 63.1 percent of GDP in 2018 before trending down, but large—and so far unquantified yet—contingent liabilities exist** (Figure 1). The debt projections assume a large payment for war reparation to Kuwait in 2018 (since the onset of the twin shocks that have hit Iraq, the Iraqis and Kuwaiti governments have consistently agreed to defer to the next year these reparations in light of Iraq's short term challenges).[22] The public debt sustainability analysis concludes that debt remains sustainable over the medium term, given the projected fiscal consolidation and improved growth prospects. It is, however, sensitive to shocks, particularly to GDP growth and the primary balance.[23] In addition, the liabilities of many financial and non-financial SOEs are likely to represent large but not yet quantified contingent liabilities for the government. As detailed in Section

[20] Estimated to be at around 1 percent of total wages, including all allowances.

[21] Following a 2006 reform, amended in 2014, all public employees retiring after January 2006 receive pension through a National Pension Fund. Civil servants retired before 2006 and people that fall into categories defined by subsequent laws (including martyrs of terrorism, victims of war and their eligible relatives) have their non-contributory pensions paid through the government budget.

[22] Equivalent to five percent of oil exports as mandated by U.N. Security Council resolution 1438 to finance war reparation is Kuwait.

[23] 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 I of the IMF July 2016 staff report contains a detailed Debt Sustainability Analysis.

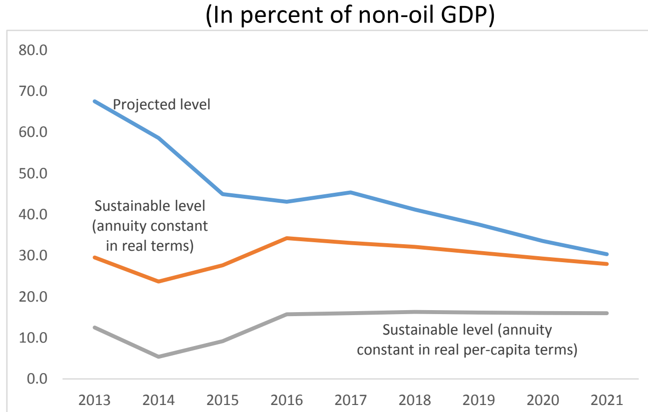
4.2, many SOEs are not financially viable and benefited from soft loans used to finance current expenditure, primarily salaries, from state-owned banks. Rasheed and Rafidain banks, the two largest state-owned banks have not been audited according to International Financial Reporting Standards since 2006. These banks carry out quasi-fiscal activities, including financing unviable SOEs, and are likely to be severely undercapitalized. Taking a longer-term view, assuming that the government will be able to sustain the fiscal consolidation effort through 2017-2021, Iraq's fiscal stance is consistent with a permanently sustainable fiscal path (Box 1).

Box 1. An Alternative Look at Iraq's Debt Sustainability

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, Iraq's large non-oil fiscal deficits would decrease in the medium term toward a level that is sustainable in light of the country's finite supply of oil.

Iraq: Projected and Sustainable Non-oil Primary Deficit Using PIH approach

(In percent of non-oil GDP)



Source: World Bank staff estimates and projections.

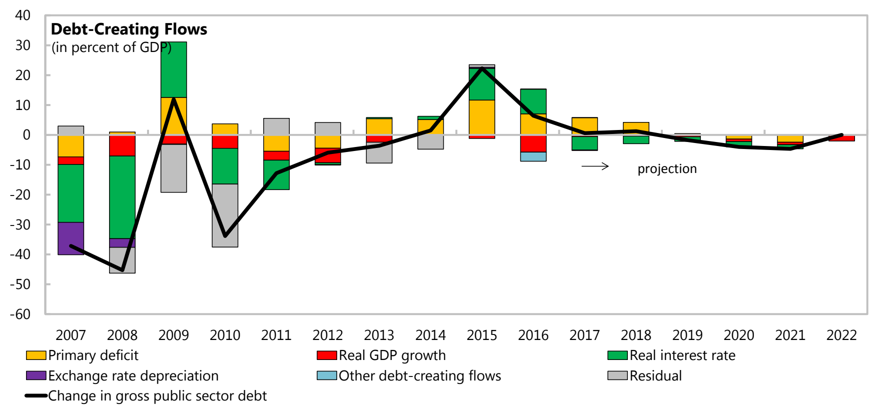
The analysis assumes that Iraq's fiscal stance would initially largely deviate from the PIH level, as the country reacts to the war against ISIS; yet the country could run sizable non-oil primary balance (NOPB) deficits while maintaining a fiscal path that is consistent with intergenerational equity. As shown in the figure above, the sustainable NOPB deficit over the medium term is estimated at 28 percent of non-oil GDP. Over the past years, Iraq had rapidly moved toward that sustainable deficit as the NOPB shrank from 58.6 percent of non-oil GDP in 2014 to 43.1 percent in 2016. The continued implementation of the program of fiscal adjustment would bring the non-oil primary deficit in line with long-term fiscal sustainability. The PIH model is based on conservative assumptions for oil production, oil prices and the discount factor to oil revenue, to account, inter-alia for the volatility of oil revenues.[1]

[1] Over the period 2017-2021 it assumes average growth of non-oil GDP at 3.2 percent; non-oil GDP deflator at 6.2 percent; and population at 3.2 percent. Oil production is assumed to slowly increase to the maximum current estimated capacity of 5.0 mbpd by 2032; oil prices are expected to remain permanently constant at US$50 per barrel, as currently indicated by futures market. The nominal discount rate is 5 percent; real return on U.S. dollar denominated reserves investment is assumed at 1 percent.

29. **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 non-oil 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 through a rigorous public investment management (PIM) system. The government will also protect oil investment as necessary to maintain oil production and maximize the largest source of revenue. The limited reduction of the wage bill and pensions are nevertheless extremely sensitive initiatives. For this reason, the government is committed to control expenditure through reduction of fraud in the payment of wages and pensions. The proposed DPF series supports government's reforms to salary payments and biometric attendance monitoring to clear the payroll from corruption cases. It also supports reforms to improve the financial sustainability of the public pension systems.

Figure 1. Iraq: Public Debt Sustainability Analysis
(Percent of GDP)



Source: IMF Iraq SBA First Review Staff Report, December 2016.

30. **Fiscal consolidation will protect much needed social spending**. Prior to the war against ISIS and the oil price shock, social spending in Iraq was below required amounts in health and inefficiently used for social protection, which led to 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 69.0 in 2014). Social protection is dominated by the Public Distribution System (PDS), which is a program whereby the government purchases imported food that is then distributed to all families, irrespective of income. 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. The authorities, as agreed under the IMF SBA, will protect social spending.[24] While expected to remain at around 22 percent of non-oil expenditure over the projection period, in line with 2015 and 2016, social spending efficiency will increase thanks to the introduction of a proxy means testing system to identify the poor and the adoption of a unified database of eligible households across all different social protection schemes. Better targeting will ensure varying combinations of higher levels of transfers to the poor and a wider reach to include the vulnerable by also targeting the near poor.

31. **The 2017 budget deficit is expected to be fully financed thanks to increased external financing compared to previous years**. The slowdown in domestic economic activity and the rise in

[24] Defined as budgetary allocations to health, education, and transfers in support of the social safety net, the internally displaced and refugees.

financing requirements have led the government to increase the share of external financing since 2016. This includes borrowing from bilateral and multilateral sources and from the international capital market (Table 2). The authorities plan to borrow at low interest rates, with an average effective interest rate projected to remain below 2.5 percent, including the expected issuance of a US$2 billion Eurobond (of which US$1 billion guaranteed by the US Treasury), and a US$450 million loan from France in 2017. Domestic financing in 2017 is projected to be covered mainly through the issuance of Treasury bills, most of which will be refinanced by commercial banks at the discount window of the CBI. As the capacity of the public debt management office improves and the domestic market is developed, financing from longer-term bonds, including Islamic financing bonds, is projected to gradually increase. Even though the debt ratio is expected to reduce over time, gross financing needs will remain high due to the repayment of external debt and the large rollover of T-bills, whose share in total public debt has increased over time.

32. **Monetary policy, anchored by the exchange rate peg, supports the effectiveness of the fiscal consolidation effort.** The fixed exchange rate regime has worked well in a highly volatile situation helping maintain stable prices in the areas not occupied by ISIS. The peg increases the effect of fiscal policy in reducing domestic demand to a level consistent with a permanently lower level of oil revenues. To protect reserves, the CBI has enforced limitation on transfer of investment proceeds and in 2016 reduced its foreign exchange sales on the official market. As a result, the spread between official and parallel market exchange rate has widened from 3 percent at end-2015 to 9 percent in October 2016. Under the IMF SBA program, to boost investors' confidence, the CBI has committed to remove restrictions to the repatriation of investment proceeds as well as remove weekly limits to purchases on foreign exchange by commercial banks and citizens.

33. **The current account is projected to gradually adjust to permanently lower prices thanks to continued improvement in oil exports and fiscal consolidation** (Table 3). Crude oil exports, which correspond to most of the oil revenue of the government, are projected to increase from their lowest level of 2016 thanks to higher production volumes and moderately increasing oil export prices. However, as oil prices are projected to remain low, oil exports would remain at about two-thirds of their pre-crisis 2014 level. The government commitment to contain expenditures but continue oil-related investments is key to reduce the current account balance over the projection period, ensure direct financing will flow to Iraq from IOCs, and limit the erosion of international reserves. Reserves drawdown will continue to remain the largest financing source for the balance of payments in 2017-2019, albeit at a much lower level compared to 2014-2016.[25] An external debt sustainability analysis indicates that Iraq's external debt is sustainable over the medium term, if fiscal adjustment is implemented (Figure 2).

34. **The medium-term framework assumes some unidentified financing in 2018 and 2019.** In 2018, Iraq expects to resume payments for war reparations to Kuwait. These payments, amounting to US$4.6 billion, were originally due in 2017. The countries agreed to postpone them by one year. The authorities committed to identify the remaining financing under the IMF's SBA program or modify the fiscal framework.

35. **Risks to the macroeconomic outlook remain very high, arising primarily from two uncorrelated risks: (1) a further fall in oil prices, and (2) a failure to improve security, but are**

[25] International reserves are projected to decrease from 6.7 in 2016 to 5.6 in 2019. While high compared to traditional metrics, Iraq's reserve adequacy needs to factor in the inherent volatility of oil exports.

mitigated by the proposed DPF series. Weaker than projected global growth or a higher than expected supply of oil into the global markets could put downward pressure on global oil prices and renew pressures on Iraq's twin deficits. The debt sustainability analysis indicates that external debt remains highly vulnerable to a current account shock, such as a further reduction in oil prices or a real exchange rate depreciation (Figure 2). Gross financing needs are expected to remain large as the government needs to refinance short-term domestic debt. If instead of the assumed continued territorial gains by the government over ISIS, the war against ISIS were to continue unabated for a longer period or the intensity of conflict to worsen, this would materially and negatively impact Iraq's economy and would require higher security expenditure. These two shocks are exogenous and independent of each other. However, a combination of higher (or lower) oil prices and an improved (or worsened) security situation would result in a large range of possible outcomes (see Box 2). As has happened in the recent past, the combination of the two negative shocks (the downside scenario in Box 2) would result in negative non-oil growth, higher fiscal deficits, and unsustainable debt dynamics, which would undermine the effort undertaken so far to maintain macroeconomic stability and increase fiscal space to enable future reforms. Because of the uncertainty of the outlook and the vulnerability of Iraq, not providing budget support to Iraq in 2016-2017 could force the government to implement abrupt cuts in public expenditure with further negative consequences for the non-oil economy and the capacity of the government to address security threats. In a downside scenario, budget support would continue to dampen the lasting impact of the shocks and allow the government to maintain social and security-related expenditure while implementing fiscal structural adjustment reforms and strengthening processes.

Table 3. Iraq: Balance of Payments Financing Requirements and Sources, 2016-19
(In US$ billion, unless otherwise indicated)

	2016	2017	2018	2019
Gross financing requirements	-12.9	-14.4	-14.5	-8.3
External current account deficit	-11.9	-13.1	-12.9	-6.3
Debt amortization	-1.0	-1.3	-1.6	-2.0
Available Financing	6.8	9.8	7.7	7.6
Foreign Direct Investment	-1.2	0.5	2.0	3.0
Public borrowing [1/]	5.0	8.9	4.2	3.0
Private inflows	3.0	0.4	1.5	1.6
Overall Balance	-6.0	-4.5	-6.8	-0.7
(In percent of GDP)	-3.5	-2.3	-3.3	-0.3
Financing	6.0	4.5	0.3	0.1
Change in Gross International Reserves (increase -)	10.7	4.5	0.4	0.8
IMF Credit (net) [2/]	-0.1	0.0	-0.2	-0.7
Changes in arrears (negative=decrease)	-4.5	0.0	0.0	0.0
Changes in payables (negative=decrease)	-0.2	0.0	0.0	0.0
Financing gap [3/]	0.0	0.0	6.5	0.6
Memorandum items:				
Current account deficit (in percent of GDP)	-6.8	-6.8	-6.2	-2.9
Fiscal Deficit (in percent of GDP)	-8.2	-7.0	-5.3	-1.7
Central Bank Gross International Reserves (end of perioc	43.0	38.5	38.1	37.3
(in months of imports of goods and services)	6.7	5.9	5.8	5.6

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

1/ Includes prospective disbursements from the IMF in 2016–19.
2/ Includes repayment of the 2009 SBA and the 2015 RFI.
3/ Includes unidentified financing for payment of war reparation to Kuwait, under the UN Security Council resolution 1483, amounting to US$4.6 billion in 2018.

36. **The outlook is also subject to significant risks related to social and political developments**. Risks are also related to the capacity of the government to provide public services and start reconstruction. Domestic political tensions remain high and could further limit the government's reform effort and its capacity to work efficiently with Parliament. Tensions could also be related to the revenue sharing agreement between Baghdad and Erbil; only a modest temporary agreement is now in place, and even though both parties are committed to negotiate a successor agreement for 2017, sustainability of the is not assured. The large fiscal consolidation effort could also give rise to social tensions and impact implementation of reforms and security-related spending and entitlements (conflict and post-conflict) could introduce budget rigidities.

Box 2. Sensitivity Analysis

Risk to the baseline macroeconomic scenario remains high most notably because of uncertainty in the security situation and in the level of oil prices. Two extreme scenarios exemplify the uncertainty surrounding the baseline (see charts below). Both scenarios assume that oil production remains unchanged with respect to the baseline as oil production areas have so far been unaffected by the ISIS war given the location of key Iraqi oil fields. Under an *upside scenario*, oil prices are assumed to reach US$76 per barrel by 2021, US$26 higher than under the baseline.[1] Following a resolution of the war against ISIS and improvement in security, the non-oil-growth rate would reach 8 percent (the pre-2014 long-term average) by 2021, compared to 4 percent baseline, pushed by the resumption of economic activity and large non-oil public investments to rebuild damaged infrastructure. Under this scenario, higher oil revenue enables both high public investments and improved fiscal balances, resulting in reserves accumulation and better debt dynamics. Improved security boosts the non-oil economy. Conversely, under a *downside scenario,* Iraq's oil export prices are assumed to remain at US$35.5 per barrel, as in 2016, corresponding to their lowest annual average level during the past ten years. The war against ISIS is expected to continue and the security situation to worsen. Under this scenario, lower oil revenue and high security-related expenditures increase fiscal deficits. Insecurity and limited public investments result in continued negative non-oil growth. Large fiscal needs create unsustainable debt dynamics. These scenarios are conceptually the upper and lower bounds of a combination of independent outcomes of various magnitude (e.g., high oil prices and high insecurity or low oil prices combined with better security).

Figure 1. Real GDP Growth

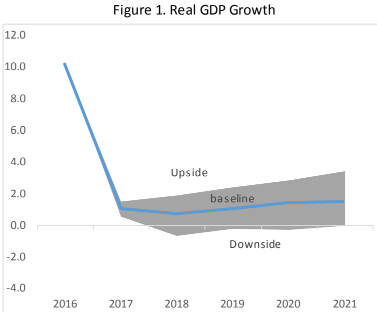


Figure 2. Fiscal Balance

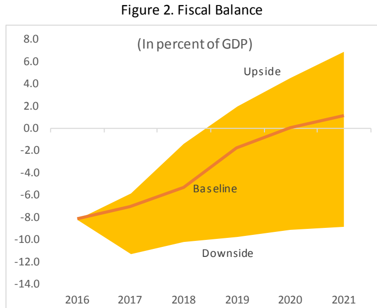
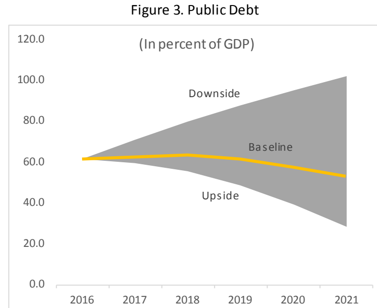


Figure 3. Public Debt

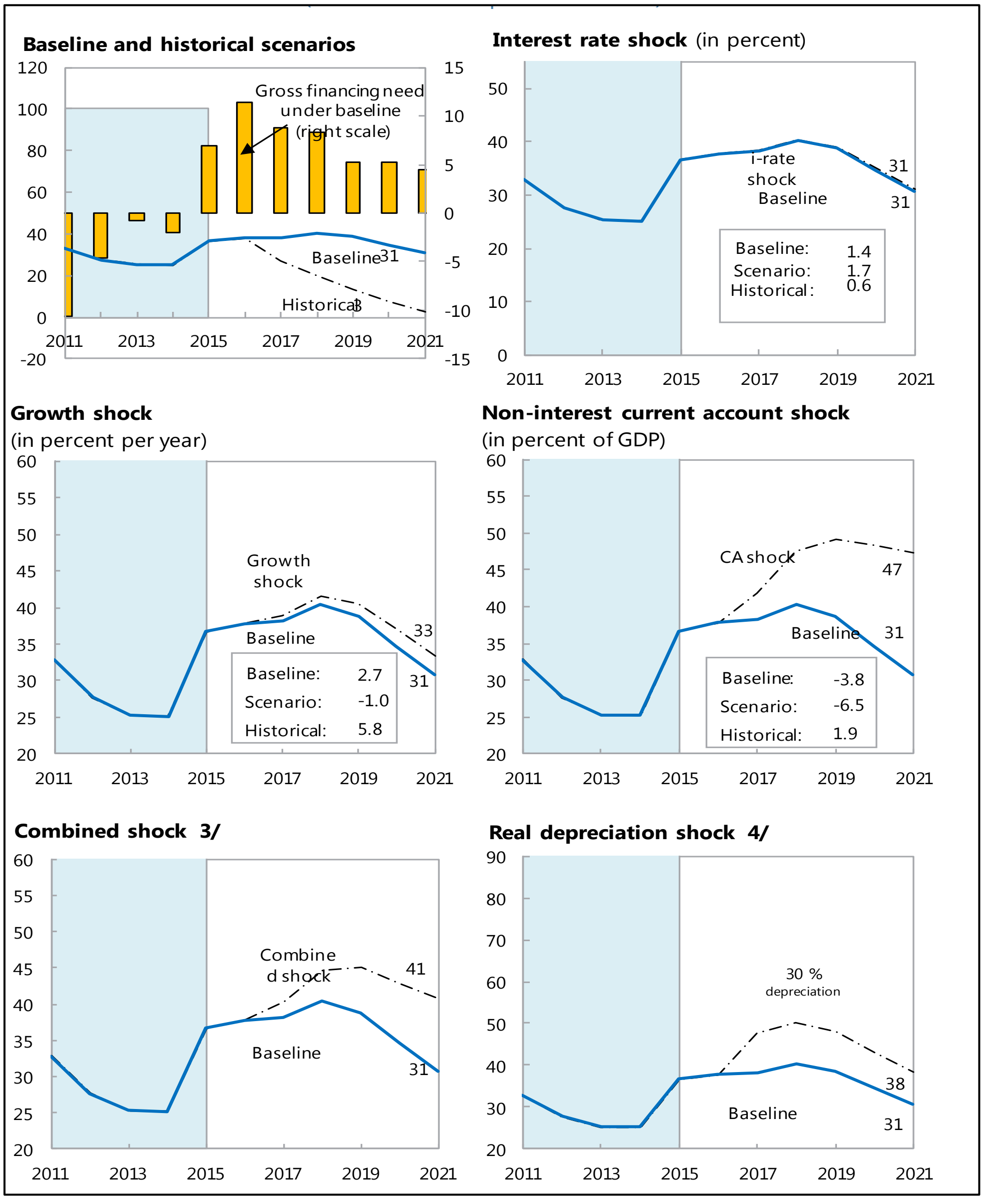


Source: World Bank Staff estimates and projections.

[1] Consistent with the long-term reference case of the Energy Information Administration. See "International Energy Outlook 2016", U.S. Energy Information Administration.

37. **Despite these challenges, Iraq's macroeconomic policy framework is adequate, providing an appropriate basis for a development policy operation.** The macroeconomic policy framework remains appropriate as long as the government maintains the reform commitments agreed in this DPF series and the IMF program, and that nonetheless, is subject to significant downside risks. The authorities remain strongly committed to continue on a path of fiscal consolidation, which would maintain the debt and international reserves to a sustainable level. Further comfort is provided by the track record built with the implementation of the IMF Staff-Monitored Program (SMP) and the expected conclusion of the first review of the IMF SBA.

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



Sources: IMF First Review of the Iraq SBA Staff Report, December 2016. 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. 2/ For historical scenarios, the historical averages are calculated over the ten-year period, 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 2016.

2.3 IMF RELATIONS

38. **After successful implementation of the November 2015 SMP, in July 2016 the IMF Board approved a US$5.3 billion SBA for 2016-2019**. This financing follows the single tranche US$1.2 billion disbursement under the Rapid Financing Instrument in July 2015. The SBA is a lending instrument to address countries' external financing needs and to support policies designed to help them emerge from

crisis and restore sustainable growth. Disbursement under the SBA program is conditional on the completion of quarterly reviews of the agreed reform program. Iraq's economic reform program supported by the SBA aims to address the urgent balance of payments needs, bring public spending in line with lower global oil prices, and ensure debt sustainability. The program also includes measures to protect the poor, strengthen public financial management, enhance financial sector stability, and curb corruption. IMF and Bank staff are closely collaborating on the macroeconomic framework, policy reforms, and technical assistance.

3. THE GOVERNMENT'S PROGRAM

39. **The government has launched a reform plan to strengthen transparency, reduce corruption, and deliver better services to the public**.[26] Iraq's main development challenge is the need to rebuild State institutions that were systematically weakened over the past three decades due to the effects of wars, international sanctions, and domestic politics. The Iraqi authorities are committed to implement the government program for 2015-2018. The first strategic priority of the government program is to achieve security and stability through liberating cities and provinces controlled by terrorist groups, and restoring the rule of law. The second priority is to deliver public services and upgrade the standard of living of the Iraqi people. This includes delivering electricity services; improving the water, health, and education sectors; and reforming the social protection system.

40. **Recent social unrest, political turmoil, and the need to adjust to protracted low oil prices have increased pressure to implement economic reforms and made them more socially and politically sensitive**. Rampant corruption in the country is undermining efforts to strengthen the State and its effectiveness. Following widespread demonstrations in August 2015, in part triggered by widespread power outages, the government launched a series of governance reforms and merging ministries. The government is also working toward adopting a strategy to develop the private sector. This includes a plan to reform governance of financially viable SOEs and close the non-viable ones. The government is implementing an action plan to reduce power outages, which includes electricity tariff adjustment (a large tariff increase took place in January 2016), improved bill payment, and strengthening of the investment climate to attract private capital in power generation. The Iraq Integrated National Energy Strategy (INES), approved by the Council of Ministers in 2014, underpins the commitment to increased private sector-led investments especially in the generation subsector.[27] Furthermore, INES aims to improve the sector's financial position, decrease its reliance on government budgetary transfers and subsidies, and increase the operational efficiency of the sector. These objectives provide confidence that the Ministry of Electricity, as the off-taker, would be able to meet its fiscal obligations. The government is committed to improving fiscal management and budget systems that are not currently aligned with the country's priorities and the government's development programs and to maintaining a sustainable fiscal stance. The government's reform drive has faced resistance, however, both from the public and from Parliament. The former took the form of protracted demonstrations against cuts in allowances and bonuses of public sector employees. The latter includes

[26] This plan was articulated in the Prime Minister's acceptance speech to Parliament in September 2014. Three months earlier (June 2014), oil prices had started a rapid fall and ISIS had blitz-captured one third of Iraq's territory, including Mosul. The political fallout from these two shocks led to a change in Prime Minister.
[27] To date, a total IPP capacity of 1500MW has been signed and negotiations are advanced for an additional 4500MW.

challenges to the government's authority to eliminate key government positions,[28] resistance to appointment of a Cabinet of technocrats, and the subsequent dismissal of key ministers (defense, interior, and finance) through votes of no confidence.

4. THE PROPOSED OPERATION

4.1 LINK TO GOVERNMENT PROGRAM AND OPERATION DESCRIPTION

41. **This DPF aims to support Iraq's structural reforms, with a particular focus on reforms that are sustainable (i.e., not easily reversible)**. The Program Development Objectives are in line with the objectives of the government's strategy described above. The operation is structured under three pillars/development objectives of improving: (1) expenditure rationalization; (2) energy efficiency; and (3) the transparency and governance of state-owned enterprises. The first pillar includes reforms aimed at improving the efficiency of the wage bill, public investment management system, the social targeting system, pension reform, and public debt management. Within the second pillar, reforms will focus on reducing gas flaring, expanding gas-to-power generation, and reducing electricity subsidies. The third pillar addresses the lack of transparency among (non-financial) SOEs in Iraq.

42. **The design of the proposed DPF series incorporates lessons learned from earlier policy-based operations in Iraq** (see Box 3). Iraq experienced large fiscal shocks in 2009 and 2014. During both crises, the budget support provided by the World Bank, along with financing from the IMF, helped maintain fiscal sustainability. By providing timely budget support, the 2010 DPL and the SBA together contributed to preventing further abrupt cuts in public spending in Iraq. The emergency financing provided by both institutions in 2015 helped Iraq at a time when the country's fiscal shock could have potentially led to a much deeper economic and social crisis. The proposed DPF series continues to support the program of structural reform measures contained in the 2015 DPF to address the ongoing crisis and help the government adjust to lower oil prices. Implementation of the 2015 DPF is broadly satisfactory, however as detailed in Section 4.2, progress has been slower than expected in the areas of gas flaring reduction and public debt management. As part of this DPF series, the authorities are committed to accelerate the implementation of reforms in these areas. The programmatic design will help sustain momentum beyond the immediate actions supported by the 2015 DPF. In addition, the risk assessment provides a candid discussion of potential risks.

Box 3. Lessons Learned from the 2010 and 2015 Iraq DPL

Iraq experienced a temporary large fiscal shock in 2009 and is likely facing a long-lasting shock since mid-2014, in a highly fragile situation. In the first shock, oil prices plunged from US$92 a barrel in 2008 to US$56 a barrel in 2009, before starting a gradual recovery and reaching an average of US$107 in 2012. In the second shock, oil prices decreased from US$96 a barrel in 2014 to US$ 34 in 2016 and are expected to gradually recover to about half of their pre-crisis level. The 2014 oil price shock was compounded by the war against ISIS. In both instances the impact on Iraq's total revenues—and thus on its economy—was severe. In 2009, Iraq's ability to dip into the Development Fund for Iraq (DFI) plus the IMF and World Bank financial support closed the financing gap and by 2010, oil prices were already moving back upward. Iraq has so far cushioned the impact of the second shock through a rapid deceleration of reserves and short-

[28] Iraq's Supreme Court, however, ruled in October 2016 that the 2015 decision by the Prime Minister to abolish the posts of Vice Presidents and Deputy Prime Ministers was unconstitutional.

term domestic borrowing. However, absent additional reforms, and despite rapid and substantial financing obtained from the World Bank, IMF and other international partners, debt and reserves levels remain on an unsustainable path. The protracted nature of the second shock requires a structural decrease of public spending given the lower fiscal revenues.

In both shocks, World Bank policy-based operations, leveraged by the IMF's financing, helped mitigate the impact of a fiscal crisis on Iraq's economy and support its medium-term economic reform program, thereby helping the country improve fiscal sustainability and reduce its fiscal and socioeconomic vulnerability to sudden drops in oil revenues. The supported reforms were seen to be interlinked by their impact on rationalizing and prioritizing fiscal resources. Financing provided by both institutions and other donors helped Iraq gradually adjust to the fiscal shock, avoid abrupt expenditure cuts, maintain the exchange rate peg and low inflation. This was particularly the case for the 2014-onward twin shocks which bloated public spending while slashing revenues.

Yet results were not entirely satisfactory. In the case of the 2010 operation, the government was not able to generate political support for full achievement of six out of 16 program outcomes (IEG rated this operation moderately satisfactory). The rapid increase in oil prices subsequent to the crisis eliminated the financing gap and the rationale for continued budget support. Reforms efforts also halted, while fiscal vulnerabilities further increased despite large oil revenue. The government implemented all prior actions for the 2015 DPF, however, reforms in the critical gas sector were not maintained as the government prioritized its cash spending and decided to run large arrears on its gas deliveries through most of 2016 and did not invest in any gas-capturing and processing capacity. Similarly, the pension reforms that the government had started with the support of the World Bank proved too timid to improve the financial sustainability of the pension system. Government performance was affected by a deep fiscal and political crisis and the need to fight the war against ISIS.

Important lessons have been learned from the last two development policy operations. The IEG evaluation of the 2010 operation highlighted that the Iraq experience demonstrated that policy-based operations can work well in a high-risk environment when governments are motivated by fiscal stress, but that sustainability of achievements is uncertain if the fiscal stress is removed. It also showed the importance of a mutually reinforcing package of properly sequenced analytical work, technical assistance, policy-based 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. As part of a program that included the IMF SBA, the Bank signaled that Iraq would get significant support in bridging its financing gap. This helped preventing abrupt spending cuts, preserving the exchange rate peg, and keeping inflation in check: all are important results in the politically fragile context. These lessons were broadly incorporated into the 2015 operation. One major exception was that the 2015 DPF was a stand-alone operation although it was designed within a medium-term reform program.

The proposed DPF series effectively builds on the 2015 operation. Starting with the 2015 operation, the Bank paid particular attention to sustainability of reform achievements (e.g., gas capturing and processing capacity; legislative pension reform) so that, even if oil prices were to rise materially, the gains achieved through the DPF-supported reforms would be locked in.

4.2. PRIOR ACTIONS, RESULTS AND ANALYTICAL UNDERPINNINGS

Pillar 1. Improve Expenditure Rationalization[29]

43. **As concluded by the *2014 Iraq Public Expenditure Review*, spending efficiency in Iraq is low in absolute terms and compared to its peers, both on current and investment expenditure**. Iraq's fiscal institutions are ill equipped to deal with the complexities of an oil-dominated budget. The State has grown 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 pensions, and subsidies, crowding out funding for services to the population and the reconstruction of infrastructure. The public investment system is deficient. The challenge is to curb inefficient and ineffective spending (partly due to corruption) and redirect resources to public investment and basic services in the context of an ongoing conflict and fiscal shock. This pillar addresses some of the longstanding issues with a view to improve efficiency and generate much needed fiscal space. Many of these reforms require a multiyear agenda for reforms to be designed, approved, and implemented. The implementation of key reforms supported by the programmatic DPF series throughout this critical gestation will also be supported through extensive and multiyear technical assistance from the World Bank and partner institutions and countries.

Wage Bill Reform

44. **As the single largest and fastest growing item of the central government budget, the wage bill is in urgent need of reform but is socially sensitive in the current context.** Wage bill reduction is a key policy recommendation of the *2014 Iraq Public Expenditure Review*. The 2015 DPF supported the introduction of a new salary scale that reduced the wage expenditure on top public sector employees.[30] Further measures to structurally control the wage bill are critically needed. Between 2003 and 2016 the general government wage bill expanded almost tenfold[31] and public employees more than tripled from 0.9 to 3 million[32] because of unchecked recruitment and fraudulent payroll practices, including the proliferation of "ghost" workers (who are not proper employees), "double dippers" (who illegally draw multiple salaries), and chronic absentees.

45. **The DPF-supported reforms aim to improve expenditure controls and budget efficiency by creating structural safeguards against payroll fraud.** Consistent with its objectives of improving governance and reducing corruption,[33] the Iraqi government aims to improve payroll processes,[34] including by introducing disbursement controls and enforcing regulations against worker absenteeism.[35] To capitalize on this momentum, the DPF-supported reforms focus on a central

[29] See Annex 1, Programmatic DPF Policy and Result Matrix.

[30] The government's 2015 Salary Law reduced the budgeted basic annual salary of top grades (defined as grade 3 with 11 years of experience) as a ratio of GDP per capita to 1.6, which exceeds the 2015 DPF target of 1.7.

[31] The 2016 wage bill was US$30.7 billion (ID36.1 trillion) or 40 percent of the government budget (World Bank. "Iraq Systematic Country Diagnostic". December 2016)

[32] Iraq Budget Laws, 2003-2016.

[33] Al-Khatteeb, Luay. 2016. "Abadi's momentous gambit against political corruption in Iraq." Brookings. August 9, 2015. https://www.brookings.edu/opinions/abadis-momentous-gambit-against-political-corruption-in-iraq/.

A 2014 government investigation that weeded out 50,000 ghost workers and double dippers from public payroll saved the government US $300-600 million per year.

[34] In early 2016, the Prime Minister formed a high-level inter-ministerial Payment Systems Committee chaired by his chief Economic Adviser and tasked with developing and overseeing payroll reform.

[35] Civil Service Law No. 14 of 1960 (amended as Law No. 1 of 1999) states that an employee who misses work for 10 consecutive days without a legally recognized excuse will be considered to have resigned from his job.

government-wide rollout of two complementary technologies that have been shown to dramatically reduce payroll waste. The first is biometric identification of employees; it is expected to tighten expenditure controls by improving payroll accuracy[36] and tracking employee absenteeism through time-and-attendance systems.[37] The second is a transition from cash to electronic salary payments (e.g. to bank accounts or to smart cards): this can strengthen the audit trail as well as prevent outright theft.[38] The structural changes introduced by these two measures—more transparent payroll processes, incentives for greater employee discipline, and systematic generation of data on public pay and employment that serve as a basis for an integrated central-government personnel and payroll database—will provide a sound foundation and evidence base for broader reforms in the future.[39]

46. **While the rollout of biometric systems is expected to be mostly completed by the end of the DPF series, the shift to a new payroll system will require a more paced approach.** This is appropriate given the substantial technical and coordination requirements involved[40] and the experience of similar reforms elsewhere.[41] The proposed DPF prior actions include the Council of Ministers' decrees, which lay out the government's strategy for payroll reform and the adoption of biometric identification system, and their roll out in pilot entities. The subsequent DPF planned for 2017 supports a broader rollout.[42]

Prior Action 1: ***The Council of Ministers has issued a decision requiring all Ministries, Departments, and Agencies (MDAs) to: (a) transition by FY 2020 to electronic payment of all civil servants' compensation (inclusive of benefits and allowances); and (b) install by FY 2018 biometric identification systems to verify civil servants' daily attendance (Decision No. 313, dated November 2, 2016).***

Prior Action 2: ***The Recipient has implemented an electronic payroll system for at least 30 percent of civil servants in two pilot MDA units, and the new biometric attendance system is implemented for all civil servants in two pilot MDA units.***

[36] Since biometric information (e.g., fingerprints) are unique, a biometric database of employees can help eliminate double dippers and certain types of ghost workers. Nigeria's biometric census of employees cut thousands of ghosts and double dippers from government payroll and saved more than US$75 million a year.

[37] Integrated time-and-attendance systems, which are cheap and easy to install, track employees' attendance, hours worked, and excused and unexcused absences.

[38] Malawi is saving US$2 million a month after abandoning cash salary payments due to reduced payroll fraud.

[39] Both reforms will leverage the comprehensive IMF-supported employee audit (due to be completed in 2017) to ensure that only verified employees are enrolled.

[40] Transition to electronic payroll by central government entities requires banks and payment service providers (PSPs) that meet regulatory standards and have a sufficiently robust payment infrastructure. Implementation will be closely coordinated with the CBI, which licenses banks and PSPs on the basis of their technical and financial capacities and compliance with regulations and which has so far ruled out the participation of the technically weak state-owned Rasheed and Rafidain banks.

[41] For comparison, similar payroll reforms currently underway in the KRG territories (USAID-funded), including biometric identification of employees and integration of payroll and HR, are expected to take at least three years.

[42] Implementation will be supported by technical assistance (including a potential partnership with USAID which is financing related reforms in the KRG), and will be aligned with the ongoing payment systems technical assistance (P158906) and Modernization of PFM Systems operation (P151357).

Indicative Trigger 1: *At least 20 percent of all central government civil servants receive their compensation electronically; at least 70 percent of central government civil servants use biometric time and attendance systems.*

Indicative Trigger 2: *The Council of Ministers issues a decree requiring central government employees found non-compliant either by the employee audit conducted by the Federal Board of Supreme Audit or by biometric attendance records (except in case of excused leaves) to be excluded from payroll.*

47. *Expected results*. **The reforms supported by the DPF series are expected to improve expenditure controls, which would reduce payroll fraud and increase the transparency of government pay and employment practices**. This result will be measured by the percentage of verified central government civil servants whose compensation and daily attendance is tracked electronically (minimum of the two variables), with a baseline (2015) of 0 percent and target (2018) of more than 30 percent. The proposed measures will be structural and difficult to reverse. They are also key prerequisites – and potential entry points – for deeper civil service reforms, including critical changes in human resource management reforms, which can meet the government's longer-term objective of ensuring wage bill sustainability and raising the quality of service delivery.

Public Investment Management Reform

48. **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 (e.g., 53 percent in 2015, despite having the investment budget slashed by 36 percent that year). Poor execution rates are exacerbated by high levels of accumulated advances, funding and management complications from budget carryovers into subsequent financial years, lack of adequate 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 the short-term needs to efficiently prioritize non-oil capital spending, given the overall fiscal consolidation needs and the need to protect oil investment.

49. **The DPF-supported reforms are part of a medium-term reform process aimed at ensuring that all public investment (PIP/PPP) passes through a modernized PIM system, thereby improving spending efficiency**. Following on the adoption of a PIM Framework, supported by the 2015 DPF, the Ministry of Planning has created and made operational a PIM Unit in charge of project appraisal, monitoring, and ex-post evaluation processes. The Unit has already undertaken a comprehensive screening of domestically financed projects, mostly legacy projects authorized by past budget laws and not fully implemented. Out of a portfolio of more than 4,000 projects, 228 projects were identified for a total expected financing of ID3.4 trillion, that could be completed by 2018, before the next parliamentary elections, and that are consistent with the six pillars of the *Strategic Priorities in Ministries: 2014-18 Action Plan*. In 2017, the government plans to adopt the Iraq Development Management System (IDMS), an aid management solution promoting good governance, public accountability, and transparency. The IDMS is an IT application designed to provide quick access to the Iraqi portfolio of public investment projects and aid data remotely via internet. It aims to provide a

consolidated overview, to identify national priorities, requests donor assistance, to link aid assistance to the national budget, and to facilitate coordination among government agencies and donor organizations to avoid duplication. Ultimately, the DPF-supported 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 undertake project prioritization (based on cost-benefit analysis and expenditure efficiency), identify financing modalities (e.g., on budget or through PPPs), and provide continuous monitoring of the fiscal affordability of all projects. The quality of the pre-feasibility/feasibility studies will be strengthened thanks to the PIM Decree No. 445 that 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. The MoP PIM unit takes into account environmental and social impacts when undertaking cost benefit analysis or assessing projects in general. In this context, MoP will work with the Environmental Impact Assessment (EIA) unit in the Ministry of Environment to improve environmental and social criteria and mitigation measures which will form an integral part of the selection, design and siting of projects.

Prior Action 3: ***In line with the Public Investment Management Framework, which was adopted under Decree No. 445 dated October 18, 2015, the Minister of Planning has submitted to the Council of Ministers the list of investment projects that are consistent with the government's priorities.***

Indicative Trigger 3: *Final validation of the Iraqi Development Management System (IDMS) and make it operational, as measured through the creation of a specialized monitoring and ex-post evaluation team, within the Central PIM Unit of the Ministry of Planning in charge of ex post evaluation.*

50. *Expected results.* **Improved selection and assessment of public investment projects** as measured by the percentage of capital projects that exceed ID100,000 billion (about US$85 million) for which a feasibility study with cost-benefit analysis was conducted. The baseline is 5 percent; the target for the end of the DPF series is above 20 percent.

Public Debt Management

51. **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.** Iraq's gross public debt-to-GDP ratio has markedly increased over the past few years, from 32.6 percent in 2014 to a projected 64.0 percent in 2016. While public debt is expected to decline over the medium-term, future financing needs would remain large and would therefore require a strong public debt management office. As the country has historically run fiscal surpluses, it has not developed financial instruments that countries often rely on to develop their domestic debt market or to access external markets. In 2015, the issuance of the first US$2 billion Eurobond was unsuccessful. In 2016, the issuance of bonds on the domestic debt market fell well short of government plans.

52. **The DPF series supports reforms to strengthen public debt management capacity.** In October 2015, the MoF established within the Public Debt Directorate a Debt Management Division that oversees and manages all operations related to the total public debt as well as debt guarantees (prior action of the 2015 DPF). With the support of JICA, one of the largest concessional lenders to Iraq, the government committed to improve the transparency of debt management operations and increase

accountability. Going forward, the Ministry of Finance will start the regular publication of a quarterly public debt bulletin that reports external debt records, in Arabic and English. In 2017, the bulletin is expected to report data consistent with audited records (the audit of external debt is a structural benchmark of the IMF SBA). The Public Debt Directorate is also preparing a debt management strategy to be published in Q1 2017 (a result of the 2015 DPF). Over time, the Public Debt Bulletin would include standard cost and risk indicators, scenario analysis, and/or stress tests. Since 2015, JICA has provided on-site and virtual seminars/training on debt management to help the Ministry of Finance develop a medium-term debt management strategy to meet the government financing needs consistent with cost and risk analysis and prepare detailed annual borrowing plans consistent with the strategy.

Prior Action 4*: Pursuant to the Prime Minister's instruction, the Ministry of Finance has started publishing quarterly Public Debt Bulletins, which include all data on external debt of the central government.*

Indicative Trigger 4*: The Minister of Finance publishes its annual Medium-Term Debt Management Strategy, which includes detailed borrowing plans for 2018 and targets for selected risk indicators*.

53. *Expected results.* **The reforms will improve accountability and transparency of debt management operations and help reduce the risk profile of Iraq's public debt**. It would support stronger accountability, as borrowing decisions, articulated in an annual borrowing plan, will be made consistent with the government's debt management strategy. The development of a Medium-Term Debt Strategy (MTDS) would result in the articulation of cost and risk trade-offs the government is willing to bear to achieve its debt management objectives. Lastly, the regular publication of accurate debt statistics would improve the transparency of debt management operations. Over time, better accountability, transparency, and improved capacity would help improve Iraq's access to the debt market, reduce costs and operational risks. As a result, the government is expected to stop the trend of increased reliance on external debt. The result indicator used is the share of the domestic public debt in total public debt (although once the MTDS is published a more pertinent risk metrics might be used for the subsequent operation). The baseline for 2015 is 34.3 percent; the target for 2018 is at least 35 percent.

Pension Reforms

54. **Iraq's social insurance and pension system is fragmented, unequal, costly, and in the relatively short term, financially unsustainable.** Public 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 also exceeds the OECD's most expensive pension system, namely, that of 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 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).[43] Both schemes are contributory and designed as pay-as-you-go, defined-benefit schemes. High generosity and financial non-viability of the system can be seen through its high accrual rate of 2.5 percent (corresponding to an

[43] The SPF currently has more than 3 million contributors, while the private sector pension scheme has less than 200,000 contributors.

implicit 5 to 8 percent real rate of return on contributions received by individuals at age 60) or through the extremely high replacement 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.

55. **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.** More than 20 percent of all civil servants today are already older than 50 years of age. The number of people retiring every year during the past two years has been around 60,000; however, during the next few years it is expected that the number of new retirees will be closer to 70,000 and would reach 80,000 by 2020. In 2015, the National Board of Pensions (NBP) improved the governance of the public pension scheme by removing 30,000 ineligible beneficiaries (prior action supported by the 2015 DPF). The government intends to further deepen pension system reform through a new integrated social insurance law that would also introduce parametric reforms. These reforms include (1) decreasing of the accrual rate from 2.5 percent to 1.5 percent; (2) increasing the minimum length of service from 15 years to 20 years for pension eligibility; (3) changing the base wage for pension calculation from the past three years to the past seven years; (4) reducing the qualifying conditions for survivorship pensions to only spouses, parents, and children; and (5) eliminating many exceptions that have led to high pension expenditures. Such reforms would generate cumulative savings through 2018 of over ID1 trillion (this is three times as much as the 2016 expenditure of goods and services for education) and ID31 trillion through 2028. To that end, the following reform measures are supported by the DPF series:

Prior Action 5: ***The Council of Ministers has approved and submitted to the Council of Representatives (Council of Ministers Decision No.346, dated November 29, 2016) the draft Integrated Social Insurance Law, including the integration of the public and private pension schemes.***

Indicative Trigger 5: *The Integrated Social Insurance Law, including the integration of the public and private pension schemes, is enacted.*

56. *Expected results.* **The reforms aim to improve the efficiency, coverage, and sustainability of Iraq's pension fund**, as measured by the expected actuarial deficit period in years left before going into deficit from a baseline of 13 years (2015) to a target of over 28 years (2018). They will result in an extension of the financial viability horizon of the pension from 2028 to at least 2044. These reforms will also remove large liabilities for the budget. A delayed implementation of reforms would result in a potentially drastic combination of weaker pension benefits and/or large increases in contributions as every year a large number of Iraqis are becoming pensioners. Specific improvements in Iraq's pension system that are expected to result from the DPF-supported reforms include:

- **Reform:** The public sector scheme (SPF) is expected to become self-financed or at least rely only lightly on the general budget.
- **Integration:** Private and public sector employees will be covered by the same national pension scheme, which will ensure portability and therefore facilitate labor mobility. 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 also 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, including social pensions, 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 easily covered by traditional contributory earnings-related pension scheme.

Social Safety Nets (SSN)

57. **Iraq's social safety net system is expensive, yet it suffers from large coverage gaps of the poor and vulnerable.** High transfers and subsidies represent an unsustainable cost to the Government of Iraq. Social assistance (SA) programs such as the PDS, pensions, and cash transfer programs account for a large share of budget expenditures but are poorly targeted and inefficient. For example, pension income reached less than 20 percent of the poor in 2012, while social protection network transfers only covered 10.6 percent of the poor (74 percent of the beneficiaries are non-poor). On the other hand, Iraq's largest SA program, the PDS, reaches a higher percentage of the poor in addition to the non-poor. The PDS provides a minimum amount of caloric consumption to the entire population. It reached 99.4 percent of the poor and accounted for 64 percent of total caloric consumption for the bottom 40 percent of households in 2012. This untargeted program is large—the 2016 revised draft budget allocated ID 1.5 trillion, or 20 percent of the non-oil budget expenditures —and inefficient as it is a universal program that covers 95 percent of the non-poor. It also suffers from significant inefficiencies in procurement, distribution, and management. As a result, the PDS costs the Ministry of Trade US$6 for each US$1 of food assistance distributed.

58. **Implementation of the Social Protection Law (11/2014), which calls for enhancing the targeting of cash transfers would improve the efficiency and sustainability of Iraq's SSN.** The law also calls for establishment of a unified registry and for participation of other government ministries and agencies to support building human capital through the cash transfer program. The implementation of the law is critical within the current fiscal consolidation context. The various targeting methods used including proxy means testing (PMT), would enable drastic reduction of exclusion errors that affect the country's most vulnerable citizens.[44] The new targeting system would also address the current fragmentation of databases used across various agencies, by introducing a unified welfare database in which applicants are well identified based on a single welfare measure for distribution of social assistance. Another critical aspect of the database is the need to build resilience in the face of increased displacement in Iraq due to conflict, and thus enhance the capacity of the government to reach IDPs. In the short-term, the SSN reform supported by the DPF will not include the PDS to avoid disrupting an effective, even though largely inefficient, social protection system. However, it is expected that the PDS will reform (i.e., to have the full PDS basket directed to the poor only) following the final adoption of the PMT and the availability of the welfare database. The specific reforms supported by the DPF series are:

Prior Action 6: ***The Council of Ministers has issued a decision to exclude non-eligible beneficiaries of the Social Safety Net System, and to redirect the assistance to the poor (Council of Ministers Decision No. 312, dated November 2, 2016), based on the targeting method stipulated in Article 6 of the Social***

[44] Social validation is expected to lead to a considerable reduction in inclusion rates. It is expected that 25 percent of the current database will be reduced allowing for a cost saving of US$228 million. The produced lists will be used by the Ministry of Planning to fine-tune the PMT formula and pilot test it to ensure its validity. The final results will be forwarded to the Council of Ministers for approval.

Protection Law No. 11 of 2014.

Indicative trigger 6: *The Council of Ministers issues decision requiring ministries and public institutions to use the Welfare database in implementing all programs targeted to the poor.*

59. *Expected results.* **Enhanced efficiency of the SSN targeting system based on clear criteria that improve the coverage of poor and vulnerable individuals and households while excluding households that are too well off to qualify for the benefits (inclusion errors)**. The proper application and testing of the targeting methodology will allow the production of the National Unified Registry. This registry will be updated regularly and will allow for crosschecking of data among different concerned government agencies. If used in all subsidized government programs, this would allow for a considerable reduction in inclusion and exclusion errors, targeting assistance to identified vulnerable households. If applied through the key subsidized safety net programs, this would lead to significant efficiency improvements. The baseline (2015) for the coverage ratio of the poor is 11 percent; the target (2018) is at least 50 percent. The baseline (2015) for inclusion error is 43 percent and it is targeted to be reduced to at least 20 percent by 2018.

Pillar 2. Improve Energy Efficiency

Gas Flaring

60. **Iraq is the second 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 in power generation**. On November 1, 2016, Iraq endorsed the World Bank's "Zero Routine Flaring by 2030" initiative,[45] which is a welcome and positive development. To date, however, more than 60 percent of the country's gas production continues to be flared in-field because of inadequate contractual and regulatory frameworks for investment in the gathering, treatment, processing, and transport of natural gas. Flaring generates significant air pollution and carbon release, the shortage of deliverable 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. Current production and gas flaring volumes amount to roughly 2.8 bscfd (billion cubic feet per day) and 1.7 bscfd, respectively. The amount of gas currently flared represents an annual economic loss approximately equivalent to US$2.5 billion and would be sufficient to meet most of Iraq's unmet needs for gas-based power generation. While installed gas-based generation capacity is close to 15,000 MW, gas-based peak load supply did not surpass 6,000 MW in 2015 due to restrictions in gas deliverability. It is estimated that currently flared gas volumes would be sufficient to support an incremental generation capacity of roughly 8.5 GW. This is particularly significant, given Iraq's severe electricity shortages, whose cost is estimated to exceed US$40 billion annually (INES report, 2013[46]). Shortages of natural gas have also led to the use of (expensive and for some parts imported) fuel, which costs the country an estimated US$6 billion to US$8 billion per year.

[45] The "Zero Routine Flaring by 2030" initiative, introduced by the World Bank, brings together governments, oil companies, and development institutions who recognize that flaring is unsustainable from a resource management and environmental perspective, and who agree to cooperate to eliminate routine flaring no later than 2030.

[46] INES stands for the Integrated National Energy Strategy. It is a long-term plan (through 2030) of the country's energy strategy and has been endorsed by Iraq's Council of Ministers in 2013.

61. **The volume and the proportion of flared gas are expected to increase in the absence of effective measures to capture it and to support increased gas utilization.** Iraq's continued increases in oil production would result in further increases in flaring and waste unless measures are undertaken to capture, process and transport associated natural gas. The government needs to take action to help internalize the costs of currently flared gas and capture the economic and social benefits that can accrue from increased private investment in gas capture, processing, and transmission infrastructure, from reduced flaring and waste and from increased electricity generation. Iraq joined the Global Gas Flaring Reduction Initiative in 2011 (the second country after Qatar) and created the Basra Gas Company (BGC) in 2013 to capture, process, and monetize associated natural gas from its giant southern oil fields. BGC has recently attained a raw gas processing record of well above 600 MMscfd and an LPG production of 3,300 tons per day. Iraq's natural gas has a significant LPG content, which can be compressed and bottled for distribution for household use in cooking and heating. As a result of increased gas processing by the BGC, and having faced acute shortages of LPG until recently, Iraq reinitiated exports of gas condensates and LPG in March and July of 2016, respectively. Furthermore, reductions in flaring and the equivalent displacement of oil, heavy fuel oil (HFO), and diesel generation by natural gas would decrease Iraq's CO2 emissions—which currently stand at around 140 million tons per year—by approximately 12 million tons per year, making it equivalent to Guatemala's and slightly lower than Kenya's total emissions in 2014.[47]

62. **Iraq's progress in reducing gas flaring has so far remained limited, and it is critically dependent on increasing processing capacity around the Basra petroleum hub in the south, where the largest five fields account for 65 percent of currently flared volumes**. At present, no more than 750 MMscfd of natural gas are allocated to power generation because of supply, treatment, and logistical constraints. Because of prioritization in cash availability, the government has incurred large arrears to its suppliers of gas used for power generation. For the same reason, it has also not made any progress in 2016 in expanding the gas capturing and processing capacity, which remains below the targeted production of 1,070 MMscfd by Q1 2017, an expected result of the 2015 DPF. To credibly reinvigorate the government's program to reduce gas flaring and capture the associated benefits for the country, the following measures are supported by the DPF series:

Prior Action 7: ***The Council of Ministers has approved and submitted to the Council of Representatives the FY 2017 draft budget which includes ID1.4 trillion to cover payments from the Ministry of Oil to associated natural gas processors for (a) processed / dry gas, LPG and condensate deliveries and (b) projected investment requirements for processing capacity expansion, toward the reduction of gas flaring.***

Indicative Trigger 7: *Publication in the National Gazette of regulations for (i) Natural Gas Pricing for both associated and non-associated natural gas for domestic use; (ii) Natural Gas Transport; and (iii) Natural Gas Marketing.*

Indicative Trigger 8: *The Council of Ministers approves a Supplementary Associated Natural Gas Production Contract template, which is made mandatory for existing Technical Service Contract holders or other interested investors, with the aim of establishing conditions, rights, and obligations to gather, process, and sell/market associated natural gas.*

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[47] European Commission, Emissions Database for Global Atmospheric Research (EDGAR), http://edgar.jrc.ec.europa.eu/overview.php?v=CO2ts1990-2014&sort=asc9

63. **The above measures are complemented by a commitment from the government under the IMF SBA to clear the stock of its external arrears** (which includes arrears to the BGC, the government's key gas supplier) by end-2016. This commitment is monitored under the SBA by a quantitative performance criterion. Another SBA quantitative performance criterion monitored throughout the duration of the SBA is the non-accumulation of new arrears.

64. *Expected results*. **The proposed reforms are expected to result in a reduction in gas flaring** as measured by (1) the expansion in Iraq's gas processing capacity; and (2) the amount of locally produced gas-to-power allocations. This will be achieved thanks to, inter alia, (i) the elimination of existing arrears with gas processors and the government's commitment (a performance criteria under the IMF's SBA) to remain current on the payment of invoices for dry gas, LPG and condensate deliveries, which will result in the reactivation of investment programs currently on hold for the expansion of natural gas processing capacity; (ii) the introduction by end-2017 of an effective contractual and regulatory framework for increased investment in gas gathering, processing and transport infrastructure; and, as a result, (ii) an increased ability to supply commercial quality natural gas for power generation needs. It is expected that the resulting expansion in natural gas processing capacity would yield an additional volume of processed gas of at least 629 MMscfd by 2018—above a baseline of 671 MMscfd in 2015—with an estimated current monetary value of US$1.05 billion per year. The baseline for locally produced gas-to-power allocation is at least 570.9 MMscfd for 2015 and the target for 2018 is 1,200 MMscfd or higher. The selected targets are aligned with the main gas operator's business plan. The target on processing volumes ensures that investment in processing capacity in Iraq will proceed apace, which will ensure that flaring is gradually reduced. The target on gas-to-power allocations ensures that the Ministry of Electricity will take the processed gas for generation purposes. Combined with the proposed increased allocations of natural gas for gas-based power generation (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 the welfare impact for the middle class and the poor.

Gas-to-Power Strategy

65. **To fully realize the benefits of reduced gas flaring, Iraq needs to ensure that the additional gas captured and processed can be effectively commercialized and allocated to serve its power generation needs.** Natural gas-based generation already contributes approximately 6,000 MW, or 45 percent, of peak load generation out of a total peak load of 13,400 MW. This, however, represents less than 50 percent of already installed, gas-based generation capacity of close to 15,000 MW; because of gas supply restrictions, more than 50 percent of gas turbines are operated today on more expensive gas oil, crude oil, and HFO, which also degrade the performance and useful life of generation equipment originally designed to operate on natural gas. The gas currently supplied for power generation already surpasses the target expected for Q1 2017 in the 2015 DPF.[48] The allocation of currently flared volumes to 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 gradually reduce domestic oil, HFO, and diesel demand by an estimated 325 thousand barrels of oil equivalent per day, which would result in additional annual oil exports of about US$5.5 billion at current prices. Iraq's Energy Master Plan and the investments programmed within it are expected to result in a total installed generation capacity of 24,400 MW by 2020, including 13,000 MW of gas-fired capacity, equivalent to a total requirement of roughly 2.5 bscfd of natural gas feedstock. A further 4,000 MW

[48] In June 2016, gas supplied for power production reached 871 MMscfd and could surpass 1000MMscfd by December 2016, against expected results for Q1 2017 of 840 MMscfd.

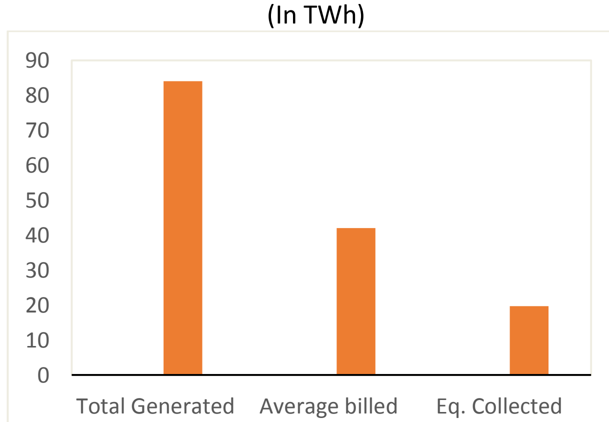
(equivalent to approximately 0.8 bscfd) is being added by the conversion of open-cycle gas turbine (OCGT) power plants to CCGT technology. Overall, a total of about 3.3 bscfd of natural gas will be required solely for power generation purposes by 2020. The planning, prioritization and financing of investments needed in power generation, natural gas processing and transport will require a dedicated "gas-to-power" strategy for the short and medium term. To that end, the programmatic DPF series would support the following reform:

Indicative Trigger 9: *The draft 2018 budget law submitted to the Council of Representatives includes the necessary FY2018 budget provisions consistent with a detailed, five-year investment program and financing plan (to be developed by the Inter-Ministerial Gas-to-Power Committee and approved by the Council of Ministers) to increase natural gas allocations for power generation.*

66. *Expected results.* **The above reforms are expected to improve electricity generation efficiency, cost, and environmental impact through increased share of gas used in the power generation mix.** The above reform leading to the effective operationalization of the Inter-Ministerial Gas-to-Power Committee is expected to improve much-needed coordination, planning, prioritization, and financing of gas-to-power investments (including gas gathering, processing, and transport infrastructure and the re-conversion and expansion of gas-based power generation capacity) among the Ministry of Oil, Ministry of Electricity, and Ministry of Finance. The prioritized implementation of planned investments is expected to result in improved gas delivery and electric generation efficiency, cost, and environmental impact through increased share of gas used in the power generation mix. The baseline for this result indicator for 2015 is 42 percent and the target for 2018 is 70 percent or higher. The associated gas supply network and the demand for additional gas from power plants are already in place to enable delivery and utilization of the projected gas supply increase. This increased use of natural gas in the power sector would also generate substantial improvement for public finances and the balance of payments. This will be specifically 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 exports, petroleum refining and industrial use, and replaced by gas-powered generation which is expected to comprise four-fifths of total capacity by 2030.

Electricity Subsidies

Figure 3. Iraq: Electricity Generated, Billed, and Collected
(In TWh)



Source: MoE 2015 Operating Statistics.

67. **Iraqis households receive an average of 14.6 hours of electricity per day and have to rely on expensive (private) diesel generation as a complement.** Unreliable electricity supply contributed to social unrest during the summer of 2015. Iraq's energy sector has been impacted by years of international sanctions and by the current conflict. These have left institutions weakened, led to under-investment and chronic deterioration in infrastructure. Due to low operational efficiency, high levels of electricity losses, and obsolete network equipment nearly half of the total energy generated is not billed. Cost recovery is also extremely low and collected revenues cover only about 15 percent of the operational expenditures (Figure 3), as users are reluctant to pay higher prices if services deteriorate.

68. **The Government of Iraq has begun tariffs adjustment and improvement of service delivery, with support from the World Bank.** In December 2015, the government adopted unsubsidized commercial tariffs for large commercial consumers (e.g., hotels) that chose to receive 24/7 electricity supply (prior action of the 2015 DPF). With continued support from the World Bank, the government has made progress in 2016:

(i) Electricity tariffs were increased by about fourfold effective January 2016, from an average of about US$0.17/KWh to US$0.8/KWh.[49] In order to protect low-income households, there was no increase for domestic consumers who utilize less than 1,500 units per month. While significantly better at providing more accurate price signals to consumers (so that they can reduce their demand), still the new tariffs covers only 60 percent of the operational costs.

(i) To improve service delivery and revenue collections, the government has initiated contracting out revenue management and low voltage network operations, starting with pilot areas in Baghdad. Preliminary results from these pilot areas indicate that high operations efficiency can be achieved.[50] The Ministry of Electricity now plans to roll out the contract services to cover the entire country.

69. **Improving the operational efficiency in parallel to increasing sector revenues is essential to achieving sector sustainability**. In the short term, the DPF supports the government's aim to reduce energy subsidies and operational inefficiencies by reducing non-technical losses, improving collections,[51] and reducing the cost of generation by increasing the share of gas-based generation in the total electricity generation mix. In addition, ongoing activities to improve the quality of electricity services include investments in generation (both new capacity and retrofitting of existing capacity), and the associated transmission and distribution network restoration and expansion. These investments are expected to increase the grid supply availability to about 20 hours by end-2017.

[49] For energy-intensive consumers, tariffs increased to ID100/KWh, exceeding the target of the 2015 DPF.

[50] In March 2016, after a very short bidding process, the MoE signed a revenue collection and low voltage operations management services contract for a pilot area in Baghdad area covering about 10,000 consumers. The contractor has completed survey and registration of the consumers (of the 8,000 premises visited; about 2,000 were found to be illegal consumers). The revenue collection during May-July 2016 has increased to ID5.1 billion compared to ID 0.8 billion collected during the same months in 2015 in the same area (though some of these likely reflect payment of arrears). The bidding process to award other areas is ongoing. Concerns have been voiced that bidding process is too short, that companies may lack adequate capital or availability of resources, and that they have little or no relevant experience.

[51] With an average annual billed energy of about 45TWh (2016) and the current average tariff of US$0.8 a 1 percent increase in revenue collection would increase sector revenues by about US$36 million/annum.

70. **These actions, although significant, are not sufficient to put the sector on a sustainable path.** In this context, the government has been unable to move to full cost recovery and has been reluctant to implement additional tariff increases given the fragile social context, including widespread dissatisfaction with service reliability and lack of effective commercial systems for service delivery and revenue collection. Therefore, there is a need for a vision and a roadmap for the future of the sector that aims to achieve sector sustainability, including full cost recovery and reliable service delivery. The vision and roadmap should include comprehensive reforms of the sector's business processes, including decentralized service delivery, improved commercial systems (meters, billing software), and an enhanced role for the private sector. To this purpose, the road map should also include a framework for procurement, in order to outsource services for electricity distribution of revenue collection. This vision and roadmap will build on recent technical assistance work, including that being provided by the World Bank Group, as well as a proposed investment operation that addresses the transmission and distribution of electricity.

Prior Action 8: ***The Council of Ministers has approved the Ministry of Electricity Loss Reduction Policy Directive 2016 (Council of Ministers' Decision No. 328, dated November 15, 2016, endorsing the Ministry of Electricity Loss Reduction Policy Directive 2016) to enhance revenue collection.***

Indicative Trigger 10: *The Council of Ministers approves a road map for the electricity sector which aims at full cost recovery and improved service delivery.*

71. *Expected results*. Reduced electricity subsidies (and their associated fiscal burden) will be measured by improved revenue collection as a percentage of generation. The baseline is 30 percent in 2015 and it is targeted to exceed 50 percent by 2018. Based on 2015 electricity sales, the target increase of 20 percent in revenue collections would be equivalent to about US$1.3 billion per year, or gross electricity sales of about US$3.2 billion per year. In 2015, total revenue collections were about US$460 million. The road map and associated reforms are expected to put Iraq on a path toward a viable electricity sector with full cost recovery and reliable services, and an increased role for the private sector. However, this will require a phased approach given the current abysmal state of the sector and the fragility of the country, pointing to the need for a comprehensive sector vision and reform program.

Pillar 3. Improve transparency and governance of SOEs

72. **Iraq's economy is still characterized by an incomplete transition to a full market economy with SOEs being an important unresolved agenda**. A network of SOEs operates in a wide range of sectors of the economy and, given their privileged status, prevents and stifles private sector growth in many of these sectors. 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 which 30 to 50 percent is estimated to be excess labor.[52]

73. **For the most part, SOEs in Iraq are non-transparent, weakly accountable, and undertake sizeable quasi-fiscal activities which generates large fiscal liabilities and risks**. Many SOEs in Iraq are decapitalized, asset-starved, inefficient, saddled with high production costs, over-staffed, and in a state of physical degradation.[53] Many of these SOEs have limited rationale beyond providing public

[52] See "Republic of Iraq: A Systematic Country Diagnostic" (2016).
[53] "Republic of Iraq: A Systematic Country Diagnostic" (2016).

employment. As a result, they are loss making and present a large burden for public finances (IMF, 2015). The MoF estimates that only one quarter of all SOEs are profitable. Most of the budget and off-budget funding for SOEs goes toward employee wages. Improving fiscal transparency, accountability, and reporting of SOEs would enable policymakers to better grasp the fiscal risks associated with SOEs in Iraq. This is especially relevant at a time when the government is undertaking a sizeable fiscal adjustment at the central government level; it is important that these efforts are not undermined by a widening of quasi-fiscal activities at the SOE level that, eventually, would require large fiscal transfers that would derail progress being achieved toward sustainable public finances.

74. **Iraq's management of the SOE sector is weak.** It is currently decentralized in various ministries and coordination with the Ministry of Finance beyond providing some financial statements is ad hoc.[54] Given the magnitude of the sector and its structural and cyclical problems, the Prime Minister decreed[55] the establishment of a Committee for SOE Restructuring to establish, operate, and supervise a database to monitor the fiscal risks as well as to improve comprehensive, accurate, and timely data collection on SOEs. This action was supported by the 2015 DPF. Currently, the database includes financial and employment information from 86 percent of non-financial SOEs (excluding those operating in ISIS-controlled territories).[56] The financial relationships between SOEs and the State are complex and nontransparent and require an in-depth analysis that goes beyond the analysis of key financial variables. These relationships, for example, include preferential policies, soft loans, and cross subsidies. The above-mentioned database, combined with a more in-depth analysis is expected to enable the government to have a more granular and actionable assessment of fiscal risks stemming from SOEs. These could then be monitored (including through the publication of regular fiscal risk assessment reports that include financial and employment metrics) and managed. In parallel, the government is also aiming to consolidate some SOEs for which synergies can be identified (in that regard, the government plans for 2016-17 has identified 72 SOEs that could be merged).

75. **Current legislation on non-financial SOEs is inadequate in promoting good governance in general and guidance on transparency practices in particular.** There is no separation between the roles and responsibilities of the government as an owner and the government as a manager, and no reporting or disclosure requirements on important financial statements. Developing a Charter of Good Corporate Governance to be approved by the Council of Ministers would provide guidance on internationally recognized good practices and realistically accounting for and adapting to the Iraqi context. The Charter would regulate SOEs on a "Comply or Explain"[57] basis providing the guidance that is needed and sought in legislation, while incentivizing through internal competition compliance beyond the voluntary. It sends a strong signal to the business community (public and private) that there is and should be an underlying trust between all stakeholders playing a role in creating more wealth and economic growth for the country and its people. Improved governance would also pave the way for the eventual restructuring, corporatization and private sector involvement of viable SOEs.

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[54] Selective data have been collected for ad hoc studies on SOE restructuring by the Prime Minister's Advisory Committee (PMAC), the Ministry of Industry and Minerals (MIM), and the MoF's Asset Valuation Department.
[55] Decree No. 446 of October 20, 2015
[56] A preliminary assessment of 136 SOEs out of the total 164 non-financial SOEs found that 13 SOEs hold more than half of total SOE assets; six SOEs account for more than half of the total operating expenses (and 15 SOEs for more than two-thirds of total operating expenses); and only 26 SOEs are profit-making.
[57] "Comply or Explain" is a regulatory approach in the field of corporate governance and financial supervision introduced in the Cadbury Report of 1992. Government regulators set out a code that entities may either comply with, or if they do not comply, explain publicly why they do not.

76. **The banking system in Iraq is small and dominated by weak state-owned banks that do not comply with key international transparency recommendations and have weak governance structures that make them vulnerable to directed lending.** Iraq's seven state-owned banks do not meet many prudential requirements owing to regulatory forbearance. A renewed push for directed lending to SOEs has further weakened them: under political and social pressures, state-owned banks are required to finance national priorities and public spending. At times, state-owned banks have provided 'loans' (unlikely to be repaid) to pay staff salaries of non-performing SOEs. Iraq's two largest state-owned banks, Rasheed and Rafidain (R&R) hold 71 percent of the system's deposits and have not been audited according to the International Financial Reporting Standards (IFRS) since 2006. The completion of the ongoing IFRS audits of both banks by an international audit firm is expected to increase transparency and disclosure in these banks' financial statements by accurately classifying assets and liabilities.[58] This will provide policy makers with a more accurate picture of the financial condition of these banks leading to a fact-based and informed decision on their likely restructuring and or resolution plans. After the completion of the R&R audits, the true extent of their liquidity and capital shortfall would be known. As a first and immediate measure, the CBI would ask the bank to stop issuing loans to non-financial SOEs and to start reducing their total lending exposures to these non-financial SOEs in a time-bound action plan.

77. The DPF-supported reforms will focus on the following:

Prior Action 9: The Council of Ministers' Secretariat has published on its website a report detailing the financial results based on FY 2015 closed financial statements of the largest nine (9) non-financial SOEs including taxes, dividends, subsidies/transfers, loans (principal and interest), and loan guarantees.

Indicative Trigger 11: *The Council of Ministers approves an SOE Charter of Good Governance, to improve Iraq's SOE corporate governance framework.*

Indicative Trigger 12: *The Central Bank of Iraq issues regulations directing state-owned banks to reduce their total lending exposure to non-financial SOEs as per a time bound action plan.*

78. *Expected results.* **The prior action and proposed trigger on non-financial SOEs aim to improve their transparency and promote good corporate governance standards within the Iraqi context.** This will help improve the monitoring of SOEs' performance, liabilities, and fiscal risks that SOEs represent for public finances in both the central government (Ministry of Finance) and state-owned banks. While this pillar is not expected to contribute to the government's short-term fiscal consolidation efforts, reforming the SOE sector is imperative for long-term efficiency gains and sustainable economic growth. It will improve fiscal transparency, reporting, accountability, and assessment of fiscal risks stemming from non-financial SOEs. Progress will be assessed against the ISAR[59] Benchmark of Corporate Governance Disclosures that captures corporate governance disclosures at a national regulatory level and compliance of disclosure practices of individual companies. The baseline for 2015 is 0 percent; the target for 2018 is greater than 15 percent.

[58] This includes the proper classification of non-performing loans (NPLs), improvements in their provisioning policies for these NPLs and more accurate identification and recognition of capital shortfalls as a result of these provisions.
[59] International Standards of Accounting and Reporting (ISAR)

79. *Expected results.* **The above reforms targeting state-owned banks are expected to improve their transparency and governance through a reduction in directed lending.** This will be measured by the share of state-owned banks' outstanding stock of lending to non-financial SOEs in their total lending. The baseline and target for this indicator will be determined following completion of the IFRS audits of Rasheed and Rafidain banks. This CBI measure is expected to result in an increased transparency of the transactions between the state-owned banking sector and its exposure and support to the non-financial SOEs. This in turn should drive a reduction in pervasive and non-transparent quasi-fiscal activities taking place between the central government, and financial and non-financial SOEs. Direct subsidies from the central government is a likely short term outcome; over the short- to medium-term, the higher scrutiny of these subsidies by government, parliament, and the general public is expected to provide a stronger call for reforms in Iraq's inefficient and growth-stifling SOE sector.

80. **The DPF series is supported by extensive technical assistance provided by the Bank, bilaterals, and multilaterals to help with reform implementation**. In addition to parallel financing provided by international partners such as IMF and JICA, the World Bank envisages technical assistance in the reform areas supported by the proposed DPF prior actions and triggers which will be delivered in partnership with international partners over the coming three years, as summarized below.

Table 4. DPF Prior Actions and Analytical Underpinnings

Prior Action	Analytical Underpinnings
<u>Prior Actions 1&2:</u> Wage bill reform	"Iraq Public Expenditure Review," World Bank Group. World Bank. 2014. "Corruption and Integrity Challenges in the Public Sector of Iraq", UNDP, 2013. "Building Public Services in Post-conflict Countries", World Bank, 2016. "Strategies for Private-Sector Development and Civil Service Reform in the Kurdistan Region – Iraq", RAND Corporation, 2014. "Iraq Public Sector Management Policy Note: The Imperative of Wage Containment and Payroll Reform", World Bank, 2006.
<u>Prior Action 3:</u> PIM reform	"2014 Iraqi Public Investment Management System 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.
<u>Prior Action 4:</u> Public debt management	IMF 2015 Article IV Consultations: Debt Sustainability Analysis. "Iraq Public Expenditure Review," World Bank. 2014.
<u>Prior Actions 5&6:</u> Pension and social	"A Stocktaking of Social Assistance Programs in the Republic of Iraq," World Bank, Dec. 2014

safety net reforms	“Iraq Public Expenditure Review,” World Bank. 2014.
<u>Prior Actions 7:</u> Gas flaring	“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 Actions 8:</u> Reduce electricity subsidies	“Iraq: Cost of Service Study,” World Bank-ECA, (2016) “Iraq: Assessment of the Economic Impact of Energy Subsidy Reduction,” World Bank, P. Griffin, 2016 “Iraq: Energy Sector Communications Strategy,” World Bank-IISD, 2016 “Iraq: Electricity Distribution Sector Reform Study,” World Bank - CPCS, 2015. “Energy Subsidy Reform: Lessons and Implications,” by Clements et al. eds. 2013, IMF. “Iraq: Integrated National Energy Strategy Report,” World Bank, 2013. “Iraq Energy Outlook Report,” International Energy Agency, October 2012. “Iraq Electricity Master Plan,” Parsons Brinckerhoff: Iraq Electricity Master Plan, 2011.
<u>Prior Action 9:</u> Transparency and governance of SOEs	“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. “Reform of SOEs and PPPs in Iraq,” S. Rimmer and M. Wafaa Al-Ani, World Bank, 2012. “Iraq: Financial Sector Review, “World Bank, 2012. “Iraq: Roadmap to Resolve Rasheed and Rafidain Banks,” December 2015.

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

81. **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, among others, on the pace and strength of reforms, and on the political and security environment. This engagement has taken several forms, including a 2010 DPF—which was rated moderately satisfactory by IEG—and the 2015 DPF, which has supported reforms that are continued by this proposed new programmatic series. In addition to the knowledge base used to design the 2015 DPF, the proposed operation benefited from several recent reports, including the *Iraq Systematic Country Diagnostic (2016)*, and the *Iraq Risk and Resilience Assessment* prepared in July 2016. The revised objectives of the CPS recognize the challenges Iraq is facing for rebuilding and strengthening the capacity of state institutions. 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) to address and help manage the country’s critical

fiscal situation and increase opportunities for the private sector. The first objective is supported by a US$350 million emergency investment operation approved by the Board on July 7, 2015. It supports the resumption of basic services in six cities that have been regained from ISIS control. The proposed DPF operation, building on the 2015 DPF, aligns with the second objective and supports Iraq's efforts toward economic stabilization, rebuilding state institutions and putting the economy on a sustainable path toward ending extreme poverty and promoting shared prosperity.

82. **The proposed DPF is aligned with the MENA Strategy**. The MENA Strategy aims to use development to promote peace and stability in the region and to establish conditions for inclusive growth. The Strategy acknowledges that conflict and violence in MENA are having 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 it. 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 MENA. This operation is consistent with at least three of the four pillars of the MENA regional strategy: (i) Renewing the Social Contract; (ii) Resilience; and (iii) Recovery and Reconstruction. The first pillar is addressing underlying causes, while the latter two tackle the immediate consequences as the DPF prior actions are focusing on major economic and social reforms in critical areas that are expected to contribute to inclusive growth and stability.

4.4 CONSULTATIONS, COLLABORATION WITH DEVELOPMENT PARTNERS

83. **Consultation has taken place through the Bank's engagement with stakeholders as well as through the government's own engagement with the Iraqi population around its national program.** This operation has benefited from the extensive stakeholder consultations undertaken in September 2016 by the Iraq SCD team in Baghdad and Erbil. As described in Section 1, the proposed operation is closely aligned with five of the six development priorities of the new government and as such this operation has benefited from the consultations surrounding the government own mandate for reforms.

84. **The programmatic DPF series is part of a package of coordinated financial assistance from international partners to help Iraq**. The proposed DPF operation is closely coordinated with donors and the IMF. In July 2016, the IMF approved a US$5.3 billion SBA that will provide financing over three years. JICA is aiming to provide parallel financing to the proposed programmatic DPF series and has participated in the DPF mission that formulated the policy reform matrix. France is also expected to extend a US$450 million bilateral loan for budget support as part of the overall international support package. The United States government intends to guarantee the issuance of a US$1 billion Eurobond in 2017. The United Kingdom and Canada are expected to support the proposed US$1,443.82 million IBRD loan by providing guarantees to IBRD up to a maximum amount of US$371.82 million and US$72 million, under which each guarantor will guarantee pro rata portions of the repayment of the loan by Iraq. . 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 provided or financed by donors (e.g. DfID, JICA, USAID).

5. OTHER DESIGN AND APPRAISAL ISSUES

5.1 POVERTY AND SOCIAL IMPACT

85. **Overall, the combined impact of the structural reforms proposed in the DPF series are expected to improve welfare**. Reforms implemented by the government are necessary to put fiscal expenditure on a sustainable path, maintain macroeconomic and price stability, and lay the foundation for inclusive growth. A number a prior actions supported by this operation will have a positive or neutral social impact. The implementation of the electronic payment and biometric system will help re-deploy resources to critical basis services. The implementation of the PIM and debt management reforms will improve the efficiency of public spending on investment and debt service and enhance fiscal space for social spending. The SOE transparency and governance reforms will provide better information on fiscal outlay and contingent liabilities.

86. **The implementation of a more efficient and well-targeted system of social spending is expected to have positive impacts on the poor and vulnerable, and improve horizontal equity.[60]** The transition from an untargeted PDS system to a better targeted safety net system through proxy means testing will broaden the reach of social program to those in need relative to the current situation (see paragraphs 87-89). Reforms of the pension system will not have a significant impact in the short term, but are likely to affect the income of some households in the long term (see paragraph 90). However, it should be noted that these reforms will ensure the sustainability of the pension system, securing the value of the pensions over time, and expanding the coverage. The roadmap for electricity sector reform is expected to include improvement in electricity revenue collection and electricity tariff adjustment to reach cost recovery level.[61] These reforms are necessary to reduce the high level of subsidies, which is not fiscally sustainable, induces over-consumption, with negative impact on the environment and at the margin favors too high capital intensity at the expense of labor and is horizontally inequitable as a large share of consumers are not paying their bills. In the immediate, the supported reform program protects expenditure targeted to deliver services to IDPs. No supported policy reform is likely to have a disproportionately adverse impact on women. An 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.

Poverty and social targeting mechanisms

87. **The DPF-supported reform on moving the SSN benefits from a categorical to a proxy means tested targeting is likely to significantly benefit the poor relative to the current situation**.[62] The adoption of a well-designed and tested proxy means formula will, in all likelihood, increase the

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[60] So that people with the same level of income would have equal access to SSN.

[61] The World Bank is providing technical assistance to support the Government in developing and implementing a strategy for subsidy reform. This 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.

[62]Public transfers to households in Iraq come from three sources—the PDS, pensions and the Social Security Network. Transfers through the PDS are, almost universal and cover more than 99 percent of the poor. While less than one fifth of PDS beneficiaries are poor, it remains the only safety net that comprehensively covers Iraq's poor population (IHSES 2012). Pensions, which are not explicitly an anti-poverty transfer reach less than 20 percent of the poor, and more than a quarter of the non-poor. About 85 percent of pension recipients belong to non-poor households. SSN transfers, on the other hand, do involve some categorical targeting of households; however, only 11 percent of the poor received some form of SSN benefits in 2012. Of the beneficiaries, 74 percent are non-poor.

coverage of the poor, and reduce inclusion and exclusion errors. In general, the move to a unified registry and database of all individuals and households in the country will be an invaluable basis for moving toward a more comprehensive social protection system.

88. **The PDS is currently the only safety net covering the poor in Iraq, and therefore, has been politically very difficult to reform**. This is in large part due to the absence of any other viable system of social protection, which has made large parts of the population very dependent on food rations, and resistant to reform. Meanwhile, the continuing instability and insecurity in the country have made it difficult to put in place alternative means of securing livelihoods, either through public intervention or through the revival of local economic activity. As a result, without putting other programs in place, any one-time reform to the PDS including targeting, will have adverse consequences on welfare, and will be hard to implement.

89. **In April 2016, the new poverty-targeting program was launched, which is expected to dramatically increase the coverage ratio and improve efficiency**. The first step in this direction was the adoption and pilot testing of a proxy means test formula, followed by the creation of a universal database of Iraqis. The DPF-supported reform proposes to exclude all non-eligible current beneficiaries and to redirect the assistance to the eligible poor. Given the large inefficiency of the PDS, which reach 99 percent of the poor but also 95 percent of the non-poor, the reform would create a more effective and efficient social safety system which, without increasing the level of current transfers, would provide increased support to the poor.

90. **The distributional impact analysis for the proposed reform in the pension system is not expected to create a significant welfare loss at the moment of its implementation, because benefits accrued are grandfathered.** However, in the long term it will impact some households (with an increase of the poverty count by an estimated 1.5 percent compared to the baseline). The government will use its proxy means testing social safety system to mitigate any impact on the affected households. The supported reform of the social insurance law would improve financial sustainability, adequacy, affordability, efficiency and would expand the coverage of the pension system. A detailed analysis of the impact of the proposed reform of the pension system is included in Annex 5.

Reduce electricity subsidies

91. **The proposed improvement in revenue collection from 30 to 50 percent of total cost of generation is unlikely to materially adversely impact household welfare and commercial viability of productive enterprises.** The government intends to improve revenue collection and increase the electricity provided through the grid from the current average of 14.6 hours per day to 20 hours per day by end-2017. For productive enterprises**,** 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 lower costs while increasing output and productivity. It is not certain, therefore, that better revenue collection, if accompanied by more reliable electricity supply 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.

92. **The full impact on households would depend on the level of compliance with payments of electricity bills and the elasticity of response to higher payments for electricity.** Simulations considered the impact on the poor and near-poor of a 20 percent improvement in revenue collection based on the new tariff adopted by the government in January 2016. Simulations are for the year 2013

based on extrapolated IHSES 2012 data. It is important to note that although almost all households are connected to the public grid, and a vast majority receives some power from that grid, only 60 percent of households in IHSES 2012 report paying for electricity from the public grid in the last 12 months. This implies that in estimating the potential welfare impact of any improvement in revenue collection, 40 percent of households would be assumed to increase payments from zero to 50 percent of the average bill paid by electricity consumers in the same income quintile. The low level of compliance underlines the importance of the reform.

93. **The impact of increased tariff collection is estimated to increase poverty rate by 0.2 percent compared to a no reform scenario.** Better tariff collection would reduce non-electricity consumption of the poor and near-poor that are not currently paying (or only partially paying) their electricity bills. As a result, there are about 50,000 individuals who would become poor because of improved revenue collection. For those who were already poor before the improved collection, the average welfare loss (as a share of household spending) is about 0.5 per cent. Similar findings are also observed for the new poor (0.7 percent). This is only a first order approximation effect, as the full welfare effect of the planned increase in revenue collection would also depend on (i) lower use by households of more expensive alternative sources of electricity generation (e.g., private generators), as a result of better service; and (ii) the reduction of consumption of electricity as higher costs would incentivize more efficiency.

94. **The impact on the above 0.2 percent of additional poor is expected to be mitigated by better targeting and potential improvement in the level of SSN, as efficiency increases**. With the expected improvement in the efficiency of the new SSN system, the government could provide to the poor a direct subsidy, for example cash subsidies or vouchers, explicitly linked to electricity consumption. A comprehensive analysis of the system of energy subsidies and alternate reform scenarios is also underway, supported by ESMAP. In addition, a comprehensive analysis of reforms to the system of energy subsidies will be undertaken that will take into account the presence of alternate sources of energy to households, both publicly and privately provided. In parallel to the DPF program, the World Bank is providing technical assistance to support the government in developing and implementing a strategy for subsidy reform. This 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

95. **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 some relative success, starting with Law No. 37 of 2008 establishing the Ministry of Environment, 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 Environmental Impact Assessment (EIA) department in the Ministry of Environment.[63]

[63] 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 Ministry of Environment reviews EIA reports and issues an environmental compliance certificate, and consultations are held

96. **As per OP 8.60, the World Bank assessed whether specific country policies supported by the DPF series 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 program supported under improving energy efficiency 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. Similarly, the strengthening gas-to-power strategy under this same objective would promote the use of natural gas in power generation instead of the more polluting fuel oil and diesel. This will significantly improve air quality by reducing energy-related emission that lead to air pollution, reducing the related impacts on human health. With respect to the reforms, to reduce gas flaring and improve energy efficiency, any significant negative environmental effect is likely to be avoided or mitigated. The EIA department has benefited from Environmental Assessment capacity building with the ongoing World Bank-financed Iraq Transport Corridor Project and the Emergency Operation for Development. Thus, the capacity exists to implement, monitor and report on mitigation measures associated with safeguards instruments susceptible to be used in power generation using gas and private sector investment in gas capture, processing and transmission infrastructure and for electricity generation. With respect to the 228 projects that were found by MoP to be aligned with government priorities, the MoP PIM unit responsible for their selection will also take into account possible environmental and social impacts when undertaking cost benefit analysis or when assessing projects in general. For this, it uses the 2008 feasibility studies guidelines for social impacts, and the EIA regulations for environmental impacts. In this context, MoP will work with the EIA unit in the Ministry of Environment to improve environmental and social criteria and mitigation measures which will form an integral part of the selection, design and siting of projects.

5.3 PFM, DISBURSEMENT, AND AUDITING ASPECTS

97. **Public Financial Management (PFM)**: PFM reforms are at the heart of the priorities of the Government of Iraq evidenced in 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) an improved new General Financial Management Law of 2016 drafted and reviewed by the State Council; (2) improvement in the budget preparation process with detailed policy focus during budget strategy discussions; (3) development of a general MTEF and budget formulation and execution based on administrative and basic economic classification; (4) development of a new budget classification (BC) and a new Chart of Accounts (CoA) with separate segments for administrative, economic, type, functional, and geographical;[64] (5) general information on the federal budget of 2015 published on the federal MOF website; and (6) an IFMIS implementation roadmap (2016-2021) with a System Requirement Study (SRS) and the design and specifications of the needed IFMIS for budget preparation and execution prepared with the support of the World Bank. Standard bidding documents were prepared and disseminated for use by different implementing agencies and complemented by development and adoption of a public procurement national training strategy. The revised Federal

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with the concerned public, stakeholders, municipalities, and ministries. The Ministry 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.

[64] 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.

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.[65] 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.

98. **While the central government enacted budget is made available to the public through the Ministry of Finance website, a number of areas require improvement**. These include (1) Iraq's score on the Open Budget Index, which retreated from 4 in 2012 to 3 in the 2015 (last round); (2) the publicly available information on the federal government budget and financial activities during the course of the budget year;[66] (3) the aggregate total expenditure deviation between the approved expenditure budget and actual expenditure outturn (41 percent in FY15); (4) the Iraq Budget classification, which still suffers from fundamental deficiencies, including a lack of a functional classification and an inadequate economic classification; (5) the chart of accounts, which does not have a program segment that allows consolidation of capital and current transactions; (6) the execution of the investment budget, which is affected by delays in MoF budget releases due to low cash inflows from tax and non-tax revenues; (7) the public procurement system, which lacks the legislative instrument found in a normal legal framework;[67] (8) the internal controls within the entire public administration, including the roles of internal auditors and Offices of Inspectors General (OIGs);[68] and (9) the timeliness of the completion of the final accounts by MoF and submission to the Federal Board of Supreme Audit (FBSA) for auditing, and the timeliness of the MoF response to the FBSA inquiries needed to complete the audits.[69]

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[65] 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.

[66] 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.

[67] 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 Council of Ministers in 2009 decided to abolish it. 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 Council of Ministers and MoF.

[68] 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 Offices of Inspectors General (OIGs) appear 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.

[69] 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 those of 2013. The final accounts are not published.

99. **To address some of these issues, the World Bank is working with the Iraqi authorities on a multiyear engagement on PFM**. The proposed US$41.5 million Modernization of Public Financial Management Systems Project aims to improve financial information management and transparency, cash management, public investment management, and public procurement modernization at selected federal and governorate agencies. The design and initial implementation of the Iraqi Financial Management Information System (IFMIS) will be the conduit for modernizing budget and financial management business processes that will allow to streamline budget planning and preparation, track financial events and record all transactions, summarize information, support reporting and policy decisions, and incorporate the element of information and communication technology (ICT), skilled personnel, procedures, controls and data. The development of the IFMIS will affect not only the federal MoF, but also the entire public administration, as well as the way the federal government operates and presents itself to citizens, businesses, and the international community. For example, the disclosure of meaningful public finance information through federal government websites will provide new opportunities to civil society and MDAs at both federal and governorate levels, once they learn how to interpret the vast amount of data that becomes available, and provides feedback on budget performance and policy decisions.

100. **The Bank currently provides advisory services through Public Management, Transparency, and Regulatory Reform Technical Assistance.** Funded by an Externally-Financed Output (EFO) agreement signed with the UK DfID, with the following main objectives: (1) improve federal MOF online information and transparency; (2) provide federal MOF with a relevant instrument to benchmark PFM performance against international practices by assessing its PFM systems using the new PEFA framework of 2016;[70] (3) assess federal MOF capacity building needs; (4) enhance the FBSA oversight capacity; and (5) improve the regulatory governance and simplification.

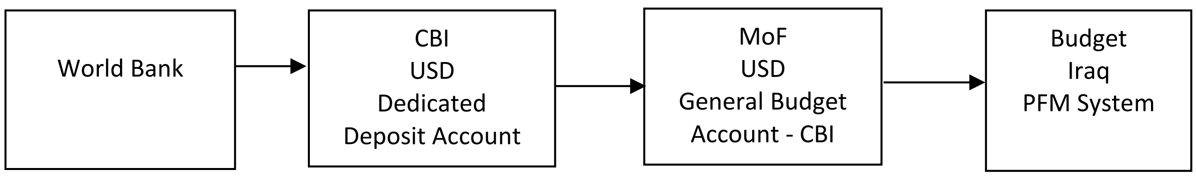
101. **Foreign exchange.** The CBI's legal framework needs strengthening to provide for independent oversight of the CBI's operations. By end-December 2016, the Governing Council of the CBI will approve a new charter for the Audit Committee prohibiting Central Bank of Iraq executive representation on the committee. By end-December 2016, the Council of Ministers plans to approve and introduce to Parliament amendments to the Law on the Central Bank of Iraq to strengthen CBI governance and the internal control framework. These reforms are structural benchmarks under the IMF SBA. 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 last audited year. The basis of the qualified opinion is the same for 2011 and 2012 related to old outstanding balances at foreign banks, funds owed to the CBI from the MoF that have been not yet returned to the CBI, and lawsuits in different countries against the CBI for past due debts.

102. **Disbursement arrangements.** The proposed loan will follow the Bank's disbursement procedures for development policy operations 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 will be deposited by the IBRD in a US dollar 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 account, the full amount is credited

[70] This assessment will provide the Iraqi federal government with more comprehensive information on the performance of PFM systems, which in turn can be used to set certain targets to assess the future impact of PFM reforms.

in the US dollar 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 expenditure, 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.

103. **The total amount of time between disbursement by the World Bank of the loan proceeds in US dollars and the credit into the general budget account should not exceed 30 days.** MoF will furnish 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:



104. **Auditing arrangements.** An independent external auditor, acceptable to the Bank, will be hired by the MoF to verify the accuracy of the transactions of the dedicated deposit account and that it was used only for the purposes of the operation and no other amounts have been deposited into the account. In addition, the auditor will have to obtain confirmation from corresponding bank(s) involved in the funds flow regarding the transaction. The time period for submission of the audit report to the Bank is six months from the loan proceeds are being credited in the designated account.

5.4 MONITORING, EVALUATION AND ACCOUNTABILITY

105. **The responsibility for implementing the program in the 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 multisector and multiagency 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.

106. **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 toward the achievement of the programmatic results are available, data for some indicators have so far been difficult to obtain. This includes data on the total number of civil servants and on liabilities of SOEs. Nevertheless, major improvements have been achieved in the quality of fiscal data as the MoF completed fiscal reporting tables at end-December 2015, end-March, and end-June 2016 in compliance with the IMF Government Finance Statistics Manual 2014 (a structural benchmark under the SBA program). Statistics in the balance of payments areas are not adequate for analyzing macro-economic developments.

107. **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 World Bank'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 World Bank's independent Inspection Panel, which determines whether harm occurred, or could occur, as a result of World Bank 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

108. **The overall risk rating of this operation is high.** Major risks that could prevent the operation from achieving its development objectives include: (1) political and governance, stakeholder and social risks; (2) macroeconomic risks; (3) fragility, conflict and violence risks; (4) institutional capacity for implementation and sustainability risks; (5) sector strategies and policies risks; and (6) fiduciary risks (Table 5). However, while risks to this proposed programmatic series are high, they should also be weighed against the risks of inaction, which currently in Iraq are extremely high.

- **Political and governance risks are high, and stakeholder and social risks are substantial**. While the crisis is viewed as an opportunity to tackle long standing issues, the reform drive could be undermined by a further weakening of the security situation, by social unrest due to low quality and availability of basic public services (such as electricity[71]), 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. Iraq indeed ranks poorly on international comparisons regarding perception and control of corruption. Backsliding of the reform agenda could, however, endanger the macroeconomic framework.

- **Macroeconomic risks are high**. The risks outlined in paragraph 35 could affect implementation, impact, and sustainability of the reforms supported by this series. 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 war (see Box 2). 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. These risks are partially mitigated by the government commitment to implement the program supported by the IMF SBA, which would provide regular quarterly

[71] 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, which could tip the country into a deep crisis.

reviews based on meeting targets for fiscal and foreign reserves aggregates. Some of the fiscal savings measures included in this operation (e.g., parametric pension reform, gas-to-power and electricity tariff reforms) would also help mitigate some of the downside risks by reducing the structural fiscal deficit.

- **Fragility, conflict, and violence risks are high**. The capacity of the country to implement the macroeconomic program and to improve service delivery critically depends on a continuous improvement of the security situation with the government able to regain territories under ISIS-control and provide needed assistance to the population. The ongoing conflict in Mosul could generate a large number of new IDPs. The battle in Mosul could lead to higher military expenditure and put further strains on the State's budget and service delivery capacity. The Iraqi government's capacity to undertake longer-term development reforms, including those included in this DPF, may be lessened should the security situation become more overwhelming. The international response to ISIS, once perceived to be largely defeated in Iraq, may also subside. This could impact the Iraqi State's capacity to address remaining insecurity and violence and secure the population in its borders.

- **Fiduciary risks related to this operation are high**. This is the general conclusion of a number of diagnostic reports.[72] The Bank is supporting the Iraqi government in strengthening its PFM system through the planned Modernization of Public Financial Management Systems Project to be presented to the Board in December 2016. This planned project is expected to improve financial information management and transparency, cash management, public investment management, and public procurement modernization at selected federal and governorate agencies. It will pursue this objective by supporting capacity development and foundational systems, including IFMIS design and initial implementation; PFM capacity development; Internal audit modernization at federal MoF; PFM systems at subnational level; PIM system strengthening; and public procurement modernization.[73]

- **Sector strategies and policies risks are rated substantial and risks related to institutional capacity for implementation and sustainability are rated high**. Reforms in the power and electricity sectors could be undermined by a piecemeal approach that would not generate the full benefit that would derive from addressing inefficiencies and bottlenecks in the gas and electricity sectors. This risk is mitigated by the technical assistance and capacity building proposed to be provided through the Energy Sector Programmatic Technical Assistance. Risks related to institutional capacity for implementation and sustainability are high due to lack of resources, capacity constraints, resistance from special interest groups, and changes in reform directions due to political and social pressures. For example, pension reforms have always been politically influenced in Iraq. The main risks remain political intervention against the suggested reform steps, and possible increase in the already long lists of victims and martyrs of terrorism

[72] 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.

[73] Under this Modernization of PFM Systems project, 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 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.

or casualties of incidents that are eligible for non-contributory pensions. Mitigation factors include the commitment to continue the process of fiscal consolidation agreed under the IMF SBA, which implies reducing the largest fiscal outlays.

Table 5. 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	H
6. Fiduciary	H
7. Environment and social	S
8. Stakeholder	S
9. Other: Fragility, Conflict, and Violence	H
Overall	**H**

ANNEX 1: PROGRAMMATIC DPF POLICY AND RESULTS MATRIX

	Prior Action DPF	Indicative Trigger DPF	Result Framework		
			Indicator	Baseline	Target
PILLAR 1. IMPROVE EXPENDITURE RATIONALIZATION					
Wage bill reform:	Prior Action #1: The Council of Ministers has issued a decision requiring all Ministries, Departments, and Agencies (MDAs) to: (a) transition by FY 2020 to electronic payment of all civil servants' compensation (inclusive of benefits and allowances); and (b) install by FY 2018 biometric identification systems to verify civil servants' daily attendance (Decision No. 313, dated November 2, 2016). Prior Action #2: The Recipient has implemented an electronic payroll system for at least 30 percent of civil servants in two pilot MDA units, and the new biometric attendance system is implemented for all civil servants in two pilot MDA units.	Indicative Trigger #1: At least 20 percent of all central government civil servants receive their compensation electronically; at least 70 percent of central government civil servants use biometric time and attendance systems. Indicative Trigger #2: The Council of Ministers issues a decree requiring central government employees found non-compliant either by the employee audit conducted by the Federal Board of Supreme Audit or by biometric attendance records (except in case of excused leaves) to be excluded from payroll.	Strengthened payroll expenditure control as measured by the percentage of verified central government employees whose compensation and daily attendance is tracked electronically (minimum of the two variables).	2015: 0 %	2018: > 30 %
PIM reform:	Prior Action #3: In line with the Public Investment Management Framework, which was adopted under Decree No 445 dated October 18, 2015, the Minister of Planning has submitted to the Council of Ministers the list of investment projects that are consistent with the government's priorities.	Indicative Trigger #3: Final validation of the Iraqi Development Management System (IDMS) and make it operational, as measured through the creation of a specialized monitoring and ex-post evaluation team, within the Central PIM Unit of the Ministry of Planning in charge of ex post evaluation.	Improved selection and assessment of public investment projects as measured by the percentage of capital projects that exceed ID100,000 billion (about US$85 million) for which a feasibility study with cost-benefit analysis was completed.	2013: 5 %	2018: > 20 %
Public Debt Management	Prior Action #4: Pursuant to the Prime Minister's instruction, the Ministry of Finance has started publishing quarterly Public Debt Bulletins, which include all data on external debt of the central government.	Indicative Trigger #4: The Minister of Finance publishes its annual Medium-Term Debt Management Strategy, which includes detailed borrowing plans for 2018 and targets for selected risk indicators	Share of the domestic debt in total public debt 1/	2015: 34.3 %	2018: ≥ 35 %
Pension reform:	Prior Action #5: The Council of Ministers has approved and submitted to the Council of Representatives (Council of Ministers Decision No.346, dated November 29, 2016) the draft Integrated Social Insurance Law, including the integration of the public and private pension schemes.	Indicative Trigger #5: The Integrated Social Insurance Law, including the integration of the public and private pension schemes, is enacted.	Improved social insurance efficiency, coverage, and sustainability as measured by the expected actuarial deficit period (years left till going into deficit from 2015)	2015: 13 years	2018: > 28 years

1/ The specific risk indicator chosen could be revised next year once the MDTS is published and the Ministry of Finance publishes the risk indicators surrounding the country's sovereign debt structure.

	Prior Action DPF	Indicative Trigger DPF	Result Framework Indicator	 Baseline	 Target
Social Safety Net:	Prior Action #6: The Council of Ministers has issued a decision to exclude non-eligible beneficiaries of the Social Safety Net System, and to redirect the assistance to the poor (Council of Ministers Decision No. 312, dated November 2, 2016), based on the targeting method stipulated in Article 6 of the Social Protection Law No. 11 of 2014.	Indicative Trigger #6: The Council of Ministers issues decision requiring ministries and public institutions to use the Welfare database in implementing all programs targeted to the poor.	Improved social safety net efficiency as measured by : (1) coverage ratio of the poor; and (2) inclusion error	(1) 2015 = 11 % (2) 2015 = 43%	(1) 2018 ≥ 50 % (2) 2018 ≤ 20 %
PILLAR 2. IMPROVE ENERGY EFFICIENCY					
Gas flaring:	Prior Action #7: The Council of Ministers has approved and submitted to the Council of Representatives the FY 2017 draft budget which includes ID1.4 trillion to cover payments from the Ministry of Oil to associated natural gas processors for (a) processed / dry gas, LPG and condensate deliveries and (b) projected investment requirements for processing capacity expansion, toward the reduction of gas flaring.	Indicative Trigger #7: Publication in the National Gazette of regulations for (i) Natural Gas Pricing for both associated and non-associated natural gas for domestic use; (ii) Natural Gas Transport; and (iii) Natural Gas Marketing. Indicative Trigger #8: The Council of Ministers approves a Supplementary Associated Natural Gas Production Contract template which is made mandatory for existing Technical Service Contract holders or other interested investors, with the aim of establishing conditions, rights, and obligations to gather, process and sell/market associated natural gas.	Reduction in gas flared as measured by (1) the expansion in Iraq's gas processing capacity; and (2) the amount of locally produced gas-to-power allocation	(1) 2015 = 671 MMscfd (2) 570.9 MMscfd	(1) 2018 ≥ 1,300 MMscfd (2) 2018 ≥ 1,200 MMscfd
Gas-to-power Strategy:		Indicative Trigger #9: The draft 2018 budget law submitted to the Council of Representatives includes the necessary FY2018 budget provisions consistent with a detailed, five-year investment program and financing plan (to be developed by the Inter-Ministerial Gas-to-Power Committee and approved by the Council of Ministers) to increase natural gas allocations for power generation.	Improve electricity generation efficiency, cost, and environmental impact through increased share of gas used in the power generation mix.	2015 = 42 %	2018: > 70 %
Electricity subsidies:	Prior Action #8: The Council of Ministers has approved the Ministry of Electricity Loss Reduction Policy Directive 2016 (Council of Ministers' Decision No. 328, dated November 15, 2016, endorsing the Ministry of Electricity Loss Reduction Policy Directive 2016) to enhance revenue collection.	Indicative Trigger #10: The Council of Ministers approves a road map for the electricity sector which aims at full cost recovery and improved service delivery.	Reduced electricity subsidies, as measured by improved revenue collection as a percentage of generation	2015 = 30 %	2018 > 50 %

	Prior Action DPF	Indicative Trigger DPF	Result Framework Indicator	 Baseline	 Target
PILLAR 3. IMPROVE THE TRANSPARENCY AND GOVERNANCE OF STATE-OWNED ENTERPRISES					
Transparency and governance of SOEs:	Prior Action #9: The Council of Ministers' Secretariat has published on its website a report detailing the financial results based on FY 2015 closed financial statements of the largest nine (9) non-financial SOEs including taxes, dividends, subsidies/transfers, loans (principal and interest), and loan guarantees.	Indicative Trigger #11: The Council of Ministers approves an SOE Charter of Good Governance, to improve Iraq's SOE corporate governance framework.	Improved SOEs transparency and governance as measured by the ISAR Benchmark of Corporate Governance Disclosures to measure corporate governance disclosure changes at a regulatory level as well as the disclosure of key financial information at a company level.	2015: 0 %	2018: > 15 %
		Indicative Trigger #12: The Central Bank of Iraq issues regulations directing state-owned banks to reduce their total lending exposure to non-financial SOEs as per a time bound action plan.	Reduction of state-owned banks' exposure to non-financial SOEs, as measured by the share of state-owned banks' outstanding stock of lending to non-financial SOEs in their total lending.	Baseline to be determined following the completion of the IFRS audits of Rasheed and Rafidain banks	Target to be determined following the completion of the IFRS audits of Rasheed and Rafidain banks

ANNEX 2: LETTER OF DEVELOPMENT POLICY

بسم الله الرحمن الرحيم

Republic of Iraq
Ministry of Finance
Minister's Office

جمهورية العراق
وزارة المالية
مكتب الوزير

العدد: 2275
التاريخ:

Dec, 1, 2016

Draft Letter of Development Policy

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

Second Expenditure Rationalization, Energy Efficiency and State-Owned Enterprise Governance Programmatic Development Policy Financing

Dear Mr. Kim,

1. Iraq's recent history has been painfully marred by security, economic and human development challenges. The country is engaged in a war against the so called Islamic State of Iraq and Syria (ISIS), and coping with a large 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. We are committed to implement reforms that would help re-build the social contract and actively support the non-oil economy. To do so, first we intend to improve governance in the public sector and combat corruption.

Background

2. The incursion of ISIS into Iraq has been brutal including on the humanitarian and economic fronts. In 2015, we have launched a concerted and ongoing military campaign against ISIS and have regained most of the territories previously occupied. we are now fighting to liberate from ISIS the city of Mosul, which is the second most populated city in Iraq. The length of the operation is still unclear, as are the costs of assisting the people who will be displaced as a result of the military campaign. In the meantime, we are currently working on reinstating the presence of the State in the liberated areas (we are doing so in partnership with the World Bank through their US$350 million Emergency Operation for Development). In addition to the lives lost as a result of terrorist activity, we are witnessing the unfolding of a humanitarian crisis: about 3.4 million Iraqi citizens are internally displaced and 225,000 Syrian refugees that have fled the conflict in their country are placing a large burden on our

already stressed public services. The U.N. Estimates that 10 million people are in need of assistance. The conflict is also leading to large destruction in physical assets and disruption of economic activities

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 partly 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.

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 ISIS crisis and the reduction in oil prices. Thanks to strong growth of oil production in 2016, the economy continues to grow, reaching an expected 10 percent growth in 2016. However, the non-oil economy has been declining for the past three years because the war has displaced and increased vulnerability of millions of people, destructed infrastructure, disrupted trade and sagged confidence. This dire non-oil economic situation has led to an estimated increase in poverty from 19 percent in 2012 to 22 percent after the onset of the conflict. Inflation remains restrained to 1.4 percent on average in 2015and is expected to average 2.0 percent in 2016, although we are concerned about potentially higher inflation rates in areas within ISIS control.

6. On the external front, the current account deficit is forecast to widen to about 7.0 percent of GDP by end 2016 compared to a deficit of 6.1 percent in 2015, when it turned negative. This deterioration is led by the plunging of oil prices since 2014 which negatively affects revenues from oil exports. The latter fell by US$36 billion (39 percent) in 2015 compared to 2014. With these balance of payment pressures, our gross reserves have been on a downward path since 2013, estimated to reach US$43 billion by end-2016, a reduction of US$10 billion compared to end-2015. This lower level of reserves is adequate to maintain our peg, as recently assessed in the first review of the IMF SBA program, which will be discussed by the IMF Board on December 5, 2016.

بسم الله الرحمن الرحيم

Republic of Iraq
Ministry of Finance
Minister's Office

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مكتب الوزير

العدد:
التاريخ:

7. On the fiscal front, the fall in oil prices has sharply reduced our revenue while the war with ISIS has increased spending needs, pushing our fiscal balance into a large deficit in 2015, despite a major fiscal consolidation effort. The overall fiscal deficit reached 12.3 percent of GDP in 2015 .The fiscal consolidation has been frontloaded in 2016, when thanks to continued expenditure controls the fiscal deficit is expected to decline to 8.2 percent of GDP. The limited financing available forced some adjustments to contain the deficit in both 2015 and 2016. On the revenue side these focused on ensuring increased volumes of oil exports. On the expenditure side, the Government prioritized payments of wages, pension, debt service and oil-related investments and sharply under-executed non-oil capital investment. As a result the country's public debt-to-GDP ratio, which almost doubled since 2014, is expected to peak at 63 percent by end-2018 and gradually decrease over the medium term.

8. Because of our limited sources of domestic and external financing we have had to accumulate arrears, but we expect to fully clear external arrears by end-2016. Domestic and external arrears accumulated since 2014 are so far estimated at ID12.5 trillion (US$10.6 billion), equivalent to 6.1 percent of 2016 GDP. Even though we made partial payments in the first half of 2016, external arrears accumulated towards international oil companies and for associated natural gas production at end-June 2016 amounted to US$3.7 billion and US$225 million respectively. We expect to clear these arrears by end-December 2016 and to remain current on future payments. We expect to finance the 2016 fiscal deficit through domestic bank financing, most of which is being refinanced at the discount window of the CBI because banks' liquidity is constrained. Since it has historically run budget surpluses, Iraq has not developed a Treasury bonds market; nor has it issued external bonds in the past decade. The attempted 2016 issuance of ID5 trillion 5-year bonds aimed at the general public mobilized only ID0.6 billion. In 2016, the external budget support financing is expected to be limited to the proposed US$1,443.82 million budget support operation from the World Bank and the US$1.2 billion financing under the IMF's SBA. Any further reduction in expected financing would require further reduction in expenditure in 2016.

9. Despite these challenges and a continued low oil price which we forecast at US$42/barrel for 2017, we expect some improvement over the next year although the situation remains challenging. With oil production projected to remain at 4.5 mbpd in 2017, we expect economic growth to slow down to 1.1 percent in 2017 with a return to positive growth to between 3 and 4 percent in the non-oil economy, assuming an improvement in the security situation. Thanks to slightly higher oil prices, oil exports are projected to also increase. We envisage that the current account deficit would narrow to 6.8 percent in 2017. Given continued fiscal consolidation efforts, we expect the fiscal deficit to improve by 7.0 percent of GDP in 2017. 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

10. The Government of Iraq is steadfast in pursuing reforms despite the challenges outlined and is committed to implement its 2014-18 Action Plan (*Action Plan* thereafter). The priority of this program is security and stability for all of Iraq, liberating ISIS-controlled areas and reinstating rule and order, a necessary condition for an improved economy and for development. The second priority is to improve governance and combat corruption to maintain fiscal sustainability and step up the level of public services, including the provisioning of electricity, water, health, education and improving 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.

11. 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 continue the program of fiscal consolidation initiated in 2015.

    a. At an estimated 17.6 percent of GDP in 2016, our wage bill, the largest current expenditure item, is high compared to international standards and growing at an unsustainable rate. We are determined to reduce the wage bill through expenditure controls. First, we plan to ensure prompt implementation of the Council of Ministers' decree 313 instructing all Ministries, Departments and Agencies (MDAs) to transition to electronic payment of salaries and biometric verification of civil servants' attendance - technologies that have been effective in reducing costly payroll waste. The technologies have already been voluntarily piloted by several Iraqi ministries, and the new decree will help to broaden and coordinate their implementation across remaining MDAs under the guidance of an inter-ministerial Payment Systems Committee chaired by a senior representative from the Prime Minister's Office. The Committee will define common standards for the technologies, procurement, and selection of third-party implementers, in line with best practices. Second, after the completion in August 2017 of the comprehensive payroll audit by the Federal Board of Supreme Audit (FBSA), we are starting discussions to create a central electronic personnel and payment database that combines all MDA records and removes irregularities found by the FBSA audit. The master registry will prepare our transition to a transparent common all-government payroll system, which will strengthen our efforts to monitor and remove payroll fraud and improve our ability to make informed budget allocations. In 2017, we will ask all MDAs to adopt this master registry as a basis for payroll and for verifying daily employee attendance, and will also ask them to send monthly updates (to be spot-audited for accuracy by the FBSA) based on legitimate personnel changes, including one update in 2017. Third, we plan to request all MDAs to provide the high-level Payment Systems Committee with detailed mid-year and end-year reports on their (1) stocks and flows of employees by grade, age, level of education, and location; (2) number of employees found to be at least once in violation of absenteeism provisions under Civil Service Law No. 14 of 1960, and the number and types of remedial actions taken; and (3) total wage expenditure (comprehensive of all benefits and allowances) by grade, age, level of education, and location. The Ministry of Finance will publish these reports on its website, with one set of MDA reports to be published in 2017.

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 we adopted Decree 445 of October 18, 2015 which defines a framework for 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 has set up through a Ministerial Order the PIM Unit to oversee project appraisal and monitoring. As a first step, the PIM Unit has submitted to the Council of Ministers the list of projects that are consistent with government priorities. These projects, which cost ID3.4 trillion will be then subject to a rigorous cost-benefit analysis before being included in the 2017 and 2018 budget, for their execution. Additionally, by the end of the following year, we aim to make a specialized monitoring and ex-post evaluation team fully operational within this unit. Through these reforms we expect to progressively improve the selection and assessment of public investment projects by increasing from 5 to above 20 the percentage of capital projects that exceed ID100,000 billion (about US$85 million) for which a feasibility study with cost-benefit analysis is done.

c. With a debt-to-GDP ratio that has doubled in the last two years and is forecast to reach 61.3 percent by end-2016, embarking on improvements in our debt management is key. In 2015, I have established a Debt Management Division within the Ministry of Finance to improve our capacity to record and report with sufficient analysis on the debt in line with international best practice, improve management of the debt, prepare medium-term debt management 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. With their support we started the regular publication of a Quarterly Public Debt Bulletin, which is available on the Ministry of Finance website in Arabic and English. The first issue includes aggregate statistics for external and domestic debt and reports the debt outstanding and disbursed of all external central government loans. As we have submitted our external debt to an external international auditor, in 2017 we plan to make our debt numbers fully consistent with the result of the audit, once finalized. By end-2018 we expect to have 9 issues of the bulletin. By end-2017, we aim to adopt a medium-term debt management strategy, which will be updated annually. The mid-term debt management strategy 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-2017 and maintaining market-based domestic debt financing to above 35 percent in 2018. In 2017 we also commit to adopt an annual borrowing plan for 2018 consistent with the debt management strategy. We shall also undertake and publish the results of a DEMPA, which would be conducted with the cooperation with JICA, 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 public pension spending is high compared to international standards. It is fragmented, suffers from coverage gaps and is unsustainable. After removing at least 30,000 non-eligible retirees from the data registry in 2015 we aim to continue medium-term reforms on this front with planned integration of the public and private pension systems, leading to reductions in overall pensions expenditures and contributing to growth in the private sector through enhanced labor market mobility and increasing pension coverage. The new system will respect good pension principles of fiscal sustainability, adequacy, fairness, good governance, and administrative efficiency. The reform are expected to improve social insurance efficiency, coverage, and sustainability as measured by the actuarial deficit period (years left till going into deficit from 2015) which is expected to increase from the current 13 to at least 28 years. We expect to pass the new Social Insurance Law in 2017 and as a result reduce the overall spending on pensions (from the National Board of Pension and the Treasury, combined) from 4.8 percent of GDP in 2015 to 4.3 percent in 2018.

e. For our social safety net program, we have reformed targeting in line with Law 11/2014, allowing for resources to go to those who need it the most. We want to reduce existing inefficiencies which waste about 40 percent of resources allocated to the social safety nets. By 2017, all our programs that target resources to the poor will use the welfare database developed by the Ministry of Labor and Social Affairs and Ministry of Planning to rationalize and better target cash and in-kind social assistance. Through these reforms the coverage ratio of the poor is expected to increase from 11 percent in 2015 to at least 50 percent by end-2018. The inclusion error would decrease from 43 percent in 2015 to 20 percent or less by end-2018. Thanks to the expected improved efficiency on our Social Safety Net system, we commit to use this system to compensate the poor and the near poor for negative impacts that may derive on their income or consumption from the reforms that we plan to implement, in particular those to the pension system (described above) and that related to the reduction of electricity subsidies (defined further below).

12. On the energy supply front, we are working to improve the efficiency and 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*. Iraq currently suffers from a shortage of electricity supply. To improve our chronic 6-7 GW of electricity shortage which generates a significant cost to our economy, we need to move to natural gas, our cheapest option compared to 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, Iraq faces a shortage of natural gas with almost 60 percent of our gas production flared in-field, rendering Iraq the second gas flaring country in the world. This shortage, which could be addressed by capturing the volumes currently flared, generates large economic and fiscal costs and is not available for power generation needs (such as introducing combined-cycle power plants (CCGT)) nor to support industries that depend on gas feedstock and gas fuel.

    a. In line with our 2013 Integrated National Energy Strategy, the Council of Ministers has committed to reducing gas flaring to zero by 2030 and the government has recently endorsed the World Bank's 2030 Zero Routine Flaring Initiative. The projected reduction is expected to result in the capture of US$2.2 billion worth of currently flared gas by end-2018. Absent this measure, our otherwise planned increase in oil and associated gas production would result in even larger energy losses. With this commitment, the expected increase in supply from capturing, processing and delivering natural gas for power generation, would result in economic and social benefits and in the reduction of air pollution and CO_2 emissions. As reported in the 2017 budget approved by the Council of Representatives, we commit to spend ID1.4 trillion to cover payments from the Ministry of Oil to associated natural gas processors for (i) processed / dry gas, LPG and condensate deliveries and (ii) projected investment requirements for processing capacity expansions toward the reduction of gas flaring. As a next step, and by end-2017, we will also adopt and begin implementation of a contractual and regulatory framework for private investment in gas capture and infrastructure, including a Supplementary Gas Production Contract, a Gas Pricing, Gas Transport and Gas Marketing regulations; these will be initiatives without precedent in Iraq's natural gas sector meant to attract and facilitate private investment in those activities. 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. In order to boost Iraq's power generation needs, the gas obtained from reduced flaring needs to be effectively allocated for use in the operation of gas turbines. Today, more than half of the feedstock used in these turbines consists of diesel and heavy fuel oil that are comparatively more polluting, costlier than natural gas, and that cause the faster degradation of generation equipment. To support adequate coordination among the Ministries involved (Oil, Electricity and Finance) and the effective conversion of gas-based plant capacity back to gas use, the Council of Ministers set up , in 2015 an Inter-Ministerial Committee to develop and implement a five-year "Gas to Power Action Plan". We expect to launch the plan's implementation by end-2017 and continuously evaluate and update it once it is in place to ensure that flaring reduction and gas-to-power targets are met. The Committee will become operational by the end of 2016 through the introduction of an executive Gas-to-Power Aggregator in charge of planning and coordination of dry gas deliveries and allocations for power generation. In addition we intend to include the necessary FY2018 budget provisions consistent with implementation of the Gas to Power Action Plan in the draft 2018 budget law to increase natural gas allocations for power generation. 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. Despite being an energy rich country, Iraq suffers from a chronic and pervasive shortage of electricity not only affecting daily life of the Iraqi citizens but also a burden on the budget due to the high subsidies. Whilst electricity supply is still constrained by system capacity, tariffs are not sufficient to cover the cost of service provision and the sector incurs high system losses with almost 70 percent of the electricity generated lost, as the equivalent revenue is not collected. To reduce the sector fiscal burden and inefficiencies: (i) tariffs were increased by about fourfold effective January 2016 thus reducing the overall electricity subsidy by about fifty percent; and (ii) the Council of Ministers has endorsed the Ministry of Electricity Loss Reduction Policy Directive that aim at increasing electricity revenue collections to at least fifty percent of the total energy generated by end FY18; and as a first step in the implementation of the policy, billing and revenue collections are being outsourced starting with the Baghdad area. These actions, although significant, are not sufficient to put the sector on a sustainable path. In this context, we commit to adopt a road map for the electricity sector which aims at full cost recovery and improved service delivery. The road map would also include a framework for procurement, in order to transparently outsource services for electricity distribution of revenue collection. As part of this road map, by end 2017, we aim to approve tariff and subsidy policy guidelines aimed at reducing the discretion that is allowed under the existing process for tariff determination. To further strengthen the sector's operational performance, accountability and transparency, the Minister of Electricity (MoE), through a ministerial decree, shall during FY 17 establish a "Regulatory Office" with responsibilities, among others, for monitoring and reporting the sector performance. Effective FY18 and on a quarterly basis, the Regulatory Office shall publish on the MoE website sector monthly performance data including but not limited to: (i) total energy generated per power station per fuel type; (ii) energy supplied to each Distribution Directorate; and (iii) billing and revenue collection data aggregated per directorate and consumer category. The published data shall include an assessment of the MoE performance against the sector key performance indicators and targets as shall have been approved by the Council of Ministers (CoM). The MoE, by end FY17, shall prepare and obtain the CoM approval of the sector key performance indicator targets for the period 2018-2022, including, but not limited to: (i) average cost of generation; (ii) electricity supply reliability; (iii) collection to generation efficiency.

13. 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 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 encouraging 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 database. To this end, the Prime Minister has committed to publish consolidated annual reports on financial and employment metrics of non-financial SOEs to improve the monitoring and managing of fiscal risks. By end-December 2016 the first report will cover at least 75 percent of the SOEs. By the end of 2017, we expect that SOE coverage will be complete for all non-financial SOEs (outside of ISIS-controlled areas and the KRG). We also decided to publish on the website of the Council of Minister's Secretariat the detailed financial relationships of the largest 9 nonfinancial SOEs (including taxes, dividends, subsidies/transfers, loans (principal and interest) and loans guarantees. We also plan to develop a Charter for Good Corporate Governance to provide guidance on internationally-recognized good practices. The Charter would provide the guidance that is needed and sought in legislation while encouraging, through internal competition, compliance beyond the voluntary. This will sends a strong signal to the business community (public and private) that the government is committed to create an underlying trust between all stakeholders playing a role in creating more wealth and economic growth for the country and its people.

b. In the financial sector, we will build on the momentum from last year, when we made the playing field more level between state-owned banks 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. This year, we have signed engagement letters with an internationally reputable audit firm, Ernst & Young, to conduct the first audits for compliance with International Financial Reporting Standards (IFRS) of Rasheed Bank and Rafidain Bank since 2005-06. The audit work has been initiated and is expected to be completed early in 2017. Following the completion of the audits, the true extent of the Banks liquidity and capital shortfall would be known. As a first and immediate measure, the Central Bank of Iraq would ask the banks to stop issuing loans to non-financial SOEs and to start reducing their total lending exposures to these non-financial SOE's in a time bound action plan. We are also continuing to strengthen our Anti-Money Laundering (AML) and Combating Financing of Terrorism (CFT) regime following the passage last year of a new AML/CFT Law, which kept Iraq off the black list of the Financial Action Task Force (FATF) on Money Laundering, which would be detrimental to the Iraqi economy. Still, much more needs to be done, as Iraq remains on FATF's grey list, with a risk of still being black listed in the absence of further progress. This year we are issuing (i) five guidelines conforming to FATF recommendations on risk indicators related to suspicious transactions of banks, exchange and transfer companies, insurance companies, non-profit organizations, and designated non-financial business professions; and (ii) regulations conforming to FATF recommendations on freezing of terrorist assets and customer due diligence. These guidelines and regulations address FATF recommendations on: (i) transmission of suspicious transaction reports from banks, remittance companies, foreign currency brokers, financial investment companies, electronic payment businesses; (ii) organization and powers of council of AML/CFT policies; (iii) AML due diligence for remittances and transfers to charities and nonprofit organizations; (iv) importation and exportation of cash and foreign currencies; and (v) mechanisms of AML/CFT auditing by supervisory authorities at CBI. We expect a Financial Intelligence Unit at the CBI to be fully operational by end-2017.

Partnership with international partners including the World Bank

14. The Government of Iraq is working hand in hand with international partners to garner financial support and technical assistance to implement the reforms we are committed to. Building on the

successful implementation of the Staff Monitored Program (SMP) with the IMF, we received financing from the IMF under a Stand-By Arrangement (SBA) program, approved by the IMF board in July 2016. We expect that the first review under the program will be approved by the IMF Board on December 5, 2016. In spite of the challenging times the country is facing, the government has maintained macroeconomic stability thanks to its commitment to and successful implementation of a large fiscal consolidation effort, and the emergency external financing received also from the World Bank in 2015 and JICA in 2016. We are now looking at program of reforms supported by the Fund SBA, and the World Bank's DPF, to send a strong signal to other development partners and international financial markets that Iraq is undertaking strong short-term and structural reforms with international partners and that it is also receiving significant budgetary support from such 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 State-Owned Enterprise (SOE) and banking sector reforms is 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.

15. The World Bank is a trusted partner in this quest. We value the partnership and timely support that the World Bank has provided in 2015 after Iraq was hit by both an oil price crash and a security crisis due to the ISIS insurgency, which has caused massive displacement and increase the need of the government to respond when the financial resources were not available. Thanks to the support provided the government could continue operate and provide vital services to the people of Iraq. The Bank's Board has also approved the US$350 million Emergency Operation for Development in July 2015 for rapid assistance to resume basic services in areas reclaimed from ISIS, including in improving damaged electricity transmission and distribution networks. Additional support is expected through a US$41.5 million public financial management reform projects. 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, and short term actions to reduce power cuts.

16. 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 a Programmatic Development Policy Financing (DPF) series. The proposed DPF series is aligned with the Government's priorities and is a welcome and important

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element of our strategy towards the successful achievement of structural fiscal reform actions and financing support. Particularly, the DPF series will support us to improve our budgetary spending through reforms in the wage bill, PIM, public debt management, pensions and social safety nets. 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.

17. 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,

Dr. Fadhil N. Othman

Deputy Minister of Finance

Republic of Iraq

ANNEX 3: ENVIRONMENT AND POVERTY/SOCIAL ANALYSIS TABLE

Prior actions	Significant positive or negative environment effects	Significant poverty, social or distributional effects positive or negative
Pillar 1: Improve Expenditure Rationalization		
Prior Action #1: The Council of Ministers has issued a decision requiring all Ministries, Departments, and Agencies (MDAs) to: (a) transition by FY 2020 to electronic payment of all civil servants' compensation (inclusive of benefits and allowances); and (b) install by FY 2018 biometric identification systems to verify civil servants' daily attendance (Decision No. 313, dated November 2, 2016).	No negative impact	No negative impact
Prior Action #2: The Recipient has implemented an electronic payroll system for at least 30 percent of civil servants in two pilot MDA units, and the new biometric attendance system is implemented for all civil servants in two pilot MDA units.	No negative impact	No negative impact
Prior Action #3: In line with the Public Investment Management Framework, which was adopted under Decree No 445 dated October 18, 2015, the Minister of Planning has submitted to the Council of Ministers the list of investment projects that are consistent with the government's priorities.	No negative impact	No negative impact
Prior Action #4: Pursuant to the Prime Minister's instruction, the Ministry of Finance has started publishing quarterly Public Debt Bulletins, which include all data on external debt of the central government.	No negative impact	No negative impact
Prior Action #5: The Council of Ministers has approved and submitted to the Council of Representatives (Council of Ministers Decision No.346, dated November 29, 2016) the draft Integrated Social Insurance Law, including the integration of the public and private pension schemes.	No negative impact	Negative impact in the long term, mitigated by better targeting of poverty
Prior Action #6: The Council of Ministers has issued a decision to exclude non-eligible beneficiaries of the Social Safety Net System, and to redirect the assistance to the poor (Council of Ministers Decision No. 312, dated November 2, 2016), based on the targeting method stipulated in Article 6 of the Social Protection Law No. 11 of 2014.	No negative impact	Significant positive impact from better targeting

Pillar 2: Improve Energy Efficiency		
Prior Action #7: The Council of Ministers has approved and submitted to the Council of Representatives the FY 2017 draft budget which includes ID1.4 trillion to cover payments from the Ministry of Oil to associated natural gas processors for (a) processed / dry gas, LPG and condensate deliveries and (b) projected investment requirements for processing capacity expansion, toward the reduction of gas flaring.	Significant positive impact from reduction in CO_2 emissions	Significant positive impact from reduction of cost of electricity generation and reduced imports of alternative energy sources
Prior Action #8: The Council of Ministers has approved the Ministry of Electricity Loss Reduction Policy Directive 2016 (Council of Ministers' Decision No. 328, dated November 15, 2016, endorsing the Ministry of Electricity Loss Reduction Policy Directive 2016) to enhance revenue collection.	No negative impact	No significant impact expected, with the exception of electricity consumers illegally connected to the grid. The impact on the poor among the illegally connected consumers is expected to be mitigated by better targeting and potential improvement in the level of SSN, as efficiency increases.
Pillar 3: Improve the Transparency and Governance of SOEs		
Prior Action #9: The Council of Ministers' Secretariat has published on its website a report detailing the financial results based on FY 2015 closed financial statements of the largest nine (9) non-financial SOEs including taxes, dividends, subsidies/transfers, loans (principal and interest), and loan guarantees.	No negative impact	No negative impact

ANNEX 4: POVERTY AND SOCIAL IMPACT ANALYSIS

1. **The PSIA is designed to provide an analysis of the potential impacts on welfare and poverty of the policy actions outlined in the DPF.** This annex focuses on the quantitative assessment of the reform of the pension system and the reduction of electricity subsidies. Under a conservative set of macroeconomic assumptions, it concludes that the pension reform is not expected to create a significant welfare loss at the moment of its implementation, but it will impact some households in the long term. The improvement in collection of electricity bills is expected to have a limited impact on poverty. However, the fiscal space created by the improved efficiency of the SSN reform supported in this programmatic series is estimated to be more than sufficient to fully compensate the households that would become poor as consequence of the impact of the reforms.

Impact on welfare of pension reforms

2. **In Iraq, most public sector employees have a retirement plan compared to their private counterparts who have no benefits at all.** In 2012, around 90 percent of public workers had a retirement plan. Thus, it is easy to infer that the majority of the contributors to the pension system are from the public sector. The Social Pension Fund (SPF) has more than 3 million contributors while the private sector pension scheme has less than 200 thousand. Moreover, less than half of the labor force contributes to a pension scheme and only 42 percent of people above 60 years old are receiving pension. It is also relevant to consider those beneficiaries who still receive a "flat-emergency" pension payment as consequence of the post-war period between 2003 and 2006. These beneficiaries add 1 million people in the system and are directly paid by general budget.

3. **Pension income was a major contributor to poverty reduction in the recent past, but the pension system is fiscally unsustainable.** Between 2007 and 2012 a period of relatively peace and security, pensions were the non-labor income component that contributes the most to poverty reduction –i.e. pensions contributed to almost 20 percent of poverty reduction.[74] However, if contributors remain constant over time and there is no proper reform of the pensions system, the SPF revenues will not be enough to cover its pension spending by around 2030.

4. **The welfare impact of the reform is estimated in 2017 and 2030 comparing the outcomes of three scenarios.** *Baseline (Base)* assumes no change in the current pension system. R*eform 1 (Ref1)* considers three main changes: (i) an increase in qualifying conditions from 15 minimum length of service to 20; (ii) decrease in the accrual rate from 2.5 percent to 1.5 percent; and (iii) modification in the wage base for pension calculation from last wage to the average of the last 7 years of contribution. *Reform 2 (Ref2)* assumes the same measures as in *Ref 1* plus that pensions are automatically indexed to inflation. The income and consumption distributions under the different scenarios are considered in two particular years: 2017, for simplicity, the year when the reform is expected to take effect and 2030 the year when the balance of the current SPF system is expected to turn negative.

5. **The estimates and analysis presented in this Annex use a microsimulation model to evaluate the welfare and distributional impacts of the pension system reform in Iraq in the short and medium term (i.e. 2017 and 2030).** The analysis compares the changes in income and consumption under the two reform scenarios compared to the baseline to estimate the impact on poverty at the national and

[74] See "Pensions in Iraq: Improving Old-Age Income Security", World Bank, 2014.

regional level. The micro-simulation model superimposes the macroeconomic projections used in this document (See Table 1 of the main text), and assuming no changes in real terms from the last year of projections to 2030, on behavioral models built on the last available household survey (Iraq Household and Socio- Economic Survey, or IHSES 2012). The approach used links the behavioral model to sectoral and aggregate macroeconomic data for Iraq, and extrapolates the microeconomic snapshot under different scenario from this projection.[75] This approach takes into account the internal forced displacement of people from the ISIS-affected governorates for 2017, while no displacement is expected in 2030.

6. In the short term (i.e. 2017), poverty headcount rates do not substantially vary under *Ref1* and *Ref2* compared to *Base* (Table A1). Under the assumption that all other sources of income (wages, public transfers and private transfers remain constant in real terms) and that accrued pension benefits are grandfathered, the levels of total income per capita and consumption per capita roughly stay the same. Similar impacts are observed across regions.

Table A1: Projected poverty indices in 2017 – baseline vs. reform scenarios

	Poverty Headcount Index					Poverty Gap				
	Baseline	Ref1	Ref2	Impact					Impact	
				Ref1	Ref2	Baseline	Ref1	Ref2	Ref1	Ref2
Iraq	22.0	22.0	22.0	0.0	0.0	8.1	8.1	8.1	0.0	0.0
Kurdistan	18.4	18.4	18.4	0.0	0.0	7.8	7.8	7.8	0.0	0.0
Baghdad	13.9	14.0	14.0	0.0	0.0	5.0	5.0	5.0	0.0	0.0
ISIS-affected	37.0	37.0	37.0	-	0.0	15.1	15.1	15.1	0.0	0.0
Rest of North	18.9	18.9	19.0	0.0	0.0	6.3	6.3	6.3	0.0	0.0
Centre	19.1	19.1	19.1	0.0	0.0	6.2	6.2	6.2	0.0	0.0
South	27.2	27.3	27.3	0.0	0.1	9.2	9.2	9.2	0.0	0.0

Source: Staff estimates based on IHSES 2012.

7. In the long term (i.e. 2030), due to the cumulative effects of the pension reform, compared to Base the poverty headcount rate increases by 0.7 percent under Ref1 and by 1.5 percent under Ref2 (Table A2). This represents roughly an additional 800 thousand individuals who could fall into poverty as consequence of the implementation of the reform.[76] In the long term, the proposed reforms do not only negatively affect the welfare levels of the population in general but also of those who would have been poor in the baseline scenario. In 2030, the poverty gap (expressed as a percentage) increases respectively by 3.5 and 8.0 percent under the two reforms. Even though the negative impacts of the reform packages affect all regions in 2030, the intensity is not the same across the country. The largest impact occurs in the South region, where the poverty headcount rate increases respectively by 1.7 percent and 3.0 percent under the two reforms, with a poverty gap also increasing by 5.7 and 12.2 percent. The smallest impact is in Kurdistan where the incidence of poverty remains almost constant under the two reform scenarios. Aggregate inequality is expected to remain stable under all scenario at the national level and across regions.

8. The government could provide a public transfer to counter the negative impact of the reform, so that these new poor are at least lifted up to the poverty line (75,000 ID per capita per month, in

[75] This approach was conceptualized, refined and tested in a diverse mix of countries not only during the financial crisis (such as Bangladesh, The Philippines, Mexico, Poland, and Mongolia) but also after the crisis (such as Costa Rica, Panama, Uruguay, Serbia, Armenia, Belarus, Kyrgyz Republic, Moldova, Poland, Romania, Ukraine and Iraq).
[76] These estimates assume that population increases on average by 3.5 percent until 2017 and by 2.5 until 2030.

constant terms). It is estimated that the government would need to provide to these households a social transfer that is 20% higher than the current average social transfer per capita per month. Thanks to improved targeting and a reduction of the inclusion error, the social security reform is expected to be able to fully compensate for the estimated increase in poverty under the two reform scenarios.

Table A2: Projected poverty indices in 2017 – baseline vs. reform scenarios

	Poverty Headcount Index					Poverty Gap				
	Baseline	Ref1	Ref2	Impact					Impact	
				Ref1	Ref2	Baseline	Ref1	Ref2	Ref1	Ref2
Iraq	20.2	20.9	21.8	0.7	1.5	5.8	6.0	6.2	0.2	0.5
Kurdistan	8.3	8.5	8.8	0.2	0.5	2.8	2.8	2.8	0.0	0.1
Baghdad	14.9	15.3	15.9	0.4	1.0	3.8	3.9	4.0	0.1	0.2
Rest of North	26.9	27.7	28.6	0.8	1.6	7.8	8.1	8.4	0.3	0.6
Centre	19.0	19.5	20.3	0.5	1.3	5.3	5.5	5.7	0.1	0.3
South	29.5	31.2	32.5	1.7	3.0	8.5	9.0	9.6	0.5	1.0

Source: Staff estimates based on IHSES 2012.

Impact on welfare of electricity reforms

9. The analysis of the impact on welfare of improved tariff collection relies on several assumptions. Because of data limitations from the Iraq's 2012 IHSES, the simulations require one critical assumption to be made related to the household electricity usage. Specifically, a poor household is assumed to consume at most 1500 KWh in a month, for an average bill of ID47,258.61 a year. A near-poor household is assumed to consume at most 2000 KWh in a month, for an average bill of ID65,503.46 ID a year. All other households are assumed to have a minimum annual usage equivalent to a bill of ID ID65,503.46. These amounts reflect bills after the tariff reform implemented by the Government in January 2016 (Table A4). For further simplification, the analysis considers only two groups (poor and non-poor) and treats these two average bills as the minimum charge for electricity usage in poor and non-poor households respectively. Therefore, the impact of the reform is likely to be overestimated as the analysis imposes a minimum spending equal to the average spending. Lastly, expenditures for electricity in 2015 are simulated based on 2012 values and assuming annual growth rates equal to those estimated for consumption spending over the period 2012-2015 (Table A4 and Table A5).

10. Two scenarios are considered for the purpose of the simulations. (i) A *no reform* scenario assumes the implementation of the January 2016 (residential and non-residential) tariffs but no improvement in collection. (ii) a *reform* scenario assumes that the central authority is able to collect half of the amount charged to each household connected to the public network (i.e., ID23,629.30 and ID32,751.73 for poor and non-poor households, respectively), consistent with the target of the result indicator (Annex 1). When simulated electricity expenditures are smaller than the collectable amount, the household will experience a welfare loss equal to the difference between the collectable amount and the simulated expenditures[77]. As a consequence, the headcount poverty rate increases by 0.2 per cent with respect to the baseline scenario. There are about 50,000 individuals who become poor because of the improved collection. For those who were already poor before the improved collection,

[77] When simulated expenditures are greater than the collectable amount, it is assumed than the household is paying the correct amount.

the average welfare loss (as a share of household spending) is about 0.5 per cent. Similar findings are observed for the new poor (0.7 percent).

Table A3. New 2016 tariff structure for simulation

Consumption category, monthly	Unit	Tariff Dinar/KWh	Unit Subsidy	Unit Subsidy
1-500	kWh	10.00	139.00	129.00
501-1000	kWh	10.00	139.00	129.00
1001-1500	kWh	20.00	139.00	119.00
1501-2000	kWh	40.00	139.00	99.00
2001-3000	kWh	80.00	139.00	59.00
3001-4000	kWh	120.00	139.00	19.00
4001-	kWh	200.00	139.00	-61.00

Source: Government of Iraq.

Table A4. Electricity expenditures and consumption distribution

	Electricity expenditures per capita (in currency)	Expenditure on electricity over the total expenditures	Consumed quantities of electricity per capita, annual (KWh)	Consumed quantities of electricity per household, monthly (KWh)
Quintile 1	5,592	0.58	462	382
Quintile 2	8,649	0.59	680	516
Quintile 3	12,329	0.64	943	629
Quintile 4	18,086	0.69	1,330	755
Quintile 5	37,912	0.80	2,463	1,045
Total	16,510	0.70	1,175	665

Source: Authors' calculations based on extrapolated IHSES 2012 data.

Table A5. Distribution of population by electricity consumption brackets

Brackets, monthly, HH level	%	%, excluding zero consumption
1-500	11	19
501-1000	18	31
1001-1500	16	27
1501-2000	6	11
2001-3000	6	10
3001-4000	1	2
4000+	1	1
Zero electricity expenditures	41	
Total	100	100

Source: Authors' calculations based on extrapolated IHSES 2012 data.