

**PROGRAM INFORMATION DOCUMENT (PID)
CONCEPT STAGE**

October 11, 2016
Report No.: AB7876

Operation Name	IRAQ SECOND STRUCTURAL FISCAL CONSOLIDATION AND INCLUSIVE GROWTH DEVELOPMENT POLICY FINANCING
Region	MIDDLE EAST AND NORTH AFRICA
Country	IRAQ
Sector	Macro and Fiscal; Governance; Finance & Markets; Energy & Extractives; Social Protection & Labor;
Operation ID	P161167
Lending Instrument	Development Policy Financing
Borrower(s)	REPUBLIC OF IRAQ
Implementing Agency	Ministry of Finance
Date PID Prepared	September 30, 2016
Estimated Date of Appraisal	November 8, 2016
Estimated Date of Board Approval	December 8, 2016
Corporate Review Decision	Following the corporate review, the decision was taken to proceed with the preparation of the operation.

I. Key development issues and rationale for Bank involvement

1. Since mid-2014, Iraq is facing the ISIS insurgency, which has increased violence, destroyed infrastructure, created a humanitarian crisis, put pressure on fiscal spending, and plunged the non-oil economy into a deep recession. 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 *pashmerga* military forces of the Kurdistan Region of Iraq (KRI) were able to regain key parts of the country, with the help of foreign-sponsored fighter groups. The federal government is preparing to regain Mosul, the last large ISIS-controlled city in Iraq. The ISIS insurgency has created a large humanitarian crisis, which with 3.4 million Iraqis internally displaced combined with the arrival of 245,000 Syrian refugees The U.N. estimates that 10 million people are in need of assistance.

2. Compounding the country's fragility is the sharp and sustained drop in oil prices which is severely impacting Iraq's non-diversified and oil-dependent economy. Iraq has the fifth largest proven crude oil reserves in the world with 141.4 billion barrels. With about 112 trillion cubic feet of proven reserves, Iraq's proven natural gas reserves are the 12th largest in the world. The oil and gas sector dominates the economy, even by regional standards. The sector accounts for over 65 percent of GDP, more than 90 percent of central government revenue, and 98 percent of the country's exports. The fall in oil prices, which have dropped to between one third and one half of their June 2014 level, has resulted in a sharp, large, and long lasting 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.

3. Long-standing structural vulnerabilities have been exacerbated by the conflict with ISIS and the oil price shock. Iraq has been in a continuous state of conflict and fragility since the early 80s.¹ In 2012, a fifth of the Iraqi population was spending less than the amount required to meet their minimum nutritional requirements and cover their basic non-food needs, such as clothing and shelter. Many more lived close to the poverty line, vulnerable to increases in the price, loss of assets and livelihoods. Poverty was accompanied by deprivation in other aspects of Iraqis' lives, too.² Jobs were not providing a pathway out of poverty. Due to the combined security and oil price shocks, 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.

4. The government has implemented a program of fiscal consolidation, which significantly improved fiscal sustainability, but the composition of public expenditure does not yet support medium-term growth. In 2015-16 non-oil-related expenditure and the primary deficit decreased by a cumulative 20 percentage points of non-oil GDP compared to 2014. Non-oil investment expenditure borne the bulk of the adjustment, which is vastly unproductive in the absence of an appropriate public investment management system. The government protected salary expenditure for the 3.0 million civil servants (these account for over 40 percent of Iraq's employment, and for almost all of its formal jobs), 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 expenditure would require to be further reduced and re-directed toward the delivery of public services and the provision of public infrastructure.

5. The proposed two-year 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. The Japan International Cooperation Agency (JICA) is also aiming to provide parallel financing to the proposed operation. Finally, the U.S. intend to guarantee the issuance of a US\$1 billion Eurobond. 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 ISIS insurgency. Donors pledged a total of US\$2.1 billion for 2016-2018. Beyond this financing package, the policy reforms proposed in the DPF series are underpinned by an extensive and multi-year ongoing and/or planned program of technical assistance and projects provided by donors and international financial organizations. This comprehensive and medium-term engagement supports fast, effective, and sustainable policy implementation of structural reforms, as requested by the authorities.

6. Iraq faces many challenges as a weak public sector and a political crisis have stymied government attempts to provide basic services to the Iraqi population, including in liberated areas. The government headed by Prime Minister Al-Abadi has responded to the ISIS insurgency and made important territorial gains. In the liberated areas, the Government is implementing a number of

¹ See "Republic of Iraq: A Systematic Country Diagnostic" (forthcoming 2016) for details on Iraq's conflicts.

² Roughly half of Iraq's population has less than primary level education; almost a third of children under five suffers from stunted growth; over 90 percent of households in Baghdad and central and southern governorates receive less than eight hours of electricity a day. Protracted violence and insecurity have directly and indirectly affected mortality rates (Infant mortality rates in Iraq are the highest regionally, barring Yemen and possibly Djibouti)—See "The Unfulfilled Promise of Oil and Growth Poverty, Inclusion and Welfare in Iraq 2007–2012, The World Bank, 2014.

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.³ 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 was blocked by Parliament, which through a series of no-confidence votes forced out key ministers.⁴

II. Proposed Objectives

7. The operation is structured under three development objectives improving: (1) budgetary spending; (2) energy efficiency; and (3) the transparency 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 SOEs (both financial and non-financial) in Iraq.

8. The DPF objectives align with the Government of Iraq reform plan to build a more transparent and less corrupt government that delivers better services to the public.⁵ Iraq's main development challenge is the need to rebuild state institutions; these have been systematically weakened over the last 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 reach 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 water, health and education sectors; and reforming the social protection system.

III. Preliminary Description

Pillar 1. Improve budgetary spending

- Wage bill reforms. As the single largest and fastest growing item on the government budget, the wage bill is an urgent reform priority for the Government of Iraq. The DPF-supported reforms aim to generate substantial budget savings by creating structural safeguards against payroll fraud.
- Public Investment management. 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. The DPF-supported reforms are

³ The Government has also moved in earnest, though still not fully successfully, to develop a comprehensive dialogue with the Kurdistan Regional Government (KRG) and to give political signals to the southern governorate—home of 85 percent of the country's oil wealth, and with the highest poverty levels—and to those citizens who perceived they were previously excluded.

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

⁵ This plan was articulated in Prime Minister Al Abadi's acceptance speech to Parliament in 2014.

part of a medium-term reform aimed at ensuring that all public investment (PIP/PPP) passes through a modernized PIM system thereby improving spending efficiency. Prior actions focus on ensuring that a proper PIM is followed for projects exceeding US\$85 million.

- **Public Debt Management.** 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. The DPF support reforms to improve accountability and transparency of debt management operations and strengthen capacity to finance the budget deficit through a rising share of market-based domestic debt instruments.
- **Social Insurance and Pensions.** Iraq's social insurance and pension system is fragmented, unequal, costly and in the relatively short-term financially unsustainable. Reforms to restore the medium-term financial viability of the Social Pension Fund through good pension design principles is urgently needed given Iraq's population age dynamics and would generate large fiscal savings. Results would be achieved through the adoption of a unified public-private pension system and parametric reforms.
- **Social Safety Nets (SSN).** Iraq's SSN system is expensive yet suffers from large coverage gaps of the poor and vulnerable. Implementation of the Social Safety Net law (11/2014) which calls for enhancing the targeting of cash transfer would improve the efficiency and sustainability of Iraq's SSN. The DPF supports reform to improve efficiency of the SSN targeting system based on clear criteria for inclusion of the poor and vulnerable individuals and households.

Pillar 2. Improve energy efficiency

- **Reduce Gas Flaring.** Iraq is the fourth largest gas flaring country in the world while at the same time it suffers from a shortage of natural gas for which it incurs large fiscal, and balance of payments costs. Shortages of natural gas are especially acute in power generation. 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 progress in reducing gas flaring is critically dependent on the projected increases in processing capacity around the Basra petroleum hub in the south, where the largest five fields account for 65 percent of currently flared volumes. The proposed reforms are expected to result in (1) the introduction of an effective contractual and regulatory framework for increased investment in gas gathering, processing and transport infrastructure; (2) a significant reduction in gas flaring volumes; and (3) an increased ability to supply commercial quality natural gas for power generation needs.
- **Strengthening Gas-to-Power Strategy.** 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. The supported reforms and actions are expected to increase the use of natural gas in the power sector leading to substantial improvement for public finances and the balance of payments.
- **Reduce Electricity Subsidies.** 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. The GoI has begun tariffs adjustment and improvement of service delivery, with support from the World Bank. The DPF supports further improving the operational efficiency in parallel to increasing sector revenues to achieve sector sustainability, as users are reluctant to pay higher prices if services deteriorate. The reforms are also expected to reduce fiscal losses and reduce the sectors' operating deficit.

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

- Non-Financial SOE reform. Iraq's management of the SOE sector is fragmented in various ministries and coordination with Ministry of Finance beyond providing some financial statements is ad hoc. Furthermore, current legislation on non-financial state owned enterprises is inadequate in promoting good governance. The prior action and proposed trigger aim to strengthen transparency and bring the non-financial SOE sector in Iraq in line with good corporate governance standards.
- Financial SOE Reform. The banking system in Iraq is small, dominated by weak state-owned banks, and is not in compliance with key international transparency recommendations. Currently, Iraq's state-owned banks are de facto exempted from meeting prudential requirements. Iraq needs also to continue progress to adopt Anti-Money Laundering and Combating Financing of Terrorism. The supported reforms are expected to strengthen the two largest state-owned banks, improve the playing field between state-owned and private banks, and ensure the resiliency of the financial system so private sector credit can continue to expand.

IV. Poverty and Social Impacts and Environment Aspects

Poverty and Social Impacts

9. Overall the structural reforms proposed in the DPF series are unlikely to adversely impact welfare. While it is difficult to assess the direct impact of some of the supported reforms on poverty and shared prosperity, their effect, either through improved efficiency of public spending, or through improved access to services, as in the case of reforms to the electricity sector, will free up resources or improve the availability of resources that can be used to increase welfare. The supported program protects expenditure targeted to deliver services to refugees. The implementation of a more efficient and well-targeted system of social spending is expected to have positive impacts on the poor and vulnerable. The impact of the reforms of the pension system will be gradual and its implementation would not negatively impact on the poor. A gender-neutral expansion in social services and essential infrastructure, if forthcoming, will likely disproportionately benefit women and girls, and help address existing gender gaps in access to health and education infrastructure. Any expansion in the supply of electricity to households (consequent to the proposed reforms) can lead to cost savings for households—preliminary analysis comparing 2014 and 2012 data suggests that when power supply through the public grid increased, household expenditures on energy declined, as a result of substitution away from more expensive fuel sources. No supported policy reform is likely to have a disproportionately adverse impact on women.

Environment Aspects

10. 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, Government has handled the issue of environmental sustainability with some relative success, starting with law no. 37 of 2008 establishing the Ministry of Environment (MoE), and then the environmental protection and improvement law No. 27 of 2009 that clearly defines the process, procedures and requirements for environmental assessment, under the overall supervision of the Environmental Impact Assessment (EIA) department in the MoE.

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

V. Tentative financing

Source:	(\$ million)
Borrower	0.00
International Bank for Reconstruction and Development	1000.00
Others (guarantee from the UK, France, and Canada)	800.00
Total	1800.00

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