



Private Sector Development in Iraq: An Investment Climate Reform Agenda

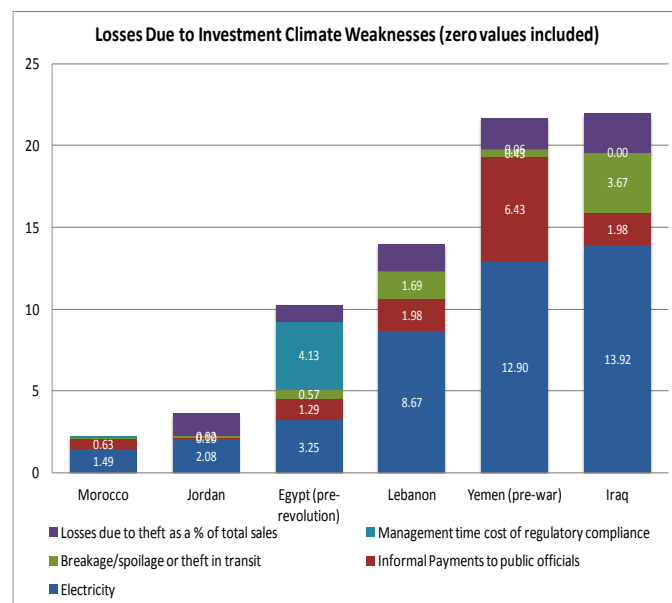
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Introduction: Despite decades of war and instability, Iraq's abundant natural resources, strategic geographic location and cultural history endow it with tremendous potential for growth and diverse economic development. Driven by windfall oil revenues in recent years the Government of Iraq (GoI) has invested heavily in rebuilding infrastructure with abundant oil reserves ensuring steady progress. However, decades of socialist policies have tightly bound Iraq's economy to the state. The private sector has had little opportunity or incentive to invest, operate efficiently or expand. Moreover, Iraq's conflicts have led to pervasive insecurity, an exodus of educated and skilled Iraqis, isolation from global networks of information and trade, and major damage to infrastructure.

A Costly and Unstable Investment Climate: The most significant constraints to the private sector include lack of electricity, political instability, corruption and lack of access to finance. These often weigh more heavily on larger firms and impose high costs on firms operating in Iraq (figure below). The impact of these constraints varies across Iraq and is more likely to be identified as serious in Baghdad. Costs are reportedly much lower in Ninewa, Kirkuk, Babil and Sulaymaniyah. This suggests that useful reform lessons can be derived not just from other countries but also between Iraq's regions. Once current binding constraints are addressed, others,

such as a shortage of skilled labor, are likely to come to the fore.



Iraq's business productivity is generally lower than other countries in the region. However, some sectors of the Iraqi economy – metals and equipment, textiles and garments, chemicals and pharmaceuticals – have higher average levels of productivity than several regional comparators. By contrast, Iraq's food processing sector has a relatively low level of productivity.

Reform Priorities: The Iraq Investment Climate Assessment (ICA) identifies seven reform areas:

1) Access to Finance: The Iraqi financial sector is relatively small in relation to its GDP and is dominated by banks which hold over 75 % of assets. State banks account for 91 % of total assets, severely constraining private banks. The collateral system is very underdeveloped, and Iraqi banks have difficulty in all stages of the secured lending chain: collateral registration, enforcement, and disposition. In response, banks demand that firms over-

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collateralize loans. Small firms report average collateral value at 140% of loan value, medium firms 180% and large firms 303%. Small firms may face a lower collateral requirement due to the credit guarantee scheme under the *Kafala* program. However, private firms mainly rely on internal funds or retained earnings for financing both working capital and new investments.

The Iraq Stock Exchange (ISX) is small and under-developed but has the potential to provide access to long term capital through equity and corporate bonds to domestic and foreign institutional and retail investors. Capital market development will need sustained support to give confidence to corporations and investors. State owned insurance companies have a near monopoly while private insurers offer limited services and have a tiny market share.

Overall, the financial system is dominated by the state, lacks competition and cannot yet play its potential role in mobilizing and intermediating finance for a growing private economy. To improve access to finance, the GoI should undertake a set of measures which include but are not limited to:

- Remove impediments for private banks doing business with the government and SOEs;
- Strengthen the regulatory and supervisory framework of bank and non-bank financial institutions, including through an accelerated program of bank restructuring and regulatory streamlining regulations and a regulatory framework conducive to the expansion of private banking;
- Improve the depth and quality of credit information available to creditors;
- Develop an enabling environment for *Shari'a*-compliant financing and microfinance; and
- Activate the privatization program to transfer a proportion of the shares of state-owned companies into the hands of Iraqi citizens and institutional and foreign portfolio investors.

2) Access to Land: Land and real estate constitute a major input to productive activities, whether in agriculture, industry or services. For international investors, delays associated with securing land access and obtaining building permits is a key deterrent to entry. Doing Business 2012 places Iraq

at 98 of 183 countries on the “registering property” index. Property registration is not procedurally complex, but is time-consuming (51 days) and costly compared to regional norms, consuming about 7% of property value. Land reform in Iraq should strive to reduce state engagement in land markets, better define property rights, reduce information asymmetry, and improve contract enforcement.

Iraq has a legal framework for Special Economic Zones (SEZs) offering special incentives to foreign companies but these are not commonly applied. It has four designated SEZs: The Basra/Khor al-Zubair Free Zone at the Khor al-Zubair seaport; Ninewa/Falafel in the North; Al-Qa'im Free Zone on the Iraqi-Syrian border; and an undeveloped zone in Fallujah in the planning stage. In the Kurdistan area, a separate zone is being developed in Sulaymaniyah, to be led by private master developers. Only the Ninewa/Falafel zone has any businesses currently operating within it and the level of activity is not significant. The regulatory body for the free zones is regarded as lacking capacity, focus and autonomy.

Policy makers must thus focus on easing regulations and registration, increasing attention to special economic zones, and streamlining the allocation of state-owned lands through actions that include:

- Building a land information system based on consolidated inventory of public land and property assets;
- Modernizing the land registry to facilitate the use of real property as collateral;
- Developing a comprehensive public land management policy that recognizes the value of public assets;
- Enhancing the institutional capacity of the Government's recently established Inter-Ministerial Committee on land allocation;
- Streamlining procedures and legal and regulatory mechanisms in the Special Economic Zones (including Free Zones); and
- Allowing private sector participation in the development, management and operation of Special Economic Zones.

3) Employment, Skills and Gender Challenges: Job creation remains one of Iraq's greatest challenges in light of high youth unemployment, inadequate training, a weak but pervasive public sector and a

constraining regulatory and legal environment. Estimates of unemployment rates range between 23 and 28%. Annually some 450,000 workers enter the labor force. Public and SOE employees account for 40% of total employment. The perception that public jobs are secure and relatively highly paid attracts skilled and educated workers, reducing their availability to private employers. Emigration and displacement of skilled and educated laborers have also played a pivotal role in shaping the current labor market. In the enterprise survey, about 24 % of firms reported that an inadequately educated labor force was a major or severe obstacle.

A cross-country comparison of **gender** indicators and survey data suggests that Iraq suffers from particularly significant gender inequality in labor force participation, educational attainment, and training. A recent World Bank report, "Confronting Poverty in Iraq" (2010), further shows that only 13% of Iraqi women are in the labor force, a far lower rate than virtually all of Iraq's neighbors. The incidence of surveyed firms with a female senior manager is higher among large firms (11%) than among SMEs (1% of both small and medium-sized firms), but still very low when compared to other MENA countries. To address labor market inefficiencies and unemployment, the Government should:

- Revisit the draft Labor Law which is currently before the Parliament. Current law impedes the capacity of the private sector to recruit effectively and easily;
- Build capacity of existing workers to effectively move into the private sector;
- Facilitate equal opportunity for women's access to education and employment;
- Strengthen the education system and develop new demand-driven curricula to align technical skills with market needs, in consultation with private sector employers; and
- Reduce the large disparities between public and private sector employment benefits.

4) Access to Infrastructure: Access to adequate power supply remains a leading impediment to private-led growth. A majority of firms surveyed reported that inadequate power supply seriously hinders their operation. The average firm suffered nearly 600 interruptions in the prior year, resulting in losses of 14% of sales. In public forums, private

firms place reliable power at the forefront of their priorities. The Energy Ministry is investing in new power plants across the country to provide 2,750 MW of additional capacity.

Although water supply is not seen as a leading constraint, a UN-World Bank Needs Assessment estimated total costs for rehabilitation and reconstruction of water supply and sanitation facilities in Iraq to be about USD 6.8 billion. The severe drought of 2008 was a further reminder of Iraqi strong dependence on rainfall.

Effective and efficient internal and external transport networks are needed for improved trade. Outside of the oil industry, Iraq's main trade relationships are with its immediate neighbors. In 2010 Turkey and Syria were the top two exporters to Iraq (at USD 11 billion and USD 8 billion in goods, respectively). Iran was third at USD 4 billion in 2009). Although transport was not a leading constraint, the World Bank Logistics Performance Index (2010) shows Iraq behind the region and other middle income countries in trade logistics efficiency. It stands at 148th out of 155 countries. The cost of getting a container into and out of Iraq is the highest in the region, averaging \$3500 per container. On the infrastructure front GoI should:

- Increase power supply via public investment in new power generation and strengthen transmission and distribution;
- Develop and implement a strategy for policy, legal and regulatory reforms to encourage competitive and transparent private provision of infrastructure - including PPP reforms.
- Invest in modern logistics services at ports and border crossings; and
- Reform water and energy utilities to emulate private sector models and achieve improved cost recovery.

5) State Owned Enterprise (SOE) Reform: The GoI provides \$1 – 3 billion in annual subsidies to SOEs, 3-4 % of the annual budget. An estimated 234,000 (37%) of the estimated 633,000 workers at Iraq's SOEs are redundant. There is an urgent need to restructure the sector through privatization, commercialization and corporatization to attract private sector investment and expertise, especially for SOEs involved in tradable goods.

To support privatization and PPPs Iraq needs to modernize its commercial laws and regulations. Sectoral frameworks are needed for power and telecommunications as well as policies for fair competition to strengthen the private sector and bolster its role in economic diversification and employment. Priority SOE reforms include:

- Implement the GoI Roadmap for SOE Reform;
- Develop support measures to facilitate the transition of redundant workers into the private sector;
- Privatize and strengthen private participation in SOEs;
- Establish a PPP unit within the Ministry of Finance;
- Enact a best-practice PPP law and sector-specific commercial laws and regulations; and
- Conduct a review of public assets, including the viability and potential of all SOEs.

6) Corruption: Corruption is the third leading constraint and over 70% of respondents see it as a “major” or “very severe” obstacle. Consistency and transparency in the issuance and enforcement of laws and regulations are essential components of investment climate reforms. To fight corruption, the GoI should consider:

- Systematically streamlining regulations to reduce opportunities for discretion;
- Strengthening public procurement transparency and introducing financial accounting and management systems;
- Strengthening transparency and administration in both the judiciary and security forces; and
- Establishing an anonymous hotline empowered to take quick action against proven corruption.

7) Informality: According to a 2011 survey by the Center for International Private Enterprise (CIPE), 55% of Iraqi firms surveyed are not registered with any authority. According to the enterprise survey results, over 50% of firms identify informal sector competition as a serious constraint, placing it fifth among leading obstacles. High costs of formal participation in the economy, weak services and legal protections, as well as lax legal and regulatory enforcement lead to the informal sector’s growth. The sector includes both those that never formalize and formal firms that partially conceal their

activities. On average, surveyed firms estimated that only 40% of sales are reported for tax purposes. Steps to tackle problems of informality include:

- Streamline tax and regulatory regimes to assure easy entry and compliance for small firms;
- Create incentives for formalization, through access to finance and business support services;
- Facilitate registration and licensing;
- Expand support for microfinance, which may encourage expansion and formalization; and
- Improve training programs to provide access to practical skills, increase worker employability and reduce the crime rate.

Conclusion: The Iraq ICA confirms that, in light of severe challenges to the private sector, the Government of Iraq and its international development partners have identified the most urgent priorities for reform and reconstruction, in an effort to positively impact the business environment. These actions include: (i) strengthening infrastructure with a particular emphasis on electricity; (ii) implementing anti-corruption measures; (iii) improving the legal and regulatory framework; and (iv) reforming State Owned Enterprises. However, there still remains a substantial gap between stated goals and achieved levels of implementation. Most urgently, the Government must generate consensus regarding the reform and growth agenda through improved dialogue with the private sector and other key stakeholders. The Government must also capitalize on its surplus oil revenues and make the needed infrastructure investments, which in tandem with transparent PPP transactions and policies, will significantly revitalize, create and grow the Iraqi private sector.

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