

Iraq: Diversified Development in a Resource-Rich Fragile State

World Bank Background Note¹

More than 10 years after the overthrow of Saddam, the impatience of the Iraqi people and government for transformation of their economy to advance shared prosperity is growing. The government has expressed the desire for the World Bank Group to enhance its role in this transformation. This note proposes two pillars for the government to consider as central to the objective of diversification: enabling transformative investments, and a comprehensive financing framework aligned with these investments. The obstacles to this approach are considerable, so a pre-requisite is high level government ownership and an implementing structure to match. A proposed institutional structure to embody this is outlined.

Introduction

The challenge of economic diversification for resource rich countries is difficult and controversial, even for a country confronting this challenge at a time of benign domestic and regional security conditions. For Iraq, afflicted by terrorism at home, spillovers from regional conflict, the legacy of war and sanctions, and political uncertainty, the challenge is exponentially more profound. This note proposes that despite the daunting obstacles, Iraq can and should design and launch a diversification strategy containing clear policy priorities for action over a 3 to 5 year period. Of course, this strategy will presume that complementary actions are being taken in related domains to improve citizen security, provide justice, and create jobs – the three pillars of the peacebuilding principles outlined in the *World Development Report* (WDR) 2011.

As WDR 2011 showed, conflict is enormously costly to developmental prospects, and can set a country back a generation in terms of progress on poverty reduction and welfare improvement. Indeed, Iraq corresponds to the most difficult fragility configuration outlined in WDR 2011: conflict has been recurring, it has had lingering internal and external components, conflicts in neighboring countries have added to external stresses, and it is resource-rich. This might suggest that the best approach for Iraq would be to direct all effort to conflict reduction and allow a diversification strategy to emerge later. Corresponding to this stability-first approach would be an economic specialization in the oil sector, on the ground that this would generate the revenue needed to promote broader economic development when conditions permit.

While not disagreeing with the needed priorities on security and oil, this note argues that the risk of *delayed development* due to insecurity needs to be balanced with the risks of *entrenched stagnation* if a diversification strategy is not initiated as soon as possible. Insecurity will disproportionately impede the non-oil economy relative to the oil economy, because the non-oil sector cannot insulate itself from insecurity to the extent that the oil sector can. In turn, the lack

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of diversification will hamper Iraq's creation of sustainable jobs and raise the attractions of rent-seeking in the oil sector, supporting the drivers of further conflict.

A Paradigm for Diversified Development

What would a meaningful diversification strategy for Iraq look like? First and foremost, it must be realistic about what can be achieved given scarce technical capacity in government and difficult implementation conditions on the ground. Second, it should avoid recommendations that would play into the statist tendencies still present in the Iraqi government, since the lack of a modern approach to the role of the state is itself a major challenge facing the government. Third, it should reflect emerging thinking at the World Bank and other development research institutions that diversification in resource-rich countries is not about interventions at the product or sector level but instead upstream at the level of policies and institutions. Furthermore, a diversification strategy should be done in a way that is cognizant of the political economy and vested interest issues that arise in a resource rich economy. In particular, this approach places strong emphasis on the institutional enablers of diversification, notably those related to management of resource revenues, service delivery, and the business climate. These areas have been shown to be critical by World Bank research examining the experience of other resource-rich regions.² A complementary view is found in other recent major studies of resource-rich development, notably from the McKinsey Global Institute.³

It is worth discussing this emerging perspective on enablers of diversification in some detail. One pitfall in looking for successful examples of resource-rich diversification is that the analysis tends to focus on countries that are currently or recently concentrated in natural resources as a share of exports or GDP. Yet a longer time horizon and a global sample find numerous countries and regions that have successfully diversified their economies from an initial concentration in natural resources. Among the most striking examples in this longer and wider view are California, Australia, Canada, and the UK. While it is tempting to look at these examples in their present status and conclude that they are not relevant for current resource rich countries, let alone fragile ones, earlier in their history they had to deal with the consequences of resource abundance. In particular, they had to ensure that critical institutional capabilities were not overwhelmed by resource wealth and instead were laying the foundation for the economies to branch out from their initial specialization. Of course, the initial specialization in exploitation of resource wealth gave these economies the means to finance the physical investments and the time to build the institutions needed for successful diversification; the key was finding the balance between intensifying as a resource economy at first while the enablers for diversification were being constructed.

² *Diversified Development: Making the Most of Natural Resources in Eurasia.*
<http://www.worldbank.org/eca/diversification>.

³ [Reverse the curse: Maximizing the potential of resource-driven economies.](#)

A Two-Pillar Diversification Strategy for Iraq

Iraq of course does not have the benefit of being able to take a longer perspective and exploit the positive institutional legacy that the previous century of resource rich countries had. To permit the government to concentrate on specific action areas, two priorities should therefore be emphasized. The first area is reduction in barriers to investment and distortions in the investment mix specifically designed to open the space for productive private investment, especially large-scale private investment from abroad with transformative potential. The second complementary area is a national investment financing framework which links the management of resource wealth to effective mobilization of funding from multiple sources for the creation of above-the-ground wealth by the public and the private sectors.

This two pillar approach is motivated by the following considerations. While Iraq has various assets, including its people, its rivers, and its land, the country's most fungible asset is oil. But unlike the former assets, oil is a non-renewable resource and thus its depletion is conceptually similar to borrowing. The exploitation of oil is generating cash which in turn is the means to finance physical capital – in exactly the same way that a prudent borrowing strategy would seek to use funds to create productive capital so that loans can be paid back. So the cash flow is the opportunity to make Iraq's other assets more productive in terms of generating more income than they are now. But as is well known, Iraq is struggling to do so. Revenues from oil are being spent on recurrent and capital purposes, but the capital needs of the country far exceed available space in the annual budget, and the state has yet to develop a comprehensive activating framework for involving the private sector in reconstruction and infrastructure provision.

Yet although the state budget is experiencing liquidity problems, in the aggregate, the resources are there to enable a substantial investment program. Central Bank of Iraq (CBI) reserves are in the range of US\$75 billion. The level of capital flight is considered to be high, and although some of this undoubtedly reflects illicit activities, a component of it consists of funds that could be induced to remain in Iraq if investment prospects were better. Iraq thus faces a paradox: the coexistence of foreign reserves and capital flight with vast funding needs for investment projects. This leaves the government reliant on *ad hoc* and segmented negotiations with foreign investment partners on a case-by-case basis. These partners are in turn deterred by the investment climate, but they can also use the negotiation process to seek preferential treatment which impedes broader market development in their sector. Building on this diagnosis, the diversification strategy therefore focuses on enabling investment through the mobilization of domestic private and foreign investors.

Why focus on investment?

An important rationale for making investment the entry point of this analysis is to realize that private investors are bringing technical capacity along with financing. It is exactly this kind of technical capacity to manage and deliver large-scale projects which is lacking in Iraq. Although technical capacity can be uncoupled from works contracting and sourced separately (e.g. advisory services to help the government manage its own projects), it would be simpler for Iraq and cleaner in terms of incentives to have a framework in which investors and contractors can bring a complete package of capacity and delivery.

The best situation is where investors are bringing their own financing – especially equity – along with sector-specific skills, allowing the government to concentrate on its core mission. But these investors will not come at the needed pace if the investment framework is unsatisfactory. Quite a bit is already known about the investment climate in Iraq, arising from the 2011 Investment Climate Assessment (ICA).⁴ This identified insecurity, electricity shortages, corruption, and competition from informal firms as major impediments to firms – a typical finding for many fragile and conflict states (FCS). These are areas where large firms can to some extent mitigate the problems, albeit at the additional cost of providing their own services. Since these firms bring scale, they bring transformative potential; correspondingly, it is difficult to see how Iraq will transform its economy without them.

The objective of mobilizing transformative investments requires a broader focus than investment climate *per se*. As the recent IEG evaluation of World Bank assistance to low income FCS showed, investment climate reform projects informed by ICAs have been a major element of Bank programs in such countries.⁵ Yet their impact has generally been low, leading to the conclusion that such reforms are necessary but not sufficient to power growth. Thus for Iraq, the recommendations should be designed to unlock the sufficiency aspect of this relationship. This requires being both more upstream and perhaps less “horizontal” than the standard ICA frame of reference would suggest.

Barriers to Investment

For the present purpose, the main area of focus is in the upstream policy domain, factors that domestic and foreign investors will consider when deciding whether to accumulate Iraqi capital at all, and if so, in which sectors. Most indications are that these investors in fact face numerous deterrents. Some constraints are well known. There is a dominant state presence in many sectors and a related overhang of un-restructured state-owned enterprises (SOEs) in commercial sectors which tie up capital and labor and absorb continued public funding. A profit-maximizing

⁴ <https://www.wbginvestmentclimate.org/regions/upload/Iraq-ICA-2012.pdf>.

⁵ See <http://ieg.worldbankgroup.org/evaluations/fcs>.

criterion has little meaning to these firms, which undermines the basis of competition in sectors where they are present.

The banking sector, which should be the first port of call for domestic firms, remains mostly publicly owned. In addition to the legacy banks, Rafidain and Rashid, the Trade Bank of Iraq (TBI) has expanded far beyond its original 2004 mandate (emergency trade finance) to become a major player in its own right. Other state banks such as the Real Estate Bank and the Industrial Bank continue to receive capital from the government despite lack of clarity about their mission or commercial discipline. All the state banks operate with the protection of a government prohibition on depositing a government check with a private bank. In addition, critical utility services upon which firms depend, like electricity and fixed line telecommunications, remain hobbled by the weakness of the state and the inability to modernize infrastructure due to the investment problems already discussed.

While the specific constraints arising from the misaligned role of the state have been well documented, there are two overarching issues which explain these manifestations. These are the discretionary powers of the government vis-à-vis the private sector, and the influence of vested interests and rent-seeking in setting the framework for private sector development.

Regarding the discretionary power of the government, there has been very little progress in the establishment of a transparent framework for regulatory actions by the government. A raft of licensing and approval requirements for routine commercial transactions is not matched by a roadmap of what businesses need to do to comply with these requirements. There are multiple approval layers, redundant or duplicative clearances and processes, burdensome documentary requirements irrelevant to the substance of transactions, and accountability structures which bear no relationship to the associated risk. As a result, opportunities for corruption, arbitrary delays, and abuse of bureaucratic power are pervasive. This contributes to a joint mentality in the private sector and government that high level political intervention is needed to unlock official action.

It should be acknowledged that the obstacles to changing this situation are formidable. The challenge begins with the persistence of a statist philosophy in government, which can be traced back to Nasserite intellectual influences. Critically, this philosophy became more insular and entrenched due to Iraq's unique and divergent trajectory. This unfolded beginning with the costly 1980-88 war with Iran. While this period was associated worldwide with the first wave of reducing the role of state and structural reforms, in Iraq the war effort further centralized the allocative role of the state, while favoring corruption and connections over private sector development. In practical terms, the war front involved Iraq's key oil producing and exporting facilities in the south, putting an end to oil sector expansion plans and causing considerable destruction. While Iraq was still able to produce and export oil during this period, and benefitted in terms of access to global commerce from suspicion about Iran, the economic base was

narrowing as defense and food imports were prioritized, to be paid for by oil. Thus, centralization was being reinforced.

The end of the Iran-Iraq war brought little respite. In principle, Iraq had the opportunity to use the late 1980s reconstruction effort to drive a broader catch-up with the lost years of the 1980s. In economic terms, the war had left large a debt overhang, a considerable amount in the form of war loans from the Gulf countries. The combination of deteriorating relations with the Gulf countries over these debts with Saddam's increasing sense of nationalistic grievance proved to be a lethal combination, leading to the invasion of Kuwait in July 1990 and then a multinational military operation to liberate Kuwait and destroy Saddam's invasion force in January 1991. Economic reform was again in abeyance.

Isolation was compounded throughout the 1990s. Unlike the Iran-Iraq war, where Iraq had significant tacit international support, the invasion of Kuwait was almost universally seen as a catastrophic miscalculation which had upended the sovereign norms of the Arab world. Iraq came under extremely tight UN sanctions following the invasion. Exports and imports were subject to a sanctions framework in which all oil export revenues had to be paid into a designated US bank account, with 5 percent going off the top for Kuwait reparations, and other revenue released only to finance approved essential imports, most notably food and medicine but also basic industrial parts and equipment. The oil sector could only accomplish routine maintenance – enough to keep crude export flowing at something like pre-1991 levels, but new investment, or even reinvestment to maintain existing capacity, was ruled out. As the country had defaulted on most of its international financial obligations following the invasion of Kuwait, its capital market access was gone and its domestic financial sector was insolvent.

For ordinary Iraqis, the manifestation of the sanctions regime was through government delivery of food rations and medicine under the auspices of the Oil-for-Food program, all under UN oversight. The sanctions had paradoxical effects: although targeting the regime, their effect was to increase the power of the regime since it had a role in delivering the goods and awarding the various export and import contracts under the program. Thus, incentives for corruption (especially given the ease of trading spot cargoes of oil) were considerable. The signal to the private sector about what kind of activities would be rewarded was unmistakable.

The next window for economic reform was in the wake of the US-led invasion in 2003, but as is well-known, this was confounded by over-ambition and protracted insurgency. In quick succession during 2003-04, the Iraqi administrative and security state was dismantled and then reassembled. Administrative and Baath party structures were abolished and the former reinstated, but at the cost of an enormous loss of remaining capacity as much of the public sector did not know who they worked for. By 2004, there was a rapidly deteriorating security situation which transformed into the sectarian civil war of 2005-06, resulting in high levels of displacement across the country and within Baghdad. The country fragmented into sectarian and security

zones, and internal economic integration – let alone integration with the outside world – regressed.

With a limited range of instruments to respond, the government placed emphasis on security spending and public sector jobs and pay increases to secure the loyalty (or at least the non-defection) of the public. The traditional role of the state was again paramount and broad-based economic development and diversification was effectively on hold until some semblance of stability could be restored.

The economic breakthrough of the reconstruction period – restoring the oil sector – did not change the overall economic model. The oil sector operates in an enclave model of development: the focus of the companies was solely on oil-field rehabilitation and export infrastructure. Thus there were limited local spillovers and a downgrading of priorities that usually feature in emerging natural resource producers, such as local content development. With restored oil production coming on stream at a time of high and rising global oil prices, large amounts of revenue and spending began flowing through the government, but in a context of very weak public financial management (PFM) and economic governance mechanisms. In the face of instability, the government had no appetite to undertake major reform of state-owned enterprises (SOEs), even though many had been defunct since the 1980s. Despite their lack of viability, the government could rely on the two large state-owned banks, Rafidain and Rashid – themselves insolvent – to lend to the SOE sector for payroll financing. This locked in continued state dominance of the commercial and financial sectors, the latter since a financial sector reform would have opened up the question of broader SOE reform.

Nonetheless, the sequence of crises is not the only reason the system was so impervious to change. This leads to a focus on emerging vested interests and rents, which provide the tacit incentives explaining the persistence of administrative rigidities to business.

It is useful first to set Iraq in the context of Dutch Disease i.e. adverse changes in relative prices induced by oil income which affect the competitiveness of the traded goods sector. The sanctions era dampened the emergence of classic Dutch Disease because oil revenues were being spent on vital imports under external supervision, so the impact of revenues on relative prices in the non-traded sector was limited. As already noted, this set-up still presented opportunities for rent-seeking, but focused on the management of oil sales and essential import procurement. But in the post-invasion era with steadily increasing exports of crude oil, spending on non-traded goods and services has ramped up, financed by public sector salaries and government contracting. The combined effect of growth in the public sector payroll and spillover effects to other sectors which benefit from higher government spending (e.g. professional employment, retail and wholesale trade) has been to favor non-traded services at the expense of agriculture and manufacturing. Of course these sectors were already hobbled by years of underinvestment and state dominance.

However, the effects of oil rents go beyond the standard relative price mechanisms. The presence of domestic oil and gas resources creates the temptation for energy subsidies, both as a form of “sharing” the benefits of resource wealth and for providing below-opportunity cost subsidies to domestic industry. And at a political economy level, the availability of oil rent streams enables the reluctance of the Iraqi government to promote an autonomous private sector (Malik and Awadallah, 2013).⁶ Instead of playing a transformative role, the private sector is seen as a forum for political influence. The various licensing and regulatory impediments mentioned above have a protectionist effect for incumbents. There have been correspondingly higher returns to those with privileged access to the government, which again deters new entrants.

Financing Transformative Investment

Even if these upstream investment climate issues were being tackled, an organizing framework for investment financing will still be a constraint. An economy in which the budget is perpetually on the edge of large deficits, there are high levels of capital flight, large central bank reserves, and state banks which exist to finance the public sector will struggle to finance truly transformative investments. The entry point for the second pillar of the diversification strategy thus comes from the need to improve this financing situation. The government is currently using a single instrument – the outlays on the capital program in the annual budget – to attempt to meet nearly all of its infrastructure needs. Some additional financing is coming from bilaterals (like JICA) and multilaterals (like the World Bank), while vendor/contractor financing is available on certain projects which is linked to the ability of the vendor to access export credit in their home country. But other commonly used instruments in infrastructure scale-up contexts such as guarantees, project bonds and public-private partnerships (PPPs) are not yet deployed. With multiple financing instruments available, the government would have far more flexibility to relieve the immediate pressures on fiscal space and at the same time provide assurance to other stakeholders that multi-year commitments can be met.

The current situation regarding budgeting for capital projects amply illustrates the depth of the problem. Normally, capital budgeting is handled by one of two approaches: i) a fully functional medium term fiscal framework which provides authorities to enter into multi-year contracts but limited to a parliament-endorsed set of detailed forward estimates that are properly maintained and scrutinized; or ii) an obligation system of appropriations, where authority to spend is provided over a fixed multi-year period, but is fully supported by a system of obligation accounting controls and reporting systems. At the moment, Iraq has neither system; there is no way for the budget to formally commit to multi-year payments, and instead an elaborate and inefficient mechanism of letters of credit and deferred payment arrangements has emerged in the vacuum. This impedes the prospect of a strategic approach to the capital program.

⁶ Malik, Adeel and Bassem Awadallah, 2013. “The Economics of the Arab Spring,” World Development Vol. 45, pp. 296–313.

Another way to present this pillar is that the government should develop a holistic financing strategy for its capital program. This can be explained by analogy to a public debt management strategy – something which the World Bank has considerable experience in preparing for many countries. In a debt management strategy, the government issues bonds at various maturities in a way that is aligned with prospective cash inflows and outflows and ensures that it does not have a cash crunch at any one time. A financing strategy would extend the same type of capacity to the public capital program. Assuming for now that an effective public investment management (PIM) system could identify and appraise good quality projects, a financing strategy would look at the right mixture of current revenues, bond issuance, bank financing, borrowing from bilaterals and multilaterals, and investor funds can be used to fund this program.

Just as a debt management strategy takes an integrated approach to all the government's financial liabilities so that they can be funded at the least overall cost, a financing strategy would take a comprehensive approach to the investment program and match funding sources accordingly. For example, since education and health projects take a longer time to realize their returns in terms of a productive workforce, longer-term general bond financing may be warranted, while projects vital to realizing opportunities in the energy sector could tap specialized project finance segments or even *sukuk*. But the government's current approach risks reducing its room for maneuver on all these options. Through its interaction with multiple modes of finance and partners, the World Bank Group (IBRD/IFC/MIGA) would be extremely well placed to advise the government on this framework.

Given Iraq's infrastructure deficit, the global lessons from experience in infrastructure finance can serve Iraq well. In addressing financial constraints, it is important to match the supply of and demand for infrastructure financing. On the supply side, the long-term nature of infrastructure investments and the perceived risks (including political, financial, currency, construction and operation risks) can reduce the attractiveness of investment in infrastructure sectors. Moreover, traditional providers of financing for infrastructure projects (e.g., commercial banks, particularly in Europe) are currently facing credit constraints, and the implementation of new regulations has shortened their investment horizon. During the global financial crisis, many institutional investors experienced difficulty refinancing liabilities, which led them to reassess making long-term illiquid investments.

On the demand side, lack of reliable and affordable access to international capital markets for long-term financing is a major hurdle for Iraq. This can be alleviated somewhat by expanding the use of guarantees, risk insurance, and innovative finance to crowd in institutional investors and improve and develop domestic capital markets. Credit enhancements – which Iraq is in a position to provide because of its large financial assets and revenue flow – can help to release more risk-averse long-term capital. On-lending facilities (including at the subnational level) may also be useful. And of course, project investments are ultimately a matter of project-level attractiveness:

the governments need to assure that incentives, pricing, and regulations are aligned to attract financing.

Organizing for Diversification

Based on the above analysis, the elements of a diversification strategy can be outlined. The prerequisite is that the government organizes itself effectively to implement the reforms that are needed as part of the strategy. Since the strategy relies on an integrated approach to oil revenue management, attracting investors, and private sector development, it is essential operate in a way that obtains top-level buy-in for this agenda while breaking down silos within and between ministries and agencies.

To reflect the institutional situation in Iraq, a promising option would be a minister-level diversification committee chaired by the Prime Minister and consisting of the Ministries of Finance, Planning, Oil, Industry and Minerals, and Trade, along the head of the National Investment Commission. This committee would be mandated to focus on the policies and institutions needed to mobilize commercially-oriented investments in Iraq, subject to the principles of a level playing field for all investors, transparency, and fiscal responsibility associated with any government guarantees or equity investment. The committee would evaluate the transformative potential of proposed investments not solely in terms of the size of investment or sector, but in terms of the complementary institutional and policy reforms that would be needed for the investment to be transformative. For example, a major investment in a sector would need to be accompanied by sector liberalization for the full benefits to be realized (e.g. matching housing sector investments with reform to the mortgage system; combining sea and air port investments with customs modernization).

In parallel with the focus on the enabling environment for investment, the committee should develop a comprehensive financing framework for the overall investment program – public and private. This should elaborate the anticipated roles of the budgetary capital program, PPPs, vendor financing, sovereign guarantees (whether from Iraq or other countries), securities markets, and the domestic and foreign financial sectors in financing major projects. Once the financing options had been determined, this would then inform the policy agenda for the respective financing instruments (e.g. development of a legal framework for guarantees, PFM reforms to manage multi-year commitments, securities market deepening, etc).