Report Number : ICRR0021927

1. Project Data

Operation ID P161167	**Operation Name** IRAQ 2nd Expenditure Rationalization DPF
Country Iraq	**Practice Area(Lead)** Macroeconomics, Trade and Investment

L/C/TF Number(s) IBRD-86880	**Closing Date (Original)** 31-Dec-2017	**Total Financing (USD)** 1,443,820,000.00
Bank Approval Date 20-Dec-2016	**Closing Date (Actual)** 31-Dec-2017	

	IBRD/IDA (USD)	Co-financing (USD)
Original Commitment	1,443,820,000.00	0.00
Revised Commitment	1,443,820,000.00	0.00
Actual	1,443,820,000.00	0.00

Prepared by	Reviewed by	ICR Review Coordinator	Group
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2. Project Objectives and Policy Areas

a. Objectives

The program document defines the operation’s Program Development Objectives (PDOs) as to “Improve (1) expenditure rationalization; (2) energy efficiency; and (3) the transparency and governance of state-owned enterprises.” (PD PDPF, p. 1, p. 21)

b. Pillars/Policy Areas

The operation was structured around three pillars: I. Improve expenditure rationalization; II. Improve energy efficiency; and III. Improve the transparency and governance of state-owned enterprises. Pillar I covered reforms aimed at controlling payroll expenditures and improving (a) the selection of public investment projects, (b) the management of public debt, (c) the coverage and efficiency of social insurance, and (d) the targeting of safety net programs; six prior actions underpinned the reforms in this pillar. Pillar II covered policies aimed at reducing gas flaring, improving efficiency of electricity generation, and reducing electricity subsidies. Two prior actions underpinned reforms in the pillar; the three indicative triggers supported a second operation that did not materialize. Pillar III covered policies aimed at improving the transparency and governance of state owned enterprises; one prior action underpinned this pillar.

c. Comments on Program Cost, Financing, and Dates

The operation built on the structural reforms initiated as part of the US$1.2 billion development policy operation approved in December 2015 (P155962) with the same title. This operation was approved on December 20, 2016 and became effective December 31, 2017 and closed as planned on December 31, 2017. **This operation for US$1,443.82 million was part of a programmatic DPF series of two in which the second did not materialize mainly because the government weakened some reforms, slowed down the pace of others and was able to close its financing gap with the surge in oil prices.**
The operation was covered by a guarantee of US$443.82 million from Canada and the United Kingdom as part of the overall international support package for Iraq. The guarantee from Canada enabled a portion of the loan equal to US$72 million and the one from the United Kingdom enabled a portion of the loan equal to US$371.82 million.

3. Relevance of Objectives & Design

a. Relevance of Objectives

In mid-2010, a sharp fall in world oil prices and a war waged by the Islamic State of Iraq and Syria (ISIS) hit Iraq's economic and social fabric. The fall in oil prices deteriorated public finances as the government lost fiscal revenues equivalent to 19 percent of GDP. The ISIS insurgency displaced over three million Iraqis bringing to the fore the problems of service delivery. Addressing the fiscal situation and improving service delivery required containing expenditures, increasing revenue, improving the efficiency of state enterprises and the electricity sector and targeting social protection programs to the poorest and most vulnerable. These actions would also respond to citizen demands for better governance, more transparency and less corruption. Containing expenditure required reducing a large amount of waste in the civil service, gas production, public investment, state owned enterprises and the pension and social safety net systems. The Iraq Systematic Country Diagnostic of FY17 identified public service delivery and the management of the oil wealth among the most pressing problems facing the authorities. The program supported goals of the government's strategy, such as inclusive growth, efficient service delivery and social protection and was aligned with the Country Partnership Strategy (FY13-16) pillars of improving governance, supporting economic diversification and improving social inclusion and reducing poverty. These objectives continue to be relevant.

Rating
High

b. Relevance of Design

The program document explains well the problems and circumstances that motivated its objectives and interventions. The problems were clear and substantial. The results chain is clear and convincing for pillar 2 –improved energy efficiency– and for most of pillar 1 –improve expenditure rationalization– but not convincing for pillar 3 –improve transparency and governance of SOEs. The results chain for pillar 2 –energy– is coherent and the prior actions pertinent to achieving the expected results and the objective. The results chain for pillar 1 -expenditure- is coherent for prior actions on wage bill, public investment management reform and social safety nets, but publishing debt data is preliminary step towards better debt management. Having a draft law on pension reform is also an initial step towards reforming the pension system, requiring significant efforts thereafter. The results chain for pillar 3 -governance of state–owned enterprises– is not convincing because publishing financial results does not credibly contribute to the achievement of the objective.

The program supported actions and pursued reforms that made it a high risk high reward program. Most SORT risk categories were rated high, with key risks identified in the PAD and the Bank pursued appropriate actions to mitigate most of them. The risk that oil prices would surge was not considered, nor was the risk that the surge could undermine support for the reform program (e.g., electricity tariffs).

Macroeconomic framework. Iraq faced a double shock in 2014-2015, from the Islamic State of Iraq and Syria (ISIS) attacks and the sharp drop in world oil prices. The shocks resulted in a decline in non-oil GDP of 3.9 and 14.4 percent in 2014 and 2015 respectively with overall GDP growth of 0.7 and 2.5 percent. In July 14, 2016, the IMF announced that Iraq had entered into a three-year Stand-By Arrangement with the IMF (US$5.34billion) "focused on implementing economic and financial policies to help the country cope with lower oil prices and ensure debt sustainability" (IMF News July 14, 2016).. This financing followed the single tranche US$1.2 billion disbursement in July 2015 under the Rapid Financing Instrument. The Stand-By Arrangement envisaged fiscal consolidation, mostly through retrenchment of inefficient capital expenditure while protecting social spending, designing and implementing revenue and expenditure reforms to contain the non-oil primary balance deficit and achieve debt sustainability. The program also sought to strengthen public financial management and preserve financial sector stability by strengthening the Central Bank's legal framework and restructuring state-owned banks.. The World Bank program document noted that 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" (par. 13, an arrangement that reduced the potential risk for the loan of macroeconomic mismanagement.

Rating

Modest

4. Achievement of Objectives (Efficacy)

Objective 1

Objective

Improve Expenditure Rationalization

Rationale

The World Bank's 2014 Iraq Public Spending Review found a *severe administrative* bloat in public *sector pay and numbers, low execution rates of the capital budget, high spending on security and administration and neglect of vital sectors.* The operation supported: (a) electronic payment and biometric identification of civil servants to control payment of salaries to ghost workers; (b) approval of investment projects consistent with the government's priorities; (c) transparent debt management; (d) reforms to the pension system; and (e) better targeting of the social safety net.

The program document defined a single result indicator for the series of two operations (the one under review and the one that did not go forward). There was no intermediate indicator for this operation and a second one for the two operations.. To assess efficacy for this operation the review uses the single indicator for the program as defined in the policy matrix of this loan.

Wage bill reform. The wage bill was the largest and fastest growing item in the central government budget. To control its size the operation supported two prior actions that required three measures: (a) transitioning to electronic payment of all civil servants' compensation (inclusive of benefits and allowances) by FY2020 ; (b) issue a decision (No. 313, dated November 2, 2016) mandating to install by FY 2018 biometric identification systems to verify civil servants' daily attendance and (c) implementing two electronic payment in ministries, departments and agencies for at least 30 percent of civil servants including all with biometric identification.. The target of over 30 percent for two pilot ministries was exceeded; by September 30, 2017, 52 percent of civil servant in the pilot ministries were paid electronically. The system was subsequently rolled out across the civil service, reaching 21 percent of all civil servants by mid-2019.

Public investment management reform. Shortcomings in the public investment process prevented prioritizing what is important and led to selecting bad projects, poor execution rates and poor control of funds released. To reduce these problems the program supported a prior action by which the Minister of Planning submitted to the Council of Ministers the list of investment projects consistent with the government's priorities and in line with its Public Investment Management Framework of 2015. The expected result was to conduct a feasibility study with cost-benefit analysis for at least 20 percent of the projects whose capital exceeded ID100,000 billion (about US$85 million). The result was achieved; by March 2019, 27 percent of the projects had gone through a feasibility study, although due to the sharp oil price decline, the overall number of projects was much smaller than envisioned (3 out of 11).

Public debt management. Historically, the government ran fiscal surpluses and did not develop its capacity to manage debt. The situation changed recently. As its financing needs grew, its debt grew rapidly between 2014 and 2016, from 33 to 64 percent of GDP. Initial steps to improve debt management are to increase the transparency of information, improve accountability and reduce the debt's risk profile. To this end, as a prior action the Ministry of Finance started publishing quarterly Public Debt Bulletins, with data on the external debt of the central government. The expected result was to raise the share of domestic public debt in total public debt above 35 percent in 2018. The share reached 37.8 percent in May 2, 2019. To achieve this, there was a coordinated effort with parallel support from JICA and IMF, including training and technical assistance on debt management, and an IFRIS audit on non-financial SOE debt.

Pension Reform. Iraq spends about 4 percent of GDP on pensions, above the OECD average of 1.8 percent. The system is unequal and fragmented, provides generous benefits to some but with large gaps in coverage. The costs cannot be sustained. To restore the system's financial viability a prior action supported the Council of Ministers submitting to the Council of Representatives the draft Integrated Social Insurance Law that would help address these issues, including integrating the public and private pension schemes. The expected result was to increase from 13 to 28 years the period it takes the expected actuarial deficit to materialize. The actual result is less than 13 years. The result was not achieved.

Social safety nets. Iraq's social safety net system is expensive per dollar of assistance provided (e.g., US$6 per dollar of food distributed), excludes many eligible people and includes many ineligible people. To enhance the system's efficiency the program supported a Council of Ministers decision to exclude non-eligible beneficiaries from the system based on a targeting method approved in the social protection law which uses clear criteria to select participants. The results were to reduce the inclusion error and increase the coverage ratio of the poor. The inclusion error fell from 82.5 percent in 2015 to 72.3 percent in 2018, far above the 20 percent target. The coverage ratio of the poor increased from 10 to 13 percent between 2015 and 2018, far below the 50 percent target. The results were partially achieved..

The ICR team confirmed the explanation stated in the ICR that the two sets of numbers for the inclusion error the ICR reports come from different methods used to calculate them. The first number, calculated at the end of 2015, defined the 43 percent baseline for the program after applying a proxy means test formula to the database of the social protection system's existing beneficiaries. By 2018 all beneficiaries in this database were below the poverty line, generating an inclusion error of zero, therefore exceeding the target of 20 percent in the program. The second set of data resulted from the SWIFT Survey (Survey of Well-being via Instant and Frequent Tracking) carried out in late 2017 and early 2018. The survey was administered to all but 14 districts which were inaccessible because of the security situation, as stated in the ICR. This data source generated an inclusion error of 82.5 percent for the baseline and 72.3 percent for the end-of-the program. The ICR used information from both methods and concluded that, while there was progress in targeting of social assistance programs and the program targets were achieved, the achievement of the objective was modest.

Overall, there was progress in reducing the wage bill and on public investment management. There was some progress on social safety nets while the sustainability of pensions deteriorated.

Rating

Substantial

Objective 2

Objective

Improve Energy Efficiency

Rationale

Iraq wastes gas through flaring, uses more expensive gas, oil and crude oil to generate electricity and collects about 20 percent of the cost of the electricity generated. To raise the system's efficiency the program supported actions to reduce these problems.

Gas flaring. Iraq flared about 60 percent of the gas produced, an economic loss of about US$2.5 billion per year. To reduce this loss it was necessary to capture, process and transport the associated natural gas. To be able to do this the government had to pay arrears incurred with its large suppliers of gas and to project the investment requirements to expand the capacity to process the gas flared. The Council of Ministers approved and submitted to the Council of Representatives a draft budget including Iraqi dinar (ID) 1.4 trillion to cover payments from the Ministry of Oil to the natural gas processors for (a) processed/dry gas, LPG and condensate deliveries and (b) projected investment requirements for processing capacity expansion. The program supported this action (prior action #7). The expected result was to reduce the amount of gas flared, expand the capacity to absorb that gas and process it and allocate the gas captured to generating electricity. The processing capacity expanded from 671 million of standard cubic feet (MMSCF) to 1,058 MMSCF, a substantial increase but below the target of 1,300 MMSCF. The gas allocated to produce power increased from 571 to 883 MMSCF, a substantial increase, but still below the expected level of 1,200 MMSCF.

Gas-to-power strategy. To realize the benefits of less glass flaring, Iraq had to capture, process, commercialize and allocate the gas for power generation. The gas used represented about 50 percent of the capacity to generate power with gas. The expansion was to be supported by the second operation, whose indicative trigger was to include sufficient funds in the 2018 draft budget law to finance a five-year investment program and financing plan to increase natural gas allocations for power generation. The expected result was to increase the share of gas used in the power generation mix from 42 to 70 percent between 2015 and 2018; the share increased to 63 percent.

Electricity Subsidies. Low operational efficiency, high electricity losses and obsolete network equipment contribute to half of the total power generated not being billed. On top of this, cost recovery is low and the amount collected is less than one third of the electricity generated. The program supported the Ministry of Electricity's policy directive to reduce losses which the Council of Ministers approved. The expected result was to improve revenue collection as a percentage of generation from 30 to 50 between 2015 and 2018. The result was not achieved, as that percentage fell to 21 percent in 2018.

The program achieved in a substantial manner its objectives of reducing gas flaring and allocate more gas to generate electricity but did not achieve the objective of reducing electricity subsidies.

Rating

Substantial

Objective 3

Objective

Improve Transparency and Governance of State Owned Enterprises

Rationale

State-owned enterprises (176) operate in many sectors, are opaque, unaccountable and carry out quasi-fiscal activities that generate large risks. Their privileged status chokes private sector growth and the country's transition to a market economy. The enterprises employed over 550,000 persons of which 30-50 percent are estimated to be excess labor. Reforming them was imperative for efficiency gains and economic growth.

Transparency and governance of SOEs. To improve SOEs transparency and governance the Council of Ministers' Secretariat published on its website a report detailing the financial results of the largest nine (9) non-financial SOEs based on FY2015 closed financial statements including taxes, dividends, subsidies/transfers, loans (principal and interest), and loan guarantees. That was a prior action. The expected result (firms complying with standards of disclosure for corporate governance) was to exceed 15 percent in the International Standards of Accounting and Reporting Benchmark of Corporate Governance Disclosures by 2018. The actual result was 3.8 percent and the expected result was not achieved.

The government completed two triggers for the second loan (DF3): (a) the Council of Ministers approves an SOE Charter of Good Governance, to improve Iraq's SOE corporate governance framework; and (b) the Central Bank of Iraq issues regulations directing state-owned banks to reduce their total lending exposure to non-financial SOEs per a time bound action plan.

Rating

Modest

5. Outcome

The program advanced in the objective of improving energy efficiency and fell short in the objectives of improving expenditure rationalization and improving transparency and governance of state-owned enterprises. Notable improvements were the reduction of gas flaring, using more gas to generate electricity, using biometric identification for civil servants, putting in place an electronic payment system for the civil servants payroll, adopting a system of cost-benefit analysis to decide on large public investments using, and reducing the exposure of the state-owned banks to non-financial SOEs in their total lending. The Ministry of Finance started publishing information about the public debt; while the result was achieved, it cannot be attributed to these actions. The program made progress in reducing the inclusion error in social safety net programs, and did not produce results on pension, electricity subsidies and transparency and governance.

The program objectives had substantial relevance while its design had modest relevance. Its efficacy was substantial.

a. Outcome Rating

Moderately Satisfactory

6. Rationale for Risk to Development Outcome Rating

The government executed important reforms to its investment and payroll management system and took significant actions to reduce gas flaring, generate electricity with the captured gas, improve the targeting of the safety net programs, and to reduce the exposure of state-owned banks to SOE's debt. These reforms may be sustained, as the electronic payments of wages has been set up, the infrastructure to capture gas and generate energy with it has been built. To realize and maintain these benefits, though, more work needs to be done. On the other hand, more effort may be needed to maintain the gains already made and make further progress. For example, to control a rising wage bill, expenditure controls are needed to reduce payroll fraud and increase the transparency of government pay and employment practices. A centralized human resources management system is also needed. In other areas the government acted slowly (e.g., state-owned enterprises), adopted policies that go against the objectives of the program (e.g., electricity), or did not push for the legal changes required to change the status quo (e.g., pension). Moreover, better oil prices reduce financing gaps and the need for external support, weakening the urgency to reform and, possibly, creating pressures to backtrack on past reforms. The reluctance to complete reforms indicates the political difficulties of doing it and the high risk to the sustainability of the reforms.

a. Risk to Development Outcome Rating

High

7. Assessment of Bank Performance

a. Quality-at-Entry

The program design addressed major problems that required prompt solutions: to close the large fiscal deficit caused by the fall in oil prices and to eliminate the substantial waste in energy and overall government expenditure. Plunging oil prices made more evident the nature and depth of the problems and the urgency for change. The macroeconomic framework was adequate, and its likelihood of implementation and success was enhanced by the government's Stand-By Agreement with the IMF. The Bank took a gamble with a high risk program. The results framework had some shortcomings in the results chain, in part because some the prior actions dealt with necessary steps, but they were insufficient to produce significant change (e.g., draft law for social insurance).

Quality-at-Entry Rating

Moderately Satisfactory

b. Quality of supervision

The Bank supported the technical needs of the implementing agencies but their fragmentation required major efforts to monitor and adjust the program as the circumstances changed, especially the government's commitment to reform. The Bank did not monitor closely the indicators for the program, which were not ready when the Bank began to prepare the ICR.

Quality of Supervision Rating

Moderately Satisfactory

Overall Bank Performance Rating

Moderately Satisfactory

8. Assessment of Borrower Performance

a. Government Performance

The government worked with the Bank to design a bold program where most of its elements could help solve deep, entrenched problems. Government commitment to the program, which was initially strong, weakened over time as the main triggers of the crisis –war with ISIS and low oil prices– eased. Although the government completed all the prior actions and executed several triggers for the second operation but faltered on its commitment to follow through with reforms, especially on pension and electricity tariffs that led the Bank to cancel the second loan. Backsliding on electricity tariff reforms was due to consumers protesting the rise in tariffs without a corresponding improvement in service. Changes within the Ministry of Finance (the Bank's counterpart) confused its staff, obliging the Bank to rely on the Prime Minister's Office as its main counterpart.

Government Performance Rating

Moderately Unsatisfactory

b. Implementing Agency Performance

Most implementing agencies did not follow through during supervision, in particular, on gathering and providing adequate information to monitor and assess program performance.

Implementing Agency Performance Rating

Moderately Satisfactory

Overall Borrower Performance Rating

Moderately Unsatisfactory

9. M&E Design, Implementation, & Utilization

a. M&E Design

In the first and second objectives most of the M&E indicators were relevant to inform about the achievement of objectives, even if the meaning of the objective on improving expenditure rationalization was unclear and the indicators measured outputs (e.g., civil servants' payment and attendance tracked electronically). In the expenditure rationalization objective, some prior actions were unlikely to lead to the expected result (e.g., draft social insurance law and financial sustainability of the pension fund). In the objective of improving transparency and governance of SOEs the link between publishing their financial statements and better governance is, at best, weak if not supported by the political and legal systems that make it possible the better governance. Meeting the target does not ensure meeting the objective, also applicable to the debt management objective.

b. M&E Implementation

The program document noted that "data availability and quality to monitor progress is sufficient for reform monitoring although some institutions have difficulty in providing some data." (par. 106) This outlook possibly explains why the program lacked a M&E plan, so there was no plan to implement; its absence was felt during preparation of the ICR when most of the data on indicators in the results framework were not readily available (ICR, par. 49).

c. M&E Utilization

The Bank and the government collected the information at the ICR preparation stage and did not use it during its implementation.

M&E Quality Rating

Modest

10. Other Issues

a. Environmental and Social Effects

Reduced CO_2 emissions constitute a major benefit along with a healthier environment for relatively poor people living in the gas flaring areas. The program document reports that Iraq's CO_2 emissions stood out at 140 million tons per year and the expected reduction in CO_2 emissions would be about 12 million tons per year. Since some 60 percent of the flaring was eliminated (actual -387/program-629), CO_2 emissions were reduced by about 7 million tons per year.

b. Fiduciary Compliance

The ICR does not report issues on fiduciary compliance

c. Unintended impacts (Positive or Negative)

None.

d. Other

None.

11. Ratings

Ratings	ICR	IEG	Reason for Disagreements/Comment
Outcome	Moderately Satisfactory	Moderately Satisfactory	---
Risk to Development Outcome	High	High	---
Bank Performance	Moderately Satisfactory	Moderately Satisfactory	---
Borrower Performance	Moderately Satisfactory	Moderately Unsatisfactory	The government and some of its agencies failed to move ahead with some important reforms when the fiscal situation improved
Quality of ICR		Modest	---

Note

When insufficient information is provided by the Bank for IEG to arrive at a clear rating, IEG will downgrade the relevant ratings as warranted beginning July 1, 2006.
The "Reason for Disagreement/Comments" column could cross-reference other sections of the ICR Review, as appropriate.

12. Lessons

The ICR offers the following lessons.
Policy reforms can be designed and implemented during periods of serious conflict and economic crisis. Development policy operations help to make this possible by providing critical budget support, giving the authorities sufficient space to address the problems identified.

In electricity, experience with past reforms and failures to improve service delivery narrowed the opportunities for implementing successful reforms as they emphasized increasing tariffs without simultaneous improvements in the quality of service. Therefore, in situations like this a strategy of effective communication explaining the scope and benefits of reform can help reduce the risks of protest against rises in electricity prices.

The program's experience shows that multisectoral reforms are feasible and implementable in conflict contexts, despite the higher risk that entails selecting a broad program. Two benefits call for this approach. First, a "more ambitious" program can draw a larger level of international support for the country. Second, higher risks can bring more rewards, even if the program does not achieve all its expected results and benefits.

13. Assessment Recommended?

No

14. Comments on Quality of ICR

The ICR presents a good overview of the initial conditions in the country and examines the achievements and shortcomings of the program in a clear manner. It presents adequate information for the reader to know the program and assess its achievements. The report, however, has some shortcomings. First, the ICR concludes that all PDOs record modest achievements (par. 73) and rates efficacy as substantial (par. 74), a conclusion inconsistent with the modest achievements in all the PDOs noted in paragraph 73. On this point the ICR team explained to IEG that the inconsistency is confined to part of paragraph (73) that was not updated as it should have been. Second, the ICR rates some outcomes based on the triggers for the second operation (e.g. Pillar 3) but does not rate other outcomes (pension reform and gas-to-power) with the argument that "Because this approval did not take place, the results indicators on pension reform and gas-to-power strategy, while reported, are not strictly considered in the efficacy rating" (Par. 55 and the Results framework Analysis table, p. vi-ix). The ICR team further explained to IEG that pension reform and gas-to-power were not supported by any DPF2 actions, and thus could not be attributed to the operation. Third, the numbers about inclusion error in the results framework table and in the text differ (in the table, the numbers are 43 percent for the baseline and 0 percent for target achieved; in par. 60 the numbers are 82.5 and 72.3 percent).The ICR team explained that the difference in numbers obeys to using the numbers in the database of existing beneficiaries for the first set and the numbers from the national survey for the second set.

While not affecting the quality of its content, the report's length more than doubles the length the guidelines recommend.

The review rates the quality of the ICR as modest.

a. Quality of ICR Rating
Modest