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# KURDISTAN REGION OF IRAQ

## REFORMING THE ECONOMY FOR SHARED PROSPERITY AND PROTECTING THE VULNERABLE

### EXECUTIVE SUMMARY

May 30, 2016

1. ***The Kurdistan Region of Iraq (KRI) is a constitutionally recognized semiautonomous region in northern Iraq.*** Its government, the Kurdistan Regional Government (KRG), based in Erbil, has the right—under the Iraqi constitution of 2005—to exercise legislative, executive, and judicial powers according to the constitution, except in what is listed therein as exclusive powers of the federal authorities. The Iraqi constitution defines the Kurdistan Region as a federal entity of Iraq. KRG has a parliamentary democracy with a regional assembly that consists of 111 seats.

2. ***KRI has been largely immune to the insecurity and conflict witnessed elsewhere in Iraq, especially following the 2003 Iraq War.*** This has allowed KRG to promote its burgeoning private sector and attract foreign investments in both oil and non-oil sectors. However, starting from mid-2014, the plunging of oil prices coupled with increasing threats to security have intensified pressure on the overall Iraqi as well KRI's economies, necessitating a need for action to address the immediate and medium-term challenges presented in this report. Government of Iraq (GoI)'s fiscal position has deteriorated and political tensions have increased with widespread demonstrations demanding reforms across legislative, executive, and judicial branches.

3. ***KRG is facing a wide range of immediate and medium to longer-term challenges that are intrinsically linked to the overall macroeconomic situation of Iraq as well as the regional and global environment.*** The immediate challenge consists in coping with (a) the deep fiscal crisis, and (b) the security and social problems brought about by the conflict with the Islamic State in Iraq and Syria (ISIS) group and the resulting influx of Syrian refugees and Iraqi Internally Displaced Persons (IDPs). These challenges are clearly immediate priorities for the KRG, and would bear significant repercussions nationally and internationally if inadequately addressed. The medium to longer-term challenges pertain to moderating dependence on the oil sector and transforming the KRI economy into a diversified one that supports private sector-led economic growth and job creation in a sustainable manner.

4. ***Similar to the rest of Iraq, the fiscal crisis and the security challenge posed by the ISIS insurgency have had a significant adverse impact on economic growth in the KRI.*** The fiscal shock is severe. KRG has been dealing with the fall in revenues by a combination of postponing its investment projects, letting payments fall in arrears including wages and salaries of government employees, borrowing domestically from private and foreign companies and banks, and borrowing externally. The impact of reduced investment in infrastructure will be felt in the medium-term through lowering private sector productivity and crowding out private investment. Also, arrears in payments to oil companies and contractors create an uncertain business environment. These, in

turn, discourage investment both foreign and local. The ISIS insurgency has put significant pressures on the Government through increased security spending and the influx of refugees and IDPs.

5. ***To address short-term as well as medium- to long-term structural issues, the Government requested the World Bank support to develop and implement a structural economic reform roadmap.*** This work is a response to an official request of the KRG Prime Minister H.E. Nechirvan Barzani in a letter to the World Bank President Dr. Jim Yong Kim in February 2016 seeking a partnership for growth and development to address the economic and social challenges. As a response to the Government request, this report proposes reform options for fiscal adjustment and for the diversification of the economy in addition to social mitigation measures to protect the vulnerable from impacts of the external shocks. The proposed economic reform roadmap is expected to guide policy makers in KRG as they address the immediate and more medium- to long-term challenges facing the region in the context of increasing vulnerabilities confronting Iraq as a whole. This work builds upon the World Bank's extensive analytical and technical assessments conducted under the Economic Growth Diagnostics Study for the KRI, as well as technical assistance for social protection reform and modernization of public procurement system. The report also draws on IFC's experience with the private sector in KRI over the last few years to identify the necessary reforms that would help KRG move to the next level of attracting necessary private sector investments in the context of a challenging domestic and regional environment. KRG is in need of a structural economic reform roadmap, which is inclusive and serves as Government's umbrella framework for reform actions in the short to medium-term. The Ministry of Planning (MoP) laid out broad objectives as guidelines for policy formulation through the *Kurdistan Region of Iraq 2020: A Vision for the Future*, with the diversification of the KRI's economy away from the oil sector being at the core of these objectives. The success of these reforms and the ability to deal with multiple shocks will require support from KRG's partners. This report is the first phase of the potential World Bank assistance to the KRG to design and implement long-standing reforms. The second phase of the technical assistance is expected to provide implementation support for the Government. The KRG has already started implementing austerity measures including wage bill and subsidy reforms.

### **Initial Conditions: Structural Issues and Recent Multiple Crises**

Similar to the rest of Iraq, the KRI economy is characterized by severe dependency in four areas:

- I. ***High dependency on the oil sector.*** Either directly or indirectly, KRI's economy is highly dependent on oil sector. Despite a series of negotiations, a dispute with the central government about the sharing of oil revenues and the budget transfer has not been resolved. Oil export revenues, which had been received from the central government as budgetary transfers (recently suspended), constituted about 85 percent of the Government's fiscal revenues. However, the sector's estimated share is only 1 percent in region's employment. Such a high level of oil sector dependency has become a "Dutch disease" particularly at times of high oil prices. Combined with a difficult enabling environment for private sector business development, skill formation that is not as advanced as desirable, and strong incentives for people to seek jobs in the public sector, it undermines other sectors' competitiveness in local and international markets and suppresses private sector development and domestic production in tradable sectors and exports.

High oil dependency has created a rentier state, a boom-bust business cycle and an uncertain business environment. The boom period concealed the structural problems the KRG faces. In the past, flush with oil money the Government became complacent to identify and address the structural problems. The current bust period has brought all structural problems to the surface.<sup>1</sup>

- II. *An excessive role of the public sector in the economy.* The public sector dominates the KRI economy. The KRG public spending to GDP ratio is over 50 percent, compared to 61 percent for the whole Iraq. The KRG is the main employer with a share of more than 50 percent in total employment (26 percent in non-military employment). Similar to the rest of Iraq, payments for salaries, pensions, social assistance and subsidies (electricity, fuel, water supply, and agriculture) comprise over 50 percent of the budget. Taxes constitute only 4.7 percent of total revenue. As a result, public expenditure is a primary driver of economic growth. A key problem is high volatility of public expenditure, which translates into high volatility of growth through the fiscal multiplier.<sup>2</sup> Volatility of expenditure originates, in turn, from volatility of the KRG revenues, which varies widely reflecting fluctuations in oil prices, interruptions in production and transportation of oil driven by conflict, and most importantly the dispute with the central government about sharing of oil revenues. Despite the strong entrepreneurial spirit and potential, the local private sector in KRI is small and under-developed due to the significant crowding out by the public sector.
- III. *Dependency on imports.* Due to the relatively undiversified nature of the overall Iraqi economy, there is a large gap between demand for and local production of tradable products in KRI (hydrocarbon exports account for around 95 percent of the total export basket of Iraq—the highest among Upper Middle Income Commodity Exporters). The gap is filled by imports, which amount to about 90 percent of non-oil GDP. Local production is confined to retailing of imported products, small-scale tradables, and other services including bloated public services. Exports of locally produced goods are very limited. This is a typical feature of a rentier economy. This is aggravated by weak behind the border policies. Under the current policy regime, it is hard for the local businesses to compete with imports to diversify and grow.
- IV. *Weak financial system and dependency on cash-economy.* An inclusive and efficient financial system is critical for private sector development. A well-developed financial system would fund greater investment for larger numbers of people. KRI has a poorly developed financial sector, including weak financial infrastructure and low access to

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<sup>1</sup> To manage the oil revenue better KRG approved a law that authorizes establishment of a Sovereign Wealth Fund (The Oil and Gas Revenue Fund Law, approved in April 2015), which could help pursue a dual objective of stabilizing the economy and saving to optimize the investments. The law identifies five areas where oil revenues may be allocated for: the Kurdistan Region's annual budget, investment spending, oil infrastructure, environmental protection, and a "future generation's" wealth fund. This is a step in the right direction, which will also help with establishing accountability and transparency in spending the natural resource revenues. However, although the law and a fund could provide the necessary infrastructure for fiscal management of natural resource revenues, by themselves they are not sufficient. A carefully designed principle for operating these funds, *e.g.*, a fiscal rule, and the political will to pursue those principles are equally important.

<sup>2</sup> One would expect a high fiscal multiplier in KRI because income tax rate and marginal propensity to save are very low although marginal propensity to import is high.

finance, especially for small and medium-sized enterprises (SMEs). There is a strong preference for cash in business transactions. Around three percent of companies rely on the banking sector for investment and working capital (over 20 percent in the Middle East and North Africa). This is explained partly by the pervasive atmosphere of mistrust in the banking sector created by frequent financial disruptions and instability in the region.

These structural challenges have been aggravated by a series of recent shocks:

- Conflict with the ISIS group since mid-2014 within 13 miles of Erbil;
- Influx of 1.8 million Syrian refugees and Iraqi IDPs increased KRI's population by 28 percent;
- A sharp decline in international oil prices, from US\$115 a barrel in June 2014 to US\$35 in December 2015 which means less revenues from direct sales; and
- A sharp fall in revenue transfers from the central government, from US\$12 billion in 2013 about US\$1 billion in 2014, which was suspended in June 2015.<sup>3</sup>

6. ***The growing inflow of Syrian refugees and internally displaced Iraqis into the KRI has imposed additional strains on the budget and service delivery.*** This major influx severely constrained the Government's ability to deliver health, education, and social protection programs to the increased population. The standard of living of the population has deteriorated, and many people have fallen into or are vulnerable to falling into poverty. As a result of the multiple crises, the poverty rate for KRI doubled in host communities—with the largest increase in Dohuk which experienced the highest influx of IDPs. When the IDP and refugee population is included, the poverty rate increased even higher: poverty in KRI increased to 12.5 percent in 2014. More than 75 percent of the refugees and IDPs are women and girls who are very vulnerable. KRG is providing public goods for the entire region and delivering services to this increased population. The needs of the displaced population are significant and cannot be adequately met under the fiscal crisis that the KRG is confronted with. According to the joint World Bank and KRG Ministry of Planning study entitled *The Kurdistan Region of Iraq: Assessing the Economic and Social Impact of the Syrian Conflict and ISIS*, the stabilization needs assessment of the IDPs and Syrian refugees were evaluated at US\$1.4 billion in 2015.

## **Diversifying the KRI Economy: Main Contours of a Structural Economic Reform for the KRI**

7. ***Kurdistan Region of Iraq 2020: A Vision for the Future provides the KRG's overarching view for its structural reforms.*** Presented in 2013, the Vision calls for “a Kurdistan Region of Iraq where all people enjoy the benefits of freedom, health, welfare, and economic security and opportunity.” It defines policy priorities in four areas: Putting People First (health,

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<sup>3</sup> In December 2014, a new agreement was reached between KRG and the Central Government to resolve the dispute. According to this agreement, KRG would export 550,000 bpd through Ceyhan, Turkey (250,000 bpd from its own fields and 300,000 bpd from federal fields) for the Central Government State Oil Marketing Organization (SOMO). In return, the Central Government would resume transferring the 17 percent of its budget to KRG. The agreement was not been fully implemented; KRG did not receive its 17 percent share fully, and has delivered less than 550,000 bpd to SOMO. Dispute continued. Finally, in June 2015, the Central Government suspended transfers, and KRG stopped delivering its oil to SOMO and continued exporting independently.

education, inclusivity, and labor); Building the Region (infrastructure); Creating an Economically Prosperous Region (agriculture, the private sector, and environmental protection); and Putting Government to Work for the People (effectiveness, transparency, fiscal responsibility, and civil service reform). By producing the Vision, the KRG has established the foundation upon which any structure economic reform for the KRI must be built.

8. ***The KRG is committed to significant structural reforms to secure fiscal consolidation and achieve sustainable and inclusive growth in the KRI.*** The region is faced with multiple challenges but also with an opportunity to move forward with long-standing reforms and diversification of the economy. The deteriorating fiscal deficit exposes KRG to greater risks and calls for gradually strengthening fiscal position by containing expenditure growth and improving revenue generation. KRG will use the opportunity to reform the economy to address continuing structural issues. The Government is committed to implementing much-needed critical reforms ranging from subsidies and public employment to financial sector and energy sector reforms. These will contribute to a higher degree of efficiency in public spending. Furthermore, deepening economic reforms aimed at diversifying the economy away from oil would help encourage private sector development and create jobs.

9. ***Rebalancing of the public sector is essential to cope with the uncertain and volatile revenue transfers and to support the private sector-led economic diversification.*** The strategy that could bring the region out of the fiscal crisis and gradually put the region's economy on a balanced and sustainable growth path needs to have two core pillars and supporting structural policies. These core pillars are fiscal consolidation for macro-stability and laying the foundations for sustainable and inclusive growth. The Government should introduce fiscal reforms to strengthen its fiscal capacity to isolate core expenditures from fluctuations in fiscal revenues, and enhance its budget credibility and sustainability in the medium and long term.

10. ***Fiscal adjustment includes expenditure and revenue-side measures.*** Expenditure-side reforms would include rationalization and reprioritization of public expenditures including targeting subsidies and retrenching excess civil servants while simultaneously preparing them for the private sector with adequate retraining and other direct labor market policies. These reforms would increase the productivity of public expenditure and crowd in private investment supporting diversification. Rebalancing requires redistribution of public expenditure towards infrastructure (where private investments and financing are not forthcoming or there is no commercial viability for private investments), education, and health services, which could be achieved by restructuring subsidies and resizing public sector employment. The Government has already launched an unprecedented fiscal adjustment equivalent to 37 percent of GDP in less than three years, by slashing almost half of its expenditures. On the revenue side, revenues collected from regional sources should be raised to cushion the impact of volatility in oil prices and the central government budget transfers. There is also a need to underpin fiscal adjustment with strengthening of the public financial management system, starting with the resumption of annual budgets, and their approval by the regional legislature (a constitutional requirement), to restore the cycle of accountability, on which systems of improved financial control and management, reporting, procurement, accounting, and external audit can be built.

11. ***Connecting sector strategies to resource allocation is critical.*** To cope with the volatile fiscal situation and highly unpredictable budgetary process, the medium-term expenditure planning should be delinked from the short-term revenue transfer estimates. This would require a medium term fiscal framework (MTFF) which in turn could be developed into a full medium term expenditure framework (MTEF) to guide annual budgeting. Such a framework should be based on identification of essential needs, some agreed upon standards to budget for core expenditures, and the fiscal capacity of KRG. The MTFF/MTEF would also assure the quality and sustainability of expenditure levels by ensuring that capital projects are properly budgeted and completed as planned, rather than their completion being contingent on the fluctuations of oil revenues and transfers.

12. ***In the medium-term, spurring private sector activities in non-oil sectors is a core objective of the Government.*** To achieve this objective, an enabling business environment coupled with entrepreneurship support (particularly for the youth labor force) and firm-level support to improve productivity, quality, innovation, and local and global market access would be critical. Policies and programs to enable SMEs to grow would be critical to create jobs. At the same time, encouraging larger companies to become competitive both in the local and global market, preferably in partnership with Foreign Direct Investment (FDI) and/or public sector, would be also important. Building a strong, diversified, and competitive private sector is a critical economic objective as discussed in the *Vision 2020*. A large number of complementary policy tools in a variety of areas could be used in conformity for an extended period to achieve this goal. A prioritized and sequenced program would include (i) reforming laws and regulations that make it difficult to start, run and close a business; (ii) piloting and scaling up interventions to promote entrepreneurship, especially among the youth; (iii) scaling up firm-level interventions related to product and service quality upgrade and innovation by becoming a part of local or global value chain; (iv) building a strong advocacy and lobbying organization for the private sector development; (v) making the borders more efficient so that transit trade can grow; (vi) putting in place an effective technical and vocational education and training program; (vii) increasing access to finance, especially for SMEs; and (viii) improving infrastructure services (especially power).

13. ***KRI's financial sector needs to be strengthened to contribute to private sector development.*** Despite a large number of banks operating in KRI, its banking sector remains underdeveloped. It does not serve its basic function of channeling financial resources to the private sector to support its development. Banks are not engaged in their core function of providing loans to KRI's real-sector economy or financing long-term investment projects. As a simple yardstick, to bring the ratio of private credit to GDP from a current 2 percent to the MENA region average of 50 percent, banks would need to provide credit to the KRI private sector of ID 15 trillion (US\$13 billion). Presently, banks in KRI are facing a severe liquidity crisis, which has crippled their operations and has had negative effects on KRI's economy. The current situation is exacerbated by weak banking-sector supervision as functions of the Central Bank have been subordinated to the direct control by the KRG Ministry of Finance and Economy (MoFE).

### **Prospects for Growth and Development of the KRI**

14. ***Services could play an important role in economic diversification efforts.*** Services are essential inputs in any form of production, as well as a major component of the regional

connectivity, hence a key determinant of KRI's competitiveness and ability to join and move up regional and global value chains. Services could also become an important source of exports outside the oil and gas sector, along models in the region, and provide jobs outside the public sector. Being landlocked, the KRI is even more relying on services; this situation could be turned into an opportunity, and KRI could become a platform for transit and services provision in the region, given it is sharing borders with large potential markets. In particular, the KRI could become a gateway for the provision of a large array of services in other areas of Iraq. Therefore, this is a win-win situation for overall Iraq. This will require, however, that the KRI first removes a number of barriers to services trade that remain, given that services trade mainly takes place at the intermediary level and within global networks. It will also require restoring some legal certainty, adapting modern laws and regulations, and building capacity (skills, standards, and infrastructure). Beyond the economic dimension, the reform of the regulatory framework and the improvement of the services offered in the KRI will first and foremost benefit the local population, given that major gaps exist, for example in the health or education sectors.

15. ***Regional connectivity can be improved through ICT and transport services.*** There are complementarities to be realized from trade in IT services in addition to the benefits of enhanced ICT services as an enabling platform for trade. In addition to being an important sector of the economy, ICT, and broadband in particular, is a powerful enabler of trade development. The transformative role of digital technologies in the KRI resides in its ability to create jobs, diversify the economy and increase the overall competitiveness and efficiency of the private sector. To harness this potential, the KRG, in coordination with the central government authorities, needs to foster the development of high-speed Internet connectivity and the IT market through a set of actions and regulatory reforms. These include i) opening the market to competition through new licenses, open access policies, new supply models such as PPPs, and sharing of infrastructure; ii) strengthening the monitoring capabilities and regulatory powers of the Ministry of Transport and Communications; iii) leveraging the geopolitical location to establish KRI and the rest of Iraq as a hub for international connectivity that serves the regional and international Internet markets; iv) devising an IT strategy to address the weaknesses in supply and demand of IT services; and v) stimulating innovation in content development in the Kurdish language. Based on good geostrategic location, in addition to ICT services, transport network plays a very important role for the economic development of the region. Transport sectors in KRI is mainly dependent on roads as the most developed transport sector, but it is neither well-connected nor maintained at the proper level. Besides this sector, air transport needs significant upgrade. Railway sector and logistic hubs are not developed which is a constraint for KRI to benefit from regional economic opportunities. Furthermore, the legislation for the transport sector is outdated. It is necessary to carry out customs and trade facilitation reforms to strengthen cooperation among neighboring counties. Therefore, with improved transport and ICT services, KRI has a significant potential to become a transport and logistics hub for the whole region based on its proximity to major markets and relatively safe geopolitical position.

16. ***Electricity sector reforms can reduce fiscal burden, enhance energy trade, and improve electricity service delivery.*** Although power generation capacity in KRI has expanded manifold over the last decade due to private sector investments, the sector continues to be characterized by heavy fiscal burden of subsidies, dependence on costly liquid fuels to address natural gas shortages, transmission bottlenecks, high technical and commercial losses, low tariffs, poor



institutional capacity, and poor quality of supply. A strategy based on three pillars is proposed to address the immediate as well as longer term challenges in the KRI's power sector: (i) *Adopt an enabling legal, policy and regulatory framework* based on clear roles and mandates for different entities. The framework would include a new electricity law, an independent sector regulator, unbundling of the vertically integrated sector, corporatization of sector entities, and their eventual privatization. (ii) *Undertake crucial infrastructure investments* to ensure adequate power availability, reliability, reduction of losses, and trade of surplus electricity with neighboring areas of Iraq as well as Turkey. Given the constrained fiscal situation, it is imminent that private sector resource induction would be required. However, private sector investments need to be undertaken carefully to ensure that current sector performance attracts adequate private sector interest, as well as sufficient ramp-up in institutional capacity and legal-policy-regulatory framework to manage a complex ecosystem. (3) *Undertake measures to support performance improvements and accountability*. This would include a systematic rationalization of electricity tariffs as well as a focused program for loss reduction and revenue enhancement. While full privatization of the distribution business is a complex undertaking, loss reduction and revenue enhancement can be achieved through a well-structured contract with the private sector to manage billing and collection services. In addition, a clear policy framework and robust program for energy efficiency, energy conservation, and renewable energy can help contain the growing electricity demand.

17. ***Agriculture presents an opportunity for the KRI, and the sector's development will be associated with divergent needs for investment and labor.*** KRI's agricultural sector has been subjected to numerous shocks during the past 30 years, including low priced food imports under the oil-for-food program, the oil boom (which moved resources out of agriculture to the public sector and construction), and high cereal subsidies (which moved resources out of non-wheat commodities). To restart the sector, in addition to required agricultural investment projects, KRG must work on the following fronts: i) data improvement should start including a launch of an agricultural survey, price collection, creation of soil and water maps as well as a land registry; ii) all subsidies, taxes, import bans, and licensing fees should be reconsidered; and iii) an effective research and extension mechanism should be put in place, which should be undertaken in coordination with the Ministry of Agriculture and Water Resources, the existing Research Stations, and the Colleges of Agriculture. Furthermore, a significant agricultural rehabilitation program can generate localized economic activity and employment.

18. ***Investments in the water sector are required to reach a more sustainable use of water.*** Water shortages are becoming increasingly common. The sector is faced with dwindling supplies due to smaller inflows into KRI and deteriorating water quality. Yet, the demand for water from agriculture, households and industry (including for oil sector) is increasing rapidly. In addition, water is needed for hydropower and environmental flows. The increasing water shortages are likely to increase over time as upstream riparians are planning to develop more water infrastructure, making KRI increasingly vulnerable. The policy mix for addressing gaps between supply and demand will depend on a range of social, environmental, economic, and technical factors. Closing the gaps is within KRG's reach if it makes the necessary adjustments to include supply management strategies into an integrated approach that also addresses demand-side issues. To reap benefits of the large investments that have been made in developing water resources, it is recommended that the Government introduces broad and poverty-targeted interventions affecting not only water resources development and management but also water service delivery. Priority



areas would be: (i) water security planning and management; (ii) improving service delivery; and (iii) strengthening governance mechanisms and water users associations.

## **Strengths of the Region and the Way Forward**

19. ***The KRI has strengths and opportunities to get the economy out of the fiscal crisis and on a balanced sustainable growth path.*** These include: (i) large oil and gas resources; (ii) fertile agricultural land; (iii) young population; (iv) central location at crossroads of trade routes; (v) a government that is determined to implement reforms; (vi) a donor community that is eager to help; (vii) the entrepreneurial spirit of its population; and (viii) a relatively stable location as of now to do business in comparison to the rest of the country. If these strengths and opportunities are used effectively in a supportive policy environment, the KRI economy has a good chance to overcome the current difficulties and have a more diversified economy and sustainable high growth in the medium to longer term.

20. ***The acceleration of economic growth and diversification of the KRI economy requires simultaneous effort in the main sectors of the economy.*** The Government could begin the reform process which should involve sectoral restructuring and further developing the legal and regulatory framework needed for a market economy. Sectoral reforms should be implemented in tandem and in a well sequenced manner. This is because the effectiveness of reform in one sector is often dependent on the success of reform in other sectors of the economy. In KRI, these linkages will be accounted for by sequencing and coordinating reform in and among the various sectors. This roadmap brings together concrete sectoral policy reforms for Government's implementation.

## **Mitigating the Adverse Social Impact and Building a Robust Social Protection System**

21. ***The most immediate priority is to stabilize the economy without further increasing socio-political fragility.*** Strengthening and retooling social protection mechanisms to deal with the emergency are critical priorities for the Government. In light of the emergency, social protection should be a top short-term priority. Existing social protection mechanisms should be strengthened and to extent possible retooled to handle the ongoing social and humanitarian crisis. The Government has recently developed a robust social protection framework to protect the poor and the vulnerable. Furthermore, the reform program proposes a range of actions, which should be carefully assessed to identify the vulnerable population groups likely to be affected, and to estimate the size of the adverse welfare impact. In particular, actions related to changes and increases in income taxes; phasing out and lowering subsidies on petroleum, electricity, wheat, and on agricultural inputs have the potential to adversely impact less-well off households. In addition, given the size of the public sector, which employs individuals of varying education levels, some of the proposed reforms to the civil service, such as rationalization of public sector employment, could adversely affect the less-well off.

22. ***The poor and the vulnerable will need to be protected.*** The proposed reforms affect different groups of the population in a heterogeneous manner. A poverty and social impact analysis exercise should be undertaken to understand the size and nature of the impacts of the reform program as a whole. This exercise will help estimate the size of the compensating transfer needed to protect the poor and vulnerable in a fiscally sustainable way. For social safety nets, targeting is

the main challenge. The categorical targeting used in KRI does not consider the poverty line or the size of the household leading to high leakage. The transfer of ID 150,000 is allocated to beneficiary household regardless of size of the household nor its status, as defined relative to the poverty line or consumption level. Cash transfers use broad social categories instead of more effective targeting mechanisms to determine eligibility which explains why the majority of the poor do not benefit from this program. As such, only 11 percent of the bottom quintile currently are receiving the cash transfer. Currently, a proxy means test (PMT) to determine eligibility under such a poverty-targeted safety net program is being developed, and discussions are underway about transitioning the Social Security Network (SSN) from a categorically targeted program to one where eligibility is determined based on the PMT. This targeted safety net system will be underpinned by a unified registry, and transparent and fair governance and grievance mechanisms.

23. ***Even prior to the crisis, KRI had been faced with the challenge of reforming its social protection system.*** KRI faces the daunting task to increase the size and dynamism of the private sector where most future employment growth is expected to come. The employment challenge comes from the small size of the private sector, a fast growing labor force due to natural population growth and geopolitical events. The employment-to-population rate in KRG stands at 22 percent and is similar to the average for the non-GCC Middle East. The employment rate is very much affected by the very low labor force participation rate of working age (15-64) women at 14 percent that nevertheless rises to 17 percent if students are excluded.

24. ***The pensions and social insurance system in KRI is not sustainable, suffers from low coverage, and is inefficient.*** In 2014, the total pension spending in KRG was estimated to be around ID 1.3 trillion (or 2.8 percent of GDP), which is high compared to other economies at a similar stage of demographic ageing. More than 50 percent of the labor force in KRI is covered by the social insurance system. However, most of them are employees in the public sector. In the private sector, around 84 percent of the labor force is not covered. Also, only around 50 percent of people above the age of 65 in KRG are currently receiving a benefit from the pensions system (mostly retired public sector employees). The rest of the elderly have to rely on informal care, or public transfers as social assistance (non-contributory social safety nets). The main challenges of the social insurance system in KRI can be summarized in four points: (i) administrative capacity is low; (ii) schemes are inequitable and financially non-sustainable; (iii) the system is fragmented, leading to distortions in the labor market between the public and the private sector; and (iv) the system suffers from low coverage in the private sector.

25. ***To address the above challenges, KRG has outlined an ambitious strategic framework for reforming social protection in KRI.*** The KRG Social Protection Strategic Framework supports implementation of this reform through an integrated package of strategies, legislation, institutions, and programs. The proposed strategies align well with, and provide the mechanisms for implementation of, the *Vision 2020* policy priorities. The strategies are as follows: (i) KRG will create an effective labor supply of well-equipped job seekers and skilled workers through the education and training systems and market driven incentives; (ii) KRG will take measures to reduce the duality between employment in the public sector and private sector and thus contribute to a more dynamic private sector; (iii) KRG will develop regulatory and institutional frameworks based on timely data analysis, well-designed employment policies, and constructive dialogue among the social partners; (iv) KRG will implement parametric reforms to the current schemes to

ensure financial sustainability and will move towards integrating public, private and other (occupational) pension schemes; (v) KRG will design and implement conventional and alternative mechanisms to expand pensions and social insurance coverage; (vi) KRG will design and implement an Unemployment Insurance Program; (vii) KRG will use poverty as a main determinant of eligibility for its social safety net programs (including the PDS) and provide effective social care for vulnerable and disadvantaged groups; and (viii) KRG will protect its human capital by providing incentives for better health and education.

### **Risks to the Reform Program**

26. ***There are substantial risks that could jeopardize the success of the reform program, which is ambitious and far-reaching in its implications.*** The risks range from security threats to political and economic challenges. Political tensions between the KRG and the Central Government could continue to persist. Furthermore, political tensions between the main political parties in the KRG could endure. In parallel, security risks remain significant. ISIS could continue to pose a security threat to the KRI. The potential for a takeover of Mosul by the Iraqi military force may increase the influx of IDPs to the KRI. Moreover, oil prices could remain depressed for a protracted period of time, thereby limiting the scope for higher fiscal revenues and economic growth. Should any of these risks materialize, their impact on the progress of the reform program may be disruptive.

### **The Lay-Out of the Report**

27. ***The detailed action plan presented in this reform roadmap is prepared in light of the strategic objectives discussed above.*** This work builds on an ongoing productive engagement of World Bank Group teams with line ministries, private sector, academia and the international partners which resulted in development of in-depth technical assessments and analytical work in all sectors of the economy, as well as IFC's growing footprint in the region across diverse sectors. The findings and policy recommendations of these evidence-based analytical work are based on comprehensive consultations with all stakeholders in KRI. The report covers economy-wide issues such as private sector development, trade and investment regime, labor market as well as sectoral issues. The first chapter provides a macroeconomic background while second and third chapters introduce proposed short-term reform actions in the form of fiscal consolidation measures and medium-term targets to lay the foundations for diversified, sustainable and inclusive economic growth. The fourth chapter discusses upcoming social sector reform actions to address ongoing major social and humanitarian crisis in KRI. The fifth and sixth chapters focus on the governance issues and reform actions including accountability, institutional framework, and judicial oversight. The final chapter presents proposed implementation modalities of the three-year structural economic reform roadmap.