

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

December 7, 2016
Report No.: 110866

Operation Name	IRAQ: Second Expenditure Rationalization, Energy Efficiency and State-Owned Enterprise Governance Programmatic Development Policy Financing
Region	MIDDLE EAST AND NORTH AFRICA
Country	Iraq
Sector	Macro and Fiscal; Governance; Finance & Markets; Energy & Extractives; Social Protection & Labor
Operation ID	P161167
Lending Instrument	Development Policy Financing (DPF)
Borrower(s)	REPUBLIC OF IRAQ
Implementing Agency	MINISTRY OF FINANCE
Date PID Prepared	November 7, 2016
Estimated Date of Appraisal	November 16, 2016
Estimated Date of Board Approval	December 20, 2016
Corporate Review Decision	Following the corporate review, the decision was taken to proceed with the preparation of the operation.

I. Country and Sector Background

1. Since mid-2014, Iraq has been facing the war initiated by the Islamic State of Iraq and Syria (ISIS), which has increased violence and destroyed infrastructure. Expanding from Syria, ISIS initially made rapid inroads into Iraq starting in June 2014. The group quickly seized control of nearly one-third of Iraq's territory including major cities. During 2015 and 2016, the federal government and the *Peshmerga* military forces of the Kurdistan Region of Iraq (KRI) were able to regain key parts of the country. The federal government is presently engaged in a battle to liberate Mosul, the last large ISIS-controlled city in Iraq.

2. The ISIS war has created a humanitarian crisis, put pressure on fiscal spending, and plunged the non-oil economy into a deep recession. The combination of 3.4 million Iraqis internally displaced and the arrival of 245,000 Syrian refugees has put enormous pressure on an already weak public service delivery system. The United Nations estimates that 10 million people are in need of assistance. Fighting ISIS has been expensive. Security-related budgetary expenditure (military and police equipment and salaries) is expected to reach US\$14.8 billion in 2016¹ (8 percent of GDP, which accounts for 18.3 percent of 2016 total government spending, and two-thirds of the 2016 fiscal deficit). Moreover, the conflict has been a key driver of the severe negative hit on the non-oil economy, which has contracted cumulatively by 29.5 percent in 2014-2016. ISIS-controlled areas

¹ IMF SBA staff report, (Forthcoming) December 2016.

have particularly suffered as productive assets and infrastructure have been destroyed, trade routes have been cut off or severely curtailed, and investor and consumer confidence dwindled.

3. Compounding the country's fragility is the sharp and sustained drop in oil prices which has severely impacted Iraq's non-diversified and oil-dependent economy. Iraq has the fifth largest proven crude oil reserves in the world with 141.4 billion barrels. With the rapid increase in production in 2015 and 2016, the country is now the world's third largest and OPEC's second largest oil exporter. With 112 trillion cubic feet of proven reserves, Iraq's proven and largely untapped natural gas reserves are the twelfth largest in the world. The oil and gas sector dominates the economy, even by regional standards. The sector accounts for over 65 percent of GDP, more than 90 percent of central government revenue, and 98 percent of the country's exports. The fall in oil prices, which have dropped to between one third and one half of their June 2014 level, has resulted in a sharp and large deterioration of the country's public finances and external balance. With oil prices expected to remain persistently low to moderate, the government and the economy will need to gradually adjust to a new level of permanently lower oil revenue. This requires reforms that materially and sustainably improve the structural fiscal balance.

II. Operation Objectives

4. This DPF series aims to support the government's effort to safeguard economic stability and lay the foundations for longer-term structural reforms that would support private sector development and inclusive growth. This would be achieved through reforms built around three pillars, which are also the Program Development Objectives (PDOs), namely to improve: (1) expenditure rationalization; (2) energy efficiency; and (3) the transparency and governance of state-owned enterprises (SOEs). The PDOs support directly a package of reforms announced by the Prime Minister in August 2015 to combat corruption, eliminate ineffective governance, improve basic services delivery, and support economic reforms.

5. The operation is aligned with key elements of Iraq's medium-term development priorities, as detailed by the Prime Minister during his inauguration speech to Parliament in September 2014, and in the *Strategic Priorities in Ministries: 2014-18 Action Plan* that lays out the six priorities of the government. These include: (1) promoting a secure and stable Iraq, (2) upgrading service to and the standard of living of citizens, (3) encouraging a shift toward the private sector, (4) increasing oil and gas production to improve financial sustainability, (5) implementing administrative and financial reform of government institutions; and (6) improving federal-local relations. The operation supports directly priorities (2) to (5) and, indirectly, priority (1). Overall, these reforms contribute to the World Bank Group's strategic goals of ending extreme poverty and boosting shared prosperity in a sustainable manner.

6. The reforms supported by this DPF series are short-term imperatives that, for the most part, are prerequisites for future reforms to take place. This DPF series supports the government efforts to structurally reduce the fiscal deficit to a sustainable level and maintain macroeconomic stability, a pre-requisite for private sector development. This objective would be achieved through reforms that improve governance through strong expenditure control measures; address the non-sustainability of the pension system; better target the poor through existing social safety nets; reduce large subsidies in the electricity sector; and improve SOEs' transparency and governance.

7. The DPF program has the following expected benefits. First, it is an important contribution to remove immediate pressures on the economy that could otherwise breed further radicalization through increased youth unemployment and poverty. In Iraq, one of the main drivers of instability and conflict has been the weakened relationship between the Government and the people, disparities in access to services, and a perceived lack of representation and voice among various groups.² Groups like ISIS have exploited the lack of trust in government and attempted to challenge its very legitimacy. Second, it helps the government address public grievances linked to perception of corruption, thanks to its focus on expenditure controls and rationalization, increased transparency and improved governance. Third, it supports reforms implemented by the government that are necessary to put fiscal expenditure on a sustainable path, maintain macroeconomic and price stability and lay the foundation for inclusive growth. Finally, it helps the government's effort to improve the efficient delivery of services to the people with particular emphasis on the strategic and socially sensitive electricity sector.

8. The key result indicators are the following:

- Strengthened payroll expenditure control as measured by the percentage of verified central government civil servants whose compensation and daily attendance is tracked electronically (minimum of the two variables). Baseline (2015): 0 percent; Target (2018): above 30 percent.
- Improved selection and assessment of public investment projects as measured by the percentage of capital projects that exceed ID100,000 billion (about US\$85 million) for which a feasibility study with cost-benefit analysis was conducted. Baseline (2013): 5 percent; Target (2018): above 20 percent.
- Share of the domestic debt in total public debt. Baseline (2015): 34.3 percent; Target (2018): at least 35 percent.
- Improved social insurance efficiency, coverage, and sustainability as measured by the expected actuarial deficit period (years until going into deficit from 2015). Baseline (2015): 13 years; Target (2018): above 28 years.
- Improved social safety net efficiency as measured by: (1) coverage ratio of the poor; and (2) inclusion error. Baseline (2015): (1) 11 percent, (2) 43 percent; Target (2018): (1) at least 50 percent, (2) at 20 percent or below.
- Reduction in gas flared as measured by (1) the expansion in Iraq's gas processing capacity (in MMscfd); and (2) the amount of locally produced gas-to-power allocation. Baseline (2015): (1) 671; (2) 570.9; Target (2018): (1) 1,300 or above; (2) 1,200 or above.
- Improve electricity generation efficiency, cost, and environmental impact through increased share of gas used in the power generation mix. Baseline (2015): 42 percent; Target (2018): 70 percent or above.
- Reduced electricity subsidies, as measured by improved revenue collection as a percentage of generation. Baseline (2015): 30 percent; Target (2018): above 50 percent.
- Improved non-financial SOEs transparency and governance as measured by the ISAR Benchmark of Corporate Governance Disclosures to measure corporate governance

² World Bank (2016) "Republic of Iraq: A Systematic Country Diagnostic," forthcoming.

disclosure changes at a regulatory level as well as the disclosure of key financial information at a company level. Baseline (2015): 0 percent; Target (2018): above 15 percent.

- Reduction of state-owned banks' exposure to non-financial SOEs, as measured by the share of state-owned banks' outstanding stock of lending to non-financial SOEs in their total lending. Baseline and target to be determined following completion of the audit of Rasheed and Rafidain banks.

III. Rationale for Bank Involvement

9. This operation comes at a time of unprecedented stress for Iraq. The country is facing the sudden dual shock of a fiscally, socially and politically costly brutal war waged by ISIS, and the sharp fall of the price of oil. This operation is part of the international community's support to government's effort to bring peace and stability to Iraq through the provision of timely and large external financing, and the support to measured structural reforms. It comes at a time when the country is undergoing a large fiscal shock which could lead to a much deeper economic and social crisis that would disproportionately hurt the poor and further delay the reconstruction of Iraq. The proposed operation is the first in a programmatic DPF series of two operations that builds on and continues the structural reforms initiated as part of the US\$1.2 billion development policy operation approved in December 2015.³ Building on that operation, this DPF series aims to help safeguard economic stability and lay the foundations for longer-term structural reforms that would support private sector development and inclusive growth. These reform efforts are being deployed in parallel to the internationally supported war effort, in what is to be construed as a quasi-unique case of the international community rallying around a country engaged in a transformational economic reform program all the while waging a war against a deeply disruptive force threatening the whole Middle East region and beyond.

10. This operation is also a critical part of the World Bank's Middle East and North Africa (MENA) Region strategy to support peace and stability for economic and social inclusion. The main objective of the MENA strategy is to contribute to peace and stability by addressing the underlying causes of fragility and conflict and renewing a social contract between governments and citizens across the region.

11. The proposed DPF series is part of an international support package to Iraq. The DPF series will be implemented during a period when Iraq and the IMF have an ongoing three-year Stand-By Arrangement (SBA) in place. The reform measures supported by other development partners are closely coordinated and aligned with the reforms of both the IMF SBA and the proposed DPF series. Beyond this financing package, the policy reforms supported by the DPF series are implemented with help from an extensive and multi-year ongoing and/or planned program of technical assistance and projects provided by donors and international financial organizations. This comprehensive and medium-term engagement supports fast, effective, and sustainable policy implementation of structural reforms, as requested by the authorities.

³ For details, see "Republic of Iraq: Emergency Fiscal Stabilization, Energy Sustainability, and State-Owned Enterprise Transparency Development Policy Financing", World Bank, December 17, 2015.

IV. Tentative financing

Source:	(\$ million)
Borrower	0.00
International Bank for Reconstruction and Development	1000.00
Others (guarantee from the UK and Canada)	443.82
Total	1443.82

V. Tranches (if applicable)

12. This is a single tranche operation.

VI. Institutional and Implementation Arrangements

13. The responsibility for implementing the program in the government rests with the Ministry of Finance (MoF). The MoF is responsible for the implementation of the DPF-supported program as well as for coordinating the actions among the concerned institutions. Together with the MoF, line ministries and agencies engaged in DPF-supported reforms will collect the necessary data for the identified monitoring indicators. Given the multi-sector and multi-agency nature of the DPF reforms, the Prime Minister's Office has also committed to continuously monitor implementation of the reforms against agreed plans and timelines and will work closely with the World Bank and the Ministry of Finance to address any slippages.

VII. Risks and Risk Mitigation

14. The overall risk rating of this operation is high. Major risks that could prevent the operation from achieving its development objectives include: political and governance, stakeholder and social risks; macroeconomic risks; fragility, conflict and violence risks; institutional capacity for implementation and sustainability risks; sector strategies and policies risks; and fiduciary risks. However, while risks to this proposed programmatic series are high, they should also be weighed against the risks of inaction which currently in Iraq are extremely high.

VIII. Poverty and Social Impacts and Environment Aspects

Poverty and Social Impacts

15. Overall, the combined impact of the structural reforms proposed in the DPF series are expected to improve welfare. Reforms implemented by the government are necessary to put fiscal expenditure on a sustainable path, maintain macroeconomic and price stability and lay the foundation for inclusive growth. A number a prior actions supported by this operation will have a positive or neutral social impact. The implementation of the electronic payment and biometric system will help re-deploy resources to critical basis services. The implementation of the PIM and debt management reforms will improve the efficiency of public spending on investment and debt service and enhance fiscal space for social spending. The SOE transparency and governance reforms will provide better information on fiscal outlay and contingent liabilities.

16. The implementation of a more efficient and well-targeted system of social spending is expected to have positive impacts on the poor and vulnerable, and improve horizontal equity.⁴ The transition from an untargeted PDS system to a better targeted safety net system through proxy means test will broaden the reach of social program to those in need relative to the current situation. Reforms of the pension system will not have significant impact in the short term, but are likely to affect the income of some households in the long term. However, it should be noted that these reforms will ensure the sustainability of the pension system, securing the value of the pensions over time, and expanding the coverage. The roadmap for electricity sector reform is expected to include improvement in electricity revenue collection and electricity tariff adjustment to reach cost recovery level. These reforms are necessary to reduce the high level of subsidies, which is not fiscally sustainable, induces over-consumption, with negative impact on the environment and at the margin favors too high capital intensity at the expense of labor and is horizontally inequitable as a large share of consumers are not paying their bills. In the immediate, the supported reform program protects expenditure targeted to deliver services to IDPs. No supported policy reform is likely to have a disproportionately adverse impact on women. An expansion in social services and essential infrastructure, if forthcoming, will likely disproportionately benefit women and girls, and help address existing gender gaps in access to health and education infrastructure.

Environment Aspects

17. The reforms supported by the proposed DPF are not likely to have significant negative effects on the country's environment, forests or other natural resources. Despite the instability and civil strife, the government has handled the issue of environmental sustainability with some relative success, starting with law No. 37 of 2008 establishing the Ministry of Environment, and then the environmental protection and improvement law No. 27 of 2009 that clearly defines the process, procedures and requirements for environmental assessment, under the overall supervision of the Environmental Impact Assessment (EIA) department in the Ministry of Environment.

18. As per OP 8.60, the World Bank assessed whether specific country policies supported by the DPF series are likely to cause significant effects on the country's environment, forests, and other natural resources. The assessment concluded that the policies supported by the proposed DPF are not likely to have negative impacts on the country's natural assets. The reform program supported under improving energy efficiency objective would help in the reduction of gas flaring, thereby reducing climate change effects, as there will be reduction of methane to the atmosphere resulting in less environmental degradation. Similarly, the strengthening gas-to-power strategy under this same objective would promote the use of natural gas in power generation instead of the more polluting fuel oil and diesel. This will significantly improve air quality by reducing energy-related emission that lead to air pollution, reducing the related impacts on human health. With respect to the reforms, to reduce gas flaring and improve energy efficiency, any significant negative environmental effect is likely to be avoided or mitigated. The EIA department has benefited from Environmental Assessment capacity building with the ongoing World Bank-financed Iraq Transport Corridor Project and the Emergency Operation for Development. Thus, the capacity exists to implement, monitor and report on mitigation measures associated with safeguards instruments

⁴ So that people with the same level of income would have equal access to SSN.

susceptible to be used in power generation using gas and private sector investment in gas capture, processing and transmission infrastructure and for electricity generation.

IX. Contact point

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