

Public sector investment in Iraq - What strategic priorities for the new Prime Minister?

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Introduction

Iraq is still in turmoil, four months since the Uprising, in October 2019. Meanwhile, Prime Minister (PM) Adel Abdul Mahdi resigned. Muhammad Tawfiq Allawiⁱ has been appointed as PM-designate. Mr. Allawi has already been rejected by the Uprising, as an affiliate to the failed post-2003 ethno-sectarian political system. Political uncertainty thus continues, and with it investment decisions in the public and private sectors.

Whoever the new PM may end up to be, two key challenges will face him; political and economic.

On the **political front**, the new PM will need to prove, *by action*, that he has *the* will and determination to serve the Iraqi people, rather than bend to ethno-sectarian interests that have shaped politics and the economy post-2003. A system that normalised pervasive corruption, sidelined the rule of law, freedom of thought and expression, peaceful gathering and the right to protest. A system that, *inter alia*, stalled economic development, leading to high unemployment, and marginalised, if not atomised, millions of Iraqis living in poverty.

On the **economic front**, the challenges are just as great as the political ones. The new PM will have only the near-term to rise to these challenges – possibly a major review of the current ‘Government Programme,’ the ‘Construction Council’ bill, and various economic “road maps” laid out by the current ‘Prime Minister’s Advisory Committee’ (PMAC), e.g. “vision 2030”, as well as comprehensive institutional reforms. He will need to draw together all these, and more, and produce a short-term realistic, rational and workable economic programme, on which more below.

Simply put, the Uprising anticipates economic reforms that create new jobs, use oil revenues for investment in productive sectors of the economy, across the country and substantially reduces the size of government employment, of which the pay roll easily absorbs over 50 percent of the national budget. The Uprising also demands early general elections, ushering a process of defragmentation of the allegedly corrupt institutions, and observing good governance and the rule of law, amongst other reforms.

Structure

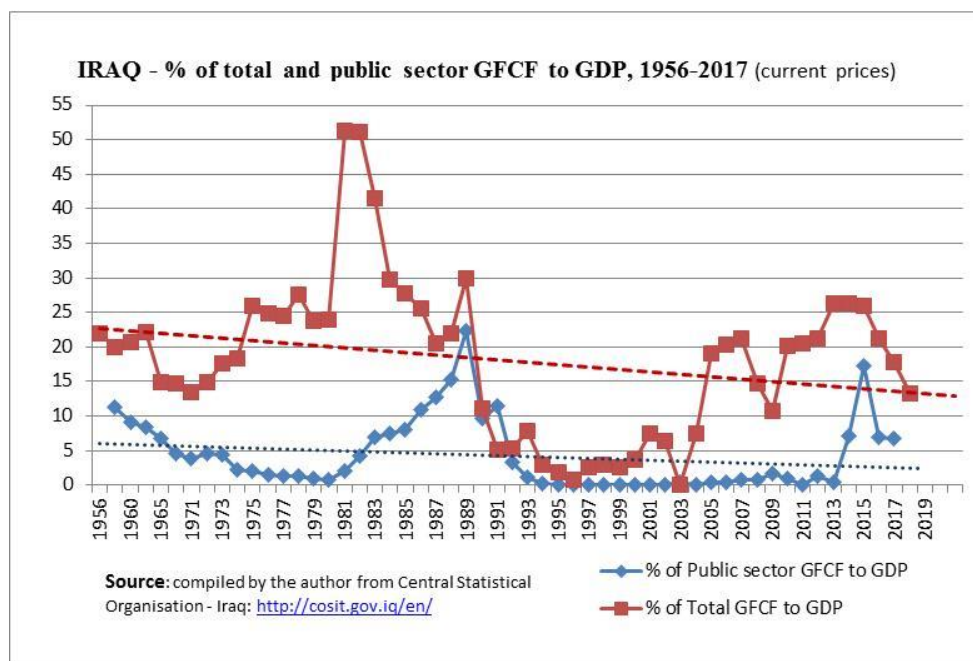
This brief note begins with a reference to the scale and nature of public sector investment in Iraq, taking a historical perspective. A set of challenges and opportunities is outlined, and some notion of priorities is set out. Finally, a few conclusions are drawn.

Public sector investment (Gross Fixed Capital Formation – GFCF) is assumed to be a driver of *economic development*, using oil revenues to diversify Iraq’s economic structure. This note does not touch on the theoretical discourse relating to the wider role of government in the country, or private sector investment.ⁱⁱ We start with history.

Scale of public sector investment in Iraq

Since 1956, the *rate of investment* (percentage of GFCF to GDP) has assumed a downward sloping trend, as the Figure below shows.

The Figure below indicates that in 1956, *rate* of combined public and private investment was nearly 22 percent in 1956, declining to 18 percent in 2017, and ending at nearly a mere 13 percent in 2018. The rate of investment in the public sector too assumed a similar trend, falling from 11 percent in 1956 to 6.8 percent in 2017 (latest data for public sector).



Of the total investment in 2017, nearly 54 percent was made by the public sector, equating to IQD 17.5 trillion (tr.) bn, at current prices. ⁱⁱⁱ

By the standards of developing and/or backward ^{iv} economies these rates sit amongst the lowest. Iraq's 13 percent overall rate of investment compares with Bangladesh and India each at 31 percent (both pushing for marked growth), Angola at 23 percent, Azerbaijan at 21 percent, Bolivia at 20, Ecuador at 25 percent, Pakistan at 15 percent, Rwanda at 24 percent and, Somalia at 7 percent. ^v

No reliable international comparisons for public sector rate of investment exist, but the logic of the above figures would point out to very low rate too, in Iraq - a trickle 6.8 percent.

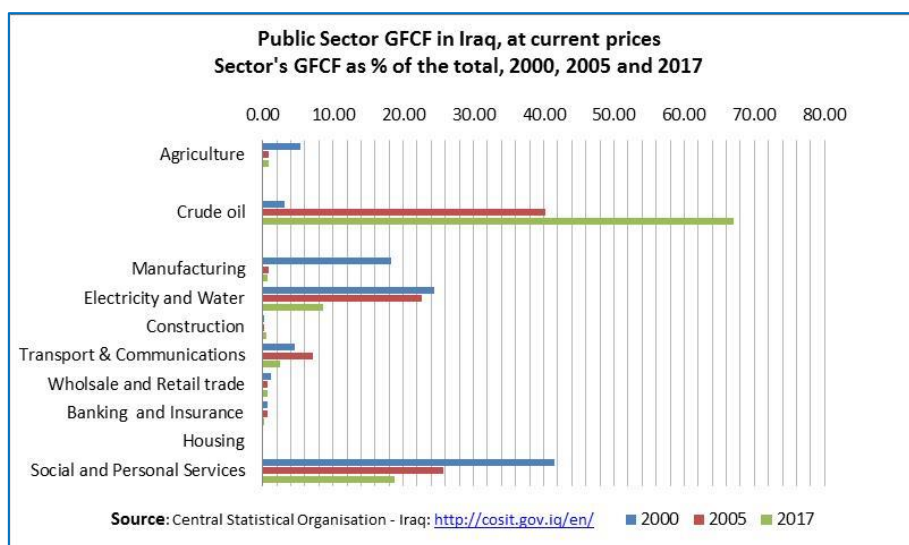
Key reasons for this poor performance are noted elsewhere. ^{vi} Suffice to say that successive governments have allocated a substantial part of the oil revenue to consolidate political interests and military expenditure, in the main. The public sector has been the main investor, and so has assumed the overwhelming responsibility for economic growth (see **end note vi**). Economic policy in Iraq has reflected acute political interest, changing frequently as a result of changing political sentiments, or priorities. This is part of the reason why the *absorptive capacity* of the economy has weakened severely. During 1950-58, it took 2.3 IQDs of capital investment to increase GDP by one unit of output. During 2005-09, it would take 7 IQD of investment to do so? This situation also reflects (in part) the colossal destruction of physical and social infrastructure in Iraq during the wars and economic sanctions period. A situation compounded post-2003 by severe shortage of skills, pervasive corruption, lack of security, near absence of good governance and the circumvention of the rule of law. The challenge to invest and increase *non-oil* GDP in Iraq has been increasingly more difficult.

The Figure above poignantly reflects this reality. However, the breakdown of public sector investment reveals a more challenging, and complex, situation.

Structure of public sector investment

The Figure below shows the direction of travel for the post-2003 government's 'economic policy' and investment priorities. Government's distinct priority has been to invest in crude oil production and export. Whilst it is important to maximise investment in the (depleting) oil resource, to support the overall economy, other sectors suffered disproportionately. To date, government has adopted an investment policy that can at best be described as unbalanced. Agriculture, manufacturing, physical infrastructure (electricity, water, roads,

ports, dams, etc.) actually saw a relative decline in public investment between 2005 and 2017 (latest figures available).



As the above Figure indicates, of the IQD 17.5 tr. public sector GFCF in 2017, IQD 11.8 tr. (67.5 percent) went to the oil sector. Electricity and Water sector was allocated IQD 1.5 tr. (8.7 percent), ‘Transport and Communications’ was allocated IQD 0.27 tr. (1.5 percent) of the total and, ‘Social and Personal Services’ sector was allocated IQD 3.3 tr., or 18.6 percent of the total. Each of the four sectors - agriculture, manufacturing, construction, and wholesale/retail - registered less than 1.0 percent of the total. (see **end note iii**).

It is clear that neither the productive sectors of the economy (e.g. agriculture and manufacturing) nor the physical infrastructure, both critical for enhancing economic growth potential, received sufficient public sector investment. The consequences on recent changes in GDP have been dire, as summarised below:

1. Crude oil sector comprised 65 percent of GDP in the first quarter of 2019, up from 52 percent in 2014 (at constant 2007 prices: http://cosit.gov.iq/documents/national_accounts/national_income/reports/gdp/%...pdf);
2. Agriculture sector comprised 1.3 percent to GDP in Q1, 2019 (down from 4.12 percent in 2014);
3. Manufacturing comprised 0.8 percent to GDP in Q1, 2019 (down from 1.2 percent in 2014); and
4. Oil exports comprised 99 percent of the total in 2018; resulting in chronic *non-oil* trade deficit.

Government priorities disfavouring investment generally, and in productive sectors and infrastructure in particular, are also mirrored in government budgets’ allocations. To take the 2019 ‘Federal Budget’ ^{vii} as a typical example post-2003, we note that:

1. Public sector ‘Capital (investment) Expenditure’ was set at IQD 33.0 tr., ‘Current (Operational) Expenditure’ was set at IQD 96.0 tr., and borrowing (deficit finance) at IQD 22.9 tr.;
2. Public investment was thus set at 15.1 percent of total expenditure; and
3. Of the total estimated domestic revenue (IQD 105.6 tr.), oil revenue was IQD 93.7 tr. (or 88.7percent of the total), taxes a mere IQD 6.3 tr., and ‘other’ IQD 5.6 tr.

Note that the ‘operational expenditure’ (mainly wages, salaries, “benefits”...) in the 2019 budget was more than the oil revenues? Much of the investment allocations were thus financed by borrowing. This means Iraq’s budget has become a *distributional* budget?

Public sector investment priorities remained unchanged in 2019. The 22 ministries were allocated IQD 26.3 tr. Of this 90.9 percent went to four ministries/sectors: the ‘Oil Ministry’ captured IQD 15.9 tr., Electricity, IQD 4.0 tr., Defence, IQD 2.1 tr., and Construction and Housing IQD 2.0 tr. The other 18 ministries were allocated less than IQD trillion each. For example, the ‘Ministry of Education’ was allocated IQD 141 bn (at a time when Iraq needs over 8,000 new schools), ^{viii} ‘Higher Education’ was allocated a mere IQD 60 bn and ‘Health and Environment’ was allocated IQD 316 bn.

A crude analysis of the above account would suggest that it is perhaps not too bold to say that investment in productive sectors, bar the oil sector, is not a priority for public sector (government) investment. Nor is investment in physical and social (health and education) infrastructure.

Challenges and opportunities for public sector investment

Adopting a *macro*, broad brush approach, it is possible to summarise the challenges facing the public sector, and the opportunities that might be seized, as follows.

On the **key challenges** side, the following is noted:

1. Increasing the rate of investment, gradually to reach 25 percent of GDP in the medium-term (5 to 7 years);
2. Under state control, a greater proportion of oil revenue must be allocated to investment in productive sectors and physical and social infrastructure, than at present;
3. In the long run a ‘sovereign fund’ must be established for emergency purposes and to underpin pensions, social care etc. if/when needed;
4. Major infrastructure projects (e.g. airports, key ports in the south, dams, highways etc.) should remain under state ownership for a long time to come, until the Iraqi economy assumes some clear characterisation (coming out of its backward state) and until the private sector is in a position to participate on the basis of demonstrating economic efficiency, demonstrating good practice/governance, and observing the rule of law;
5. The health and education sectors should be regulated by the state, comprising state provision in the main. Both sectors should serve economic development (e.g. providing the ‘right’ supply of healthy graduates for economic sectors demanding specific skills). In other words, strong links between the education sector (including vocational education) and the economy must be established, to absorb new graduates, in gainful employment. The Uprising in Iraq since September of last year clearly illustrated the importance of rising to this serious challenge;
6. Reducing poverty remains a massive challenge; Iraq should move towards establishing a welfare
7. Government should contribute to increasing the housing stock - over two million people live in shanty towns in Baghdad only, occupying 136,689 “units” ^{ix};
8. The banking sector should be tightly regulated; supervision is virtually non-existent; the sector suffers from major structural weaknesses. An overhaul of the public and private banks is essential so that the banking sector becomes a vehicle to encourage private and public sectors’ investment in the economy (cf. <https://www.imf.org/en/Publications/CR/Issues/2019/07/25/Iraq-2019-Article-IV-...Program-Monitoring-Press-Release-48527>);
9. Reconstruction of areas damaged by ISIS remain an upside risk if not tackled in a planned way, with the public sector taking the lead and engaging private sector development in the process;
10. Inward foreign direct investment (FDI) has been in decline since 2015, and outward FDI has assumed an upward trajectory (https://unctad.org/sections/dite_dir/docs/wir09_fs_iq_en.pdf); Government should create the right environment for *doing business in Iraq* to reverse this situation (cf. <http://documents.worldbank.org/curated/en/183731574998383481/Doing-Business-2020-Comparing-Business-Regulation-in-190-Economies-Economy-Profile-of-Iraq>);
11. Government should achieve consistency in the legal framework that govern public and private investment in Iraq, and establish a solid basis for observing the rule of law and diminish institutionalised corruptions.

On the **key opportunities** side, the following is noted:

1. An obvious opportunity that presents itself, which has attracted professional and academic attention, is the rejuvenation of the currently loss-making ‘State-Owned Enterprises’ (SOEs). As noted elsewhere (see **end note ii**), the new prime minister could initiate the restructuring and rejuvenating the SOEs, to improve their productivity, keeping in mind the socio-political risk this action might have. Keeping the 170 plus ^x SOEs afloat, as it were, is a drain on government’s finances due to underemployment, redundancy and maladministration. The SOEs have also assumed control over the sectors concerned and in effect crowded-out private firms. ^{xi} A quick win for the new prime minister might be introducing a form of partnership with the (domestic or foreign) private sector to rejuvenate the SOEs, based on, say, 30-40 years lease, profit-sharing, joint operation, ensuring continuous professional development for Iraqi workers and innovative ‘Research and Development’ (R&D);
2. Reforming public finance management, including *two key imbalances* in the ‘Federal Budget’ is another opportunity waiting to be seized. These imbalances relate to, **firstly**, the extremely high public sector payroll. Since 2003, the number of government employees has risen by *five* times, according to a senior advisor to the prime minister, and the wages (and “benefits”) paid rose *seven* times (<http://iraqieconomists.net/ar/wp-content/uploads/sites/2/2019/12/...pdf>). This is unsustainable; should this trend continue, Iraq will have to borrow money not only for

investment, but also for consumption (via increasing current expenditure)? **Secondly**, the new prime minister must re-balance the budget in favour of investment, especially in productive sectors and in social and physical infrastructure to absorb the unemployed and those entering the labour market annually, due to population growth. Government should start with labour-intensive projects, gradually moving to capital-intensive projects, which must be based on rigorous financial and economic feasibility studies.

3. A third, and quick win for the new prime minister, would be seizing the opportunity of establishing a robust *legal framework* that would stimulate public investment and, simultaneously, ensure that this framework would minimise corruption through engendering good governance institutionally and at the firm level. The rule of law must be enforced through impartial, professional, judiciary. Such an opportunity could be seized fairly quickly by establishing a Commission, headed by a senior judge, which should establish consistency in various business-related laws and regulations, in accordance with the constitution.
4. Both the current ‘Government Programme’ and the proposed ‘Construction Council’ bill need a major review and changes, and so they present an opportunity for the new PM to revamp both, in the interest of wealth and jobs creation. Both should be reviewed by highly skilled, specialist, experts; they should contain no loop wholes that would sow the seeds of corruption and the circumvention of the rule of law.

For the new PM to be able to seize the above opportunities, and rise to the enormous challenges set out above, they should swiftly establish political stability and *trust* with Iraqis that changes are being made effectively and efficiently. They should establish stable legal and regulatory environment for doing business in Iraq. These are key country characteristics sought by investors (foreign or domestic), and should be the case within the public sector too (*cf.* documents.worldbank.org/curated/en/169531510741671962/pdf/121404-PUB-PUBLIC-PUBDATE-10-25-2017.pdf). Establishing a secure environment by enforcing the rule of law is critical; the new PM must abolish “economic committees” within ministries, currently serving political parties, dissolve all militias and the ‘popular mobilisation units’ (Hashd al-Sha’bi); security must be the job of the official army and police only.

For investors, these are important considerations. The level and effectiveness of internationally recognised legal protection against political and regulatory risks (driven by corruption). Investors would normally seek transparency in dealing with public institutions, and would wish to reduce risks to the minimum, e.g. ensure that, *inter alia*, their properties might not be subject to expropriation. The new PM should also establish macro-economic stability, consistency between fiscal and monetary policies and work hard on education and skills (know-how) development in the county.

Conclusions

Public sector investment in Iraq has been on a downward sloping trend over nearly 70 years. Public investment assumed the bulk of total investment. This situation presents a major challenge for the new PM who might wish to break away from the failed ethno-sectarian political system and their poor economic policies that served the political elite. The new PM should aim to increase the overall rate of investment, gradually to reach 25 percent of GDP in the medium-term (5 to 7 years).

Given the current acute complexities of the political (and economic) situation in Iraq, the new PM would need to have *the will* and *determination* to drive a robust economic strategy that would revive manufacturing and agriculture as well and the physical and social infrastructure of the next five-ten years. They will also need to create a conducive environment for doing business in Iraq, supported by an enforceable legal and regulatory framework that would ensure the good governance is strictly observed and the rule of law is not circumvented. The public sector will have to undergo major institutional defragmentation to diminish corruption and provide security and stability for public (and private) investment to take place, and for tackling unemployment via the creation of new gainful employment.

End notes

ⁱ Iraq's president has appointed a prime minister-designate (PM) – Mr Mohammad Tawfiq Allawi. Appointed on February 1st, 2020, the PM-designate has 30 days to present his 'new' cabinet for parliamentary approval. Allawi, an architect by profession, a former minister of communications and self-confessed "Real Islamist", had already set out, on his blog (mohammedallawi.com), a relatively micro, detailed, political and economic 'road-map' for Iraq. This can be summarised as follows:

1. Promulgate a new elections law, and hold elections sooner, to remove the corrupt politicians. The current political class must be changed. The new parliament would gradually amend the constitution to suit social changes;
2. All the key government employees' appointments should be made by the civil service; parliament must not interfere. Those who looted money must be brought to justice, and international organisations should be engaged to retrieve the stolen (laundered) money;
3. There must be an economic plan for investment in industry and agriculture, and a protectionist policy should be adopted re: industrial and agricultural products;
4. Reduce unemployment and provide security, through encouraging start-ups, providing preferential credit facilities, and offering private sector employees same pension privileges as those working in the public sector.

This is a politician's road-map, and is not grounded in theory; it is based on personal experience, and ambitions.

Still, the political situation in Iraq remains fluid, to say the least, and the PM-designate does not command the support of the on-going Uprising - Allawi is seen as "part of the ruling class they have rejected as corrupt and beholden to foreign interests" (Chloe Cornish - <https://www.ft.com/...-955839e06441> <https://www.ft.com/content/fd9395d8-451f-11ea-aeb3-955839e06441>). It is not clear whether ethno-sectarian **Political barter** is already underway, which could lead to outcomes that might still be rejected by the poorly organised, leaderless, Uprising, which does not seem to have *specific* well-articulated and thought out demands that they wish to be met in a given period of time. Vague reforms are always difficult to negotiate.

ⁱⁱ For a recent contribution by the author on the private sector investment in Iraq, and possible future of SOEs (see: <http://www.iraq-businessnews.com/2019/12/13/private-sector-investment-what-strategy-for-the-next-pm/>).

ⁱⁱⁱ See: Central Statistical Organisation – Iraq at:

http://cosit.gov.iq/documents/national_accounts/forming_capitals/reports/...pdf, table 3, p. 9, accessed on February 12, 2020).

^{iv} In this note a **backward economy** is one characterized by high population growth rate (ca. 3.0 percent pa), low standards of living (high proportion of population living in poverty), high mortality rate, low life expectancy, severe inequality in income distribution, poor health and education services, high unemployment, low women's participation in the labour market, weak private sector and high level of dependency on rent from natural resources and government, and lack of functional democracy.

^v See <https://data.worldbank.org/indicator/NE.GDI.TOTL.ZS>.

^{vi} See Hirmis, A. K., 2018, *The Economics of Iraq – ancient past to distant future* (Grosvenor House Publishing, UK, pp. 99-102).

^{vii} See: <http://mof.gov.iq/pages/ar/FederalBudgetLaw.aspx> (in Arabic).

^{viii} Ministry of Planning, 2019, *National Development Plan 2018-2022* (p. 195, available at:

<https://mop.gov.iq/en/static/uploads/8/pdf/1545900842d4eeef48c6122449898d79a86b841fb...pdf>, accessed on January 20, 2020).

^{ix} Omar al-Jafal, 2019, *Shanty towns in Baghdad: spread everywhere* (posted at:

<http://assafirarabi.com/ar/28197/2019/12/05/%d8> to be continued, accessed on July 18, 2019).

^x Eric Le Borgne, et al. 2016, *Performance and Fiscal Risks from Non-Financial State-Owned Enterprises in the Republic of Iraq* (available at:

<http://www.iraqatabank.org/storage/app/uploads/public/59b/59b/e28/59b59be28b2b6228092287.pdf>, accessed on August 20, 2018). As far as is known, this report was compiled by World Bank staff for the Prime Minister's Advisory Committee (PMAC). On page 7, the report states that the 176 SOEs are 'owned' by 14 ministries, with four ministries assuming majority share - Ministry of Industry and Minerals (76 SOEs), the Ministry of Electricity (23), the Ministry of Oil (14) and the Ministry of Finance (12). The rest are shared by 10 ministries. The amended Public Companies' Law no. 22 of 1997 defines a public company as "a self-funded economic unit which is fully owned by the state, has a legal personality, financially and economically independent, and operates according to economic bases". A 2017 SOEs 'Good Governance Charter' was published, requiring third party 'independent audit.' As of the time of writing, the author is not aware of any that has taken places and made public.

^{xi} World Bank, 2017, *Iraq - Systematic Country Diagnostic* (available at:

<http://documents.worldbank.org/curated/en/54281148727729890/pdf/IRAQ-SCD-FINAL-cleared-02132017.pdf>, accessed on January 10, 2020).

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END