

Iraq: The Missing Keystone in U.S. Policy  
in the Gulf

# Annex Two: Dealing with the Civil Crisis in Iraq

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## **Annex Two: Dealing with the Civil Crisis in Iraq**

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The focus on fighting ISIS and extremism – and Iran’s growing influence in Iraq – has led the U.S. to place far more emphasis on immediate security issues relative to the massive civil challenges Iraq must deal with to achieve any lasting degree of security and stability. Warnings about the civil and economic crises in Iraq by bodies like the UN, World Bank, and IMF have received far too little attention. So have factors like Iraq’s population growth, levels of corruptions and failed governance, and other civil challenges.

A similar focus on short term goals and on factional or personal interests has affected far too many Iraqi political leaders as well – with notable and important exceptions. Iraq’s current Prime Minister, Mustafa Al-Kadhimi, has made it clear that Iraq faces even greater challenges in creating the political unity, effective civil government, and economy it needs than it does in creating effective security forces. The same is true of some other Iraqi political leaders, and a number of Iraqi analysts and economists. A long series of polls have also shown how concerned Iraqis are with job, the economy, and corruption.

The fact remains, however, that far too many of Iraq’s other leaders, particularly those of given sectarian and ethnic factions, have failed to focus on Iraq’s true civil challenges. Far too often they have focused on feuding with other leaders in their own faction – as well as with different sectarian and ethnic groups. Corruption and incompetence not only affect many leaders but are critical problems at the lowest to the highest levels of government. So are ties to outside powers and economic interests.

Some religious leaders – like the Ayatollah Sistani – have done much to try to heal the country. Once again, there are all too many critical exceptions. These religious figures have both encouraged sectarian tension and advocated religious practices that would drag Iraq back centuries into the past and make effective civil and economic reform impossible. Others are little more than self-seeking demagogues. A number of factional leaders – both political and religious – have their own security forces or PMFs, and corruption and self-seeking are as common at the factional level as the national level.

The end result is that Iraq’s civil problems have grown steadily worse over a period of decades. Some are structural like Iraq’s massive population growth, the fact that the population is so young, and that the need for jobs is growing so quickly. The same is true of its divisions by sect and ethnicity. This means that even the best efforts to reform Iraq’s more immediate political, governance, and security problems can fail in the face of the previous lack of effective policies for overall civil development – and for the need to deal with sectoral problems in agriculture, water, utilities, and business whose growth dates back to the fall of the monarchy in July 1958.

The monarchy made many mistakes, but each of military and authoritarian leaders that followed imposed further problems in civil governance and added state interference in the economy. Efforts to modernize and develop the modern business sector and industry also became critical as a result of the massive growth of state industries and the key foreign plants that occurred under Saddam Hussein at the end of the 1970s.

The crippling impact of the Iran-Iraq War from 1980 to 1988 made things far worse. It affected every aspect of the economy and Iraq’s social order, as did the first Gulf War and the mix of

sanctions that followed. None of these problems were fully corrected after the U.S.-led invasion in 2003, and most economic reform plans created after 2003 were never properly actually implemented.

Only Iraqis can ultimately solve their political, leadership, and governance problems. But, any successful U.S. strategic relationship with Iraq must look beyond the security dimension. It must recognize that the sheer scale of Iraq's structural and economic problems means it will need significant aid in dealing with every aspect of development. Such outside aid will also be a critical tool in creating incentives in bringing given factions together and gaining support for a united and independent Iraq.

The scale of these issues and the need for reform are summarized in the following sections of this annex:

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## **The Failed U.S. Civil Aid Effort: “Guns Without Butter”**

An effective U.S. aid effort must recognize just how badly past U.S. aid efforts failed to meet Iraq's needs. Many individual efforts by U.S. and other aid workers did perform critical humanitarian services, and many individual aid projects did make contributions to Iraq's civil programs from 2003 onwards. Many other individual efforts failed because of a lack of effective U.S. planning and central direction, unstable funding, annual rotations of key personnel, aid that did more to serve U.S. bureaucratic categories than Iraqi needs, and shifts of aid resources to serve tactical military goals.

More broadly, the U.S.-led civil aid effort after 2003 failed to effectively address Iraq's deeper structural problems in politics, governance, and economics – and it largely collapsed by 2011. It is equally clear that the current U.S. civil aid effort has now become so small that it has virtually no impact on Iraq's deeper civil problems, and it is almost meaningless as an incentive for Iraqis to support the U.S., move towards added unity, or make vital reforms.

The Lead Inspector General's (LIG's) Quarterly Report to Congress for the end of 2020 showed that the total FY2021 budget request for Department of Defense aid intended to build-up the capacity of the Iraqi Security Forces (ISF) and vetted Syrian opposition forces to counter ISIS in support of the U.S. comprehensive regional strategy was \$6.9 billion.<sup>1</sup>

- \$0.3 billion for funds are for active and reserve component requirements. For the active component, this includes incremental deployment pay associated with military personnel deployed in support of OIR. Additionally, for activated reservists, the funding includes deployed military personnel, as well as those remaining in the United States supporting combat operations in theater.
- \$4.6 billion for a range of costs for the military services and defense agencies including operations, fuel, spare parts, maintenance, communications, intelligence support, transportation, retrograde, reset, and civilian personnel in support of OIR. This category also includes the Counter-ISIS Train and Equip Fund.
- \$845 million for a range of costs for the military services and defense agencies including operations, fuel, spare parts, maintenance, communications, intelligence support, transportation, retrograde, reset, and civilian personnel in support of OIR. This category also included the Counter-ISIS Train and Equip Fund.
- \$.17 billion for procurement of unmanned aerial systems (UAS), engineering equipment, vehicles, counter-improvised explosive device (counter-IED) systems, and other equipment for use by U.S. forces. This request also funded the procurement of bombs, missiles, and other munitions.
- \$0.1 billion for the research, development, test, and evaluation of programs, including UAS and counter-IED systems.

The DoS and USAID budget request for FY2021 for Iraq added another \$1.1 billion, but it too focused largely on security issues.<sup>2</sup> The Lead Inspector General's (LIG's) Quarterly Report to Congress for the end of 2020 reported that the Department of State (DOS) and USAID budget request for FY2021 totaled \$1.1 billion, and involved the following major elements:<sup>3</sup>

- \$733.8 million to support ongoing Diplomatic Security programs in Iraq, including international cooperative administrative support services costs, diplomatic couriers, static/local guards, Embassy Air overseas support costs, premium pay, temporary duty-related costs, armored vehicle replacements, training, and physical and technical security. The budget request includes a decrease of \$75 million due to expected savings associated with the current suspension of operations at Consulate Basrah.
- \$79.2 million for the U.S. Embassy in Baghdad and U.S. Consulate in Erbil operations and support costs. The budget request includes \$28.5 million for U.S. Mission support for operations, \$46.8 million for logistics support and \$3.9 million for Consulate operations.
- \$156.2 million to support the Aviation Working Capital Fund to provide fixed-wing aircraft service into and out of Iraq, and a mixture of airplanes and helicopters to support embassy programs and the movement of passengers within country.
- \$47.5 million to improve Iraq's ability to defend itself against external threats to internal stability through bilateral conventional weapons destruction, anti-terrorism assistance, and export control and related border security assistance programs.
- \$1.0 million to build on the previous work of the Department of Justice International Criminal Investigative Training and Assistance Program. An International Narcotics Control and Law Enforcement advisor assists key personnel in Ministry of Interior units to develop Iraq-led training programs and strategic plans; conduct criminal investigations and analyze forensic evidence; investigate and pursue organized crime, including

illicit finance and money laundering; and conduct internal investigations in accordance with international norms and standards.

- 1.0 million for International Military Education and Training (IMET) to enhance the development and professionalism of the Iraqi military forces, improve their interoperability with the United States and partners within the region, and support security sector reform and defense institution-building initiatives. This military education and training is designed to develop security expertise and respect for human rights and the rule of law for select members of the Iraqi Air Force, Army, Navy, Kurdish Peshmerga, Counterterrorism Service, and civilian defense and security officials.

The main element of U.S. economic aid was remarkably small, given the scale of Iraq's problems.

- \$75.0 million for Economic Security Funds (ESF) to support stabilization and recovery in areas liberated from ISIS; reinforce Iraq's own economic and fiscal reforms; strengthen governance and government responsiveness; and promote reconciliation, accountability, and human rights. Additionally, these funds support Iraqi minorities most affected by ISIS.

State and USAID did provide additional unstated amounts for the United Nations Assistance Mission for Iraq, additional Humanitarian Assistance Activities, Foreign Military Financing, and other purposes, including protecting religious minorities. This did not affect the fact that total funding on the civil side was far too small to help Iraq address any major aspect of its economic and civil programs.

## **Demographic Pressures, Sectarian and Ethnic Divisions, and Employment**

The limits imposed by such low levels of U.S. civil aid – as well as the even more important failures of Iraqi political leaders – become clear the moment one considers the sheer scale of the different pressures that now shape Iraq's civil crises. It is also critical to note that Iraq's wars, crises, and the need for conventional economic reform are only part of the story. One key problem in such efforts to date is that they have largely ignored the impact of massive population growth, demographic shifts to an urban economy, permeating corruption and ineffective governance, and the destructive behavior of far too many of Iraq's factional leaders.

Population pressure and demographics have helped to create critical civil problems. For decades, Iraq's massive population growth has put growing pressure on Iraq's politics, governance, economy, and stability. They are critical reasons why Iraq's "wealth" in terms of critical resources like water and petroleum has steady diminished on a per capita basis, while the need for jobs and economic growth has increased. The end result is that Iraqi demographics have become structural forces that have shape the need for civil aid, economic growth, and government reform in modern Iraq. Yet, they get surprisingly little practical attention from both Iraqis and from outside security and economic analysts.

### ***Population Growth***

The numbers are striking. Estimates differ, but the World Bank estimates that Iraq's population rose from only 7.3 million in 1960 to 39.3 million in 2019 – more than five times. Its labor force increased from 3.97 million to 10.47 million, far less than its young population and those too old to work. This created a far higher dependency ratio and shifted Iraq from an agricultural and rural state to one dominated by urban areas, government payments, and commerce.<sup>4</sup>

**Figure One** shows an estimate taken from the International Data Base of the U.S. Census Bureau, which reports a total population of only 5.3 million for 1950, and one that grew to 39.7 million for

2021. The IDB projects a further massive rise to 63.1 million by 2050, and 83.5 million by 2100, in spite of a steady drop in the rate of annual population growth.<sup>5</sup>

If one uses the same U.S. Census Bureau database to look at the nearer term trends since the October War, Iraq had a population of some 10.4 million in 1973. It had a population of 13.2 million when it invaded Iran in 1980, a population of 17.5 million when the first Gulf War took place in 1991, a population of 25.1 million when the U.S. invaded in 2003, a population of 30.1 million when U.S. combat troops left in 2011, and 39.7 million in 2021 – after the break-up of the ISIS “caliphate” and with U.S. troops again largely withdrawn. Today’s population is nearly four times what it was in 1973, and three times the level in 1990.

Forty years of war, crisis, and refugees have not eased demographic pressure or led to any clear effort to limit the growth of Iraq’s population.<sup>6</sup> It also has helped to increase the levels of tension between Iraqi factions and the economic challenges all Iraqis face in ways that are often blamed of war, crisis, or government mismanagement, and economic policies alone. Population growth has also sharply restricted the per capita levels of growth in the value of petroleum exports as well as the per capita amount of arable land and water, jobs, and government services. It also has led to steadily higher levels of urbanization, created a very young population, and sharply raised the number of younger and elderly Iraqis outside the labor force that depend on other employed Iraqis.

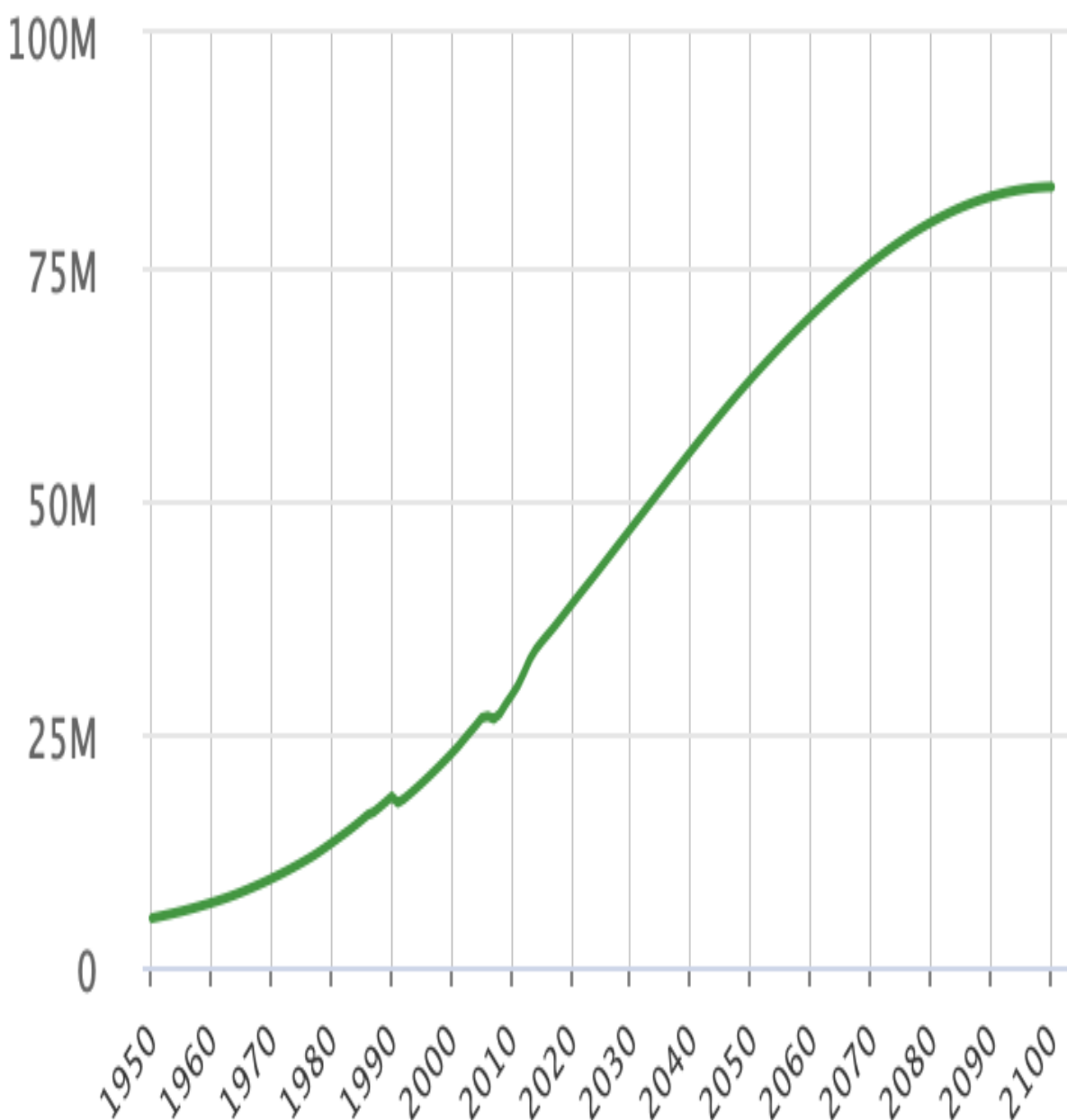
The CIA *World Factbook* reports that over 37% of Iraq’s population is under 14 years of age, and the median age is only 21.2 years. It also has long created a serious employment crisis for the young Iraqis entering the labor market. While such figures are “guesstimates,” the CIA currently estimates youth unemployment at 25.6%. This estimate, however, is extremely conservative, and the real rate is probably well over 30%. Data on poverty rates is even more uncertain than most Iraqi data, but the real figure is probably well over 25% in spite of massive expenditure on job creation in inefficient and unproductive state industries.<sup>7</sup>

A combination of high birth rates and longer life expectancy have helped to create an extremely high dependency ratio of 69.9%, a very high national dependency on the employment of other Iraqis, and a support ratio of 17.1. At the same time, a long series of war and crisis affected many aspects of Iraq’s government services like education. While Iraq has developed some excellent schools, a lack of money, wars, and poor governance have helped to limit the growth of literacy to around 50%.<sup>8</sup>



### Figure One: Iraq's Massive Population Increase:

USCB-IDB Estimate: 1950-210



Coun-try/Area Name	↑	1990	2000	2010	2020	2030	2040	2050
		18,207,728	22,839,753	29,072,967	38,828,885	47,088,189	55,363,280	63,087,363

Source: International Data Base (IDB), U.S. Census Bureau, [https://www.census.gov/data-tools/demo/idb/#/country?YR\\_ANIM=2021&FIPS\\_SINGLE=IZ](https://www.census.gov/data-tools/demo/idb/#/country?YR_ANIM=2021&FIPS_SINGLE=IZ).

### ***Population Pressure, Agriculture, and Urbanization,***

The CIA reports the population is concentrated in the north, center, and eastern parts of the country, as well as in the larger urban agglomerations found along extensive parts of the Tigris and Euphrates Rivers. Much of the western and southern areas are either lightly populated or uninhabited.

Agricultural reform and better water infrastructure and planning can help, but only to a limited degree. The “land of two rivers” – whose water supplies could easily support a rural and agricultural state – is gone. Iraq’s population is now far too large to be dominated by its agricultural sector – particularly in a country where a combination of Turkish and Iranian dams as well as climate change are reducing the water supply, and where irrigation capabilities are increasingly strained.

Farming is steadily more dependent on capital investment and mechanization, and only a very limited part of Iraq’s total area is suited to agriculture. The CIA uses 2018 data and estimates that 18.1% of the land is agricultural – arable land: 8.4%, permanent crops: 0.5%, permanent pasture: 9.2%, and forest: 1.9%. The remaining 80% is not suitable and consists largely of mountains and deserts.<sup>9</sup>

The CIA estimates that Iraqi urbanization has reached 70.1% and continues to increase at a rate of over 3% a year. Once again, estimates differ, but the end result is that Iraq’s politics and development are now heavily driven by the progress and stability in five cities that have a nominal official population of 11.8 million, but one where the population in the greater urban areas may well reach 15 million: 7.323 million in Baghdad (capital and mixed), 1.683 million in Mosul (Sunni), 1.382 million in Basra (Shiite), 1.031 million in Kirkuk (mixed but Kurdish controlled), 901,000 in Najaf (Shiite), and 861,000 in Erbil (Kurdish) (2021).<sup>10</sup>

These population pressures are also reflected in the structure of the labor force. Estimates date back to 2008, but the percentages by occupation clearly reflected the limits in Iraq’s economy: 21.6% for agriculture, 18.7% for industry, and 59.8% for services. The limited productivity of agriculture, however, means that it only provided 3.3% of the GDP. Industry (heavily dominated by petroleum) provided 51%, and services provided 48.5%.<sup>11</sup>

The practical impact is a lack of agricultural income and productivity, whose impact is compounded by a lack of real jobs outside the limited hiring of the petroleum sector and by the sharply increased dependence on the state to create jobs in the civil service and state industries that often have marginal economic value and offer limited opportunity for any real career. While overall unemployment was reported as somewhere between 13-15%, such figures are highly suspect, employment income was often marginal, and opportunity limited.

### ***Population Pressure and the Job Creation Crisis***

Job creation is a critical issue, as is the need to convince Iraqis that jobs will be based on merit and will be available to all Iraqis. A World Bank study issued in 2018, noted that,<sup>12</sup>

The demand for jobs in Iraq presents an extraordinary challenge. At least 2.5 million unemployed Iraqis urgently need jobs today. Most of the unemployed are young: compared to the national unemployment rate of 16 percent, youth unemployment is about 36 percent (Figure 1.B). By 2030, Iraq’s adult population will increase from 20 to 32 million (Figures 1.C and 1.D), and the number of Iraqis in need of new jobs is projected to range between five and seven million (holding labor force participation and public employment constant – see Figure 1.A). This projected increase of 100 to 180 percent in the demand for new jobs in the next 13 years underscores that Iraq’s



jobs challenge is anything but a short-term phenomenon. Rather, the challenge's magnitude could reach crisis proportions unless positive changes are enacted. Better jobs prospects matter in meeting the expectations Iraqis have for their lives. Because of the magnitude of the challenge, they also matter for stability and the success of reconstruction. Without the hope for a better future, the unemployed, and in particular youth, may give up on their ideas and aspirations, disengage from the project of building a better future for Iraq, seek to leave, or potentially become targets for recruitment by armed factions.

The potential future unmet demand for jobs hinges on policy choices. Even if all current public sector jobs remain, there will be unmet demand for at least five million new jobs in 2030. If the Government of Iraq (GOI) were to cut public sector employment by 50 percent, Iraq would need 7 million new jobs. Two other factors will influence the unmet demand for jobs in the medium term. First, depleting sources of subsistence in rural areas have triggered large numbers of the poor to migrate to urban areas, exacerbating the demand for urban jobs. Evidently, more than eleven million Iraqis are currently considered to need some form of humanitarian assistance, and in 2014, poverty was estimated to vary between the national average of 22 percent and 44 percent in Daesh-occupied areas. Two, many Iraqis lack the practical skills necessary to find a job in a fragile, post-conflict country that is grappling with multiple challenges. About 33 percent of the youth between the ages of 15 and 29 are illiterate or only semi-literate, 33 percent have completed primary school, 28 percent have finished middle or high school, and only seven percent have completed post-secondary education.

Youth, women, and internally displaced persons (IDPs) urgently need more access to jobs. Three groups – youth, women, and IDPs – are affected disproportionately by the paucity of jobs (Figure 1). Without special attention to their demand for jobs, peace and reconstruction are at risk. The nature and extent of joblessness are specific to each group and underscore why these excluded groups need a tailored solution in the short term.

- Iraq has one of the youngest populations in the world. Nearly 50 percent of Iraqis are younger than 19 years, and 60 percent are below 25 years of age. The youth population is projected to increase from seven to ten million between 2015 and 2030. Low levels of human capital constrain young Iraqis from engaging in productive activities. Of the seven million Iraqi youth, over 3.4 million are out of school. Insecurity, poor access to basic services and the dim prospect of finding a satisfying job anytime soon are recipes for distrust in the GOI, disengagement from the project of rebuilding Iraq, and perhaps even a low opportunity cost of joining militias who offer significant sums of money to potential recruits.

Iraqi women are well-represented in public sector employment and have a strong position under labor law, but few less educated women participate in the labor force. Iraqi women have a strong presence in public sector employment, where they hold more than half of all positions. The law prohibits gender discrimination in hiring and firing decisions and provides for maternity leave. At the same time, the modeled labor force participation rate (LFPR) for women in Iraq is 19 percent, compared to 74 percent among men – below the median among Arab countries. In particular, fewer than one in ten adult women with intermediate or lower levels of education participates in the labor market. Women who do participate in the labor market are also more likely to be unemployed. In 2016, about 27 percent of women of all ages were unemployed, compared to 14 percent of men; among youth, 65 percent of young women were unemployed compared to 32 percent of young men.

- Protracted violence and the conflict with Daesh have reared a large population of IDPs. The challenge is further compounded by the fact that Iraq has experienced earlier waves of internal displacement in the course of the conflicts of the past decades. In 2015, about 4.2 million Iraqis were IDP and an additional 300,000 were officially registered refugees. About 27 percent of the IDPs are unemployed. The most vulnerable IDPs are women and children – 49 percent are less than 18 years old. About 20 percent of the IDPs live in shelters/camps where service delivery is deplorable and less than half the children attend school. Opposition from militia in liberated areas, and de facto restrictions on IDP movements could bar many IDPs from returning to their homes (UNOCHA, 2015). A dignified life for this set of IDPs depends on acceptance and integration with their host communities. Yet, this requires economic self-sufficiency which is constrained by the lack of jobs and access to basic services. For IDPs who can return and reintegrate with their communities, jobs are also a necessity. Integration of both groups – those able to return to their homes and those who settle elsewhere in Iraq – also depends on ensuring that the communities they return to or remain with have sufficient job opportunities.

Numerous other studies make the same point, although most do not address the challenge posed by Iraq's massive population growth. A UN study that OCHA places on its Relief Web issued in January 2021 does not update the World Bank data, but notes that,<sup>13</sup>

Unemployment remains a persistent challenge in Iraq especially for youth and women. Many internally displaced persons are unemployed, underemployed, informally employed, or out of the labor force. The COVID-19 pandemic has further compounded these employment challenges. In this context, providing jobs and livelihoods remains a high priority in order to promote social cohesion and improve resilience.

### ***Population and Sectarian and Ethnic Differences***

Population pressure, urbanization, and the lack of jobs – compound by ethnic and sectarian tensions – combine to create other major civil problems. Estimates of the size of these major sectarian and ethnic divisions are dated and uncertain, but still illustrate the size of key dynamics that divide the Iraqi people and the potential value of economic development that could benefit the entire population and offer a wide range of real employment opportunities.

It should be noted that various polls taken since 2003 show that most Iraqis see themselves as Iraqi nationals and favor unity rather than choose some form of sectarian or ethnic division. However, polls in Kurdish areas tend to favor Kurdish separation; the results vary by locality and region; and much depends on the degree to which given groups feel they get a fair share of security, jobs, income, and opportunities for their children. It is all too clear from Iraq's recent history that the nation remains deeply divided

Estimates of the size of given ethnic and sectarian groups are uncertain and vary by source. Most do broadly agree with the CIA in estimating that the key ethnic groups are Arab 75-80%, Kurdish 15-20%, and other 5% (includes Turkmen, Yezidi, Shabak, Kaka'i, Bedouin, Romani, Assyrian, Circassian, Sabaeen-Mandaean, and Persian). However, the CIA is careful to warn that but notes that the data are, "a 1987 government estimate; no more recent reliable numbers are available."<sup>14</sup>

The CIA also reports that divisions by sect are Muslim (official) 95-98% (Shia 64-69%, Sunni 29-34%); Christian 1% (includes Catholic, Orthodox, Protestant, Assyrian Church of the East), other 1-4% (2015 est.). The most striking, and now probably irreversible, shift has been in the percentage of Christians: "while there has been voluntary relocation of many Christian families to northern Iraq, the overall Christian population has decreased at least 50% – and perhaps as high as 90% – since the fall of the Saddam Hussein regime in 2003," according to US Embassy estimates, with many fleeing to Syria, Jordan, and Lebanon.<sup>15</sup>

Efforts to map such divisions generally show large Arab Shiite areas in the East and South, Sunni areas in the West, and Kurdish areas in the North, but they also show mixed populations in areas like Baghdad as well as large areas with mixed populations, desert areas with limited populations, and "islands" of other ethnic or sectarian groups.

These maps often do not reflect the violent changes that have occurred since 2003, exclude pockets of different sects and ethnicities, and ignore the extent to which population pressure has steadily push different groups together – sometimes creating relatively stable mixed areas and sometimes increasing the tensions between them – as is the case in areas like Kirkuk. Periods of conflict and economic crisis have also tended to increase local tensions, although it seems likely that more stable economic growth and more equal government services and leadership would have a powerful impact in increasing national unity.

The impact of these differences on Iraq's politics also has changed over time. While there is no consensus among experts, many would broadly agree with a World Bank assessment in 2020 that found,<sup>16</sup>

The post-2003 political system in Iraq was built on ethnic and sectarian identities that eventually came to fuel conflict and fragility. This political system, established in the aftermath of the US invasion, was grounded in a power-sharing agreement between different ethno-sectarian parties and was meant to restore peace and stability to the country. Under this system, key political positions are allocated to specific ethnic or sectarian communities: the prime minister's office to the Shia, the presidency to the Kurds, and the speaker of parliament to the Sunnis.

In addition, each bloc is allocated control over certain ministries and their respective budgets. However, the identity-based nature of this system exacerbated both intercommunal tensions and competition among parties from different communities over wealth and power, and it did not prevent the civil war of 2004–08. The domination of the political system by sect-centric Shia political elites and their Kurdish and Sunni allies, along with the centralization of power and neglect of and hostility toward the predominantly Sunni areas in northwestern Iraq, also contributed to the ISIS insurgency in 2014–17.

Throughout the years, the process of elite politics has shifted from sectarian and ethnic power sharing toward political party-based power sharing and polarization. As the allocation of political positions and ministries based on sectarian and ethnic identities became more institutionalized and less contested, competition between elites and parties within the same identity bloc over these "allocated" positions increased (Haddad 2019). Intracommunal group competition thus created an additional layer of contestation beyond sectarian divisions, and this competition has at times turned violent, as demonstrated by the conflict among Shia parties in 2008 and more recent clashes in southern Iraq.

The shift of power-sharing struggles from between sects to within them has led to a splintering of Iraq's political parties and a growing disenchantment by the electorate with them. Since 2005, the number of registered parties has doubled and the number of parties within the main party coalitions has tripled, while the highest percentage of votes won by one single coalition has shrunk by more than 60 percent (to 16 percent), and voter participation has dropped to less than 45 percent (Mansour and van den Toorn 2018). The country reached a particular impasse in 2018, after the national elections returned highly fragmented and inconclusive results.

... key cabinet and bureaucratic positions ended up split between competing parties, further weakening the prime minister's executive powers (Mansour 2019). Rather than representing the political diversity of Iraq, the political system reflects a fragmented power-sharing agreement between the country's elites and their respective parties that often results in stalled decision-making, as witnessed in the protracted process of forming a new government in late 2019 and early 2020 following the resignation of Prime Minister Abdul Mahdi.

The fragmented nature of Iraq's political settlement and uncertainty over the stability of the government hinders the country's prospects for growth. First, the constant (re-)negotiation of the distribution of resources, and the fact that political exchanges take place in informal environments where the ability to enforce agreements is weak, makes political elites more risk averse (World Bank 2012a). This uncertainty also makes it harder for decision-makers to assess the implications of policies or legislative actions that have broad impacts or far-reaching distributional consequences for their constituencies (e.g., tax or pension reforms). And second, complex reforms are likely to require more time to elaborate to the many actors in this fragmented system and to win a consensus among them, increasing the likelihood that the reforms will take longer than one minister's term in office. This environment, combined with the country's significant oil rents, shifts elite incentives to privilege short-term rent distribution over public-service delivery and long-term productive investment (as later sections of this chapter discuss).

... State authority in Iraq is fragmented, and a complex array of political parties, militias, armed groups, and extremist groups share the capacity for violence. Over the past 15 years, the elite contestation described earlier has led to the proliferation of these groups. Violent actors have included Sunni, Shia, and Kurdish groups, including the various groups under the Popular Mobilization Forces (PMFs). The PMFs, which emerged in the fight against ISIS, consist of dozens of militias (some of which had existed prior to ISIS's capture of Mosul) that fall under divided leadership. In 2016, under the so-called Hashd law, the PMFs

became officially integrated into the country's security forces. However, the law left some contentious ambiguities, framing the PMFs both as part of the country's security forces and as independent groups. notable actors within the PMFs maintain strong ties with local elites or external backers, indicating another arena in which Iraq's elites compete with one another at the expense of the country's institutions.

... Communal divides between Sunnis, Shias, and Kurds in Iraq have decreased in recent years, but the country's social cohesion remains weak and will continue to shape fragility and the risk of violence (and thus the prospect for growth) for the foreseeable future. A majority of Iraqis (64 percent) say the country is divided as opposed to unified (NDI 2019). It is therefore important to understand Iraq's societal fault lines, patterns of exclusion, and group-based grievances. Polling shows that Iraqis identify themselves foremost as Iraqis, rather than by other identity markers such as sect or tribe, and that relations between social groups are perceived to be improving. Today, Iraqis see the division between citizens and the state and those between political parties as the main fault lines in the country. However, Iraq still ranks among the countries where "social hostilities" between religious groups are highest (Pew research Center 2019), and levels of interpersonal trust stand at only 10 percent (Arab Barometer 2019). This hostility provides fertile ground for the instrumentalization and mobilization of sectarian identities (and associated grievances) by political parties or armed groups.

Issues of cohesion and social trust are particularly salient in areas of Iraq liberated from ISIS and in disputed territories where internal displacement remains high. As of April 2020, there are still an estimated 1.39 million internally displaced persons (IDPs) in Iraq, with a majority concentrated in four governorates. In both the krg and the north of the country, IDPs constitute a substantial share of the population. A pervasive issue in liberated areas is the stigmatization of individuals suspected of having supported ISIS or being related to someone in ISIS. These people form a large part of the population of IDP camps, and some of them report being denied services in camps as a result of their perceived affiliation and being unable to obtain security clearances or important civil documents. Many IDPs, fearing further stigmatization and possible recriminations, therefore do not return to their communities of origin. This exclusion raises concern over IDP camps as potential incubators for radicalized youth and sites for recruitment into extremist groups.

... The decade from 2007 to 2017 saw various effects on horizontal inequality in Iraq with respect to monetary poverty. The urban-rural gap closed significantly over the decade (figure 1.12). In 2007, the rural poverty rate was 39 percent, 23 percentage points higher than the urban poverty rate. However, by 2017, the gap had closed to 13 percentage points, with urban poverty stagnant at 14.6 percent (partly because of the 2014 conflict) and rural poverty down to 27.5 percent. In contrast, the regional and ethno-religious gap remains significant: the distribution of poverty is now split between the historically poor Shia south and the newly poor Sunni north, on one hand, and the relatively less poor Shia center and Sunni Kurdish areas, on the other (figure 1.13). Moreover, the higher poverty rates in the Sunni north are driven largely by another group disparity, that between the displaced and the nondisplaced. The poverty rate for IDPs in both the Kurdistan region of Iraq and the Sunni north—regions that account for the vast majority of the displaced—is about 2.5 times higher than the rate for non-IDPs, and in the north, about half of all IDPs live in poverty.

The same World Bank study also warns, however, that the level of income, government services, development, and recovery vary sharply by region and within given sects and ethnic groups. Civil aid cannot be based on sect and ethnicity. It must be tailored to given regions and look beyond them to address very different living standards and conditions.<sup>17</sup>

## **Governance, Corruption, and Kleptocracy**

These structural pressures, however, are only a part of the story. Iraq's problems in governance, its political divisions, and its levels of corruption pose a challenge to its civil and economic development equal to that posed by its population growth and demographics – and they are key reasons why all outside aid must be ruthlessly conditional on the integrity with which aid and reform programs are actually executed. As the U.S. experience in Afghanistan and Iraq – and the experience of donors in far too many other countries – have shown, reform plans, pledges to fight corruption, and misleading claims of success often become little more than empty facades unless

a host country's waste, fraud, and abuse are exposed; the flow of money is halted; the corrupt are forced out of power; and related contractors are blacklisted.

A World Bank study described Iraq's grim situation in 2020 as follows,<sup>18</sup>

Iraq is on the brink of catastrophe. Almost two decades after the Iraq war began, the country remains caught in a fragility trap and faces increasing political instability and fragmentation, geopolitical risks, growing social unrest, and a deepening divide between the state and its citizens. The impact of the COVID-19 crisis and the crash in oil prices compound Iraq's preexisting fragilities and could lead to economic meltdown and a new cycle of violence and conflict—or they could provide an opportunity to fundamentally realign the government's priorities, advance much-needed reforms, and tackle the deep structural issues that hold back progress in Iraq.

Iraq's power-sharing system has resulted in widespread corruption and patronage and has reinforced competition over oil rents while giving few incentives to build accountable institutions, diversify economically, or deliver benefits to the Iraqi population. The failure to equitably share the benefits of oil wealth and provide employment opportunities and basic services to all Iraqis has fueled grievances and widened spatial inequalities. In combination with a young population seeking jobs, and amid decreasing opportunities for public-sector employment and high levels of frustration and alienation from the political elite, the country faces significant risks.

... Oil dependence acts as a powerful driver of fragility in Iraq and has reinforced contestation at all levels, fueling elite competition, undermining accountability to citizens, and increasing the risk of conflict. Iraq's dependence on oil income not only fundamentally affects the structure of the Iraqi economy but also plays a critical role in shaping the state, notably its political settlement and the relationship between it and its citizens. Weak governance and poor resource management undermine the potential of Iraq's vast oil wealth, contributing to a vicious cycle in which oil rent-sharing reinforces fragility and increases political instability. elite contestation over oil rents is also a source of conflict, and the capture and smuggling of oil can finance an armed insurgency, as was seen with the Islamic State of Iraq and the Levant (ISIS). Oil price shocks and the slowdown in global demand caused by the COVID-19 crisis, along with an ever-growing young population, underline the unsustainability of the current model, which seeks to respond to demand for jobs and services with patronage-based distribution of public sector jobs and social benefits. There are thus other strong reasons (beyond the economic imperative) for Iraq to diversify its economy and break out of its fragility trap.

...external actors and their competing agendas have reinforced Iraq's fragile political system and threatened the country's sovereignty. Iraq's oil wealth and location have traditionally made it prone to foreign interference, and many regional and international geopolitical tensions play out in Iraq (World Bank 2017c). The geopolitical rivalry between external actors, especially the US and Iran, is an underlying point of tension that manifests across security, political, economic, and social lines in Iraq. In domestic politics, it creates a significant fault line among the ruling elite and aggravates public distrust in government by spurring people's resentment of foreign interference. One of the most prominent external actors shaping Iraq's politics today, Iran, has used its sectarian ties, deep economic and political relationships with local elites and parties, and security partnerships with paramilitary groups to solidify its presence in Iraq. Following the US invasion in 2003, extraordinarily high levels of international aid have been provided or pledged for Iraq's reconstruction efforts, but the impact of this aid has been limited at best, and the aid has been prone to elite capture.

...The contestation and negotiation between political parties over control of Iraq's formal bureaucracy has resulted in elite capture of state institutions. The process of de-Ba'athification in 2003 and the dissolving of the Iraqi army eroded the country's existing bureaucratic infrastructure and displaced the elites that had run it and the tens of thousands of workers it had employed. In the aftermath, many senior positions, down to the level of director general (*al-darajat al-khassa*) within the country's new bureaucracy, were filled by political appointees of the country's main parties. In turn, politicizing the appointment of key bureaucratic posts became a fundamental piece of how the parties extended their patronage networks to strengthen their legitimacy, power, and wealth (Dodge 2019). Parties also awarded public contracts to their delegates, paid at higher salaries than was standard for the respective positions, in what was known as the *wikala* (proxy) system.

This politicization of the Iraqi civil service has blurred the lines of accountability and shifted power from formal state institutions to political actors. The heightened role political parties play in appointing candidates for senior bureaucratic positions, along with the *wikala* system, creates a conflict of interest: appointees prioritize and report to the parties behind their nomination before their respective ministers or official superiors (Mansour 2020). This conflict of interest often undermines the authority of ministers over their departments and obfuscates the formal hierarchies within the ministries. And senior officials allied with political parties have more influence than their nonaffiliated counterparts (al-Shadeedi and van Veen 2020), which creates a structural incentive for greater alignment with political parties.

As described by Dodge et al. (2018), the bargains under this political settlement flow in three ways: “First, the dominant parties use government payrolls to reward political loyalty. Second, they use government contracts to enrich business people close to their leaderships. Third, money is simply stolen from the ministerial budgets for both personal gain and party use.” These effects are particularly visible during elections and in times of crisis, when the elites use promises of public sector jobs to win votes or to appease dissent. Many of these mass job appointments are based not on merit but on patronage by the elite. The political elites also use pensions and social allowances in similar ways to reward their constituencies. As a result, the number of public sector employees has increased significantly, and the security services in particular have seen significant expansions in public spending (see the following section). Likewise, spending on recurrent costs has crowded out capital investments.

Beyond this rent-sharing, Iraq’s political elites also engage in contestation over rent generation. State and nonstate actors compete for revenue at its source (e.g., by taking control of oil fields, refineries, or border crossings), raising taxes informally (e.g., through checkpoints by militia or security forces or by insurgents in areas under their control), smuggling oil products out of the country, or smuggling other goods into it.

### ***Failed Governance Means a Failed State***

Once again, any outside success in providing civil aid will be dependent on Iraq’s capability to take responsibility for its own future, and the level of conditionality in providing U.S. and other outside aid will need to be at least as ruthless and rigidly enforced as security aid. It is brutally clear that Iraq’s economic crisis is closely tied to one of the worst levels of governance in the world for any country with anything approaching Iraq’s natural resources and petroleum wealth, and one of the highest levels of governmental corruption in the world.

**Figure Two** shows that World Bank’s rating of every aspect of Iraq’s governance is dismal, that upward trends since 2003 are marginal at a best, and that violence and failures in the rule of law have continued to make the quality of governance decline.<sup>19</sup> These are all areas where Prime Minister Kadhimi and other Iraqi leaders are seeking reform and progress, but Iraq’s previous efforts since 2003 have been hollow failures.

Furthermore, the World Bank’s ratings for the ease of doing business – which largely exclude the critical agricultural sector – show that failures in governance pose serious barriers to economic development even if one ignores corruption.<sup>20</sup> Iraq ranks only 172<sup>nd</sup> in the world and has dismal rankings in getting credit (182<sup>nd</sup>), starting a business (152<sup>nd</sup>) getting electricity (131<sup>st</sup>), and registering property (121<sup>st</sup>).<sup>21</sup>

The World Bank study quoted earlier notes that,<sup>22</sup>

Despite the federal structure established in the 2005 constitution, Iraq’s institutional and legal framework for decentralization remains incomplete, and the federal government continues to resist devolving power and resources to lower tiers of government. In 2018, the latest amendments to the Decentralization Act reversed the devolution of responsibility for health and education (Al-Mawlawi 2019a). revenue generation by lower tiers of government is not encouraged by the federal government (Al-Mawlawi 2019a; Fleet 2019), and fiscal transfers to governorates and the Kurdistan regional government (krg) are disbursed unevenly, erratically, and partially. The parliament’s recent move to suspend provincial councils until new elections, in response



to mass protests in October 2019 over “gross dereliction of duties,” further undermined the legitimacy of these councils and, indirectly, the governors whom the councils elect.

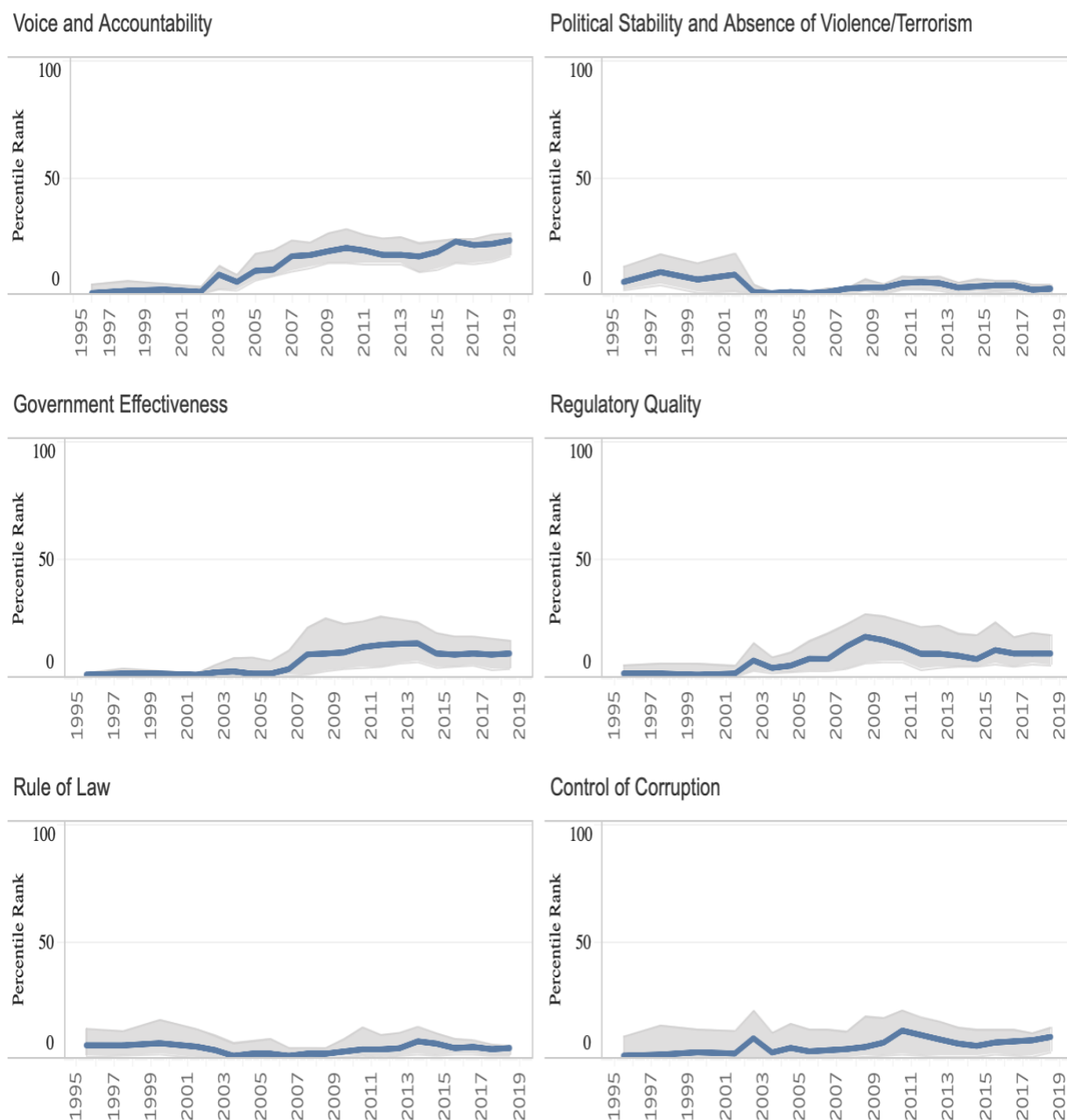
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The CIA draws similar conclusions about Iraq’s poor level of governance,<sup>25</sup>

Iraq is making slow progress enacting laws and developing the institutions needed to implement economic policy, and political reforms are still needed to assuage investors' concerns regarding the uncertain business climate. The Government of Iraq is eager to attract additional foreign direct investment, but it faces a number of obstacles, including a tenuous political system and concerns about security and societal stability. Rampant corruption, outdated infrastructure, insufficient essential services, skilled labor shortages, and antiquated commercial laws stifle investment and continue to constrain growth of private, nonoil sectors. Under the Iraqi constitution, some competencies relevant to the overall investment climate are either shared by the federal government and the regions or are devolved entirely to local governments. Investment in the IKR operates within the framework of the Kurdistan Region Investment Law (Law 4 of 2006) and the Kurdistan Board of Investment, which is designed to provide incentives to help economic development in areas under the authority of the KRG.

**Figure Two: Iraq's Failed Level of Governance: 1995-2000**

The solid blue line shows the selected country's percentile rank on each of the six aggregate indicators. The grey-shaded region indicates the margin of error.

Source: Kaufmann D., A. Kraay, and M. Mastruzzi (2010), *The Worldwide Governance Indicators: Methodology and Analytical Issues* - [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1682130](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1682130)

The Worldwide Governance Indicators are available at: <http://info.worldbank.org/governance/wgi/index.aspx#home>

**Note:** The Worldwide Governance Indicators (WGI) are a research dataset summarizing the views on the quality of governance provided by a large number of enterprise, citizen and expert survey respondents in industrial and developing countries. These data are gathered from a number of survey institutes, think tanks, non-governmental organizations, international organizations, and private sector firms. The WGI do not reflect the official views of the World Bank, its Executive Directors, or the countries they represent. The WGI are not used by the World Bank Group to allocate resources.

Source: "Iraq-Time Series Comparison, World Bank, Governance Indicators, <https://info.worldbank.org/governance/wgi/Home/Reports>.

## ***Corruption and Governance by Kleptocracy***

Corruption is a truly critical problem, and Iraq is corrupt to the point of becoming a kleptocracy. The Corruption Perception Index for Iraq that Transparency International issued in February 2021 ranks Iraq as the fourth most corrupt government in the world.<sup>26</sup> Public opinion polls and even the statements of Iraq's current prime minister strongly argue that many Iraqis feel the same way.<sup>27</sup>

The U.S. State Department's *Country Report on Human Rights for 2020* flags the extent to which Iraq's exceptional corruption permeates its civil society and government.<sup>28</sup>

The law provides criminal penalties for corruption by officials, but the government struggled to implement the laws effectively. The law allows some individuals convicted of corruption to receive amnesty upon repaying money they had obtained by corruption, which had the effect of allowing them to keep any profits from stolen funds. Officials in federal Iraq and the IKR frequently engaged in corrupt practices with impunity. There were numerous reports of government corruption during the year.

Corruption remained a chief obstacle to effective governance at all institutional levels. The existence of armed militias, which are directly involved in corruption and provided protection for corrupt officials, made serious and sustainable anticorruption efforts difficult to enforce.

Corruption: UK-based newspaper, *The Independent*, reported in June that \$300 billion had been funneled to thousands of fake and inactive projects around the country. The report revealed that 85 percent of 50,000 industrial projects in the private sector were inactive, and 250 state factories were not operating despite receiving funds from the government. Bribery, money laundering, nepotism, and misappropriation of public funds were common at all levels and across all branches of government. Family, tribal, and ethnosectarian considerations significantly influenced government decisions at all levels and across all branches of government.

Investigations of corruption were not free from political influence. Anticorruption efforts were hampered by a lack of agreement concerning institutional roles, political will, political influence, lack of transparency, and unclear governing legislation and regulatory processes. Although anticorruption institutions increasingly collaborated with civil society groups, the effect of expanded cooperation was limited. Media and NGOs attempted to expose corruption independently, but their capacity was limited. Anticorruption, law enforcement, and judicial officials, as well as members of civil society and media, faced threats, intimidation, and abuse in their efforts to combat corrupt practices.

In August, Prime Minister al-Kadhimi issued an executive order forming a "special and permanent committee" to investigate and prosecute major corruption files and high-profile crimes within government ministries and public agencies.

In September the anticorruption committee arrested 19 high-profile individuals, including Iraqi Retirement Authority director Ahmed al-Saadi, Baghdad Investment Commission chief Shaker al-Zamili, and Qi Card CEO Bahaa Abdul-Hussein, all of whom were remanded to Counterterrorism Service custody. Following the arrests friends and family of the detainees alleged the detainees had suffered physical abuse in custody and were denied access to medical and legal services. The prime minister publicly refuted the allegations.

The Central Bank leads the government's efforts to combat money laundering and terrorist financing. The Central Bank's Office of Anti-Money Laundering and Terrorist Financing worked with law enforcement agencies and the judiciary to identify and prosecute illicit financial transactions. The latest report released by the office in 2019 showed it investigated 400 potential cases of money laundering during that year, with 34 cases referred to the judiciary and 192 cases under review by the office's analysts. In July the office issued a statement on the European Commission's (EC) decision to keep Iraq on the revised list of high-risk countries regarding money laundering and terrorist financing. The statement expressed displeasure at Iraq's inclusion on the list, asserting the EC's decision was based solely on security and lacked technical bases.

The Council of Ministers Secretariat has an anticorruption advisor, and the COR has an Integrity Committee. The Council of Ministers secretary general led the Joint Anticorruption Council, which also included agency inspectors general. In October the council dismissed approximately 1,000 civil servants after convicting them of public-integrity crimes, including wasting public money, bribery, and embezzlement.

Border corruption continued to be a problem. In July the prime minister launched a campaign to secure borders with Iran and other neighboring countries. He granted extended powers to the Iraqi military and navy to control borders with Iran and Kuwait and provided the border guards with additional reserve forces. KRG officials launched an investigation in September into corruption and smuggling at the Parwez Khan border crossing with Iran.

The KRG maintained its own Commission of Integrity (COI), which issued its first report in 2017. According to the COI's 2020 report, there were 158 corruption cases underway or completed from January to November 18, with 26 individuals convicted. The convictions came from across the IKR including Erbil (11), Duhok (7), Garmian (5), and Sulaymaniya (3).

Financial Disclosure: The law authorizes the federal COI to obtain annual financial disclosures from senior public officials, including ministers, governors, and parliamentarians, and to take legal action for nondisclosure. Penalties range from fines to imprisonment. A unified system for enforcing annual financial disclosures does not exist. The federal COI has no jurisdiction over the IKR, but Kurdish members of the central government were required to conform to the law. The law obligates the federal COI to provide public annual reports on prosecutions, transparency, accountability, and ethics of public service. The prime minister and his cabinet submitted financial disclosures for 2020. The federal COI did not issue a semiannual report during the year.

The Kurdistan COI is responsible for distributing and collecting financial disclosure forms in the IKR. There was no information available indicating that public officials faced penalties for financial nondisclosure during the year.

These high levels had all too great of an impact in wasting U.S. military and civil aid, although U.S. civil aid has been only a small – nearly token – part of the U.S. aid effort. Here, it is notable that the U.S. government has sometimes talked about *conditionality* in providing such aid but never seems to seriously report it.

The LIG report quoted earlier did not address this issue or give any real details on how such aid was planned, allocated, accounted, and assessed for effectiveness. The LIG report did, however, indicate that the U.S. no longer has enough personnel in the field to properly assess its effectiveness or the impact of the levels of corruption and waste involved. The LIG report made it clear that corruption was a major issue at the national level.

The LIG report issued in February 2021 stated that,

USCENTCOM reported that addressing corruption within security institutions is also a priority for Prime Minister al-Kadhimi's cabinet. In December 2020, the Iraqi government affirmed its commitment to addressing corruption by signing a new memorandum of understanding with the United Nations Development Programme in support of a reform plan to combat corruption in Iraq. USCENTCOM said that corruption in Iraq's security institutions often takes place due to a lack of bureaucratic and administrative oversight. The most notable is the "ghost soldier" phenomenon, where soldiers exist only on paper and their pay is effectively stolen, resulting in the loss of hundreds of millions of dollars every month, according to USCENTCOM.

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Corruption is also aided by the fact that so much of Iraq's revenues come from petroleum – resources, which once developed, require relatively little labor, can be tightly controlled by the state, and operated or developed by outside companies. The World Bank notes that,<sup>29</sup>

Iraq is the most oil-dependent country in the world, as is further explored in chapter 2, and its reliance on oil has had a major impact on its political settlement and economy and has acted as a driver of fragility and conflict. Iraq is the world's sixth-largest oil producer and the world's third-largest oil exporter. In 2019, it exported about 4 million barrels of oil per day of the estimated 4.7 million barrels per day it produced.

Over the past decade (2010–19), and despite fluctuations in oil prices, Iraq's hydrocarbon sector has accounted for more than 95 percent of the country's export values, 90 percent of governmental revenues, and 57 percent of gross domestic product (GDP) in real terms. The quality of governance and institutions is critical for determining whether a resource-rich country can reap the benefits of its natural wealth. Work on the resource curse shows that resource wealth has a positive effect on growth in countries with good institutions and a negative effect on growth in those with poor institutions.

However, the quality of institutions is itself influenced by the presence of natural resources. Collier and Venables (2010) have argued that natural resources negatively impact the quality of governance in a country while at the same time playing a more important role in resource-rich countries than in other countries in determining a country's development trajectory. This link creates a mutually reinforcing relationship that can start a vicious circle: "if governance quality is above a certain level, then natural resources can lead to further improvement, while below the threshold, further deterioration may occur" (Collier and Venables 2010).

In Iraq, oil wealth has both fueled contestation between elites over control of natural resource rents (and thus of offices) and contributed to financing of the ISIS insurgency. Having the state be the main collector and distributor of rents raises the incentive for elites and political parties to secure access to the government and thereby control key institutions. This incentive has also contributed to the fractionalization of Iraq's political parties and pushed them to compete for voters on the basis of their patronage networks (paid off with resource rents) rather than programs.

These networks have not included the wider population, only a narrow segment that has become clients of individual leaders (Mansour 2020). Oil revenue has also allowed political parties to maintain power bases outside of formal state structures by employing their own militias and armed groups (Mansour 2020). During the 2014–17 conflict, ISIS's capture of oil fields and trading points played an important role in financing the insurgency in its early stages, even though oil generation at those fields declined substantially over time and was replaced as the group's key revenue source by extortion and taxation ...

Iraq's oil wealth has also diminished the need for taxation, weakening the accountability link between citizens and the state, and has fueled corruption. Dependence on oil wealth reduces the incentive for a state to generate other forms of revenue, such as taxation... This, in turn, reduces the need for state-society bargaining over how the state should respond to citizens' expectations and priorities, which are at the heart of successful state-building processes.

It also undermines the process of governance and leads to the expansion of state jobs and SOEs with limited value, as well as to creating larger and more expensive mixes of security forces.

Pervasive political patronage distorts fiscal resource allocation in Iraq by inflating the wage bill at the expense of public investment. Since 2004, Iraq's wage and pension bill has increased from 10 percent to 51 percent of budget expenditures and from 12 percent to 15.6 percent of GDP.

This growth resulted from both increases in the number of government employees and the following factors:<sup>30</sup>

...increases in the number of government employees (from 1.2 million to more than 3 million) and salary increases, (led) to the effect that the wage bill has been nearly multiplied by 10 and the premium on wages in the public sector compared with the private sector has reached 300 to 400 percent (Al-Mawlawi 2019b).

The sector and spatial distribution of the civil service leaves critical services such as health (with only 10 percent of the total) and certain parts of the country (the south and north) underserved (UNODC 2012). In contrast, security personnel represent more than 40 percent of total federal government employees.

The recent absorption of militias (PMFs) into the state security forces and the recruitment of large numbers of graduates into ministries and SOEs should continue to increase the wage bill. Political patronage is also reflected in the prioritization of employee compensation in the security sector.

Since 2003, military expenditures have increased from less than 2 percent of public expenditures to 7.8 percent in 2019 (after a peak of more than 12 percent in 2015 because of the fight against ISIS) and from 1.7 percent to 3.5 percent of GDP in 2019 (with a peak of 5.4 percent in 2015)... However, the incorporation of the PMFs' 120,000 authorized personnel into the military and the allocation of US\$2.16 billion (an increase of 20 percent from 2018) to the PMFs in the 2019 defense budget may be deemed the fiscal price of bringing these nonstate security actors under state authority.

The 2019 appropriation process also reflects the prioritization of military expenditures and employee compensation by the legislative branch of the government as a result of party politics: after the appropriation bill's review by the Council of representatives, funds allocated to security forces increased by 15 percent, those allocated to employee compensation increased by 20 percent, and those allocated to the PMFs incorporated into the security forces increased by 25 percent (Al-Mawlawi 2020).

### ***Corruption, Failed Governance, Youth Employment, and Popular Protests***

The end result has greatly compounded the impact of population growth, helped lead to major popular dissatisfaction with the decline in Iraq's education system, led to one of the lowest ranking levels of popular hope for a job in the developing world, and added major new forces to popular unrest that have little or nothing to do with sectarian and ethnic differences or extremism. The World Bank reports that,<sup>31</sup>

Job creation is among the main concerns of the Iraqi people, and perception of poor government performance in this regard is a major driver of public dissatisfaction and the current protests. At least 2.5 million Iraqis, mainly youth, are currently unemployed and in need of jobs. youth unemployment in Iraq is 36 percent, compared with the national unemployment rate of 16 percent (World Bank 2018). The crisis of youth unemployment in Iraq cannot be understated, given that the country has one of the youngest populations in the world (see the following section). Opinion polls indicate that most Iraqis (more than 80 percent) believe that job opportunities are getting scarcer (NDI 2019), more than in most other oil-rich economies (figure 1.10). notably, youth satisfaction with the government's performance at creating job opportunities, at 6 percent, is one of the lowest in the region (raz 2019). Almost all Iraqi youth (95 percent) believe that personal connections, or *wasta*, shape one's employment opportunities—the highest rate in the region (raz 2019). Public concern about the government's capacity to address this demand for jobs may be aggravated by a general feeling that one's "situation can only improve with government assistance or salaries," expressed by 70 percent of respondents (NDI 2019).

Iraq's failure to diversify its economy away from the dominant, capital-intensive oil sector has meant that few economic opportunities have been created in nonoil and labor-intensive sectors. Instead, the government's dominant approach to creating jobs has been to expand the public sector. However, youth are seriously underrepresented in the civil service—in 2011, those age 18–29 made up 37.7 of the general labor force but only 15.3 percent of civil servants—although with significant variations (e.g., much less so in Kurdistan and for young women) (UNODC 2012). Furthermore, this model of responding to dissatisfaction with job prospects (including the October 2019 protests) is no longer viable, not only because it stifles the prospects for creating employment in the private sector but also because the sheer demand for jobs over the next decade cannot be met through public sector employment. Moreover, the Iraqi government's reliance on oil wealth renders this strategy high-risk: a reduction of public service jobs by 50 percent would cause a need for 7 million new employment opportunities.

The particularly low levels of trust among Iraqi youth in the government's performance on job creation, along with widespread concern over corruption and a general sense of exclusion from the political system, contributes to a significant alienation of youth. This alienation has led many youths to take part in recent protests despite the violent response to them. Alienation also increases the risk that some segments of this population will become radicalized and that tensions will rise between communities whose members fear or suspect that employment is distributed to preferred groups. Iraq's demography puts additional pressure on this situation: about 700,000 young Iraqis enter the job market each year, and the country's demand for jobs will at least double in the next 13 years. The combination of high levels of youth unemployment, strong projected demand for new jobs, and vulnerability to oil price shocks calls for a new approach.

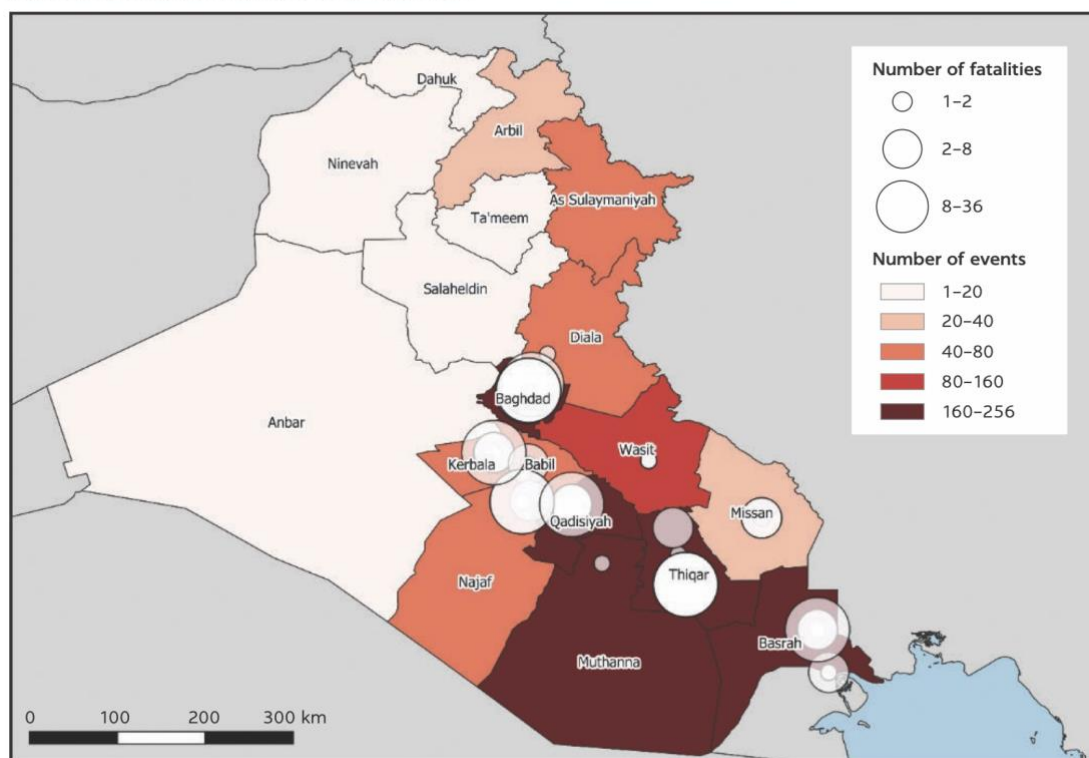


... The protests that emerged in October 2019 also differ from previous protest movements in their grassroots nature, their composition, and their demands. Unlike past protests, which were more connected to political parties, Iraq's most recent protests are no longer elite-driven. Demonstrators are mobilized locally, "mostly by youth organized in coordination committees, with each local context generating [a] different socio-political coalition driving the protests" (Costantini 2020, 15). Although these forms of local mobilization do not necessarily translate into a national movement, the demonstrators are widely supported by the broader public. The protesters also represent a much younger portion of the population than in previous events, and many of them do not have permanent employment (Mansour 2020). Women have also played a significant role in the demonstrations and held feminist rallies in early 2020 that stressed their role in the movement.

**Figure Three** is taken from the same World Bank study and illustrates the scale of the new impact from the interaction between demographics, governance, and corruption. It cuts across virtually all of the areas that have not been the scene of the major fighting against the ISIS "caliphate," and it shows that motives go far beyond demographics and jobs – and include legitimate protests against Iraq's failures in politics, governance, and corruption.

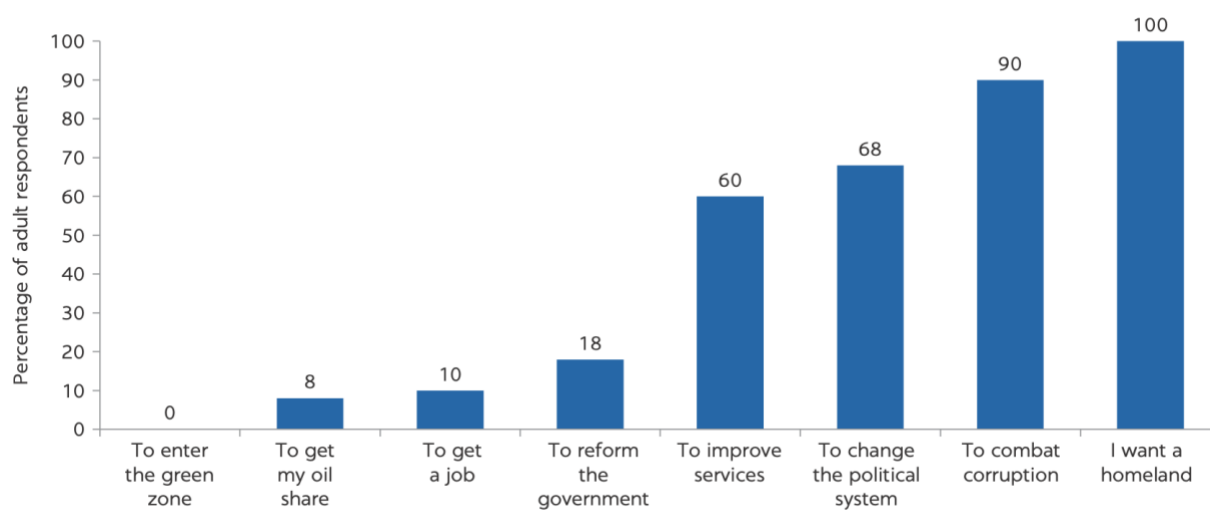
### Figure Three: Iraq's Youth Reacts to Failed Governance, Failed Politics, Corruption, and Unemployment

Protests and riots, September 2019–April 2020



Source: ACLED data set.

#### Motivation for participating in the current (2019) protests



Source: Mansour 2020.

Source World Bank, *Breaking Out of Fragility, A Country Memorandum for Diversification and Growth in Iraq*, September 30, 2020, 41-42, <https://www.worldbank.org/en/country/iraq/publication/breaking-out-of-fragility-a-country-economic-memorandum-for-diversification-and-growth-in-iraq>.

## *Meeting the Challenge*

These challenges must be addressed in any new U.S. civil aid program that attempts to underpin a successful strategic relationship with Iraq, as in any effort to form an international effort. And they mean putting constant pressure on Iraqi leaders. This needs is illustrated in a review of Iraqi corruption by Robert F. Worth called “Inside the Iraqi Kleptocracy” in the *New York Times Magazine* that summarizes why corruption did so much to lead to popular demonstrations and unrest in 2020.<sup>32</sup> The same is true of an analysis by Frank R. Gunter of Lehigh University that address both the causes of Iraqi corruption and possible remedies,<sup>33</sup>

Like sand after a desert storm, corruption permeates every corner of Iraqi society. According to Transparency International (2021), Iraq is not the most corrupt country on earth! ...that dubious honor is a tie between Somalia and South Sudan! but Iraq is in the bottom 12% ranking 160<sup>th</sup> out of the 180 countries evaluated. With respect to corruption, Iraq is tied with Cambodia, Chad, Comoros, and Eritrea. Corruption in Iraq extends from the ministries in Baghdad to police stations and food distribution centers in every small town. (For excellent overviews of the range and challenges of corruption in Iraq, see Allawi 2020 and Looney 2008.) While academics may argue that small amounts of corruption can help expedite government activities, the large scale of corruption in Iraq undermines private and public attempts to achieve a better life for the average Iraqi. A former Iraqi Minister of Finance and a Governor of the Central Bank both stated that the deleterious impact of corruption was worse than that of the insurgency

There are, however, signs of Iraqi progress. Prime Minister Kadhimi launched an anticorruption drive in November 2020, and pledged that, “We have established a Committee to Combat Corruption and Exceptional Crimes, and for the first time, senior officials have found themselves in prison, unprotected by party affiliation or the power wielded by some influential people. We will continue on this track and 2021 will be the year of uncovering major truths about the corruption that has affected both the economy and development.”<sup>34</sup>

This drive has made at least modest progress – although past experience with most such efforts all over the world warns that such drives all too end in exaggerated claims, scapegoating, and attacks of rivals. The LIG summarized such progress as follows in its February 2021 report.<sup>35</sup>

...The DoS reported that Prime Minister al-Kadhimi’s anticorruption task force, formed during the previous quarter, arrested several well-connected Iraqi politicians and business figures for corruption this quarter. As of the end of the quarter, the defendants were being held awaiting trial... Media sources reported that the former governor of Ninewa province, who was accused of embezzling several million dollars, including aid designated for persons displaced by ISIS, was among those arrested...

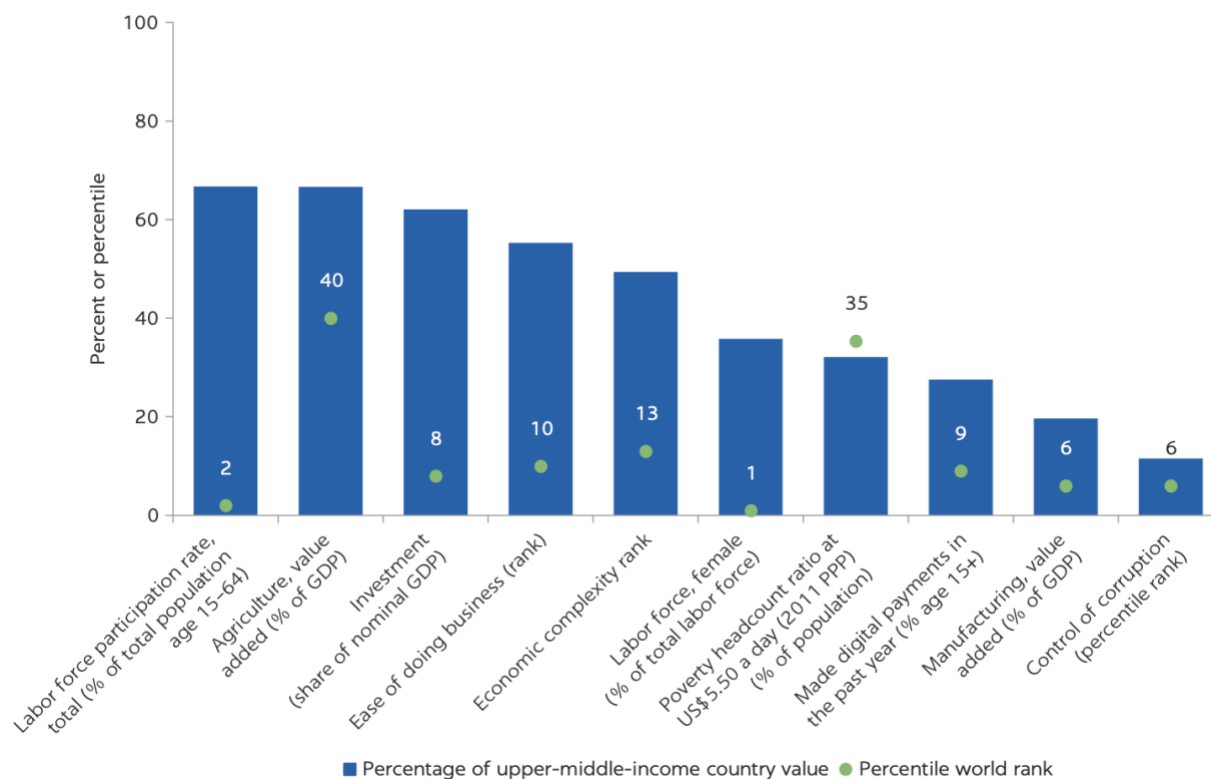
However, corruption remained pervasive in the Iraqi government. On October 27, 2020, Baghdad Mayor Manhal al-Haboubi’s resigned after less than 2 months in office, citing personal medical reasons. This did not surprise Iraqi political observers, the DoS said, as it was widely believed that al-Haboubi resigned because he refused to engage in corrupt contracting practices with Iraq’s political parties. Rumors circulating in Baghdad suggested Mayor al-Haboubi was under intense pressure to sell Baghdad municipal properties to parties below market value. The DoS further reported that others suggested that al-Haboubi refused to grant contracts to members of parliament affiliated with cleric Moqtada al-Sadr, and that al-Haboubi came under fire from parties after citing their corruption as the main source of Baghdad’s deteriorating infrastructure in a recent report to the prime minister about seasonal flooding in the capital.

The DoS reported that this quarter, the U.S. Government held preliminary discussions with Iraqi customs authorities on how to support the prime minister’s drive towards customs automation, an important element of his anticorruption efforts. The DoS also continued to support e-government initiatives such as an online single window for business registration... In addition, the DoS reported that the DoJ is currently assessing a proposal to provide technical assistance to Iraqi anticorruption mechanisms through its International Criminal Investigative Training Assistance Program (ICITAP). On November 30, the U.S. Embassy in Baghdad and the American Chamber of Commerce-Iraq hosted a roundtable on corruption with U.S. companies to gather information for the DoJ’s ICITAP assessment team...

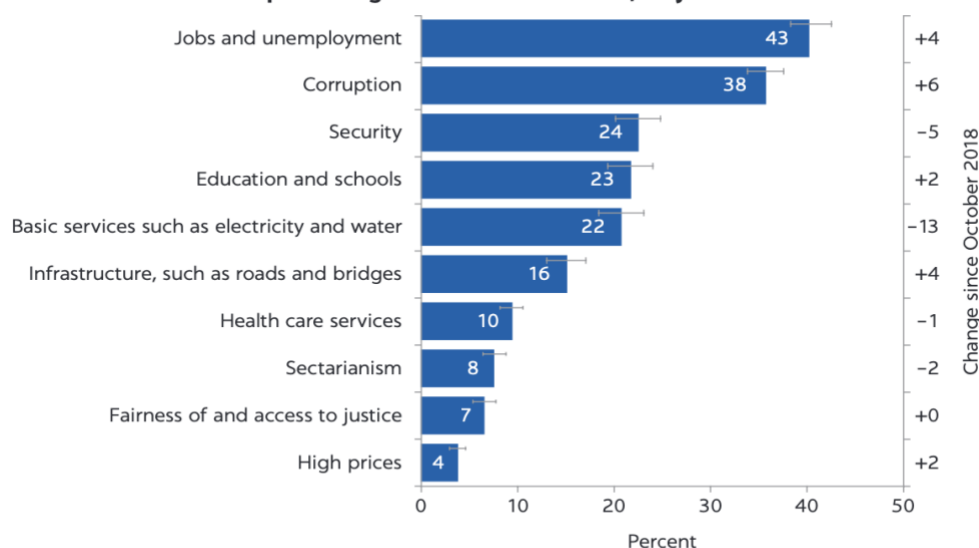
Here, it is interesting to note a summary graphic assessment of the relative impact of corruption in Iraq that World Bank issued in 2020. **Figure Four** shows that Iraq's overall economic ratings are remarkably low for a country with its resources and potential, but the polling data are consistent in showing that Iraq's level of corruption is extraordinarily high and that Iraqis are more concerned with employment and correction than security.

## Figure Four: The Impact of Corruption in Iraq

Iraq resembles a low-income, fragile country on many socioeconomic dimensions



### Main issues citizens expect the government to address, July 2019



Source: NDI 2019.

Source: *Breaking Out of Fragility, A Country Memorandum for Diversification and Growth in Iraq*, World Bank, September 30, 2020, 2, 37, <https://www.worldbank.org/en/country/iraq/publication/breaking-out-of-fragility-a-country-economic-memorandum-for-diversification-and-growth-in-iraq>.

## **Iraq's Real Civil-Economic Challenges**

As for the direct economic challenges Iraq faces, it is difficult to track current trends since estimates of the impact of Covid-19 – and any potential recovery times – are so different. Moreover, most reporting also again only addresses economic issues on a national basis and does not address the economic aspects of Iraqi politics, governance, internal sectarian and ethnic divisions, and Iraq's other civil problems.

### ***Looking Beyond Economic Growth***

At the same time, such studies do describe just how critical these broader economic problems have become. The LIG report referenced earlier, however, describes Iraq's economic situation at the end of 2020 as follows:

To address the public sector salary crisis, the draft budget incorporated a 22 percent devaluation of the Iraqi dinar that officially took effect on December 22... Even before the official devaluation, the value of the dinar had declined in reaction to media reports... The devaluation immediately resulted in price increases on almost all products, most of which are imported. At the same time, Iraq's inability to transfer funds to Iran to pay for imported electricity and gas to generate electricity led Iran to cut off these exports, limiting the availability of electricity to many Iraqis. Iraqi officials have said that much of their inability to pay Iran for electricity and gas imports results from Iraqi compliance with U.S. sanctions against Iran, including the blacklisting of its banking system... On December 29, media reported that Iran had agreed to resume gas and electricity exports to Iraq after Iraq agreed to pay \$6 billion in unpaid bills. An agreement was reportedly reached during a meeting

between Iran's Electricity Minister Reza Ardakanian and Iraq's Energy Minister Majid Mahdi Hantoush... According to an Islamic Republic News Agency report on December 30, Iran is opening a euro account in Baghdad that will allow Iraq to pay its debts to Iran for gas and electricity imports while avoiding U.S. banking sanctions...

The currency devaluation has also produced a significant cost-of-living increase for citizens throughout Iraq, including the Iraqi Kurdistan region. U.S. Embassy contacts reported prices of food staples have jumped between 25 and 30 percent throughout the country. Some local shop owners have responded by raising prices to cover their high supply costs, while others have closed their businesses... Residents of Iraqi Kurdistan were already suffering from the loss of steady income due to the COVID-19 pandemic and the halt in public salary payments. While every resident's purchasing power declined overnight by 22 percent, KRG civil servants, who make up 60 percent of the region's workforce, were already receiving reduced salaries at a less frequent rate. The ongoing budget dispute between the Iraqi government and the KRG has made the de facto salary decrease even starker. The DoS reported that the economic stress devaluation placed on nearly all Iraqis is likely to add to further rounds of protests throughout Iraq...

An Article IV report made by the IMF in February 2021 also lists such problems, although it then spins its analysis to provide an unrealistically reassuring picture of future progress *if* Iraq makes the usual generic economic reforms that the IMF has recommended for years:<sup>36</sup>

The COVID-19 pandemic and a sharp decline in oil revenues have exacerbated Iraq's longstanding economic vulnerabilities. Real GDP contracted by an estimated 11 percent in 2020, reflecting a slowdown in non-oil activity and cutbacks in oil output as a result of OPEC+ decisions. Large fiscal and external current account deficits of 20 and 16 percent of GDP, respectively, constrained the government's ability to mount an effective fiscal response to the crisis.

The authorities have begun to take much-needed steps towards ensuring macroeconomic stability while protecting the vulnerable. To help safeguard foreign exchange reserves and reduce the external imbalance, the Central Bank of Iraq has announced a devaluation of the exchange rate. Alongside, the draft 2021 budget, submitted to Parliament, aims to reduce the fiscal deficit through measures to contain the unsustainable expansion of government wage and pension bills and to raise non-oil revenues, while significantly boosting targeted assistance to shield the most vulnerable. The authorities have also set aside sizable resources in



support of their efforts to minimize the loss of life to COVID-19, including through acquisition and distribution of a vaccine.

The economy is expected to gradually recover, and the imbalances to narrow, although the outlook remains challenging. Real GDP is projected to return to its pre-pandemic level by 2024. The fiscal and external current account deficits are projected to decline over the medium term. Government debt is expected to peak in 2023 and decline gradually thereafter.

This outlook hinges on strong implementation of reforms and is subject to significant downside risks. Political constraints ahead of the parliamentary elections, renewed bouts of social unrest, or security risks could undermine the reform efforts, putting macroeconomic stability at risk. Furthermore, pandemic-related risks and oil market uncertainties could further complicate the economic situation.

The World Bank summary *Outlook* issued in April 2021 provides similar warnings, but it also tends to follow the same standard format for reform that the World Bank applies to most developing states and that makes the same optimistic projections of the speed with which reform can take place based on Iraq achieving impossibly quick levels of rapid and consistent reform. It states that,<sup>37</sup>

The volatility of oil prices and the impact of the pandemic have both amplified Iraq's economic woes, reversing two years of steady recovery. These twin shocks have also deepened existing economic and social fragilities, adding to public grievances that existed pre-COVID-19. The Government of Iraq's (GoI's) ability to provide a stimulus package for an economy highly dependent on oil exports for growth and revenue has been limited by this absence of fiscal space. As a result, the country has experienced the largest contraction of its economy since 2003.

Indeed, Iraq's GDP posted a sharp contraction of 10.4% in 2020. Growth was stymied by depressed global demand for oil and Iraq's adherence to OPEC+ production cuts. Its non-oil economy has undergone a 9% contraction, with religious tourism and the service sectors suffering the most from COVID-induced lockdowns. But weak domestic demand and cheaper imported goods have kept inflation pressures low, with headline inflation only edging up to 0.6% in 2020.

In response to the severity of the crisis, the government devised a national plan in a White Paper that sets out reforms for sustainable, medium-term growth. These address some of the impediments standing in the way of private sector-led diversification—as discussed by the government and World Bank Group in October 2019—related to: (i) fiscal stability, economic governance, the financial sector and business environment; and (ii) agriculture, gas, electricity, social protection and labor. The ultimate success of these reforms—which are transformative in nature—depends on political will and public support for leading the country out of its fragility trap. Meanwhile, popular perceptions of corruption, as well as Iraq's weak public service delivery could give rise to more social tensions and undermine their implementation.

The key challenge for Iraq will be to move ahead with its White Paper reforms amidst recovery in international oil markets, and to maintain a sustainable macroeconomic framework. Even with oil prices passing the US\$60 a barrel mark, Iraq will need to take action to rebuild its fiscal space by cutting distortionary, inefficient spending; boosting domestic revenue mobilization; and strengthening the medium-term orientation of macroeconomic policies. Failure to narrow its twin deficits (fiscal and current account) and halt the rapid build-up of government debt will divert more resources away from productive investment and chip away at foreign exchange reserves and the economy's resilience to shocks. Other priorities include limiting COVID-19 and ensuring a quick rollout of vaccines.

As such, Iraq's outlook will depend on global oil markets, structures for reforms (and their implementation), and the capacity of the Iraqi healthcare system to respond to COVID-19. As conditions ease, growth is projected to return from 2% in 2021 to 8.4% in 2022, with the non-oil economy projected to bounce back to an average of 4%. Amidst recovering oil prices, the fiscal deficit is expected to gradually decline, from 5.5% in 2021 to 0.6% of GDP in 2023. It is projected to remain in deficit, however, without reform to the public wage bill and pensions. Consequently, Iraq's debt-to-GDP ratio is projected to remain elevated.

Economic recovery and mass vaccination should gradually reverse a surge in poverty—projected to be 7 to 14 percentage points above the national poverty line—but the disproportionate impact that economic shocks

have had on people in an informal sector already dominated by the poor and vulnerable is likely to result in increased inequality. A currency devaluation may push inflation to 8.5% in 2021, due to Iraq's limited capacity for import substitution. This will present additional pressure on household well-being and could impede poverty reduction.

Here, an earlier World Bank report entitled *Iraq Economic Monitor, Protecting Vulnerable Iraqis in the Time of a Pandemic, the Case For Urgent Stimulus and Economic Reforms With a Special Focus on Impacts of COVID-19 and Weak Oil Prices on Household Poverty in Iraq* that was issued in the fall of 2020 seems to provide a less optimistic and more valid perspective.<sup>38</sup>

***Decades of political, economic and security shocks have shaped major structural imbalances in Iraq's economy, reinforcing Iraq's current fragility trap.*** Iraq remains as one of the most oil- dependent countries in the world. Oil accounted for over 96 percent of exports, 92 percent of government budget revenues and 43 percent of gross domestic product (GDP) in 2019. Overdependence on oil has also increased economic volatility and discouraged investment in other sectors. Multiple security shocks including regional conflicts and ISIS attacks have left little room for non-oil sector growth. An unfavorable business environment has undermined private sector's crucial role in job creation. The large size of the public sector and wage bill rigidity has restricted fiscal space required for investments in human capital and infrastructure and restricted response to economic shocks. Poor service delivery and rampant corruption along with soaring unemployment and poverty rates have led to public grievances even before the global pandemic.

***Iraq's economy continues to face significant macroeconomic challenges following the twin shocks of the COVID-19 pandemic and collapse in global oil markets.*** Iraq's GDP shrank by 6 .8 percent year-on year (y/y) in the first half of 2020 (H1-20) reversing a steady improving economic growth trend over the previous two years. Depressed global energy demand and the OPEC+ production cut led Iraq's oil GDP to contract by 10 .4 percent (y/y) in Q2-20. Since then, oil production declined to reach a five-year low of 3.58 mbpd in August 2020. Lower economic activity was most pronounced in the services sector, which contracted by 20 .7 percent (y/y) in Q2-20, following the introduction of lockdowns and curfews in March 2020. This sharp contraction led non-oil GDP to decline by 9 .2 percent (y/y) in H1-20. As of September 2020, geo-mobility data showed activity in workplace areas to have partially improved to around 20 percent below their pre COVID-19 levels. However, the surge in COVID-19 cases, which exceeded 400,000 confirmed cases and 10,000 deaths in October 2020, highlights the ongoing nature of the health crisis and the necessity to focus on saving lives to avoid longer term irreversible impacts of the crisis.

***The twin shocks are taking a toll on fiscal revenues leaving the government with limited financing options.*** While government revenues fell by 47 .5 percent (y/y) in the first 8 months of 2020 (8M-20), expenditures remained high at 21 .8 percent of GDP due to large share of the public wage bill and pensions. These budget rigidities put pressure on government financing needs which are estimated to reach a staggering 25 .8 percent of GDP by end-2020. The Government of Iraq (GoI) has started pursuing consolidation measures by stopping discretionary spending including pro-growth programs such as those linked to human capital and public service delivery and has focused all available resources on paying the public sector wage bill and pensions. These measures alone will not be enough as oil prices are expected to remain well below the breakeven price (US\$58/bbl) to cover these two major spending items. The lack of fiscal space also has negative implications for growth and the ability of the GoI to provide a stimulus to the economy and mitigate the impact of the pandemic. Higher financing needs will create significant challenges for the country's macroeconomic balances and put pressure on the exchange rate and central bank reserves.

***Iraq's economic outlook hinges on the prospects of global oil markets and the capacity of the healthcare sector to cope with the pandemic.*** Improved outlook for oil markets and increased production, as part of the OPEC agreement, are expected to drive growth in 2021 and 2022 in the absence of strong reforms. If the health situation improves, growth is projected to gradually rebound from 2 .0 percent in 2021 and to 7 .3 percent in 2022 with non-oil economy growth projected to bounce back to an average of 4 percent in 2021–22. As such, the fiscal and external pressures are expected to remain as the twin balances remain in deficit.

***The breadth and depth of economic challenges highlight the urgent need for the implementation of long overdue structural reforms.*** Current cuts to public investment and pro- growth programs are short-term measures to appease the fiscal situation; but cannot be sustained over the medium-term given their implications on growth and poverty. As such they cannot substitute overdue structural reforms. Cognizant of

the situation, the GoI's White Paper sets out a blueprint of reforms that if implemented could mark a turning point for Iraq. There are large economic gains to be made from implementing long awaited structural reforms. The World Bank simulates that such reforms could add as much as 58.4 percent to Iraq's per capita GDP growth. The ultimate success of this reform initiative depends on resolute political will and the garnering of public support to lead Iraq out of the fragility trap it has been grappling with for so long.

### **Impacts of COVID-19 and weak oil prices on household poverty in Iraq**

***The security and economic crises of recent years have left unequal imprints across regions and groups in Iraq.*** After a period of relative lull in violence, poverty fell in 2012 but increased to a record high in 2014 as a result of the ISIS conflict and oil price shock, before falling again slightly in 2017/18 as recovery began. The national trends, however, mask important spatial and group disparities. While the urban-rural gap has been declining, the poverty distribution is now polarized between the historically poor South and the newly poor North, which are characterized by acute and chronic poverty on the one hand, and relatively low levels of poverty in the Center and Kurdistan regions on the other. These spatial disparities, in many cases, are driven by the significant gaps that exist between the displaced and non-displaced population. In both the North and Kurdistan regions, where the vast majority of the IDPs are, the poverty rate among displaced households is more than twice that of non-displaced households. These pre-existing vulnerability disparities mean that the impact of COVID-19 across the country is likely to be different.

***The dual shocks of COVID-19 and oil price will exacerbate these trends and test Iraqi households' resilience further through multiple channels.*** While disruption in supply chains could increase basic prices, households' labor and non-labor incomes are likely to decrease due to the economic slowdown and reduced remittances. Many households may lose most or all of their incomes, especially those in the informal private sector, compelling them to exhaust any meager savings and employ negative coping strategies. A narrower fiscal space could also affect food and public cash transfers. In the absence of a significant government response, these short-term effects coupled with the reduced access to education, healthcare, and other services will have lasting impacts on households' economic growth, intergenerational mobility and the ability to escape poverty. These negative impacts can be profound and persistent, especially, when faced during early childhood. They can significantly limit one's lifetime earnings, upward economic mobility, human capital accumulation and health; and can, even, transfer on to next generations.

***Poverty in Iraq, even under a benign impact scenario, is estimated to increase in the short-term by 7 to 14 percentage points.*** This means 2.7 to 5.5 million Iraqis would become newly poor due to the twin crises in addition to the existing 6.9 million pre-crisis poor. With the pandemic continuing to surge, the government is faced with the difficult tasks of trying to contain the virus and people's health and restart a crumbling economy.

***Furthermore, reducing the public wage bill and pensions could push an additional 0.4 to 1.7 million Iraqis into poverty unless the rightsizing exercise is introduced in a progressive and efficient fashion.*** With Iraq's fiscal space already very tight, the current crises have created even greater constraints on government spending, which has driven the government's plan to address the size of the public wage bill. Rightsizing the public sector could have a significant poverty impact depending on how the reform is implemented. Thus it will be important to consider distributional consequences when determining which public sector workers will be affected. Geographically, reforms such as across the board wage cuts would increase poverty the most in the Kurdistan region and the Center given high shares of public sector workers. However, current poor households in the North and the South would be pushed even further into poverty.

***The policy response needs to address health and livelihood challenges in the short term but also address structural issues through a deeper reforms program.*** Given the worsening poverty trends, the GoI will need to launch an urgent fiscal stimulus to protect the poor and create short-term employment opportunities:

- In the short run, the focus should be on maintaining access to essential goods and nutrition, identifying and reaching those most vulnerable to the pandemic and scaling up targeted social protection; i.e., providing temporary cash and in-kind support to workers and enterprises that have lost jobs or whose incomes were cut due to COVID-19. The GoI should utilize existing systems such as the Ministry of Social Affairs' Unconditional Cash Transfer Program (UCT), which covers 1.35 million households, that would be critical to adequately protect as many poor and vulnerable Iraqis as possible. The GoI could also engage on active labor market policies and programs to protect

jobs and increase jobseekers' employability, emulating the positive lessons from around the world. These include wage support programs in the private sector, on-the-job training, reskilling and entrepreneurship programs, as well as public works programs. A strong public response to the crisis should not necessarily entail new costly permanent programs but the urgency for such interventions necessitates fiscal discipline to mobilize resources to this end.

- In the longer-term, low revenues and the cost of responding to the crisis mean that Iraq will face intense pressures to fiscally consolidate during the recovery period. It is essential that this consolidation minimizes the impact of reduced spending and any potential broadening of the tax base on the poor and vulnerable. It is also important to examine efficiency gains and ring-fence spending on pro-growth and pro-poor programs like spending on public investment for human capital and service delivery. Moreover, structural reforms which boost job creation, especially in the private sector, need to be implemented.

Real world reform will have to take place in the face of all the political pressures – that have blocked reform in the past – corruption, and Iraq's different popular demands for progress and better living standards, as well as the at least some continuing levels of violence. It must address the full range of economic pressures on Iraq; all its internal tensions; the need to meet factional and regional expectations rather than simply providing broad economic growth; and how to deal with the impact of Iraq's dysfunctional politics, corruption, and problems in governance.

### ***The Kadhimī Reform Plan***

Prime Minister Mustafa al-Kadhimi has issued the outline of a reform “plan” that at least addresses many of Iraq's basic economics problems in broad terms, although it generally avoids providing any full justification of its recommendations, any implementation plans, any cost estimates, and any measures of success. It also avoids a number of sensitive other issues like Iraq's population growth and birth rate; the lack of unity and willingness to compromise in the Iraqi legislature; corruption; and sectarian, ethnic and other factional tensions.

Like so many development “plans” it largely fails to assess the issues it lists, provide any implementation plans and costs, any clear schedules for action, and any detailed measures of effectiveness. It also does not address most regional ethnic and sectarian issues and divisions.

Prime Minister al-Kadhimi did, however, task a Crisis Cell for Financial and Fiscal Reforms with writing an economic reform plan in a White Paper that was approved on October 13, 2020. Much of the result White Paper was dedicated to describing the root causes of Iraq's economic crisis,<sup>39</sup>

The expansion of the role of the state... The White Paper identifies the expansion of the role of the state and emergence of a command economy in Iraq as a key cause of the crisis. From the nationalization of vital economic sectors in 1970s, to the commandeering of all economic levers by the state to support the war effort in the 1980s, through the period of sanctions imposed on Iraq in the 1990s, these shocks, as well as the absence of strategic planning, mismanagement, maladministration, patronage and misguided political ideology, all led to an expansion of the role of the state in all aspects of economic life in Iraq.

The Iraqi economy continued to be directed by the state after the events of 2003 because of the failure of the new political system to create a free and diversified modern economy as outlined in Iraq's Constitution, and instead continued to rely on the state as the almost only driver of economic activity in the country. The expansion of the role of the state, and the associated increase in the number of those employed in the public sector and the cost to Iraqi exchequer of their salaries and pensions, came at the expense of the government's ability to invest in basic infrastructure in Iraq.

To illustrate the point, the White Paper points out that from 2004 to 2020, state expenditure on the salaries of civil servants and on public sector pensions increased by 400% in real terms, as the total number of public sector workers during the same period increased by threefold. And between 2006 and 2018, average public sector salaries increased by 134%, more than the increase in labor productivity, which rose by only 12%, or

the cost of living, which rose by 28% during the same period. Over the past 17 years, government spending on the salaries of state employees, and on public sector pensions became the fastest growing expenditure item in Iraq's successive federal budgets during this period. There are currently around 4,500,000 public sector employees and 2,500,000 pensioners.

### **Decline of the private sector**

The expansion of the state's role, in addition to the complex administrative system and the state's weakness in imposing the rule of law, the militarization of society, and the influence of non-governmental actors in public institutions, led to the decline of the Iraqi private sector.

With the exception of a number of small and medium-sized companies operating in the oil and telecommunications sectors, and very small companies operating in the fields of trade, retail, transport, construction, hospitality and textiles, there is almost a complete absence of private sector companies in manufacturing. In addition, most of the larger private sector companies depend on providing services to the state and on government contracts.

### **Other Factors**

The White Paper also identified other factors that led to the deteriorating economic situation in Iraq is, most notably:

- The collapse of oil revenues
- The impact of Covid-19
- Mismanagement and lack of planning
- The weakness of financial institutions
- The absence of modern coherent systems for managing state revenues
- An ineffective and outdated banking sector
- Complex and antiquated government procedures
- Destruction of infrastructure and the costs of the war against Daesh terrorists,

The White Paper identified two strategic objectives for Iraq. The first is to immediately address the budget deficit and apply short-term reforms, creating fiscal leeway to implement wider reforms for the long-term. The second is to make the economy and the federal budget sustainable. These objectives were given 3 to 5 years to implement.

To achieve these objectives, the White Paper identified five key pillars for reform,<sup>2</sup>

#### **1. Achieving sustainable financial stability**

Key reforms include:

- *Reducing the deficit from 20% to 3% of GDP and expenditure on salaries from 25% to 12.5% of the federal budget*
- Collecting electricity tariffs from all users based on the real price of fuel on global markets
- Recovering and returning Iraq's smuggled and stolen money
- Increasing revenues from customs and taxes
- Reforming Iraq's Pensions Fund and move to gradually end federal budget support
- Reforming financial management systems
- Reviewing the current exchange rate of the dollar against the dinar<sup>2</sup>.

#### **2. Implementing strategic reforms and creating sustainable job opportunities**

Key reforms include:

- Modernizing and rehabilitating the financial sector.
- Modernizing and rehabilitating the banking system, supporting the development of private banks, reforming government banks, and introducing the Core Banking System in Al Rafidain and Rasheed Banks.
- Expediting the development of e-banking services.
- Establishing new trading markets, such as a commodity market and a currency exchange market (Forex)
- Supporting the sectors that drive the economy, such as agriculture, oil, and gas.
- Introducing a private sector support fund, simplifying procedures, and providing other non-financial aid.
- Creating job opportunities in the private sector and supporting small and medium enterprises.
- Adopting a national strategy for education and training that links education outcomes with the future needs for the labor market.

### **3. Improving basic infrastructure**

Key reforms include:

- Increasing the effectiveness and improving the performance of all parts of Iraq's electricity sector
- Developing Iraq's digital infrastructure, including the introduction of advanced technology (4G) at the beginning of next year, and preparing for the introduction of (5G) technology
- Modernizing the legal and regulatory framework of the transport sector, and encourage private investment in transport
- Developing industrial cities and free zones in Iraq

### **4. Providing basic services and protecting vulnerable groups during and after the reform process**

Key reforms include:

- Improving water supply for both drinking and irrigation and complete sanitation projects and networks
- Building 1,000 new schools during the period of the reform program
- Reforming the social security system\
- Establishing a unified and financially sustainable pension system for all Iraqis whether they are working in the public, private, cooperative or mixed sector
- Completing and implementing the draft health insurance law to ensure that all Iraqis have access to essential health services<sup>5</sup>.

### **5. Improving governance and introducing changes to the legal framework to enable institutions and individuals to implement reforms**

Key reforms include:

- Reviewing and amending the official guidance in relation to government contracts
- Introducing e-governance systems to strengthen oversight of government contracting and the collection of taxes and customs
- Working with specialist investigative international organizations to return the large sums of money smuggled out of Iraq
- Introducing an electronic governance system in the field of government contracting and tax and customs collection

- Completing the project establishing the National Information Centre to facilitate the introduction of government e-services to citizens, and automate the procedures for obtaining key documents such as nationality and passports and accessing pensions and social security
- Introducing electronic signature and transactions throughout the public administration system and phasing out paper transactions

The White Paper does acknowledge one of the major sources of financial insecurity, which is Iraq's overinflated public sector. The government's expenditure on public servants' salaries and pensions increased by a staggering 400% from 2004-2020, which will not be sustainable taking into account Iraq's also growing population. However, how Kadhimi will attempt to shift this burden to the private sector is unclear.

It also sets an ambitious near-term timeline for the implementation of all its recommended changes of only 3 to 5 years. However, these reforms, including the reduced payments of public sector workers, that are met with rapid change may hurt Iraq's working class and in turn create more public unrest. Other measures intended to stabilize the Iraqi economy, including freezing recruitment in public institutions to reduce the public sector wage bill, will also negatively affect the unemployment rate.<sup>40</sup>

In terms of decreasing the deficit, Iraq's parliament approved the 2021 state budget of \$89 billion with a deficit of \$19.79 billion.<sup>41</sup> The 2021 budget set an oil price of \$45 a barrel with the expected exports of 3.25 million barrels per day (bpd), including 250,000 bpd from the Kurdish region of which the Kurdish Regional Government (KRG) must hand over revenues generated from those exports to Baghdad.

Iraq's rentier economy and reliance of oil to cover 95% of the government's expenditures is another key point for reform, following the crisis after the drop in oil prices in 2020. The White Paper proposes the establishment of a national gas company and policy to diversify energy income and further the development of the natural gas industry.<sup>42</sup> Furthermore, the White Paper proposes the establishment of a national oil company, Inoc, in order to separate political influence from the oil sector, ensure the fair distribution of wealth, and improve the relationship between federal and local governments.<sup>43</sup>

As of February 2021, the Government of Iraq (GoI) stated that it had begun implementation of its White Paper, which included,<sup>44</sup>

- Putting in place governance, oversight, monitoring and evaluation mechanisms to ensure that the reform process is administrated and managed effectively under the direction and guidance of strong and competent leadership which will have a direct link to the Prime Minister, with the aim of equipping the implementation team with the necessary authority to carry out the reform program, providing vigorous oversight of the implementation process, and ensuring coordination between different governmental institutions.
- Translating the vision of the White Paper for Economic Reform into a practical program for delivering 64 projects and for ensuring their implementation in an integrated and coherent manner by specifying detailed procedures for each project, setting a specific timeline for progress and identifying the state entity which will be responsible for carrying out each project.

It is still far from clear, however, that the Iraqi government will actually implement a major portion of the Kadhimi reform plan. And, if there is any one historical lesson from past economic reform plans throughout the world, it is that good intentions do not necessarily pave the road to hell, but often do fail to pave any path out of purgatory.

### ***Looking at the Full Need for Civil Reform***

Fortunately, there is a study by the World Bank that does address the full range of issues that Iraq – and any successful civil aid program – must deal with and where key factoids have already been quoted in earlier parts of this study. This report has already been quoted at length, and is entitled *Breaking Out of Fragility, A Country Memorandum for Diversification and Growth in Iraq*. The World Bank, issued in September 30, 2020, and it does address the political challenges, governance issues, factional barriers, and other real-world issues that require full civil reform rather than simply economic reform.<sup>45</sup>

The study builds on a previous World Bank diagnostic of Iraq that also came to grips with many of the real-world issues in civil reform. Like some of the World Bank studies that emerged out of teams working in Afghanistan, it demonstrates that the World Bank does have cadres that can provide a basis for realistic planning and staffing that the U.S. Department of State, United Nations, and IMF cannot perform.

There is no easy way to summarize the suggested reforms presented in a complex 161-page report or address its many detailed recommendations. The previous excerpts do make it clear, however, that study does address the full range of issues necessary to create a successful civil aid effort, quantify them, and compare Iraq's performance over time with that of other countries as well as the improvements that could occur with suitable reform.

Its content can be also illustrated by quoting key excerpts that address reasons why Iraq's past performances have not produced sustained growth and better living standards for Iraqis, and by summary lists of reforms that should drive any future Iraqi – as well as the U.S. or any U.S. led – aid effort:<sup>46</sup>

Iraq is at a crossroads. Almost two decades after the 2003 war, the country remains caught in a fragility trap, facing increasing political instability, growing social unrest, and a deepening state-citizen divide. Amid a multitude of crises (including an oil price shock, the COVID-19 pandemic, and recent protests) as well as a culmination of poor economic policies, a lack of reforms, and an inability to tackle corruption, Iraq is having its worst annual gross domestic product (GDP) growth performance in 2020 since the fall of the Saddam regime. Instability, a lack of jobs, corruption, and poor service delivery remain among the most important risks to the country's long-term growth.

With every crisis comes an opportunity to reform. However, Iraq's path to reform will be challenging and uncertain. Given current oil prices and the persistent drop in global demand for oil because of the COVID-19 pandemic, the country will have a tough time addressing the needs of its people in the short term. It can, however, embark on a long but much-needed path toward structural transformation and reform, one that could leave its economy less dependent on oil and more driven by private sector activity. The widespread protests since October 2019, which have called into the question the country's current political economy, illustrate that such path for reform can no longer be avoided. Nevertheless, as this report shows, this path will demand persistence, and Iraq will face much uncertainty as it tries to address its long-lasting challenges and change the status quo.

This report highlights *what* Iraq can do to sustain future growth, but it also shows *why* the country has not yet managed to achieve high levels of diversified growth alongside peace, stability, and a better standard of living for its people. Iraq's high levels of fragility and conflict, reinforced by high oil dependency, hinder the country's prospects for economic reform and growth. The report also suggests strategic pathways by which Iraq can break free from this fragility trap, in which peace and stability can create the conditions for people to fulfill their aspirations, find private sector jobs, and thrive. In this context, the report's four chapters provide (a) an understanding of Iraq's underlying fragility and political economy challenges and their implications for a diversified growth model, (b) an analysis of Iraq's growth characteristics and the country's potential for and benefits from economic diversification, (c) a trade diagnostic and assessment of Iraq's potential for trade and regional integration to create growth and stability, and (d) a review of Iraq's agriculture



sector, from primary agriculture to agrifood systems, and its potential to support economic diversification, growth, and stability.

### **...Iraq lags upper-middle-income countries on most socioeconomic indicators**

Although oil wealth has allowed Iraq to obtain upper-middle-income status, in many ways its institutions and socioeconomic outcomes more closely resemble those of a low-income, fragile country. The Iraqi education system once ranked near the top of the Middle east and North Africa (MeNA) region, but it now sits near the bottom. Iraq's rate of participation in the economy is also low, and the country has one of the lowest female labor force participation rates in the world, low levels of human and physical capital, and deteriorating business conditions (figure O.1). Iraq also has one of the highest poverty rates among upper-middle-income countries (uMICs). Without key reforms in these areas, the country will find it increasingly difficult to grow sustainably and equitably and to sustain its standard of living.

### **Repeated conflicts in an inherently volatile oil economy have not delivered sustainable prosperity**

Iraq's recent conflicts have had significant economic and social costs. The country's per capita GDP is about 18–21 percent lower in 2018 than it would have been if not for the conflict beginning in 2014. In particular, although Iraq's oil GDP grew steadily during the conflict, the country's nonoil GDP is estimated to be about 33 percent lower in 2018 than it would have been without the conflict (figure O.2) and has fallen below its peers (figure O.3). Iraq's national poverty headcount is estimated to be almost 7 percent higher than it would otherwise have been. Although some of this weakness reflects the 2014 oil price shock and the conflict with the Islamic State of Iraq and the Levant (ISIS), it also reflects losses in productivity and competitiveness in the real economy that have put nonoil GDP on a declining trend.

### **Iraq has missed opportunities to reform despite thorough diagnostics**

Previous studies, including the World Bank's previous two Country economic Memorandums (CeMs), in 2006 and 2012, have emphasized similar areas for reform as this report, but Iraq has made no visible progress in most of those areas to date. The two earlier reports noted that in order to improve its living standards, Iraq needed to transition (a) from conflict to rehabilitation, (b) from state dominance to market orientation, (c) from oil dependence to diversification, and (d) from isolation to better global and regional integration. The 2006 CeM called for generating growth and employment in the private sector, protecting the poor and vulnerable with strong safety nets and sustainable pensions, and improving public management and accountability, especially for oil revenues. It also noted that although the state had a role to play in post conflict reconstruction, it also had to step back to allow Iraq's private sector to flourish. The 2012 CeM recommended "three pillars to promote diversification: private sector development, integration of nonoil public spending with diversification objectives, and strengthened linkages of the wider economy to the energy sector."

These earlier recommendations remain valid. Moreover, the state still needs to provide security, rebuild infrastructure, and improve service delivery following yet another conflict; while the country's nonoil economy still struggles to grow amid heavy government regulation, an uncertain business environment, and an unstable political climate. With little progress made on these recommendations, the country's situation has markedly worsened in most socioeconomic aspects. This observation calls for a thorough analysis of the underlying fragility constraints on development in Iraq and of the political economy of the country's decision-making and economic reforms, their intricacies and what sets them in motion.

### **Understanding development in Iraq requires a close analysis of its political system and the nature of its social contract**

Contestation between political elites ("elite bargaining"), relations between the Iraqi state and society ("social contract bargaining"), and the relationships between social groups ("social cohesion") are critical to understanding the political economy of Iraq. At various times in Iraq's recent history, the aforementioned contestation has turned violent. Conflict has erupted mainly over competition for power and resources, and Iraq's elites have instrumentalized ethno-sectarian divisions between groups in their pursuit of power. High levels of external interference reinforce these fault lines and turn Iraq into an arena for wider geopolitical contestation (figure O.4). However, contestation in the country is increasingly shifting toward popular grievances over poor delivery of services, state corruption, and the lack of economic opportunities, as Iraq's

most recent protests illustrate. In addition, oil dependence is a powerful driver of fragility in Iraq and has reinforced contestation at all levels, fueling elite competition and undermining the state's accountability to citizens.

### **Iraq's political settlement consists of elite contestation over power and resources**

Iraq's current political settlement, which rests on rent-sharing and power-sharing by political parties, has led to elite capture, widespread clientelism and patronage, and political paralysis. The post-2003 political system in Iraq grew out of an elite pact built on ethnic and sectarian identities. In its early years, the process of de-Ba'athification and the dissolution of the Saddam-era army led to an erosion of the country's existing bureaucratic infrastructure and displaced the senior civil service that had run it. As time went on, the process of elite politics shifted from sectarian and ethnic power-sharing to political party-based power-sharing and polarization, in which contestation and negotiation take place over control of the formal bureaucracy. Politicizing appointment for key bureaucratic posts became a fundamental component of how political parties extended their patronage networks to strengthen their legitimacy, power, and wealth (Dodge 2019). Furthermore, the increasing fragmentation of Iraq's political landscape has led to political instability and paralysis and fueled fragility.

### **Iraq's oil wealth (or curse) has affected the politics of resource management**

Iraq's reliance on oil has had a major impact on the country's political settlement and economic outcomes. Over the past decade, despite fluctuations in oil prices, Iraq's hydrocarbon sector has accounted for almost all of the country's export value, 90 percent of government revenues, and more than 57 percent of GDP. Iraq's oil wealth has eroded the country's international competitiveness by fueling the gradual appreciation of its real exchange rate. Dependence on oil wealth has also reduced Iraq's incentive to generate other forms of government revenue, such as tax revenue (Devarajan, Raballand, and le 2012). This, in turn, has reduced the need for state-society bargaining, which is at the heart of successful state-building processes. As a result, Iraq's administrative capacity has declined and its institutions have grown unresponsive.

Ongoing disputes over oil resource control in Iraq are inextricably linked to unsettled debates about the country's federal system, which has also hampered the adoption of a revenue-sharing law. Intergovernmental relationships are inevitably challenging in resource-rich economies, where resources are unevenly distributed, rents are pooled and managed from the center, and producing regions do not always benefit from rent dividends (Ahmad 2020). Additionally, ongoing disputes over resource control in disputed territories (including the Kirkuk governorate) impair their recovery from the ISIS conflict. Resource control is also an arena of contestation between the federal government and other oil-producing provinces, such as the Basrah governorate (Isakhan and Mulherin 2018).

Political instability, oil rents, and high government discount rates in Iraq lead to short-term rent maximization and an incentive system in which decision-makers highly discount future payments and prefer present rewards. The political instability caused by Iraq's increasing political fragmentation and alienation undermines the credibility of the government's long-term commitments. It also breeds a strong sense of insecurity within the ruling elite, which is reflected in their preference for the political status quo (Mansour 2020). For the sake of this status quo, the ruling elite has observed some level of fiscal prudence in recent years, but the Iraqi government has yet to invest in fiscal stabilization mechanisms or long-term reforms. Focusing on short-term rent maximization leads governments to discount future revenue (including oil tax revenue, which is more challenging to collect than royalties) at a significant cost to the economy (World Bank 2012).

### **State-society contestation has emerged as a new fault line**

The social contract between Iraq's ruling elite and the people has failed to meet social demands, fueling growing discontent. The country's increasing political fragmentation has exacerbated this power struggle and the elite's concern for the status quo, widening the divide between the ruling elite and its constituencies. As a result, grievances have accumulated, particularly among Iraq's youth, and social unrest has spread, culminating in the 2019 protests. Protesters' demands include improvements to public services, such as education and electricity and water provision, and jobs, which the Iraqi government has until now sought to provide mainly by expanding public sector employment. However, as oil revenues decrease and the Iraqi population grows, this model, and its consequent expansion of the state's wage bill, are no longer sustainable.

Iraq's rapidly changing demographics suggest that the country's political equilibrium will become even more fragile in the coming years. Iraq's youth unemployment rate is 36 percent (World Bank 2018), a particularly serious problem given that the country has one of the youngest populations in the world. Moreover, almost all Iraqi youth (95 percent) believe that personal connections, or *wasta*, shape one's employment opportunities—the highest share in the region (according to the Arab Barometer Wave 5 survey).

... regional disparities within Iraq point to yet more risk factors for conflict and instability. A wide literature considers between-group inequality to be a contributing factor to the onset of conflict. Iraq contains several regional and religious disparities, in terms of both poverty and service delivery indicators. Most Iraqis (64 percent) say the country is divided as opposed to unified (NDI 2019). Issues of cohesion and social trust are particularly salient in areas liberated from ISIS and in disputed territories where internal displacement remains high. The country's south has consistently had the highest poverty rates, and the Kurdistan region the lowest; however, the regions most affected by the recent conflict (the Kurdistan region and the north) saw increases in poverty compared with 2012.

### **From a wealth accounting approach, Iraq's vast oil wealth hides a growing gap in human capital between it and peer countries**

... rather than focusing on what a country produces and sells, one can focus instead on how it goes about producing it (Gill et al. 2014; Lange, Wodon, and Carey 2018). reliance on a broader and more productive portfolio of assets ultimately determines a country's ability to grow sustainably. Wealth creation in Iraq is overwhelmingly driven by oil, unlike in its peers, which derive their wealth from human capital.<sup>4</sup> Iraq's wealth grew by 133 percent in the 2005–14 period, one of the highest rates among both resource-rich countries and resource-rich fragile countries (see chapter 2). However, compared with other upper-middle-income countries and selected peers, Iraq's wealth was driven far more by depletion of its oil reserves than by improving the country's stock of human capital (as measured by the size and quality of its labor force). In fact, over the past few decades, Iraq has witnessed a significant decline in health and education outcomes.

### **Development in Iraq's private and nonoil sectors is held back by a range of regulatory and political factors**

Iraq's anticompetitive environment is a bottleneck for both firm-level productivity and the overall development of the country's private sector. Iraq's performance in the Doing Business rankings has fallen markedly in recent years, especially in the “getting electricity” and “paying taxes” categories. Iraq's performance in the logistics Performance Index also deteriorated between 2014 and 2018; the country fell further behind not only its developmental peers but also other countries in the region. relative to its structural and aspirational peers, Iraq has a much riskier business environment, with greater prevalence of cronyism and, especially, unfair competitive practices. The results of this environment can be seen when evaluating the time and cost to trade across Iraq's borders. Although the country has few regulatory restrictions on cross-border trade, the cost of and time needed for complying with import and export rules are much higher in Iraq than in both Iraq's peers and neighboring countries.

### **... Iraq's priority should be to refocus the country's political settlement on development and restore the authority of formal state institutions over nonstate actors**

A stable elite bargain is an important but not sufficient prerequisite for peace. Only if Iraq's elite bargain is oriented toward growth and development will the country's citizens fully enjoy peace dividends, and only then are they likely to grant public institutions and the ruling elite the legitimacy necessary for governing. Iraq also needs to restore the authority of formal state institutions over non- state armed groups, not only to stabilize the political settlement but also to help reduce informal and front-loaded rent extraction, which currently deprives the government of much of its potential fiscal space.

Although institutional reform is a slow-moving and gradual process that can take years, it requires reform coalitions among both ruling elites and citizens of all social groups. There may be opportunities in the short term to build new plat- forms or mechanisms for dialogue and consensus building that can bring together Iraq's various political and social actors, including protesters, civil society, the private sector, and religious authorities. Progress in Iraq will remain elusive unless elite incentives shift and the country assumes a new, shared political vision that acknowledges that it needs to shift from its current clientelist and patronage-based model toward a system that delivers the benefits of development to its people.

**Iraq needs to strengthen the management and allocation of its oil wealth and public resources**

The short-term rent maximization induced by Iraq's current political settlement is leading to growth in the production and export of oil irrespective of, and even at the expense of, maximizing revenue generation over time (including from nonoil products). It is also skewing rent allocation toward recurrent expenditures to the detriment of productive investment.

Transitioning from a distributive to a developmental model of fiscal federalism will be critical to the success of such reforms. Iraq's contested federalism hampers revenue generation by inducing revenue capture at the source by nonstate actors affiliated with dissenting authorities and by slowing down the devolution of fiscal resources, thus limiting the institutional capacity of provincial and local governments. Intergovernmental disputes also prevent the stabilization of the legal and institutional framework of Iraq's federal system and impede policy and program implementation and service delivery. As long as federalism is construed as a zero-sum game, in which a gain by one tier of government must mean a loss by another, and rent-sharing is seen as the only or the main objective of fiscal federalism, ongoing disputes and debates may remain unsettled, and Iraq may struggle to escape from its rent-seeking trap.

**Restoring the social contract, building confidence between citizens and the government, and addressing grievances will be key**

Iraq needs to strengthen its existing accountability institutions so that they can effectively respond to public concerns about corruption. These institutions need to focus on mitigating the risk of corruption and enhancing government performance. They should aim to improve citizens' actual experiences of corruption, red tape, arbitrariness, abuse of authority, and other problems when availing themselves of public services and interacting with public officials. Petty corruption and bureaucratic harassment hurt citizens as much as grand corruption, and they could be addressed through delivery mechanisms such as e-service delivery and online grievance-redress mechanisms. Public perception of corruption can also be improved by measures that signal the willingness of political leaders to make amends, such as the public disclosure of the asset, income, and financial declarations of government officials.

Iraq could also strengthen citizen engagement and government accountability in the delivery of priority services and infrastructure. First, Iraq would need to ensure that federal investments are prioritized by their importance to citizens in the relevant region. Second, the state could recognize that the way services are delivered and how fair they are perceived to be matter at least as much to state legitimacy as who delivers them and how effective they are. Prioritizing investments identified as citizens' top priorities and embedding within them mechanisms to support accountability, participation, and grievance-redress could help improve the relationship between Iraqi citizens and the state.

Establishing a fiscal contract between the government and citizens is another part of the equation. One way Iraq could do so is to transfer part of the country's oil revenue directly to citizens through uniform and universal cash transfers and then introduce the direct taxation of distributed revenues (Devarajan, Raballand, and le 2012). Taxation fosters social demand for government accountability that oil revenues do not, because "they go directly from the extractive company—usually a multinational—to the government, without passing through the citizens" (Devarajan et al. 2013). Given that the federal government of Iraq currently spends much of its budget on wages, pensions, social allowances, and tariff subsidies, the effectiveness of public expenditures for restoring the social contract should also be reviewed. The government could also consider introducing local taxation to help establish a fiscal contract.

Responding to youth demand for jobs and addressing medium-term demographic pressures is important to reduce the risk of instability and avoid downward pressure on incomes. As highlighted above, Iraq needs to cater to a growing number of young job seekers, and thus it needs to shift from a public sector-centric employment model to a private sector-centric one. This shift will require a change in mind-set among the country's youth, who currently expect jobs in the public sector. Despite this challenge, important pathways for job expansion are available to Iraq, especially in construction, agriculture, and small and medium enterprises (World Bank 2018). But in order to perform those jobs, Iraq's youth will need more education, skills development, and efforts to strengthen female labor force participation.

... tackling socioeconomic inequalities, which can fuel group-based grievances and increase gender inequality, will also be key to addressing Iraq's structural vulnerability to violent conflict. A concerted effort

will need to be made to ensure that resources are distributed equitably across groups and that perceived or real inequalities in access to welfare, basic services, and employment opportunities are addressed. Finally, Iraq will need to reach remote and underserved communities in order to ameliorate their condition and help build up their human capital. Particular attention should be paid to Iraq's disputed territories (e.g., Nineveh, Kirkuk, and Diyala), to areas where nonstate actors provide security or other services, and to areas where attacks by ISIS and other terrorist groups are on the rise.

**Iraq has lost some opportunities, but plenty of potential lies ahead**

Iraq's GDP per capita could be up to 60 percent higher if it had the same levels of labor force participation, investment, human capital, and productivity as other upper-middle-income countries. At the moment, Iraq lags behind its aspirational peers on all of these indicators, particularly the labor force participation rate (especially among women) (figure O.5). Raising Iraq's participation rate to the uMiC average would alone increase...

Iraq's GDP per capita by almost 31 percent (figure O.6)... raising the investment rate and the quality of the labor force would each also raise GDP by about 13 percent. However, to achieve these outcomes, Iraq would need to implement reforms with payoffs farther in the future than its ruling elites have yet shown interest in.

These points are also highlighted in the report's conclusions:<sup>47</sup>

Oil wealth has allowed Iraq to obtain upper-middle-income status, but in many aspects, its institutions and socioeconomic outcomes more closely resemble those of a lower-income, fragile country. Wealth creation in the country is overwhelmingly driven by oil, unlike in its peers, which derive their wealth from human capital. Indeed, Iraq's human capital, business environment, quality of service delivery, and governance indicators all sit near the bottom of global rankings; the country's overall economic productivity is on the decline; and Iraq's labor force participation rate, especially by women and youth, is one of the lowest among its income peers as well as in its region. Amid repeated conflicts in an inherently volatile oil-dependent economy, one could credit Iraq for maintaining its territorial integrity and functioning institutions; however, its system has failed to deliver on inclusive growth and better living standards.

The Iraqi political system and the nature of the country's social contract can explain much of this failure to reform or deliver better outcomes. As highlighted in this report, elite bargaining, social-contract bargaining, and a lack of social cohesion are prone to turn into violence. Conflict in Iraq has erupted mainly over competition for power and resources, and the country's elites have exploited ethno-sectarian divisions in order to gain and hold power. However, over the years, the process of elite politics has shifted from sectarian and ethnic power sharing to political party power sharing and polarization, in which contestation and negotiation take place over control of the formal bureaucracy. Iraq's current political settlement, which rests on rent sharing and power sharing among political parties, has led to elite capture, widespread clientelism and patronage, and political paralysis. These problems, in turn, have undermined government effectiveness, hampered the provision of public services and development, and increased fragility. The resulting fragmentation of Iraq's political landscape has led to political instability and paralysis and shifted the topic of contestation once again, toward popular grievances over poor delivery of services, state corruption, and a lack of economic opportunities

... there is a peace dividend in Iraq, although its benefits have been obscured by short-termism and a focus on oil. Iraq's per capita gross domestic product (GDP) was around 18–21 percent lower in 2018 than it would have been if not for the conflict beginning in 2014, and Iraq's nonoil GDP is one-third lower than it would have been without conflict. Maintaining peace can by itself be a strong driver of growth. However, Iraq's reliance on oil has had a major impact on its political settlement and economic outcomes. Political parties use oil wealth to fund patronage, notably the provision of public sector employment and subsidies to their supporters. Also, oil wealth has eroded the country's competitiveness, reduced the need for taxation, weakened the accountability link between citizens and the state, and fueled corruption.

As a result, the ruling elite has failed to meet people's social demands, including for employment opportunities and adequate service delivery, leading to growing discontent and a breakdown of trust. Amid political instability and elite contestation, the incentive system for decision-makers is biased toward present rewards. Such short-termism undermines the credibility of long-term reform commitments, because the payout of such reforms comes with a large discount factor. However, Iraq's changing political landscape,

including the collapse of oil prices and stronger contestation from youth (as shown in the October 2019 protests), could be (a) an opportunity to change the country's socioeconomic and political model into one that redistributes oil wealth in a more transparent manner and invests it in other assets—namely, human capital—and (b) a chance to push for more accountability, good governance, and economic diversification.

... Medium-term reforms will have to tackle complementary challenges concerning water and food security, including some related to infrastructure. But those efforts will likely prove worthwhile: rebuilding agriculture is an important strategy for post conflict reconstruction and, along with well-timed food security-related interventions, can build resilience to conflict.

To avoid missing any more opportunities for reform, Iraq's main challenge lies in launching a virtuous cycle that can advance these key pathways to growth. The realities of Iraq's political economy will impose themselves on the reform agenda, especially as it faces the complex contestations described throughout this report. As such, Iraq's growth strategy needs to focus on diversifying the country's asset portfolio by investing in its people, its capital stock, its institutions, and its regional position.

...Such measures will, on one hand, refocus the country's political settlement on the development agenda and restore the authority of formal state institutions over nonstate actors. On the other hand, they will restore Iraq's social contract; build confidence between citizens and government; and address grievances, particularly by strengthening accountability institutions. Accompanying measures, such as taxation policies and public financial management reforms, could also strengthen the management and allocation of oil wealth and public resources.

Moreover, injecting more competition and contestability can do much to ensure a level playing field between Iraq's large public sector, its politically connected private sector, and its future economic actors—including youth—which could boost the private nonoil economy. This change will involve improving the quality of regulations, as well as of organizations such as the judiciary and market regulators, and increasing the transparency and accountability of national and local governments, capital and financial market institutions, and other actors in order to ensure overall adherence to rules and regulations. Although these reforms might prove difficult to implement in the short term, a gradual approach to reforms could be applied—one that builds a coalition of reformists and encourages deeper ownership among government and other societal actors.

## **Meeting the Deeper Civil Challenges**

Creating an effective civil aid program is clearly critical to Iraq security and stability. Work by the World Bank and other experts also indicates that the costs of civil reform would be limited if it was implemented effectively and consistently. Many reforms – in areas ranging from the private sector to government spending and from investment to agricultural reform – would not only be self-financing but increase economic growth and/or government revenues and effectiveness in ways that more than offset their cost.

It is clear, however, that any successful mix of U.S., other outside, and Iraqi efforts must go far beyond economic development. It must consider demographics and population pressure, deal with sectarian and ethnic divisions, make aid conditional, and address all of the key issues involved in dealing with a deeply divided country with weak institutions and governance.

An effective plan must achieve the following objectives:

- Iraqi corruption and waste must be far more limited;
- Population growth must be addressed in ways that accelerate the current low decline in the birth rate;
- Equity for all groups of Iraqis – and building Iraqi unity and stability – will be more important than maximizing economic growth;

- Arab Shi'ite, Arab Sunni, Kurd, and minorities must see balanced support and progress on a national, regional, and major urban basis;
- The demands of Iraqi youth for education and real jobs must be given priority, but jobs must be real – not government sincerities that do not offer real careers and have little real value;
- Urban economic growth must be accompanied with agricultural reform – bounded by real world assessments of possible job growth in the agricultural sector, the growing need for capital intensive agriculture, and dealing with the impact of limits on water and of climate change;
- Aid must address the major differences needed by region;
- Adequate levels of governmental transparency and progress reporting reform must be developed and sustained in ways that win popular support;
- Donor aid must be consistent and focus on aiding Iraq rather than increasing outside influence;
- Outside nations need to accept the fact that a stable, developing Iraq will ultimately serve their interests better than trying to dominate Iraq;
- And, at a very different level, Iraqis need to address the reality that extremist forms of Islam that cannot possibly produce an effective Iraq economy and educational social structure are not based on legitimate interpretations of Islam or any credible hope for the future of Iraq.

Such efforts will be far from perfect, and they will involve a great amount of practical compromises. For all the reasons outlined earlier, however, a security program cannot succeed without a successful civil reform effort, and that reform must go far beyond Iraq's economy.

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<sup>1</sup> Lead Inspector General for Operation Inherent Resolve, *Quarterly Report to the United States Congress: October 1, 2020 – December 31, 2020*, Department of Defense, February 5, 2021, 15-16, <https://www.dodig.mil/Reports/Lead-Inspector-General-Reports/Article/2497904/lead-inspector-general-for-operation-inherent-resolve-quarterly-report-to-the-u/>.

<sup>2</sup> Lead Inspector General for Operation Inherent Resolve, *Quarterly Report to the United States Congress: October 1, 2020 – December 31, 2020*, Department of Defense, February 5, 2021, 13-15, <https://www.dodig.mil/Reports/Lead-Inspector-General-Reports/Article/2497904/lead-inspector-general-for-operation-inherent-resolve-quarterly-report-to-the-u/>.

<sup>3</sup> Lead Inspector General for Operation Inherent Resolve, *Quarterly Report to the United States Congress: October 1, 2020 – December 31, 2020*, Department of Defense, February 5, 2021, 13-15, <https://www.dodig.mil/Reports/Lead-Inspector-General-Reports/Article/2497904/lead-inspector-general-for-operation-inherent-resolve-quarterly-report-to-the-u/>.

<sup>4</sup> “Iraq,” World Bank, <https://data.worldbank.org/indicator/SL.TLF.TOTL.IN?locations=IQ>.

<sup>5</sup> International Data Base (IDB), U.S. Census Bureau, [https://www.census.gov/data-tools/demo/idb/#/country?YR\\_ANIM=2021&FIPS\\_SINGLE=IZ](https://www.census.gov/data-tools/demo/idb/#/country?YR_ANIM=2021&FIPS_SINGLE=IZ).

<sup>6</sup> U.S. Census Bureau, IDB, [https://www.census.gov/data-tools/demo/idb/#/trends?YR\\_ANIM=2021&menu=trendsViz&TREND\\_RANGE=2021,2100&TREND\\_STEP=10&TREND\\_ADD\\_YRS=&FIPS=IZ](https://www.census.gov/data-tools/demo/idb/#/trends?YR_ANIM=2021&menu=trendsViz&TREND_RANGE=2021,2100&TREND_STEP=10&TREND_ADD_YRS=&FIPS=IZ).

<sup>7</sup> Estimates differ by source. These data are taken from CIA, “Iraq,” *World Factbook*, <https://www.cia.gov/the-world-factbook/countries/iraq/>.

<sup>8</sup> Estimates differ by source. These data are taken from CIA, “Iraq,” *World Factbook*, <https://www.cia.gov/the-world-factbook/countries/iraq/>.

<sup>9</sup> Estimates differ by source. These data are taken from CIA, “Iraq,” *World Factbook*, <https://www.cia.gov/the-world-factbook/countries/iraq/>.

<sup>10</sup> Estimates differ by source. These data are taken from CIA, “Iraq,” *World Factbook*, <https://www.cia.gov/the-world-factbook/countries/iraq/>.

<sup>11</sup> Estimates differ by source. These data are taken from CIA, “Iraq,” *World Factbook*, <https://www.cia.gov/the-world-factbook/countries/iraq/>.

<sup>12</sup> *Jobs in Iraq: a primer on job creation in the short-term*, World Bank, June 15, 2018, <http://documents1.worldbank.org/curated/en/255111529495871846/pdf/Jobs-in-Iraq-a-primer-on-job-creation-in-the-short-term.pdf>.

<sup>13</sup> OCHA UNAMI, *Promoting inclusive economic growth and job creation in Iraq*, January 20, 2021, <https://reliefweb.int/report/iraq/promoting-inclusive-economic-growth-and-job-creation-iraq>.

<sup>14</sup> Estimates differ by source. These data are taken from CIA, “Iraq,” *World Factbook*, <https://www.cia.gov/the-world-factbook/countries/iraq/>.

<sup>15</sup> Estimates differ by source. These data are taken from CIA, “Iraq,” *World Factbook*, <https://www.cia.gov/the-world-factbook/countries/iraq/>.

<sup>16</sup> World Bank, *Breaking Out of Fragility, A Country Memorandum for Diversification and Growth in Iraq*, September 30, 2020, 22-2, 41, 46-47, <https://www.worldbank.org/en/country/iraq/publication/breaking-out-of-fragility-a-country-economic-memorandum-for-diversification-and-growth-in-iraq>.

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<sup>18</sup> World Bank, *Breaking Out of Fragility, A Country Memorandum for Diversification and Growth in Iraq*, September 30, 2020, 24, 26, <https://www.worldbank.org/en/country/iraq/publication/breaking-out-of-fragility-a-country-economic-memorandum-for-diversification-and-growth-in-iraq>.

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<sup>20</sup> See the detailed “Economy Profile Iraq,” *Doing Business 2020, Comparing Business Regulation in 190 Economies*, World Bank, 2021, <https://www.doingbusiness.org/en/data/exploreeconomies/iraq>.

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<sup>23</sup> See the detailed “Economy Profile Iraq,” *Doing Business 2020, Comparing Business Regulation in 190 Economies*, World Bank, 2021, <https://www.doingbusiness.org/en/data/exploreeconomies/iraq>.

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<sup>26</sup> *Corruption Perceptions Index 2020*, Transparency International, February 2021, <https://www.transparency.org/en/cpi/2020/index/nzl>.

<sup>27</sup> See “Iraqis take Kadhimis’s anti-corruption pledge with a grain of salt,” *The Arab Weekly*, April 1, 2020, <https://the arabweekly.com/iraqis-take-kadhimis-anti-corruption-pledge-grain-salt>.

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<sup>35</sup> Lead Inspector General for Operation Inherent Resolve, *Quarterly Report to the United States Congress | October 1, 2020 – December 31, 2020*, Department of Defense, February 5, 2021, <https://www.dodig.mil/Reports/Lead->

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