

# Iraq's Post-Government Formation Economic Outlook

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**Abstract:** Iraq is at a historic crossroads after stop-start efforts to reform its economy. Rapidly recovering oil prices have seen the return of Iraq's investment budget and are providing a unique opportunity for the government to rebuild war torn cities and provide services for millions of citizens. The new government therefore faces the challenge of breaking with the past because even if high oil prices last, the economic inefficiency built into Iraq's bloated governance will not sustain the current system.

The next government will be tasked with several vital economic goals: to push back against corruption, rapidly reform the country's investment environment to allow for greater private sector job creation and therefore, allow for deeper cuts to energy and food subsidies, freeing up funding for services.

There will be significant pushback against these reforms. Many vested interests within the Iraqi government are resistant to change. Some may actively resist privatization or anti-corruption initiatives because they stand to benefit from the status quo. At the same time, key strategic goals such as electricity tariff reform and the reform of government ministries, which suffer vastly over-inflated payrolls, will be politically unpopular. The problem now is that unless strategies for reform are energetically pursued, mass waves of popular protest will be inevitable in coming years. This instability will invite foreign meddling in Iraqi affairs, risking even worse problems further down the line.

To counter this, Iraq needs to continue its policy of pragmatically rebuilding relations with regional partners. Iraq must not only avoid becoming entangled in regional conflict, but must play a unifying role in the Arab world as the basis of a future economic union. Beyond the region, Iraq must re-invigorate relations with world powers, leveraging as much support as possible to implement systemic reforms, knowing that the greatest threat to Iraq's stability is not terrorism or civil conflict, but the gross mismanagement that has typified governance in the country since 2003.

### **The Ticking Clock to Fix Services**

After nearly six months of political jockeying following the May 2018 general elections, Iraq's top presidential appointments have now been confirmed, including President Barham Salih, Parliament Speaker Mohammed al-Halbousi and designated Prime Minister Adil Abdul-Mahdi. The new government is due to be sworn in by no later than November 2nd, tasked with formulating national strategies to address Iraq's multiple challenges. The mammoth task ahead will require both rapid response to near term crises, such as water shortages and reconstruction, as well as long term strategic vision.

Iraq's recent summer protests have been more intense than usual this year, centred on Basra but also affecting a number of cities across the South, shaking the foundations of the state. Unlike in previous years, this is not something that will die down as the Iraqi summer inferno passes, when temperatures often pass 50 Celsius.<sup>1</sup> In the long term, the underlying causes of the demonstrations, including a lack of treated water in cities, rapidly rising populations, decreasing water in the Tigris and Euphrates due to the Turkish dam construction and climate change, and the failure of electricity generation to meet the demand, as well as mass unemployment, are not being addressed. This is a long list of challenges a new government will face, even if the self-declared Islamic State (hereafter, Daesh) are largely defeated.

In the South, there has been an alarming level of violence accompanying protests and unlike the storming of Iraq's parliament in April 2016, when protesters peacefully disbursed, Iraq simply cannot afford to lose control of Basra.<sup>2</sup> This is more than government buildings, what

is at stake is the vital organs of Iraq's economy and the petrodollars needed for reconstruction. As the saying goes in Iraq, "the rise of Iraq or the failure of Iraq, is underpinned by Basra."

Nor can the protests be quelled with promises to quickly fix electricity problems or create more jobs. To rational observers, it feels like something has truly broken in Iraq and Iraqi policy makers would be highly ill advised to ignore these warning signs.<sup>3</sup> The same applies to Iraq's friends, be it in the West or in the region. Iraq's allies must understand that without helping Iraq achieve radical change, a grave crisis will come sooner or later. British Ambassador to Iraq Jon Wilks was unusually frank about this point, when he announced on social media that he had spoken with his Iranian counterpart on the need for the incoming government to improve services.

As a result of this, there has been more attention on the problems affecting the South, particularly Basra, once the epicentre of the 1991 uprising against Saddam Hussein.<sup>4</sup> In recent weeks, the city has seen at least 100,000 residents poisoned by brackish tap water contaminated with numerous toxins, in addition to being highly saline.<sup>5</sup>

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With insufficient power, and a range of other problems impacting the energy sector (electricity is also needed for water pumps, sewage treatment and wastewater purification) Basra has experienced hell on earth. Electricity production, which



was under 60% of the summer demand, has suffered blow after blow, with Iran withdrawing 1.5 GW exports<sup>6</sup> due to unpaid bills and worn down infrastructure cancelling out much additional generation. On the Iranian side, Iran rightly claimed that the country experienced its own peak summer demand (in addition to Iraq's unpaid bills).<sup>7</sup> For this reason, supply dropped below 15 GW as demand reached at least 23.5 GW.<sup>8</sup> This was just the beginning of a protest which later exploded as water availability and quality drastically plummeted.

As a result, citizens have turned their rage on various foreign representatives in the city, in addition to the offices of the ruling parties in Baghdad: the Iranian consulate was stormed and burned along with many political party offices.<sup>9</sup> It was quickly clear that the Basrawis were fed up with anyone who has tried to help them, due to years of broken promises, from local leaders to parliamentarians and beyond.

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Even still, the situation is particularly dangerous now, as government formation invites foreign interest in Iraq regarding how the next four years will pan out. If chaos continues, it will only be a matter of time before an external power starts to pick proxy allies, but this is highly complicated. Iraqi politics is now so fragmented that there is no longer talk about sect, or even party but instead parties that are internally fragmented. Iran and the United States (U.S.) have struggled to make sense of this changing landscape.

The Iraqi government, after 15 years, is looking at the last chance to fix Iraq. The data points are highly alarming and will require not only reform, but a radical new mindset for the incoming government. First, the government needs to put aside the recent triumph over Daesh, because the glory of this victory is quickly fading without services. There must be immediate focus on building a modern, civilian administration focused on service delivery and economic diversification. There has been no justification for what we have seen in the past four years, which is Iraqi politicians complaining that services could not be prioritised "because of the war on Daesh."

In reality, there are thousands of engineers trained in electricity grid maintenance and the dynamics of water infrastructure, tens of thousands of bureaucrats in Iraqi ministries and an international community that was willing to lend funds to support Iraq during the war. For many provinces, the war was a financial issue, not a security problem. Not only this, but much of what should have been achieved, particularly in the energy sector, could have been made possible by privatisation reforms and the careful structuring of the Independent Power Producer (IPP) arrangements for new power stations, designed to save Iraq money in both the short and long term.

In most of Iraq's provinces (four out of 14 in Federal Iraq were seriously affected by war) service delivery is irrelevant to the conflict.<sup>10</sup> But the government has continued to blame the war for lack of services, despite the fact that service delivery was failing in Basra before the emergence of Daesh and before the precipitous drop in oil prices. In 2013, Basra was described by United Nations International Children's Emergency Fund



(UNICEF) as one of Iraq's "most deprived" provinces, despite bringing in over 90% of Iraq's oil revenue and bearing the brunt of the accompanying pollution.<sup>11</sup>

An immediate concern is the water supply. The recent visit by a team of engineers from the Marja'iyya to the city, while only a short term attempt at assessing the situation and installing a few new pieces of equipment, is more of a warning to the government that it is losing legitimacy.

In a panic, the outgoing government has made a number of rash promises, including the creation of at least 10,000 new jobs in an area where there have often been protests over the years, at the vital West Qurna oil field.<sup>12</sup> This is extremely dangerous and should be avoided. Any incoming government will have to be clear that there are no quick fixes in Basra, because the underlying infrastructure of clean water and electricity --not treatment and power generation, but the grid and water lines, is in a serious state of disrepair. Secondly, leaking water lines and ageing power lines are being illegally tapped or re-connected.<sup>13</sup>

Another pressing issue is decentralisation. The government was supposed to transfer a wide range of local powers to provinces such as Basra almost a decade ago.<sup>14</sup> Instead, there has been a struggle on the part of Baghdad to hold onto these powers. On the fiscal side, this has meant Baghdad turning back on a promise of \$5 per barrel produced by Basra, later changed to 5% per barrel to account for price volatility.<sup>15</sup>

This would have led to a major injection of funding for projects and would have sent a strong signal to locals that they were now closer to their representatives, whether they succeeded or failed.

Baghdad can rightly blame the drop in oil prices for the failure to hand over these funds, but Basra was also promised customs revenues, which were not transferred, while petrodollar funding was not forthcoming even as oil prices rose.

As Basra was rocked with protests, the government response was unfortunate, blaming the provincial council for failures. In the absence of real decentralisation and functioning federalism, the final blame must go to Baghdad for never giving provinces a chance to govern themselves, however flawed such a process would be at the onset. Now the predictable response from locals has been a rise in secessionism, although it is likely that enduring Iraqi nationalism will hold out.

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What next? Iraqis must come together as quickly as possible for both short term solutions to deal with the emergency, that is welcoming foreign assistance from UNICEF and the U.S., in addition to any other help foreign partners are willing to offer. But Iraqi politicians must be under no illusions. There is no magical solution that will solve these problems without long term reform. When Siemens' proposed a \$15 billion deal to provide 11 General Electric (GE) of power it seemed like a fantastic offer and many Iraqi politicians would have been tremendously excited by this<sup>16</sup> but soon after the German mega deal was proposed, the U.S. persuaded Iraq to quash the Siemens deal in favor of



GE.<sup>17</sup> At the current time, there are now two MOUs between Iraq, Siemens and GE, leaving the final decision to the new government to assess the two roadmaps. Iraq may choose one or even settle on a combination of the two with both companies.

But how will Siemens or GE interface with the public sector? Will gas pricing be reformed to ensure a reliable supply of feedstock to power stations, or will Iraq simply go back to burning more valuable oil and continue flaring 1.6 billion cubic feet of gas per day? Will the grid really be repaired, or will the old problems of corruption return? Will they offer a cost effective approach to upgrade existing power generation from simple cycle to combined cycle to increase efficiency or will they try to sell more turbines to Iraq? Will they handle the rehabilitation of transmission, distribution and management of the smart grid and collections? All these questions are management and strategy related, and they need to be answered.

For now, rising oil prices and an impressive 4.68 million barrels a day in total production are providing Iraq with much needed financial relief to fight these challenges.<sup>18</sup> But Iraq has had fantastic budgets in the past, topping \$94 billion in 2012 and actually returning to a similar level if current prices continue.

Deep reform is needed and Iraq's leaders are wrong if they think they can throw money at these problems. They may find that when the power is out, it's not the lightbulb that needs replacing, but the entire house that needs fixing, which is rotting to its foundations. If they ignore that, it will only be a matter of time before it all comes crashing down.

### **The National Picture**

Beyond the crisis in the south, the Iraqi government is directing its efforts to rebuilding the vast war ravaged areas. International and regional donors are part of these efforts as part of the Kuwait conference held in February 2018.

International media has focused on this apparently slow effort, but oil prices only recovered to allow for any significant Iraqi input by the beginning of 2018, barely passing \$65 a barrel.<sup>19</sup> Factoring in Iraqi discounts to oil prices in order to compete for market share, this has meant that Iraq's budget was just covering salaries, speaking of the fundamental challenges of resource revenue dependence in the country. With oil prices now in the \$80 range, Iraq has a historic opportunity to fix problems, but this may be the last chance as the future of the oil market is increasingly uncertain.

Secondly, international assistance, while vital, has been slow in coming. As late as August 2018, the U.N. Humanitarian Response Plan for Mosul was only at 61% of its funding target.<sup>20</sup> Much of the Western part of the city is still in ruins and reconstruction agencies talk of billions of dollars that will be needed to complete the task.<sup>21</sup> In the war affected provinces, an estimated \$7 billion will be needed just to rebuild the energy infrastructure,<sup>22</sup> although there has been some progress at the once destroyed Baiji oil refinery, which also has a power station within the complex and is now producing at almost a quarter of its former 300,000 bpd capacity.<sup>23</sup> These small victories will help all of Northern Iraq and by extension, take pressure off Baghdad, which is connected to the grid in the north and south.<sup>24</sup> All across the war affected provinces however, the reconstruction of hospitals, service infrastructure and schools still





require reconstruction funds, despite some progress.<sup>25</sup> Similarly, the sprawling city of Basra and many rural communities across the South remain underserved in the health sector. Basra for example, has only four hospitals to serve a city of over 2 million people.<sup>26</sup>

***How will the economic and developmental priorities of an upcoming government be shaped both in the context of post-ISIS reconstruction and the Southern unrest? In theory, if oil prices remain the same and the incoming government can keep salary expenditures down, the expected budget surplus of up to \$20 billion***

Even considering these pressing needs, increasing polarisation over the formulation of the upcoming government might have an impact on reconstruction efforts, with protests in the South, especially Basra, potentially pushing the upcoming government to re-allocate additional funds to develop these areas.

How will the economic and developmental priorities of an upcoming government be shaped both in the context of post-ISIS reconstruction and the Southern unrest? In theory, if oil prices remain the same and the incoming government can keep salary expenditures down, the expected budget surplus of up to \$20 billion<sup>27</sup> should allow for significant projects in both Mosul and Baghdad. Assuming Iraq is able to spend as much as an additional \$1 billion per month on investments through 2019, this would provide enough funding to rebuild electricity infrastructure affected by war, leaving \$5 billion for other reconstruction which would go a significant way, with foreign support, to restoring the infrastructure in Basra. These are conservative figures, because the chance of even higher oil prices could mean there is significantly

more than \$1 billion per month available for investment. But importantly, the government has historically had limited capacity to spend on infrastructure projects.

Therefore, this positive picture comes with a catch, which is the impact of corruption on this process. It is often said that corruption adds 10% to the cost of a typical project in most countries and as much as 25% of procurement costs.<sup>28</sup> Considering the cost of subcontracting in Iraq, which is linked to the widespread practice of political hiring and nepotism, this cost can be substantially higher, not only due to bribery and kickbacks, but additional inefficiency.<sup>29</sup> In the worst cases, according to Transparency International, corruption in the handling of contracts can add as much as 50% to the cost of service delivery.<sup>30</sup>

Mismanagement, linked to the above practices, can do even more damage. Mismanagement in Iraq often takes the form of extremely poor coordination between government ministries and provincial government, a lack of clear lines of responsibility and arguments over who has the power to hire workers and sign contracts, while even provincial governments face political divisions. This has led to a very obscure picture in parliament of Basra's water crisis, with PM Abadi blaming the provincial government in Basra, the provincial government blaming Baghdad and the Ministry of Planning blaming the Ministry of Water Resources. In the worst case scenarios, this can lead to the abandonment of projects, but also losses of up to 50% of project costs are possible.

A further problem is the business environment, which is still burdened by cumbersome bureaucracy despite



a number of reforms in recent years, shortening procedures to apply for various permits for example and implementing a limited “One stop shop” facility. This means that the long term sustainability of key projects, in particular power stations as IPP projects, will be in doubt unless there is reform in this area. The same applies to refineries, and failed attempts to attract investment in this vital downstream sector. Without further fuel subsidy reforms and attractive terms to build these structures, Iraq will face a bill of billions to build refineries by itself, in addition to spending large sums on imported fuel.

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If not, the government will end up paying an increasingly large bill for services that it can no longer afford, in the event of the next oil price drop. In fact, Iraq's recent past makes clear that even high oil prices will likely not be enough to avert another crisis.

Iraq is increasingly aware of these problems, but it is a race against time to implement real reform. The outgoing government has tasked the anti-corruption body, the Integrity Commission, to investigate hold ups with critical projects in Basra, in particular water treatment work.<sup>31</sup>

### **The way forward**

A particularly pressing effort, and one which has been discussed for some years, would involve the establishment of a

Sovereign Wealth Fund (SWF) for Iraq, given the irresponsibility of successive governments with oil revenue windfalls, and considering rising production and prices in Iraq. This also speaks to the need to keep state spending on salaries and political projects to a minimum, if not completely eliminating the latter and progressively diminishing the role of the state to only providing basic services (health, education, water, electricity) and a lean but powerful armed force capable of defending Iraq.

To protect these rising revenues from squander, such an SWF would ringfence future oil revenues to a fiscal breakeven price in the \$50 range, which should become incorporated into a new budget law, enshrining fiscal discipline. Surplus revenues beyond this (aside from debt repayments) should be split between a reconstruction and development bank. This would be different from the Development Board of the 1950s, which oversaw major investments in the health, water and agricultural sectors. Rather, such a fund would cover all key sectors with the aim of making Iraq internationally competitive.

The rest of the funds would go to an SWF, stabilising the Iraqi economy from the roller coaster turmoil of oil markets. In future, if Iraq achieves some of the more optimistic production scenarios, in the region of 6-7 million barrels per day for instance, additional revenues from these gains--anything above 5 million bpd, must be invested in mega projects, adding value to Iraq's cities, especially Basra, which will remain the most strategic city in Iraq for years to come. These mega projects can take the form of business clusters, large industrial cities to support the growing Asian economies, whose growth rates will eventually outstrip their own capacity to produce goods.



Finally, Iraq must fast-track associated gas processing from current fields and future production, which will give the country a regional industrial edge over some of Iraq's energy poor neighbours, boosting linked industries such as petrochemicals, fertiliser and cement, the latter of which will be in high demand.

***The new government of 2018-2022 will need to deal with all the above and beyond, but most importantly, will need to manage the expectations of the people by presenting a realistic program with measurable targets, and manage it with full responsibility and accountability***

In the short term, as Iraq restores trade with Jordan at the Trebil crossing, it must also seek to balance trade relations with all neighbors, working with Turkey on a potential water-hydroelectricity-oil strategic agreement and seeking exemptions from U.S. sanctions against Iran. This must remain the case, at least for the three years Iraq will be importing Iranian gas, until flared gas is fully monetised and ready to supply the grid, in association with the power roadmaps from Siemens and GE, and reforms to provide sustainable feedstock for power.

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