In Best of Times and Worst of Times: Addressing Structural Weaknesses of the Kurdistan Region's Economy

January 2016

MERI
Middle East
Research Institute

Erbil - Kurdistan Region - Iraq
www.meri-k.org | info@meri-k.org | +964(0)662649690

Registered at KRG – Directorate General for NGOs on 02/07/2013 – No. K843

In Best of Times and Worst of Times:
Addressing Structural Weaknesses of the Kurdistan Region's Economy

ACKNOWLEDGEMENTS

MERI would like to thank key stakeholders in the Kurdistan Region of Iraq who participated in interviews and shared their insights as part of the research for this publication. They include representatives from Kurdistan's Parliament, KRG's Economic Council, commerce institutions, financial sector, investment funds, local business groups and private stakeholders.

This MERI report was prepared by Roger Guiu, with fieldwork contribution by Athanasios Manis and Shivan Fazil.

ABOUT MERI

The Middle East Research Institute (MERI) engages in policy issues contributing to the process of nation building and democratisation in the Middle East. Through independent analysis and policy debates, our research aims to promote and develop good governance, human rights, rule of law and social and economic prosperity in the region.

MERI was established in 2014 as an independent not-for-profit organisation based in Erbil, Kurdistan Region of Iraq. For more information, visit www.meri-k.org.

CONTENTS

EXECUTIVE SUMMARY

Kurdistan's current economic situation is a tale of three crises in confluence, embedded within the political dynamics of Iraq and the Kurdistan Region. The ensuing economic downturn has resulted from a fiscal crisis, ongoing war in Iraq, and political in-fighting. The Kurdistan Regional Government's (KRG) response to this downturn has focused on its symptoms rather than any underlying weaknesses within Kurdistan's extant economic system as a whole. In an effort to better understand the interplay between the current symptoms of the overall crisis in Kurdistan and structural issues within the economic system, the Middle East Research Institute (MERI) conducted key stakeholder interviews and secondary source data analysis to propose possible ways forward that will allow Kurdistan's economy not only to survive but flourish, in best and worst of times.

The impacts of Kurdistan's budgetary, security and political shocks are evident through a number of symptoms within its economy. These are visible in the form of fiscal constraints in the public sector; shrinking of an already weak private sector; operational constraints in the banking sector, and risk of collapse in the provision of public services.

The current crisis context offers an opportunity for policymakers to explain that these symptoms, which the general public is experiencing firsthand, are part of embedded weaknesses in the economy in order to better obtain support for addressing them in real and meaningful ways. This is important because the ultimate origin of said symptoms goes beyond disputes with Baghdad, internal political blockage, or the war in Iraq, and are rather byproducts of the development path chosen for Kurdistan itself, one that shares many characteristics with other countries whose growth is based on oil resources and revenues. The areas where weaknesses persist include:

1. Unhealthy public sector finances
2. Underdeveloped non-oil private sector
3. Dysfunctional banking sector
4. Non-resilient public services provision

Differentiating between symptoms and structural weaknesses allows us to counter-argue the deep-seated belief that solving the KRG's budget issues —and returning to a business-as-usual model— will recover the economy. On the contrary, it is only by implementing a genuine reform agenda that the budget austerity will become bearable and more importantly, economic opportunities will rise again, in a sustainable and more predictable way. The way forward out of crises and into a more resilient economic system entails the following reform objectives (see details in Table 1):

- **Improving the functioning of the State and its budget:** in order to have a more balanced and manageable budget, the main components of urgent fiscal reforms should be to put public expenses, especially government payroll, under tighter control and initiate public revenue diversification in conjunction with a rationalisation of the public administration.
- **Reinforcing initiatives and policies on private sector development:** to build on the existing light manufacturing and services sectors, reforms should focus on turning the State away from its current role as a regulatory agent and toward becoming a support platform for the free development of businesses, removing barriers and enhancing their technical capacity.
- **Transforming Kurdistan's institutional landscape linked to the economy:** institutions, laws and public initiatives have a strong impact on the economic opportunities within Kurdistan and there is scope for reform with respect to: the Investment Law, the public procurement framework, institutional transparency and accountability, management of oil funds, and know-how transfer from international companies and joint ventures to local enterprises.

Table 1. Summary of the key recommendations of the report

IMPROVING THE FUNCTIONING OF THE STATE AND ITS BUDGET
• Austerity measures to limit expenses in the public payroll are urgently needed to achieve a sustainable and balanced budget. • Improve incentives to work for the private sector, reducing the number of redundant civil servants. • Initiate fiscal reforms to diversify public revenues; an introduction of small taxes in this regard should be a first step. • Improve public administration efficiency and save resources through a system of employment categorisation and performance review as well as a rationalisation of administrative costs and revamp the management of state-owned enterprises. • Adopt consistent steps to reduce corruption with respect to public payroll and public revenues. • Initiate substantial reform on petrol and electricity subsidies, which take around4% of the annual budget.
REINFORCING INITIATIVES AND POLICIES ON PRIVATE SECTOR DEVELOPMENT
• Need to find political consensus to implement new laws that reinforce a freer business environment. • Maintain an allocation of funds to encourage new businesses in Kurdistan, particularly small and medium enterprises (SMEs). • Create a platform to promote and support SMEs into regional markets. • Encourage the participation of microfinance mechanisms as an alternative to a dysfunctional banking sector while putting in place the conditions necessary for banks to gradually better serve business community needs.

- Avoid relying on solely protectionist measures, such as bans or tariffs on imports, to support local producers as this only harms the population and reduces incentives for improvement.
- Facilitate better participation of the private sector in the provision of public services (health, education, water and electricity supply).

TRANSFORMING KURDISTAN'S INSTITUTIONAL LANDSCAPE LINKED TO THE ECONOMY

- Reforms on the Investment Law, the most visible milestone of Kurdistan's economic legislation, should be oriented to improve the quality of investments.
- Kurdistan's Parliament should take seriously and implement the Commission for Integrity's proposals and recommendations to strengthen its impact on tackling corruption.
- Promote better management of Kurdistan's oil revenues by reconfiguring the Oil and Gas Fund to mirror similar mechanisms used in Gulf countries rather than that used in Iraq.
- Re-launch plans for a deep overhaul of KRG's public procurement framework in order to improve contractors' quality and capacity and reduce the misallocation of resources.
- Integrate and embed know-how transfer mechanisms in Kurdistan's institutional structures for the benefit of local businesses.
- Kurdistan's policymakers in the Federal Parliament should push for an overhaul of Iraq's revenue-sharing policy with focus on creating a decentralised system.

1. INTRODUCTION

This is a tale of three crises. The economic boom the Kurdistan Region of Iraq has enjoyed for the past six years came to a rather abrupt end in early 2014 with the onset of a severe economic downturn, revealing how vulnerable this economy is to external shocks. The economic growth rate decreased from 8% to 3%, trade and investment flows dropped around 30%[1], and youth unemployment drastically rose from 7% in 2013 to 16% by end of the 2014[2]. Underemployment is pervasive and migration trends have sharply increased, with 71% of the people stating that they would migrate if they had the means[3]. This downturn is the result of three simultaneous crises, embedded within the political dynamics of Iraq and the Kurdistan Region:

The economic boom the Kurdistan Region of Iraq has enjoyed for the past six years came to a rather abrupt end in early 2014, revealing how vulnerable this economy is to external shocks.

- A **fiscal crisis**, leaving the Kurdistan Regional Government (KRG) unable to fund its own budget because the Iraqi Federal Government in Baghdad suspended the transfer of Kurdistan's share of the federal budget —due to both political blockage and liquidity constraints in Baghdad, as oil revenues have dropped by near 65% and public expenses have skyrocketed as compared to previous years.

- An **economic paralysis** in Kurdistan due to the internal conflict in Iraq, which has raised insecurity, displaced thousands of families who are now in need of assistance, affected trade routes and decreased investor confidence. These impacts are largely exacerbated by the fiscal crisis, as the KRG and public services are unable to cope with the increasing needs of the rising population and larger military expenses.

- A **political rivalry** within the national unity government in Kurdistan deeply dividing the Council of Ministers and leaving no formal opposition in the legislature to balance executive

1 - World Bank (2015). Kurdistan Region of Iraq: Economic and social impact assessment of the Syrian conflict and ISIS crisis.

2 - Kurdistan Region Statistical Office (2015). Indicators on labour market.

3 - Reform Institute for Development (2015). Assessment on youth migration in the Kurdistan Region of Iraq.

power. Continuing disputes and lack of transparency between the governing parties has undermined the ability of the KRG to formulate and pass new policy initiatives.

At the onset of these crises, the KRG took a defensive stance regarding the economy, with no particular reform strategy implemented other than keeping public expenses at minimum by suspending the regular servicing of contracts and salaries, and piling up public debt from local banks and local businesses to cover costs. The extreme budget austerity has not been followed by attempts to address the underlying vulnerability of the economy, and in this sense, Kurdistan is paying no heed to the old adage, "never let a crisis go to waste". Potential reforms and promising policy actions, such as local capacity building programs for the oil sector or borrowing money from international capital markets, have been either blocked due to the political impasse or postponed for better times given the inability to mobilise necessary resources.

The absence of a structural bail-out program complementing the harsh austerity measures in place seems to indicate that policymakers and legislators perceive the crisis as a setback that will vanish automatically once there is enough oil production capacity in place in Kurdistan, as this will bring in the revenue needed to, theoretically, return the region to its previous status quo. Claims that the budget crisis will be solved relatively soon are based on achieving oil production targets that will offset the missing budget transfers from Baghdad. However, given the current budgetary shortfall this approach seems self-defeating since the government has failed to allocate payment to the oil companies operating in Kurdistan, putting some of them in a dangerous financial situation and, more critically, making most of them halt both the flow of investment and plans to scale up operations in the region. This is particularly problematic now as there are no other sources of public revenue aside from oil production in Kurdistan.

With this mindset, Kurdistan's business-as-usual scenario, based on a boom from oil revenues, did not lead to a consolidated economic system and was rather weak in terms of future prospects. On this point, it is important to distinguish, as one private stakeholder noted, between business optimism and business confidence. The boom period brought optimism to this region, but not much confidence. International companies started sending in observers and hiring office space to understand the region's evolution, but most never moved beyond their 'observer' status and decided against real business engagement, pointing to internal politics and lack of transparency within the KRG as detrimental factors. Although internal stability is a key asset, it is not enough to compete in the global economy with other more business-friendly frontier markets to attract productive investment.

Making the current budget austerity bearable, feasible and effective will depend on the government's ability to communicate that this is not only about cutting salaries but also about putting forward an altogether wider program of reforms.

In this context, making the current budget austerity bearable, feasible and effective will depend on the government's ability to communicate that this is not only about cutting salaries and services but also about putting forward an altogether wider program of reforms to strengthen the economic system. In other words, KRG must demonstrate that the burden of adjustments is shared and fair at all levels of society and that their efforts serve the greater good in the long-term. This is important given how wide spread the effects of the crisis are across Kurdistan's social fabric, increasing levels of distrust between people and the government. Taking this approach ensures greater public acceptance of government efforts while avoiding further stresses on social cohesion. The program of reforms then must entail rethinking Kurdistan's development path, not only addressing the visible impacts of the crisis —that is, the symptoms of the crisis. These symptoms are embedded in structural weaknesses of the economy that the boom period reinforced rather than resolved. These range from the dependency on a single commodity and the absence of a sound private sector to the unsustainable fiscal functioning of the state apparatus. The

problem is therefore not limited solely to the government lacking funds. The economy will always remain vulnerable to internal and external shocks, regardless of revenue, if underlying factors are not addressed.

In an effort to better understand these structural issues and propose possible ways forward that will allow Kurdistan's economy not only to survive but flourish, in best and worst of times, the Middle East Research Institute (MERI) conducted interviews with key stakeholders from Kurdistan's Parliament, KRG's Economic Council, business institutions, financial sector, investment funds, local business groups and private stakeholders. We conducted further analysis using data provided by stakeholders as well as most recently available household surveys tracking socioeconomic indicators.

This report then puts forward a set of proposals on priority reforms for the Kurdistan Region to strengthen its economic structures. After evaluating the effects of the fiscal crisis, Iraq's conflict and the political impasse on the economy (Section 2), we identify the key root causes in the economic system that makes Kurdistan vulnerable (Section 3). Finally, we propose a set of policy options and recommendations that can form the base for Kurdistan's economic reforms path (Section 4). Given our analysis, the report places priority on aspects aiming to reform the public administration and balance the budget, but there is specific emphasis on private sector development, as any long-term economic recovery must certainly entail a measure of diversification.

The report places priority on aspects aiming to reform the public administration and balance the budget, but there is specific emphasis on private sector development

2. SYMPTOMS OF THE OVERALL CRISIS

The impacts of Kurdistan's budgetary, security and political shocks are evident within its economy and to the stakeholders interviewed for this report. The range of symptoms they observed can be grouped into the following specific categories:

1. Fiscal constraints in the public sector
2. Shrinking of an already weak private sector
3. Operational constraints in the banking sector
4. Risk of collapse in the provision of public services

Below, we analyse each in turn to understand the magnitude of these symptoms and how they interrelate, with the aim of being able to propose immediate, corrective actions to resolve the most pressing issues. It is important to note however that there is a larger narrative beyond these symptoms, which relates to embedded weaknesses in the economy —the aim of next section. These weaknesses should be the ultimate target of deeper structural reforms.

Differentiating between symptoms and structural weaknesses will allow us to better target the ultimate solutions that can put Kurdistan on a path to sustainable growth and counter-argue the deep-seated belief that solving the KRG's budget issues —and returning to a business-as-usual model— will recover the economy. On the contrary, an approach on addressing only the symptoms now leaves room for them to appear again in the future. The current crisis context offers an opportunity for policymakers to explain that these symptoms, which the general public is experiencing firsthand, are part of embedded weaknesses in the economy in order to better obtain support for addressing them in real and meaningful ways.

Fiscal constraints in the public sector

The starting point for an economy such as Kurdistan's is to analyse how the public sector has been coping in the wake of recent shocks. The economy is highly centralised around government spending, from business sustainability to household income and consumption. Hence, when Baghdad only transferred funds to finance the 15% of KRG's budget in 2014 and 33% in 2015, additional revenue sources needed to be obtained to keep the economy afloat and expenses could only be paid as financial resources became available. The following constraints are particularly illustrative:

- **Delays on payment of salaries and contractors**.
  Public employees have not received regular and timely payment of their salaries for 2014 and 2015 and the payment of pensions and allowances have also slowed. Up to this point, at least four months of salaries are being due for 2015. This is particularly problematic as 60% of the employed population of Kurdistan works for the State and virtually every household has a member on the public payroll[4]. In addition, the government has either stopped paying contractors and suppliers altogether or taken to freezing their installments in bank accounts. By the end of 2014, the World Bank estimated that the government owed $12.5 billion to contractors, which is equal to nearly the whole of the KRG's 2013 budget[5]. As a result, many families and businesses have no money coming in, which has sparked public protest, including worker strikes. In response, the KRG has given priority to paying back public salaries in arrears, with only some debt repaid to contractors.

Delays on payment of salaries are is particularly problematic as 60% of the employed population of Kurdistan works for the State and virtually every household has a member on the public payroll.

- **Sharp reduction in other public expenses and investments**.
  The government has been forced to drastically reduce the operating expenses (excluding salaries and pensions) of its ministries. This has particularly impacted the provision of public services;

4 - KRSO (2015).

5 - Recently, KRG's prime minister issued a decree allowing all contractors to cancel their contracts with the government. This way, the KRG hopes to save at least 6.2 trillion IQD currently outstanding as future obligations to contractors.

expenditure in this regard was 43% less in 2015 than in 2013. In addition, capital expenses and investments, previously totalling around 30% of the entire budget, now corresponds to only 7% of it[6]. Overall, key programmes for the support and development of the private sector, such as seed capital provision, have been stalled with no future plans to allocate funds to them, as the Parliament is limited in its ability to pass bills that incur public expenses.

- **No budget law.**
  The KRG was unable to pass and approve a budget law for 2015 because of the lack of a stable source of funding. This issue led to a deep dispute between political parties and further blocked public access to information on government spending in 2015.

The KRG has had to rely on risky practices, such as obtaining funds from international oil companies and seeking from an already weak local financial and business community.

- **Damaging public borrowing.**
  The government also needed to obtain additional emergency funds to continue to operate and turned to independent oils sales from Kurdistan's operational oil fields as the main source of this revenue. Although internal oil production has increased, the still-low production levels coupled with pressure from Baghdad on the international markets not to accept Kurdish oil exports make this an unsustainable approach for income generation. In addition, the KRG has had to rely on risky practices, such as obtaining funds from international oil companies in exchange for future oil sales and seeking loans from an already weak local financial and business community. Even more dangerous due to the wider negative effects on the economy and people's trust is the fact that deposits at banks have been seized by the government during this crisis —up to $3 billion according to Parliamentarian and business sources. All in all, this has crowded out capital available to invest in the economy. Information on the amount and source of public debt incurred is completely opaque, corresponding to the murky circumstances in which the government has to move in to secure funds.

6 - KRG Council of Ministers (2015). Kurdistan Region economic factsheet. Unpublished report.

- **Difficulties in accessing international capital markets.**
  Finally, in an effort to secure funds through more standard means, the KRG sought to raise funds in the international capital markets in mid-2015. This would have provided resources to boost internal oil production by paying oil operators, but after rallying the main trading floors, hopes of the KRG obtaining a loan of $5 billion —at 12% interest rate, which is comparatively high— promptly disappeared given internal disagreements. There was strong opposition from Parliament to such action. Several political parties voted against it and even boycotted the legal process, fearing it would fuel corruption. The subsequent presidential dispute during the month of August dealt the final deathblow to this prospect for funding as it ultimately damaged the confidence investors had in lending money to the KRG.

Shrinking of an already weak private sector

The initial shock to public sector spending immediately rippled through the rest of the economy, since virtually every significant activity in the productive economy, including within the oil sector, is dependent —directly or indirectly— on the State. Key variables such as consumption, employment, poverty rates, production levels and business profitability quickly and drastically worsened, as detailed below:

- **Drop in investments flows.**
  Investor and business community optimism regarding Kurdistan's business environment sharply decreased since the onset of the crisis, following a deterioration that started in 2013. This current perception is directly attributable to political issues and a rise in insecurity. According to recent World Bank estimates, investment flows have decreased by one-third as compared to the

Information for 2015 points to a total investment amount that is 10% of what was in 2013, and projects approved in 2013 and 2014 are unlikely to go ahead under current conditions.

average over the last five years. Information for 2015 points to a total investment amount that is 10% of what was in 2013, with an additional caveat that investment projects approved in 2013 and 2014 are unlikely to go ahead under current conditions[7].

- **Burst of the real estate bubble.**
  The real estate sector presents the most visible impacts of the current overall crisis. Construction used to attract the bulk of investment but the sector is saturated and there is currently not enough demand for the assets built, with a clear excess of office space left empty. Some investors are financially unable or unwilling to complete residential developments, leaving those individuals who bought such properties with illiquid and now depreciated assets. Figures also point to a fall in residential property prices from between 30% and 50% with real estate transactions down by 80%[8]. Given such a rapid and drastic depression in this sector, recovery will be slow as investment is not likely to take off again in the immediate-term.

- **Impact on contractors sector, main private employer.**
  Because of the KRG's inability to pay its private contractors, this sector has been hit hard, with an increase in both small companies filing for bankruptcy and black market business licenses and promissory notes. The contractors' union estimates that in Sulaimaniya alone, one-third of local contractors stopped their operations and more than 60% of employees have been laid off —note that near 29% of the workers employed in the private sector across Kurdistan were working in construction[9]. In addition, a large number of foreign contractors, especially Turkish, have allegedly abandoned operations in Kurdistan, as reported by an official within the Turkish consulate in Erbil. The bulk of the effects of this subsequently extend to industrial activities centred in supplying inputs to the internal construction sector, such as cement and steel, which compose the largest part of the non-oil industry in Kurdistan. With the stoppage of most construction works, such industrial activity has significantly decreased given

7 - AUIS Institute of Regional and International Studies (2015). Kurdistan's great recession: from boom to bust in the rentier economy.

8 - Idem.

9 - World Bank & CSRO (2012) Iraq socio-economic household survey.

lack of internal demand and inability to compete in the foreign export market.

- **Investment and operational delays in the oil sector.**
  This sector has also felt the hit of the overall crisis through a combination of security risks and negative business prospects. Due to insecurity caused by ongoing conflict in Iraq, many companies have not brought back all their staff to Kurdistan for work after they were evacuated due to ISIS advance. In parallel, trust levels between the oil companies and the KRG is reported to be at an all-time low due to the KRG's inability to remunerate expenses. The government's recent decision to allocate a portion of revenue from its direct crude oil sales to producing oil companies on a monthly basis is a good first step in correcting this but alone is not enough to reverse oil companies' deteriorating confidence in the Kurdistan market. While some companies are at risk of serious financial trouble, the bigger concern is that, without payment, companies will not proceed with new investments — and without investment, oil production capacity will not increase and no additional revenue will be generated to pay the companies back, and so the vicious cycle continues. The target of 750,000 barrels per day of production to be reached in 2016 seems not feasible under such conditions. Sources close to the sector argue that big oil companies will simply leave Kurdistan if they feel they cannot continue operations in an adequate and safe way.

The bigger concern is that oil companies will not proceed with new investments —and oil production capacity will not increase and no additional revenue will be generated

- **Job destruction in the private sector.**
  Unemployment has risen in part as a consequence of the above, given the destruction of the job market and in part because of an influx of displaced families into the region that fled the conflict in Iraq. The unemployment rate stood at around 8% in November 2014, but it was 16% for youth between the ages of 14 and 28, according to official estimates by the KRSO. An alternative way

to look at the unemployment issue is by excluding the public workforce: the proportion of unemployed people corresponds to 19% of the workers employed in the private sector. This ratio illustrates the high level of competition for scarce employment opportunities outside of the government. Neither the formal nor informal private sector has the capacity to absorb an increasing workforce, sharply driving down wages. Lack of employment opportunities is expected to be a recurrent topic in the future, especially for the youth, as 50% of the society is composed by individuals aged 20 or younger.

Kurdistan is experiencing a gradual destruction of the middle class as the impact is harder on the central quintiles of the population.

• **Disappearance of the middle class and raising indebtedness.**
Due to the inability to pay public salaries and the consequent loss of dynamism and jobs in the private sector, the final and most noticeable impact of the overall crisis is on Kurdistan's households. As Table 2 illustrates, Kurdistan is experiencing a slowdown in households' consumption[10] and, in particular, a gradual destruction of the middle class as the impact is harder on the central quintiles of the population. In many cases, households have compensated for the loss of regular income with debts and borrowing, usually from relatives and neighbours, creating a new problem in the medium-term as savings are quickly depleting. Available data shows that nearly one-third of families have incurred new debts in the last year[11]. As a whole, lower consumption and higher indebtedness by households also impacts the fabric of the local business sector, whose sales inevitably decrease —starting a vicious cycle of lack of investment, unemployment and social tensions.

Operational constraints in the banking sector

The use of the banking system in Kurdistan has never been widespread among households, but plays a crucial role for the payment of public

10 - Domestic expenses and consumption levels are frequently used as a proxy for a household's well-being dynamics.

11 - REACH Initiative (2015). Multi-cluster needs assessment for the host community of the Kurdistan Region of Iraq; surveys carried out in January and April 2015.

Table 2. Evolution of household total monthly expenditure (on average) in Kurdistan during the crisis

Population segment	January 2015	April 2015	% Variation
Poorest quintile	$208	$215	3.3%
2nd quintile	$420	$380	-9.5%
3rd quintile	$561	$497	-11.4%
4th quintile	$757	$647	-14.4%
Richest quintile	$1,371	$1,367	-0.3%

Source: REACH Initiative (2015).

salaries, pensions and allowances and for importers and contractors. Banks operating in Kurdistan have been indirectly affected by the overall crisis as follows:

- **Lower repayment to banks.**
  The banking sector continues to be adversely affected by the sharp reduction in revenues of businesses in Kurdistan, either by reduction of sales or lack of contract payments. Companies with liquidity constraints are unable to operate with banks or pay back interests or debt maturities, damaging the robustness of the banks' financial positions. These issues also carry with them dangerous spill-over effects abroad. For example, in early 2015, stakeholders consulted pointed that there was a patent danger that Turkish banks would cease the provision of credit to Turkish contractors operating in Kurdistan given the high financial risk of working for the KRG.

- **Scarcity of currencies.**
  In face of the financial restrictions also faced by the federal government in Baghdad the Central Bank of Iraq has been

imposing additional severe limitations over the access to dollars and other foreign currencies through its currency auctions. The decrease in oil prices implied that fewer dollars were entering Iraq, not enough to cover all needs. Therefore, banks operating in Iraq have had to further limit credit to businesses even more than before.

- **More core capital in banks.**
  Some banks in Kurdistan, mainly foreign ones, have been obligated to increase their capital requirements. This may strengthen their financial robustness in face of the crisis, but means the parent companies need to further invest in the Kurdish branches to continue operating in an increasingly risky context.

Risk of collapse in public services provision

The influx of displaced families in Kurdistan coupled with the lack of available funds to cover government operational costs is straining public service provision to households. The situation is particularly precarious for many displaced households who are unable to use public services because of legal obstacles to access them, inability to afford them, or lack of capacity within the services themselves. There have been many calls to address the most visible impacts on the provision of public services, especially in the following areas:

- **Public services not coping with needs.**
  The World Bank estimates that the overall stabilisation needs to adjust provision of services to meet the new demand in 2015 was around $1.4 billion, mainly in the areas of health, food security, social safety nets and education. The most affected public services have been health, in which there is a patent lack of available medicines (most imported from elsewhere), and education, as quality is undermined given class overcrowding and a reliance on multiple class turns.

- **Public utilities supply disrupted. Public infrastructure, including water supply, solid waste management, and electricity, is also under increasing stress.**
  Demand for these services is rising and investments for supply improvements are currently not possible due to the KRG's fiscal constraints. The most severe case is electricity supply. Because its provision is heavily subsidised, a sharp rise in consumption as a result of displacement means that the government does not have enough funds to keep paying producers. Adding to this vulnerability is the fact that the fuel needed to run Kurdish power plants is mostly imported and security threats have limited its availability. As such, the national grid can only meet only 35% of electricity needs[12]. Forced to provide a quick response, the Ministry of Electricity has resorted to policies that may increase the availability of electricity for citizens but come at the expense of economic activity in the manufacturing sector (e.g., the decision to cut power supply to cement and iron factories).

12 - KRG Joint Coordination and Crisis Centre (2016). January information brief.

3. STRUCTURAL WEAKNESSES OF KURDISTAN'S ECONOMY

Although it is important that policymakers are aware of and address the symptoms outlined above, it is even more necessary to understand *why* they appear. The ultimate origin of these symptoms do not stem from the political dispute with Baghdad, internal political blockage, or the war in Iraq alone, but deeper structural weaknesses in Kurdistan's economy. These weaknesses are more often than not the product of the development path chosen for Kurdistan, one that shares many characteristics with other countries whose growth is based on oil resources and revenues, including Iraq. As such, and because Kurdistan is part of Iraq as a whole, many of its policy initiatives mirror Baghdad's political economy.

Although it is important that policymakers are aware of and address the symptoms outlined above, it is even more necessary to understand why they appear.

It is only by extending reforms beyond symptoms to address structural weaknesses as well that Kurdistan will become more resistant to future shocks and crises that will undoubtedly and periodically arise. As before, the discussion here is based on four economic areas where weaknesses persist:

1. Unhealthy public sector finances
2. Underdeveloped non-oil private sector
3. Dysfunctional banking sector
4. Non-resilient public services provision

Unhealthy public sector finances

- **The ultimate origin of about 90% of the KRG's revenues is oil resources, including funds transferred from Baghdad.** Therefore, the ability to run the State does not depend on a good performance of the local economy at all levels or on the capability of the policymakers to govern in the best interests

of the populace, but on high oil prices and good relations with Baghdad. With respect to the former, no structures are in place to ensure them and, with the latter, issues with both Baghdad and the oil market emerge frequently. Effective strategies to diversify public revenues have been absent both in the Kurdistan Region and in Iraq as a whole —pre-crisis tax revenues for the KRG (not including trade fees at the borders) are just $130 million, or near 1% of their total budget.

- **The Oil and Gas Fund, developed with part of the revenue from independent oil sales, has failed to become a financial buffer against periods of crisis.**
  The KRG's management of oil revenues has not been transparent and as a result, have not been properly regulated nor adequately used. Successive governments in Erbil have traditionally believed the best way to build up the region was to immediately use any oil revenue generated for the budget, instead of setting it aside in a development fund. As such, only a small fund in Kurdistan could be maintained from this approach, but it is extremely weak as compared to development funds elsewhere in oil producing countries that use their respective funds as a financial reserve to counterbalance expected decreases in state revenues and avoid austerity measures. The KRG does not have this option.

The annual increase of government revenues in Kurdistan has averaged 20% in the last five years, while expenditure increased an average of 26% over this period.

- **State-building and development have been based on an ever-expanding and inflated public budget, rooted in clientelist behaviour.**
  The World Bank estimates that the annual increase of government revenues in Kurdistan has averaged 20% in the last five years, while expenditure increased an average of 26% over this period. Most of the additional revenue generated was allocated to operating expenses in the budget, especially salaries, not to investment. The large increase in salary expenses also has its roots in other

structural issues including the absence of actual job descriptions for ministerial human resources needs, a salary calculation system based on additional allowances completely detached from productivity[13], the presence of ghost employees, and a pervasive clientelist system that generates and rewards political loyalty with public employment or safety nets (see Table 3). These practices have been denounced by a number of analysts[14]. In addition, Kurdistan lacks a reliable mechanism or institution to audit public spending.

Table 3. Amount of individuals receiving payments from government

Public employees	720,000
Receivers of safety nets (disability, family, poverty, etc.)	420,000
Pensioners	220,000
Contractors	20,000
Total	1,380,000

Source: KRG Council of Ministers.

- **The public sector is the main employer in the economy, directly and indirectly, creating a very centralised and vulnerable system.**

  60% of the employed population of Kurdistan works for the State and most of the private sector is dependent on direct public expense, such as contractors. If the public sector is affected by a shock, or a number of shocks as it is now, the whole of the economy is paralysed due to its dependency on government and lack of alternative economic growth areas. While the private sector has been sluggish in creating job opportunities that are not dependent on government spending, the bigger and more critical issue is that working for the private sector does not offer the same social benefits that a public

Working for the private sector does not offer the same social benefits that a public sector post does.

13 - Of the total amount spent on public payroll, 44% corresponds to the base salary and 56% corresponds to an extensive and diverse set of allowances.

14 - See for instance: Natali, D. (2010). Kurdish quasi-state: Development and dependency in post-Gulf War Iraq. Hassan, K. (2015). Kurdistan's politicized society confronts a sultanistic system.

sector post does. Public employees receive allowances, pensions, social security, and land grants, among others, undermining any incentive to work for a private employer[15]. Cultural perceptions, as a consequence, also tend to regard those individuals working for the public sector as better established within society.

- **As a whole, Iraq's revenue-sharing system is not fully developed.**
  The Iraqi fiscal system is still largely centralised, with the Federal Government owning all revenues generated in the country and re-distributing them to respective governorates. Promises of a more complete federal system with decentralised use of resources have not been taken forward. It thus hinders Iraq's regions and governorates in creating their own development strategies and raises tensions within the country.

Underdeveloped non-oil private sector

- **Local producers of goods are essentially uncompetitive against imports of foreign goods and cannot develop as a viable economic alternative to the public sector.**
  Contrary to the widely held perception that the Kurdistan Region is solely an oil producer, it also has a light industrial sector, mostly focused on construction materials and agricultural products. However, with weak local production capacity, the private sector cannot become an anchor to help the economy weather external threats and oil sector problems. There are various causes for this underdevelopment and lack of competitiveness, starting with low technical capacity (how to grow / how to sell), higher production costs, the presence of oligopolies in many sectors, the large number of obstacles companies face in to carrying out financial operations with banks, inconsistencies in policies and norms, and poor functioning of local courts in

With weak local production capacity, the private sector cannot become an anchor to help the economy weather external threats and oil sector problems.

15 - The government has historically worked as a money lender for the people, acting as a bank in practice, providing loans for housing, business, agriculture and even to cover marriage and tourism expenses. According to Parliamentarian sources, a total of $2.8 billion were loaned in the past years.

business affairs. At the same time, there is not a proper system for transfering technical know-how to local producers benefitting from the presence of international companies.

- **The Investment Law of 2006 was successful in many ways but, overall, did not attract significant, direct foreign investment to non-oil and non-housing sectors.**
  The law has been characterised as being significantly liberal and used as a symbol of Kurdistan's business-friendly environment. However, according to data collected by Kurdistan's Board of Investment, 77% of the capital invested came from within Iraq, not international. Many stakeholders interviewed suggested that most of the businesses attracted to Kurdistan are of "low quality", pointing to the absence of supporting institutions as the main cause, such as a functioning judiciary system and a formal framework for government procurement. In addition, most of the investment in Kurdistan has gone into the services sector, focusing on families' relatively high consumption capacity, not into other added-value sectors. As the law stipulated equal conditions across the sectors instead of differentiating between them and incentivising some over others, investment opportunities were largely biased towards the housing sector as it provided a quick way to produce benefits and returns on revenue.

- **Real estate sector underwent a boom period, attracting capital generated from oil given the absence of a functioning banking system, which created a dangerous bubble.**
  Physical assets have historically been the preferred platform in which to invest available capital when the financial institutions are not developed, as these assets are relatively safer than keeping them liquid. Kurdistan's rapid development of its oil sector then led to large volumes of capital flowing directly to the real estate sector. Real estate developments in Kurdistan over the past five years however have been totally disconnected from the needs of the region: there is very limited affordable housing available but ample supply of high-end, luxury dwellings, including hotels,

which often now lay empty. The sector also suffers from a lack of proper regulation, leading to the emergence of business cartels and artificially inflated pricing that is now bursting.

- **KRG procedures, including unpredictable policy changes and its permissiveness toward —and facilitation of— the formation of oligopolies has further undermined the region's business environment.**
  Some distrust from within the local business community toward Kurdistan's policymaking system was noticeable from stakeholder interviews based on their experience so far. They noted that putting forward policies and regulations is not enough if the government consistently lacks conviction with respect to implementing these policies on economic development and on generating a levelled playing field for entrepreneurs. Past experience reveals that in some cases, government decisions are short-lived due to political interference and electoral manoeuvring. Policy implementation also gets stalled within the bureaucratic process because relevant technical departments do not follow-through, as recently happened with laws promoting the mining of metallic and non-metallic materials. Furthermore, the arbitrariness in the issuance of business licenses is also a significant obstacle to a fair and robust business environment and is a source of corruption. Both factors contribute to the creation of oligopolies, often linked to political parties. Again, a law on monopolies exists, but its enforcement is very weak. In general, this policy inconsistency and lack of accountability has undermined the ability and willingness of the business community to engage in economic activity in Kurdistan for fear of sudden changes in policy, halt in support, lack of enforcement of new laws or regulations, and/or unfair competition.

- **Local service contractors are not prepared to compete with Iranian and Turkish service providers.**
  Perceptions of an unfair business playing field notwithstanding

(i.e. many stakeholders claimed that authorities favour foreign contractors), most local companies cannot compete with external service providers given their small size and/or lack of technical capacity. As one stakeholder noted, small foreign contractors are frequently bigger than even large local contractors in Kurdistan. Policy frameworks like the public procurement system have not been aimed at addressing these disadvantages.

- **There is a significant absence of reliable and transparent data on Kurdistan's economic performance overall and within specific sectors, leading to a lack of accountability in this area.**
  Both national and international private stakeholders report very little visible improvement with respect to transparency regarding data on economic performance and this perception hinders any further investment in Kurdistan. Furthermore, this lack of transparency creates a fertile breeding ground for corruption.

Dysfunctional banking sector

- **The financial sector in both Kurdistan and the whole of Iraq is not very developed, and the current cash-based economy paves the way for financial bubbles.**
  As noted above, a large percentage of revenue generated from oil sector development in Kurdistan has been invested in real estate and has not entered the banking system, diverting possible investment to other more productive sectors. Confidence in the financial sector is extremely low among households and, to a significant extent, local and micro-businesses as well, and as a consequence, these groups prefer to keep money in liquid assets. This lack of confidence can be attributed in part to the fact that virtually every episode of conflict in Iraq has resulted in losses in bank deposits with no compensation —the fact that the

A large percentage of revenue generated from oil sector development in Kurdistan has been invested in real estate and has not entered the banking system, diverting possible investment.

KRG has seized again deposits in commercial banks during this crisis to face their financial obligations does not help in reverse this distrust, but the contrary.

- **The banking sector's operations are opaque and dysfunctional due to an excess of regulations and an inability to provide for the actual needs of households and particularly businesses.**
  In general, banks are ill-equipped to provide significant financial support to business operations, especially large ones. For example, businesses are required to provide high collaterals, like possessing land assets worth 150% of the amount requested, to obtain funds from banks. Stakeholders consulted for this report noted that such practices deter any expansion of firms' economic activity. In addition, stakeholders also noted that the financial system is extremely centralised in the hands of the Central Bank of Iraq, an institution not known for being consistent in its policy decisions. Furthermore, in a financial practice that is non-standard and highly unusual, Iraqi banks seeking funds must request them from the Central Bank, which controls the flow of foreign currencies (e.g., dollars) into the country. The Central Bank imposes a ceiling on the amount of currency that banks can obtain and this impedes their ability to provide funding to support large business operations.

Non-resilient public services provision

- **Because of historical underinvestment, the organisation and provision of public services have lagged behind people's needs.**
  Pre-crisis provision of health, education and related public services in Kurdistan enjoyed better socio-economic outcomes than in the rest of Iraq. However, some limitations in the service provision model have historically impeded investment and efficiency in these sectors. The fact that there is widespread deterioration of all services post-crisis implies that the capacity

and provision mechanisms were not adequate before the onset of the overall crisis. Past investment generally did not match the needs of an increasing and wealthier population nor was there a resource buffer in place, such a functioning development fund, to absorb any shockwaves stemming from this underinvestment. Finally, at present, there is no financial capacity for quick response actions to address service shortages.

- **The opening of public services provision to the private sector has yielded mixed results with the system in need of better regulation.**
  Although the participation of the private sector in health, education and utilities has brought an increase in service supply levels, it has not been accompanied by a significant increase in the quality said services, either private or public. Private options also remain largely unaffordable for the bulk of the population. The current regulation system for services, built on the basis of a legal framework established some decades ago, stifles private operator investment and competition and does not encourage any increase in public operators' quality and efficiency either.

- **While fees are applied for the use of some services, the payment collection process is inefficient and the revenues garnered do not cover the bulk of the costs incurred by the government.**
  Most public services then are provided free of charge, which does not encourage a sustainable use of resources or more participatory involvement of the populace in how service is provided. The two main services where fee applies are water and electricity supply. Data for 2014 on electricity supply suggests that the amount billed is about 10% of the total operating cost incurred by the government for this supply not including capital investment), while collection rates are just around 75% ($300 million of revenue for $3.2 billion of cost)[16].

16 - KRG Council of Ministers (2015).

4. A PATH OF REFORMS

Linking the need to address the direct symptoms of the overall crisis in Kurdistan with the existence of deeper systemic weaknesses in the economy provides a strong case for pursuing a genuine agenda of economic reforms. The following proposed policy initiatives aim to bring both short- and longer-term change to Kurdistan to help transform it into a more resilient region in the face of internal and external shocks, particularly with respect to the economy.

By formulating a more comprehensive reform strategy, the KRG improves not only its economic standing but its reputation with foreign creditors, local stakeholders and the civil society alike.

While painful for households and businesses, balancing the budget in terms of revenues and expenses is a priority for Kurdistan. This process must be accompanied by other measures, however, for several reasons: to ensure Kurdistan does not find itself in this position again, to make the cost more bearable for society by sharing the burden fairly, and to gain the support of international actors present in the region willing to provide assistance. Indeed, by formulating a more comprehensive reform strategy focused on fighting corruption, on boosting the private sector, and on creating better institutions rather than just on slashing public expenses, the KRG improves not only its economic standing but its reputation with foreign creditors, local stakeholders and the civil society alike. Deeper reforms can pay-off with positive results in the medium-term and drastically reduce, if not eliminate, instability.

Based on the analysis of both the symptoms of the overall crisis and the deeper structural weaknesses in the economy, reforms should focus on the following priorities:

1. Improving the functioning of the State and its budget
2. Reinforcing initiatives and policies on private sector development
3. Transforming Kurdistan's institutional landscape linked to the economy

Improving the functioning of the State and its budget

- **Austerity measures to limit expenses in the public payroll are urgently needed to achieve a sustainable and balanced budget.**
  Any other austerity measure dwarfs in comparison to the challenge of trying to address the public payroll issue, given that it accounts for 70% of the total public expenses in the KRG. Measures in this field require a combination of painful salary cuts, a reassessment of how wage levels and salary complements are calculated —e.g., linking them to performance and productivity criteria, removing some allowance categories, transforming recurring allowances into stipends, etc.— and forcing the retirement of those civil servants beyond the legal working age.

Any other austerity measure dwarfs in comparison to the challenge of trying to address the public payroll issue, given that it accounts for 70% of the total public expenses.

- **Improve incentives to work for the private sector, reducing the number of redundant civil servants**.
  Public sector salaries absorb a significant portion of the budget. The State is currently the main employer and, in order to strengthen the employment potential of the private sector, specific policies to reform the outsized public payroll are required. Two main initiatives are as follows:

A) A bill recently discussed in Kurdistan's Parliament aims to create a dual system for pensions and social security for both the private and public sector, creating benefits for private sector employees that are currently non-existent. This is critical in making the private sector more desirable to join and helping reduce public payroll. The implementation of this bill however is likely to be suspended and ignored given that it would entail an initial annual disbursement of an additional $1 billion. This is an investment however that the KRG must make, despite its cost. The current distortion in the labour market in favour

of the public sector must be corrected. The financial savings this bill will incur in years to come by reducing the amount the government pays in public salaries is more than worth the cost its implementation would incur now.

B) The KRG had in place a programme that allows civil servants to take leaves of absence (of about three years) to join the private sector with the possibility to remain there indefinitely. This programme should not only be kept going, but enhanced further as well. There is room for improvement in the effectiveness of this policy by evaluating its results, making the process more attractive to employees and expanding its scope.

- **Initiate fiscal reforms to diversify public revenues; an introduction of small taxes in this regard should be a first step.**

  According to the Federal Government's budget, non-oil revenues should account for about 16% of all public revenues in Iraq for 2015, as opposed to 5% in previous years. This is in part because the Federal Government introduced new small taxes such as goods as imported cars, cigarettes and phone cards. This is a good step forward in increasing non-oil revenue and one that the KRG can adopt in other areas as well (pre-crisis tax income of KRG, not including trade fees in the borders, was just $130 million, or 1% of the total budget). Although the Parliament has in the past debated a full fiscal transformation package containing corporate tax, income tax and real estate tax, the proposal seems unrealistic and faces the risk of never being implemented due to its large scope. Instead, a step-by-step approach is recommended in which some new small taxes are piloted during this term in order to gradually change the culture and perception of funding public spending in Kurdistan. For instance, setting a tax on property assets that exceed a certain value or enforcing the collection of utilities fees (water, electricity, garbage, etc.). Such initiatives will gradually change Kurdistan's taxation culture and allow for the implementation for wider fiscal reforms in the future.

The biggest positive impact on the efficiency of public administration is within human resources, specifically in developing a full set of job descriptions that includes personnel responsibilities, rights and obligations.

- **Adopt consistent steps to reduce corruption with respect to public payroll and public revenues.**
  The KRG needs to provide a strong signal to the public and business community alike that corruption is being addressed. Initiatives such as controlling the payment of public salaries through digital means and more transparent oversight of the now-opaque revenues from independent oil sales should be enforced this year as steps toward greater government accountability.

- **Improve public administration efficiency and save resources through a system of employment categorisation and performance review as well as a rationalisation of administrative costs and revamp the management of state-owned enterprises.**
  The extremely large size of State apparatus gives room to save resources in many areas. The biggest positive impact on the efficiency of public administration is within human resources, specifically in developing a full set of job descriptions that includes personnel responsibilities, rights and obligations. This would allow for much-need re-sizing and re-allocation the workforce based on actual needs, a reduction in job duplication, and the activation of employee performance reviews. Further rationalisation of expenses in public administration is possible through better management of resources, including the amount of rent paid for office space, the use of public vehicles, and the high number of administrative bodies, directorates and even ministries. Lastly, acting on state-owned companies can also improve their efficiency. This can be done though such means as professionalising their management to operate like corporations or, alternatively, privatising them[17]. To ensure effective oversight of reforms in these areas, stakeholders suggested creating a post for an Inspector General.

17 - For instance, data available shared by Parliamentarian stakeholders indicates that as much as 113 state-owned enterprises out of 157 in Iraq are not profitable and losing public money.

- **Initiate substantial reform on petrol and electricity subsidies, which take around 4% of the annual budget.**
  These subsidies are frequently regressive and inefficient, diverting public resources from other productive uses, and benefiting the rich rather than poor families. They also place a significant burden on the budget —it is estimated that subsidies on petroleum-related products such as benzine represented 4% of the budget in 2014. In addition, 90% of the cost of electricity is subsidised. Reform should be focused on reducing the total amount of subsidies given by limiting them to low-income families, rather applying them universally, increasing prices for the rest of households to near cover the cost. The success of such reforms is only achieved with a detailed and open public debate that will reveal costs and benefits of the change.

Reinforcing initiatives and policies on private sector development

- **Need to find political consensus to implement new laws that reinforce a freer business environment.**
  Although there have been past efforts to make Kurdistan an attractive place for investments, many areas of the economy remain shrouded in excessive regulations and red tape. Reducing these obstacles requires reform of Kurdistan's institutional landscape (described in more detail in next section), on the one hand, and clearer policies on the other to prevent arbitrary decisions over license concessions, remove protections on oligopolies, and make business creation easier, among others. Policymakers must evaluate where businesses find inefficiencies within the system and identify where in the system entry barriers and obstacles to a healthy, competitive private sector remain. They must then develop policies to reduce and eliminate them effectively. Local business institutions should also serve as interlocutors between

Policymakers must evaluate where businesses find inefficiencies within the system and identify where entry barriers and obstacles to a healthy, competitive private sector remain.

private stakeholders and the government, where complaints, proposals and obstacles can be openly debated.

- **Maintain an allocation of funds to encourage new businesses in Kurdistan, particularly small and medium enterprises (SME).**

  A past KRG initiative allocated $14 million to fund a policy programme that provided small grants and seed capital for entrepreneurs. According to the Parliamentarian Committee on Economic and Financial Affairs, around 6,000 SMEs were created through 2013. The KRG did not allocate any funds for this purpose in 2015. Such a programme should be restarted after evaluating its feasibility, as this is an optimal way to create new employment and income opportunities in the private sector.

- **Create a platform to promote and support SMEs into regional markets.**

  There have been many one-way efforts to attract international companies into Kurdistan, but not many that help local producers expand their markets and presence abroad. Two-way business missions are required. Kurdistan currently has an existing fabric of SMEs to build on. These SMEs frequently lack the resources, ability, and appropriate channels to export or improve their value chain. Existing institutions, such as chambers of commerce, could be empowered as business promotion platforms that would accompany and support SMEs in their international expansion.

Two-way business missions are required. Kurdistan currently has an existing fabric of SMEs to build on.

- **Encourage the participation of microfinance mechanisms as an alternative to a dysfunctional banking sector while putting in place the conditions necessary for banks to gradually better serve business community needs.**

  Microfinance and development funds can provide a short-term solution with respect to readily available funding for many business needs. Very few mechanisms like this operate right now

in Kurdistan and it is necessary to understand what is preventing a larger presence of such institutions. In parallel, with a longer-term view, Kurdistan's Parliament should prioritise the initiation of reforms aimed at addressing regulation flaws in the banking sector. The expansion of the private sector is not possible without a dynamic banking sector.

- **Avoid relying on solely protectionist measures, such as bans or tariffs on imports, to support local producers as this only harms the population and reduces incentives for local improvement.**
  Many stakeholders noted that the penalisation of some key imports is the only way forward for benefiting local production. However, such measures ultimately penalise the population, who will be paying for more expensive local products that are not necessarily of better quality, while not addressing the root of the problem: uncompetitive production. Although protection may be beneficial in the development of a dynamic light manufacturing sector, it tends to have no effect on improving the raw materials industry, such as agricultural goods. Instead, modernisation plans in the form of soft loans to invest in technology and mechanise processes should be promoted when the fiscal situation improves. In parallel, this must be accompanied by better quality standards regulation at the border, especially for agricultural imports.

- **Facilitate better participation of the private sector in the provision of public services (health, education, water and electricity supply).**
  Actions in this direction will not only help create new employment opportunities, but will expand the provision of services, without the State having to allocate funds it currently does not have for creating new schools, medical facilities, or energy plants. For this to happen, a clear regulatory framework is needed to boost public-private partnerships, address regulation gaps that do not provide incentives for quality investment, and, most critically, ensure a correct cost-recovery mechanism for private investments.

Transforming Kurdistan's institutional landscape linked to the economy

- **Reforms on the Investment Law, the most visible milestone of Kurdistan's economic legislation, should be oriented to improve the quality of investments.**

The housing sector should be taken out of the investment law as it distorts investment incentives; instead, the sector should have its own regulatory law.

There is currently no consensus between policymakers and business community leaders on whether the law should become more or less favourable to investors. Focusing on modifying attractive fiscal concessions for investors within the law does not solve the main issue, which is the poor quality of investments received in Kurdistan so far. Instead, some clear actions to attract better investment should be put forward. The housing sector should be taken out of the law as it distorts investment incentives; instead, the sector should have its own regulatory law. Contingencies to guarantee a better quality of investments than in the past are needed in the form of a proper monitoring and evaluation frameworks for coming and prospective investors and more checks and balances to reduce arbitrariness when assessing the feasibility of proposed investments.

- **Kurdistan's Parliament should take seriously and implement the Commission for Integrity's proposals and recommendations to strengthen its impact on tackling corruption.**

Many stakeholders in the private sector demanded that this Commission become a cornerstone for Kurdistan in terms of progressive legislation at the same level as the Investment Law. Attracting quality investments is not guaranteed only with reforming the Investment Law, but needs to be accompanied by a proper institutional setting, ensuring fair and transparent opportunities to do business. Reducing corruption in areas that are prone to it is a critical step in this process. As a new institution, formed in 2011, the Commission for Integrity still has room for

improvement and Parliament can help by addressing its proposals and recommendations.

- **Promote better management of Kurdistan's oil revenues by reconfiguring the Oil and Gas Fund to mirror similar mechanisms used in Gulf countries rather than that used in Iraq.**
  There is consensus among stakeholders on the fact that Kurdistan's independent oil sales should be used to sustain the development of the region for future generations, supporting budgetary needs when necessary. However, in the current context, there is little clarity on how revenues generated have been used for this purpose as they are not directly used within the budget. Some comparative examples from around the Middle East, especially in Gulf countries, provide a good blueprint for how to do this. Specifically in how to reconfigure the Oil and Gas Fund to enable oil revenues to serve as financial buffers for use in times of crisis, to serve as investments abroad, and to serve as funds for economic diversification.

Put forward processes that improve partnership mechanisms with foreign companies to better absorb the technical skills and know-how they bring.

- **Re-launch plans for a deep overhaul of KRG's public procurement framework in order to improve contractors' quality and capacity and reduce the misallocation of resources.**
  In 2012, the World Bank assessed the performance of Kurdistan's public procurement system, that is, how the State publishes and manages contractor bids for the provision of infrastructure and public services. The assessment showed great inefficiencies when benchmarked against other regional frameworks. Since this sector mobilises a significant part of the economic activity in Kurdistan, its reform should yield better quality investment and less financial resources misallocated in overpriced and delayed public projects. Although a plan to create a law for public procurement according to international standards was put forward a few years ago, no progress has been achieved so far.

- **Integrate and embed know-how transfer mechanisms in Kurdistan's institutional structures for the benefit of local businesses.**
  If companies from Turkey, for instance, operating in Kurdistan are more productive than local ones, there is a need to understand why and learn how to become more competitive. For this, it is necessary to put forward processes that improve partnership mechanisms with foreign companies to better absorb the technical skills and know-how they bring. Some practical steps include the promotion of joint ventures with a focus on shared management, and a better design of investment contracts. For instance, stakeholders at Kurdistan's Board of Investment noted that they do not have mechanisms to ensure a proper use of local professionals and workforce when investments come to Kurdistan. This is especially crucial in the oil sector, where very few local graduates are employed in high-skilled positions. Therefore, a review or re-definition of service contracts to promote this know-how transfer through local employment is highly encouraged; this should be a core part of the region's institutional development.

- **Kurdistan's policymakers in the Federal Parliament should push for an overhaul of Iraq's revenue-sharing policy with focus on creating a decentralised system**.
  Iraq is still a highly centralised state, despite being officially recognised as a federal one, with the Federal Government owning all revenues generated in the country and re-distributing them based on population shares instead of regional needs. The country would benefit from a reform of this revenue-sharing system, moving towards a more decentralised one, where governorates own and exploit their own natural resources and contribute to fund the sovereign services provided by the central government. By owning their resources, governorates then are incentivised and expected to promote more efficient and adequate regional development strategies.

5. CONCLUSION

The Kurdistan Region of Iraq is now entering its third year of economic crisis, with mounting harmful social and political fallout emerging from it. The symptoms of the overall crisis extend pervasively over the whole economic system, negatively impacting government function, household resilience, private sector survival and public services provision.

Although these symptoms are directly attributable to the sudden shocks Kurdistan has experienced in the last few years, including fiscal restrictions, armed conflict in Iraq and internal political blockages, the severity of their effects is due to underlying structural weaknesses extant in the economy pre-crisis. Interviews with relevant stakeholders in Kurdistan, carried out by MERI, highlighted the major gaps in this region's economic development, which are linked to unhealthy public sector finances, an underdeveloped non-oil private sector, a dysfunctional banking sector, and non-resilient public services provision.

The overarching message to take away from this, after analysing both symptoms of the overall crisis and structural weaknesses in the economy, is that the system was never prepared to buffer any kind of crisis. It has remained —and remains— vulnerable to internal and external shocks, despite the fact that because of its geopolitical position, Kurdistan is prone to regular shocks including fluctuations in oil prices, conflict, and/or political instability. In order to change course for the better then, the extreme austerity measures the KRG implemented, as an immediate response to crisis symptoms, must be balanced with a wider agenda of reforms to be put forward gradually to build a more resilient system, able to weather and withstand future shocks. Critical to this is the reinforcement of initiatives and policies aimed at private sector development; improvement of the functioning of the State and its budget; and transformation of Kurdistan's institutional landscape connected to the economy.

Developing a vision with these deeper reforms in mind will yield positive results in the medium-term, with the biggest pay-off being a reduction in instability and uncertainty within the economy. In the short-term it will be beneficial as well because foreign creditors, local business community, civil society, and the public as a whole demand a strong signal that there is a political will to change how things work at all levels, despite the government's present submersion in crisis management, This process of change will not be easy however and raises other questions that require wider debate on the political economy of such reforms: How to implement them? How to sequence them? Who gains and who loses from them? Who would support and/or adapt them? Who would still oppose them and why? Answering these questions will entail examining the culture of governance and its impact on the culture at large in a rentier state.

This process of change will not be easy however, and raises other questions that require wider debate on the political economy of such reforms; answering them will entail examining the culture of governance.

In laying out the symptoms of the overall crisis, understanding their link to existing structural weaknesses in the economy, and proposing a set of recommendations on the way forward, we hope with this report to set the basis for broader discussion, debate, and more importantly, action to move Kurdistan in the direction of greater sustainability and prosperity for all its inhabitants.

Middle East Research Institute

Erbil - Kurdistan Region - Iraq
info@meri-k.org | +964(0)662649690
facebook.com/meri.info | twitter.com/meri_info
WWW.MERI-K.ORG