Iraq is expected to be one of the fastest growing countries in the world and the country could experience further growth, if Oil & Gas legislation and regulatory reform are approved. Recent years have clearly shown that Iraq’s socio-economic problems can be attributed to the ineffective use of oil revenues and to weak institutions, which have become a constraint to delivering even basic services. This paper shows that Iraq has made limited economic progress and will demonstrate that without sound institutions and social cohesion it is impossible to make significant economic progress. Since oil is the country main drive for economic growth, the paper will discuss the potential of implementing the “National Energy Strategy” to meet domestic energy needs; foster the growth of a diversified national economy; improve the standard of living of Iraqi citizens and create employment. The analysis will also demonstrate that the new energy strategy could make Iraq one of the most powerful economies in the region but that this is highly contingent on its having sound and robust institutions. If this is not achieved, the country could move towards what is commonly referred to as the “Oil Curse”.

Kamal Field Al-Basri and Mudhar Al-Sebahi, Iraqi Institute for Economic Reform, Baghdad, Iraq.
1. The evolution of democracy

Despite the existence of several hurdles and challenges, Iraq has made significant progress towards the establishment of an inclusive democratic system, especially when compared to the regional scenario (see Figure 1). This has been attested by the October 2005 referendum on the constitution and various national and provincial voting, as well as by a series of major reforms implemented to protect civil liberties, strengthen freedom of press and favor greater decentralization. Notwithstanding these points, some significant challenges in protecting human rights and difficulties in implementing the decentralization process still remain.

Figure 1 - Democracy Index 2011

Within this framework, in order to assess the consolidation of the Iraqi democratic system, we should first recognize that democracy has not evolved naturally in the country. While prior to 2003 democracy in Iraq was virtually inexisten, since the fall of Saddam politics have mainly evolved through competition between political parties presenting clear ethno-sectarian agendas. This kind of political climate has hampered the development of modern institutions that promote the rule of law, which is vital for the establishment of a democracy as well as for economic development. It is well documented in the economic literature that growth cannot take place in the absence of sound institutions. Without good institutions, transaction costs will be high or unpredictable, with it being difficult to assure agents that their transactions will take place in an orderly manner and their contractual rights will be protected by law. The weakness of its institutions and the absence of the rule of law are the main reasons why Iraq has failed to attract sufficient foreign direct investment, especially in non-oil sectors, which is vital to realize sustainable growth of the Iraqi economic foundations.
2. Economic development

Since 2003, Iraq’s economy continues to be heavily dependent on oil. However, the relative contribution of oil to total GDP decreased from 70% in 2004 to 43% in 2011, as the contribution of other sectors such as social services, finance and agriculture expanded. Despite the existence of difficult security conditions, since 2004 the Iraqi economic system has benefited from a series of positive trends such as:

- Growth in Nominal GDP per capita from $US1,670 in 2004 to $US5,400 in 2011\(^1\), and real GDP (measured by constant 1981 prices) increased from ID 41 trillion (Iraqi Dinar) in 2004 to ID 61 trillion in 2011. Furthermore, daily oil production increased from 1.8 million barrels per day in 2005 to 2.9 million barrels in 2012\(^2\). Consequently government spending has increased from ID34trn to ID117trn ($US100.7bn) and Iraq is now expected to achieve a real growth rate of 8-9 %.

- Unemployment rates have fallen from 28% in 2004 to 15% in 2011, and the poverty rate has been reduced from 54% to 19% (using the World Bank measure of the proportion of population living on less than $US1.25 per day). The inflation rate has dropped from 68% in 2006 to 6% in 2011.

- The supply of electricity has increased from 3500MW in 2004 to 7500MW in 2011, however the demand for electricity has been growing even faster and electricity supply remains a big challenge. Other public services have improved but remain substantially below expectations, which has shamed the government.

- Iraq’s external debt is now down from $127 billion to $50.3 billion due to the Paris Club / IMF arrangement of 80% reduction through the contribution of the government’s payment towards the remaining 20%.

On the other side of the coin, implementation of the national investment budget is poor as only around 60% of financial resources allocated have been used effectively, and public spending is not driven by a robust economic strategy. For example, despite the fact that education should be a top priority for social-economic development, adequate funding remains a big challenge. Education spending is on average 9% of total public expenditure nevertheless, but with only 13% of the budget allocated to investments and the other 87% allocated to operational costs. As a result, there is a shortage of over 5,000 schools, while over 40% of existing schools

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\(^1\)All figures from Annual Yearbook of Statistics, Ministry of Planning, Government of Iraq, unless otherwise stated. Economic data is not of a high quality in Iraq at present, and the government is assisted by the World Bank and the UNDP in developing its economic data.

\(^2\) According to Ministry of Oil, Government of Iraq
are in need of reconstruction. Illiteracy remains at 28% (of the total population aged 10 years and over), while school dropout rates are around 8% in primary education and 9% at the secondary level.

A similar situation affects the health sector: the general health of citizens is declining as a result of destruction, conflict and sanctions. While the country is striving to improve its current health situation, the situation remains extremely severe, as evidenced by the following indicators which show that per every 10,000 citizens:

- Infant Mortality Rate decreased from 50 to 31, but the Millennium Development Goal (MDG) is to reach 17 by 2015.
- Maternal Mortality Rate decreased from 117 to 70 (MDG target is 29 by 2015).
- Under Five Years of Age Mortality decreased from 39 to 21 (MDG target is 21 by 2015).

A comparison of some of Iraq’s health indicators with those of Turkey and the UK further demonstrates how dire the situation is. Bearing in mind this gap, one would expect the budgeted financial resources to be allocated in favor of improved health, whereas in reality this is not the case. In 2010, the share of health in public spending was 8%, while in Turkey and the UK the percentages were 13% and 16% respectively.

Table 1 · Health Indicators between Iraq, Turkey and the UK

<table>
<thead>
<tr>
<th>Item</th>
<th>Year</th>
<th>Iraq</th>
<th>Turkey</th>
<th>UK</th>
</tr>
</thead>
<tbody>
<tr>
<td>Life expectancy at age 60 (years) (Adults)</td>
<td>2009</td>
<td>17</td>
<td>20</td>
<td>23</td>
</tr>
<tr>
<td>Infant mortality rate (probability of dying between birth and age 1 per 1000 live births)</td>
<td>2011</td>
<td>31</td>
<td>12</td>
<td>4</td>
</tr>
<tr>
<td>Adult mortality rate (probability of dying between 15 and 60 years per 1000 population)</td>
<td>2009</td>
<td>222</td>
<td>104</td>
<td>77</td>
</tr>
<tr>
<td>Diphtheria, tetanus toxoid and pertussis (DTP3) immunization coverage among 1 year-olds (%)</td>
<td>2011</td>
<td>89</td>
<td>97</td>
<td>95</td>
</tr>
<tr>
<td>Measles (MCV) immunization coverage among 1 year-olds (%)</td>
<td>2011</td>
<td>91</td>
<td>98</td>
<td>90</td>
</tr>
<tr>
<td>Population using improved drinking-water sources (%)</td>
<td>2010</td>
<td>79</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td>Population using improved sanitation facilities (%)</td>
<td>2010</td>
<td>73</td>
<td>90</td>
<td>100</td>
</tr>
<tr>
<td>General government expenditure on health as a percentage of total government expenditure</td>
<td>2010</td>
<td>8.98</td>
<td>12.79</td>
<td>16.03</td>
</tr>
<tr>
<td>General government expenditure on health as a percentage of total expenditure on health</td>
<td>2010</td>
<td>81.18</td>
<td>75.2</td>
<td>83.89</td>
</tr>
<tr>
<td>Total expenditure on health as a percentage of gross domestic product</td>
<td>2010</td>
<td>8.42</td>
<td>6.74</td>
<td>9.64</td>
</tr>
<tr>
<td>Per capita total expenditure on health (PPP int. $)</td>
<td>2010</td>
<td>340.13</td>
<td>1029.14</td>
<td>3479.56</td>
</tr>
</tbody>
</table>

Source: World Bank
Furthermore, the Iraqi government has failed to reform the inefficient public sector and promote the development of the private sector. For example, in percentage terms the contribution of the private sector to GDP increased only minimally between 2004 and 2011, from 31% to 35%. Research conducted by the Brookings Institute has found that Iraq is among four countries where the government fails to provide basic services⁵. There were similar findings in the Good Governance database of the World Bank 2011, with Figure 2 showing a comparison of some regional countries.

Figure 2 - Index of State Weakness

*Source* World Bank

These figures clearly show that the rule of law index is lower than that of Iran, Algeria, Egypt, Saudi Arabia, Jordan, and Turkey. This can be explained by the lack of political stability and accountability in Iraq.

3. Management of Oil Resources

Iraq’s oil production has increased by 1m barrels a day since 2002, the year before the US invasion, to about 3mb/d. Last year it reached a crucial milestone when it overtook Iran to become OPEC’s second-biggest producer of oil after Saudi Arabia.

The oil sector continues to dominate other sectors in the economy and Iraq has become highly dependent on oil. The oil and gas contribution to GDP in 2012 was about 47%, with about 95% of public revenue coming from oil exports (see Figures 3 and 4).

On 12th June 2013, Iraq announced the National Energy Strategy 2014-2030, with the aim of developing the energy sector in a coherent, sustainable and environment-friendly manner to:
1) meet domestic energy needs;
2) foster the growth of a diversified national economy;
3) improve the standard of living of Iraqi citizens;
4) create employment;
5) position Iraq as a major player in regional and global energy markets.

The strategy proposes an investment ceiling of $620 billion (at 2011 values) of which $540bn is allocated for capital and $80bn for operational costs. It is emphasized that the crux of the investment work should be implemented during the first few years, possibly between 2013 and 2014-2016. Iraq should accordingly raise its crude oil production to 9mb/d by 2020 as the medium planning scenario. According to the plan (see Figure 5), 85% of the investment fund should come from governmental sources while only 15% of funds should be contributed by the private sector. Furthermore, the graph shows how the investment should be distributed over the years, as well as throughout the industry, including upstream, downstream, power etc.

Figure 5 - Investments Required 2012-2030

INES will require ~$540 Bn investments till 2030, most of it borne by the GoI due to the type and size of upstream contracts

Source: National Energy Strategy

According to the strategy, oil exports will increase from 3 million barrels per day in 2013 to 6 mb/d in 2017, and then to 8 mb/d in 2020 (see Figure
The implication for gas production from new and old fields shows that Iraq will start to export after 2017 (see Figure 7).

Figure 6 - Oil Exports

After refinery requirements have been met, up to 8 mmmbpd of crude oil will be available for export

![Crude Grade Volumes Available for Export](source: National Energy Strategy)

Comments
- Crude grade volumes available for exports are net of domestic needs for refineries (based on MoO refinery plans)
- Crude grades volumes assume the medium oil production planning scenario
- In case the high oil production planning scenario is achieved, ~6.2 mmmbpd of crude grades will be available for export in 2014 (~0.5 mmmbpd of Kirkuk Light, ~2.9 mmmbpd of Basra Light and ~2.8 mmmbpd of South Heavy)

Figure 7 - Gas Surplus

Incremental gas volumes of ~2-3 bscfd will need to be found to sustain the medium-term gas surplus

![Incremental Gas Supply](source: National Energy Strategy)

The strategy also covers electricity production and states that Iraq will be able to meet its internal demand by mid 2015. Currently, the country has to import and generate 14GW per year. According to the strategy esti...
mates, energy imports will stop only in 2016, and by 2017 and 2030 Iraqi energy production will reach 24 and 42 GW respectively (see Figure 8).

Figure 8 - Power Capacity

The new energy strategy could make Iraq a powerful economy in the region, but this is highly contingent on the country’s building sound and robust institutions, where efficiency, transparency and the rule of law are all observed in the various government departments and organizations. If this is not achieved, the strategy could lead Iraq in a completely different direction, towards what is commonly referred to as the “Oil Curse”, which could threaten the future of Iraq’s political stability.

Under current practices, there is much doubt regarding Iraq’s ability to implement this strategy. The challenges can be summarized as the absence of qualified personnel, weak support from local organizations, poor facilities and the absence of robust governmental institutions that support an efficient business environment⁴. These factors all contribute to the distrust of foreign oil companies.

4. Policy options for the government

Iraq is expected to produce a rapid increase in oil revenue in the coming years. With this in mind the economy will face two key challenges, the first being the capacity to use financial resources to deliver proper public services, and the second being the ability to improve institutions.

⁴For example, contracts for crucial infrastructure projects are not being awarded efficiently or quickly enough.
To address these sets of challenges the government should adopt short-term policies:

a) Given the weakness of both the private and the public sectors, there is a need to initiate public-private partnerships (PPP) for a quick restoration of public services. This initiative will ensure the availability of finances for projects and the rapid transfer of technologies and skills, which are much required.

b) Modernize government institutions in order to improve efficiency, and more importantly, create a business-friendly environment for national and international business organizations.

c) In the fifties, the government was facing similar challenges and established the “Reconstruction Council” to provide leadership and management for economic projects. A similar initiative is recommended to be put in place.

To sustain economic development, Iraq should begin to forge a three-pronged strategy based on investments in different types of capital:

(i) human capital: investment in education to build the necessary skills and values;

(ii) political capital: Iraqi politics should support building a state with sound institutions, where principles and values of good governance are all in place;

(iii) social capital: Iraq has to manage the diversity of society by strengthening social cohesion and protecting the rights of individuals. There is empirical evidence which indicates that without proper social cohesion, the government’s ability to legislate and implement change will be limited.

Iraq is expected to face four possibilities in the future. These will depend on:

a) the extent to which the government is successful in achieving the rule of law and good governance which are crucial for sound institutions;

b) success in implementing Regulated Reform which is essential for creating a business-friendly environment.

Figure 9 illustrates the implications of four possible reform scenarios on GDP structure, based on projections by the Iraqi Institute for Economic Reform. Iraq’s economic potential is unequivocal, but future policy choices will determine whether the opportunities are realized or missed.
The World Bank’s well-known 1993 report, *The East Asian Miracle: Economic Growth and Public Policy* summarized the achievements of East and Southeast Asia, offering a canonical explanation for them and prompting a wave of further comparative research aimed at extracting practical lessons from the Asian development experience in the late twentieth century. According to this report, the eight ‘High Performing Asian Economies’ (Japan, South Korea, Hong Kong, Taiwan, Thailand, Malaysia, Singapore, and Indonesia) had succeeded by a number of common means: by ensuring low inflation and competitive exchange rates; by creating an effective banking system; by investing in human capital through education; by supporting rather than neglecting agriculture; by insulating civil servants from political pressures; by forging institutionalized alliances between government and business; and – most characteristically – by emphasizing the growth of exports as both a goal strategy and a touchstone of development (World Bank 1993, pp. 347-68).

**Conclusion**

In the coming years Iraq is expected to be one of the world’s fastest growing economies. According to the Economist Intelligence Services, growth this year is expected to be 8.2%, while the USA and OECD countries will not exceed 2%.
This growth has been mainly driven by the rapid increase in oil production and exports. According to government statistics, the oil share of GDP in 2012 amounted to 50%.

It is unlikely that the increase in oil revenue will translate into improvements in economic and social welfare for all citizens. In the last few years, it has been clear that the state has failed to deliver basic services. An obvious reason for this is the lack of good governance and sound institutions, incompetency, political interference in government business and the absence of sound regulation systems, all of which are major issues.

It is well established in the economic literature that institutions play a significant role in constraining economic development. Lack of robust institutions in Iraq with rising oil revenues will continue to provide poor quality policies and implementation. There is no international evidence to suggest that the new democracy in Iraq will in itself naturally lead to economic growth and prosperity; this can only be achieved through human development, which is an important element for sound institutions.

Iraq currently has a higher democracy index than other countries in the region5 but scores low on the human development index6. Current government spending on education is no more than 9% (for comparison, Algeria’s spending is 20% and Saudi Arabia’s 25%), with 90% of that spending going to operational costs and not investment costs7.

The Federal Budget is the main economic instrument for economic development in Iraq, yet it is poorly articulated towards sound economic policies (over half of Iraqi citizens depend on the Federal Budget for salaries, retirement pensions etc). Other countries’ experiences have shown that transparency and sound tax systems can lead to an increase in government accountability. Currently, the Iraqi state budget has a transparency index close to zero (according to Budget Partnership Index, 2013 rankings) and there is an absence of an adequately structured tax system (currently oil revenue amounts to 95% of government spending).

Furthermore, in such an environment the media can play an important role through the investigation of government policies and spending. From the authors’ experience, Iraqi media reporting on economic affairs is largely “spoon fed” by officials, without any verification, analysis of government policies etc. In a democracy without a sound transparent system it is unlikely that citizens will hold the government accountable, which explains why Iraq still suffers from the practice of old economic policies

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5 Democracy Index 2011, Economist Intelligence Unit.
6 World Bank Statistics on Good Governing, 2011.
7 See Federal Budget of Iraq, 2013 and previous years.
defined by the oil curse. The authors conclude that without such sound institutions Iraq’s democracy is hampered, and can be described as a bird struggling to fly with a single wing.

There is a high risk that Iraq will burn itself with oil, if the government continues to provide poor public services, avoid reforming its policies, and maintain weak social cohesion which is likely to fuel social unrest.

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