

# **Labour & Employment in Reconstruction and Development: Iraq in Transition, Liberalization & Reform**

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1. **Transition, Growth & Employment.** This paper addresses a number of issues relating to labour & employment in the context of the post-conflict reconstruction of Iraq. Iraq faces a number of transitions. One, from a State dominated economy, with extensive regulation, distortions, and barriers to competition and to labour mobility, towards a market based economy with a dominant role played by the private sector. Two, effecting a political transition from a one-party, authoritarian regime, to a pluralistic political regime, with effective protection of human rights and democratic representation. Three, moving from a closed economy to increased openness, with lower tariff barriers to trade in goods and greater mobility of capital and assets. Four, achieving economic diversification by moving from an oil-sector dominated economy to a more diversified production and activity structure. Indeed, the recently issued National Development Strategy calls for extensive liberalization, privatization and de-regulation of the economy, along with deep structural and institutional changes that would result from a substantially diminished role of the State in the economy and more generally, society. It is clear that there is a need for a comprehensive approach to reform, going beyond the confines of macro-economic reform, and including internal market liberalization (including labour-market reforms), ensuring competition and SOE reform, privatization and public administration reform and modernization.
2. **Reforms and priorities.** The implementation of reforms poses a number of issues, including the reform priorities, the speed and sequencing of reforms, the institutional setup and mechanism to achieve consensus and acceptance of the package of economic reforms and the implementation process. Reforms and initial measures to move towards a market economy have included the completion of a national currency exchange with the achievement of comparatively stable foreign exchange market conditions, the approval of new central bank and commercial bank laws, the liberalization of interest rates, approval of a foreign direct investment law, the establishment of the Trade Bank of Iraq, the passage of the Financial Management Law and a new tax law, reform of the public administration wage structure and the simplification of the trade regime.<sup>1</sup> However, while there has been some progress –as noted above-, the main policy issues include key structural policy reforms in the medium term, such as the rehabilitation and rebuilding of the physical infrastructure, removal of market distortions and price liberalization, banking sector restructuring, state-owned enterprise reform, and social safety net issues.

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\* Note prepared for the ILO. The opinions, views and statements are the author's and should not be taken to represent the views and position of the ILO, the UN or any other official body or agency.

<sup>1</sup> For a description and recent discussion of these measures and reforms, see the IMF Iraq Country Report No. 04/325, September 2004. <http://www.imf.org/external/pubs/ft/scr/2004/cr04325.pdf>

3. **State Building, Reconstruction & Uncertainty.** Undertaking the above-noted transitions is difficult under the best of circumstances. They become more difficult to achieve under conditions of rehabilitation and reconstruction, under conditions requiring State re-building. The Iraqi government faces numerous challenges and constraints: restoring security, rehabilitating and rebuilding basic infrastructure, addressing pressing poverty, humanitarian and social issues, strengthening and maintaining national unity and cohesion, while developing regional economic and social policies. The State and government face these challenges and must implement remedial and corrective policies, undertake reconstruction and set Iraq on the path of growth and sustainable development without having the effective tools and capacity for the tasks; in particular, public administration requires modernization and reform. Violence, uncertainty as to future political and economic outcomes and insecurity has posed the major obstacles to economic recovery and investment, along with a number of strategic policy mistakes, including the disbanding of the Iraqi army and attempted, pre-mature privatization of State Owned Enterprises (SOEs). It is clear that a vicious cycle is now in place, with violence and insecurity leading to diminished investment and economic activity, a lower rate of job creation and higher unemployment, resulting in increased poverty and deteriorating social conditions. Higher unemployment and poverty, the lack of job prospects encourage participation in criminal activities and violent crimes, including in political violence and insurgency. The vicious cycle needs to be broken. Clearly, favourable outcomes to the political process, successful elections leading to parliamentary representation and a parliament approved government will enhance stability and generate expectations of economic recovery and reconstruction. However, focusing on job creation and responding to the population's basic requirements in terms of infrastructure services, basic utilities and social requirements are important means and measures to address the underlying sources and factors feeding discontent and violence.
  
4. **Demography, labour force growth and poverty.** Similar to many of the MENA countries, Iraq has had a delayed demographic transition. Continuing high fertility rates and –until the early nineties- secular improvement in health conditions, resulted in high population growth rates and higher labour force growth rates. The Iraqi population is expected to grow at a rate exceeding 2.7% over the next decade, with the labour force growing at about 3.4%, one of the highest in the world, while the fraction of young people 14 years and below is about 40% of the population, implying a high dependency rate. . High education expenditures also led to an educated LF, with a comparatively high educational attainment rate among females. However, employment growth has not kept, resulting in persistently high or growing unemployment rates, particularly among the educated LF. Indeed, the combination of demographics, low productivity, wars and violence have resulted in low labour force participation rates in Iraq, along with high unemployment rates in all categories compared to the other countries in the Middle East.

Table 1 compares labour market data for Iraq with the ME region. The evidence reveals the disparities, with Iraqi unemployment rates at about double the ME average, while LF participation rates and the employment ratios some 30% below the ME average. In turn, low participation and high unemployment rates have resulted in a high and growing incidence of poverty. The more serious and long-term consequence is that high

unemployment rates among youth in a demographically young population implies no on-the-job training and a lower rate of investment in work skills; a lower build-up of human capital, negatively affecting the lifetime earnings of the population.

	Trends Model Middle East Sub Region Data				Iraq 2003 Labour Force Survey Data	
	1993	2003	2004	2005	2003	
<i>Unemployment</i>						
Total unemployment rate	10.0%	11.1%	11.1%	11.1%	28.1%	
Female unemployment rate	12.8%	14.0%	13.9%	13.9%	16.0%	
Male unemployment rate	9.1%	10.0%	10.0%	10.0%	30.0%	
Youth unemployment rate	22.2%	23.8%	23.7%	23.8%	n.a.	
<i>Labour Force Participation</i>						
Total labour force participation rate	54.3%	56.5%	56.6%	56.7%	44.1%	
Female labour force participation rate	26.9%	32.5%	32.5%	32.6%	14.2%	
Male labour force participation rate	79.0%	78.9%	79.1%	79.2%	73.7%	
Youth labour force participation rate	77.5%	78.5%	78.6%	78.7%	n.a.	
<i>Employment-to-Population Ratios</i>						
Total employment-to-population ratio	48.9%	50.2%	50.4%	50.5%	31.7%	
Female employment-to-population ratio	23.4%	27.9%	28.0%	28.1%	11.9%	
Male employment-to-population ratio	71.8%	71.0%	71.2%	71.3%	51.6%	
Youth employment-to-population ratio	31.6%	33.9%	34.1%	34.2%	n.a.	

Source: ILO

The underlying demographic dynamics is a ticking time bomb. The Iraqi authorities face a problem not only of high and pervasive unemployment, but also of low participation rates in a country with a high dependency rate. Job creation should be a high priority for the government to avoid a vicious circle of high population growth leading to a large and growing labour force, increasing unemployment and poverty. In turn, poverty, unemployment and the deterioration in social conditions can foster violence and prove fertile ground for dissension and insurgency. The problem is aggravated by political uncertainty and insecurity, displacement due to war and violent conflict and economic uncertainty as a result of the war, its aftermath and the delay in the onset of reconstruction and rehabilitation.

5. **The National Development Strategy & Employment.** The NDS proposes the objectives and an overall framework for development over the period 2005-2007 and the medium-term. The NDS economic reform strategy covers major structural and related reforms. The strategy aims to: enhance the role of the private sector, develop human resources, promote the capacity of Governmental institutions and enhance their performance, reduce subsidies, undertake SOE Reform, aims to liberalize foreign trade, encourage foreign investment, and, given the large regional disparities in incomes, focus on regional development.

The NDS as it currently stands does not develop specific goals or targets for employment growth or unemployment. Nor does it propose that government should develop an employment policy. It recognizes the existence of very high unemployment rates,

exacerbated by refugee returns and movement of internally displaced persons (IDPs). The NDS proposes a number of measures<sup>2</sup> as part of a short-term employment policy, including:

- *Make-work schemes*. These are deemed temporary programs designed to provide income and employment generation for a limited duration.
- *Development of Skills* through rehabilitation of training centres aimed at vulnerable groups, including the semi-educated Iraqi unemployed labour force, high school drop-outs.
- *Micro-finance programs* aimed at small scale investment and helping vulnerable groups to meet their emergency needs and build assets should also create private sector employment.

However, the measures proposed in the NDS need to be: (a) translated into policies and projects with measurable goals and targets; (b) linked to the achievement of the MDGs for Iraq and more important, (c) developed into an employment policy that is integrated with and consistent with the NDS.

6. **Opening-up, Liberalization & Sequencing of Reforms.** For the past several decades, Iraq has managed an economy that was effectively closed, implementing protectionist, import-substitution policies. The result was an increase in the concentration of trade in crude oil exports, which represented more than 90% of the value of imports, making the external sector and the economy highly vulnerable to the fluctuations and volatility of crude oil production and delivery, energy prices and the world oil market. Economic and social development became dependent on and vulnerable to the oil sector. Non-diversification also increased the vulnerability of economy and the population to economic sanctions, resulting in rapid deterioration of economic and social indicators of development over the decade of the 1990s and into 2003. The protectionist trade regime implied limited integration with the country's trade partners in the region and the rest of the world. Indeed, it is only in the later period, between 1999 and 2003 that the previous Iraqi regime undertook a change in the trade policy regime, undertaking to open up on a selective basis, by signing bilateral free trade agreements with a number of countries selected for political-economy considerations, and not on the basis of comparative advantage or of being complementary to Iraqi resources and requirements.

Similarly, Iraq was not integrated in terms of the asset or factor markets, with severe restrictions, licensing and other barriers imposed on non-Arab, foreign investment. The combination of high sovereign and economic risks along with capital controls and restrictions implied an absence of foreign investment (including Arab), whether physical or financial. The lack of foreign direct investment also aggravated the near absence of technological progress. The combination of protectionist policies, lack of investment, and State dirigisme prevented Iraq in the past twenty five years from absorbing or integrating new technologies in its various productive sectors. The result has been low labour and total factor productivity growth. The period of sanctions following the first Gulf War in 1990-91 led to an aggravation and further deterioration of physical as well as human capital. Plant and equipment of the 1970s and early 1980s vintage which had reached the

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<sup>2</sup> See NDS (2004), pp.

end of its useful economic life, experienced additional deterioration due to the absence of replacement investment, maintenance, the absence of spare parts and rehabilitation. Importantly, the level of skills in the labour force deteriorated as a result of attrition, lack of on-the-job training, outward migration of the skilled and professional segments, and the absence of investment in new technology and products. This is the phenomenon of “unlearning by not doing”.

With the demise of the Saddam regime, the Iraqi economy has been more open to the rest of the world, with a rapid, but unplanned, change in the trade regime. The result has been a flood of imports, but mainly of consumer products, some construction industry and building materials and a limited amount of infrastructure related imports. Importantly, the share of capital goods and intermediate inputs in civilian imports has been limited. Domestic and foreign investment has not picked up, resulting in a limited increase in production capacity and in employment.

The decision to open the Iraqi economy to trade and reduce tariffs was not the result of a well-designed reform of the trade policy regime. Nevertheless, the recent openness of the Iraqi economy should not be reversed. Returning to a protectionist, import-substitution trade policy regime is not advisable and would be a costly policy, even on a temporary or short-term basis. With a return to a protectionist policy regime, resources, investment and labour would move to (or remain in) the protected and mostly obsolete industrial and manufacturing sectors. Trade and economic reforms would then require the outward movement of labour, other factors of production and resources from protected sectors and activities towards sectors in which Iraq has a comparative advantage. This would delay recovery and reconstruction and increase the cost of transition and adjustment. At the moment domestic producers, including SOEs, face international prices and are forced to adjust. Sectors such as agriculture, foodstuffs and agro-industry, in which Iraq has a comparative advantage tend to benefit from increased openness. These tend to be sectors which are labour-intensive and which can generate employment and incomes. However, the current situation of de facto openness is not a substitute for consciously and deliberately designed and implemented trade policy reform.

In order for the Iraqi economy, producers, consumers and labour to benefit from increased openness, the Iraqi authorities should deliberate and design a trade policy regime in the best national interest, leading to the required trade policy reforms. Iraq having obtained observer status at the WTO should design a trade policy and build trade capacity and the ability and capacity to negotiate trade agreements on a multilateral basis and in the best interests of Iraq and its population. Negotiating entry into the WTO provides the opportunity to review the trade and tariff regime, including the laws, regulations and barriers to competition in all sectors of the economy and table proposals for reform that can be discussed with all national stakeholders, including the SOEs, private business and labour.

Liberalization of the economy and increased external openness require preparedness of the Iraqi economy to meet international competition, a ‘mise a niveau’ through investment to modernize plant and equipment, better management and governance, as well as programmes to train and rehabilitate labour to impart skills and knowledge

allowing them to compete on a regional and international basis. In the absence of such investments in infrastructure, physical capital and human capital, Iraq will likely experience high costs of transition, with high unemployment rates and social unrest; a situation similar to that of the Former Soviet Union countries in the early 1990s.

7. **Restructuring the Iraqi Economy and the Move towards a Market Economy** will require three basic programmes: (a) Establishing an enabling institutional framework (laws, regulations, and agencies) for the undertaking of private activity and (b) Better governance, Reform and Privatization of the State Owned Enterprises (SOEs) and State-Owned Assets (SOAs), and (c) rehabilitation and rebuilding of infrastructure. It is in this context of transitions, of reconstruction and restructuring, of institutional change that government will need to develop a strategy and implement appropriate policies for the labour market and employment. Clearly, investment, economic growth and employment are linked. In the initial phase of reconstruction and development, higher reconstruction-related investment will raise economic growth, with higher capital and installed capacity leading to higher labour productivity and increased employment. In turn, higher employment generates higher incomes, higher consumption expenditures, but also increases human capital related investment expenditures (health, education and on-the-job training), helping sustain economic growth. Labour market conditions, sustainable employment growth over the medium-term and job creation are directly linked to infrastructure and investment expenditure by the government and the private sector. The fundamental domestic and foreign factors, as well as the macroeconomic and structural policies and reforms affecting growth and investment, will directly impinge on the labour market, employment and unemployment.
  
8. **Macroeconomic Performance and Unemployment.** The recent IMF country report (2004) based on consultations with the Iraqi authorities, reviews the performance of the Iraqi economy, proposed reform measures, and undertakes a projection for major macroeconomic variables. However, it does not explicitly address employment issues. In particular, the report projects GDP recovering at a rapid pace, security allowing, with high initial rates from a low base (as projected for 2004), in line with the experience of other post-conflict recovery countries<sup>3</sup>.

**Table 1: Macroeconomic Indicators and Projections**

	2004	2005	2006	2007	2008	2009
<b>Real GDP in US\$ (% change)</b>	<b>51.7</b>	<b>16.7</b>	<b>14.6</b>	<b>5.9</b>	<b>5.5</b>	<b>10.0</b>
<b>Population growth (% p.a.)</b>	<b>3.0</b>	<b>3.0</b>	<b>3.0</b>	<b>2.9</b>	<b>2.8</b>	<b>2.7</b>
<b>Gross domestic investment (% GDP)</b>	<b>34.9</b>	<b>44.8</b>	<b>38.5</b>	<b>34.0</b>	<b>32.8</b>	<b>31.6</b>
<b><i>Of which: public</i></b>	<b>26.4</b>	<b>37.4</b>	<b>33.8</b>	<b>29.7</b>	<b>27.9</b>	<b>26.7</b>
<b>Investment expenditures (\$ millions)</b>	<b>5,585</b>	<b>9,087</b>	<b>10,548</b>	<b>10,152</b>	<b>10,482</b>	<b>11,181</b>
<b>Non-oil investment expenditures</b>	<b>4,325</b>	<b>6,087</b>	<b>7,025</b>	<b>6,120</b>	<b>6,212</b>	<b>6,159</b>
<b><i>Change in Unemployment rate %<sup>4</sup></i></b>	<b><i>n.a.</i></b>	<b><i>-6.85</i></b>	<b><i>-5.3</i></b>	<b><i>-0.45</i></b>	<b><i>0.0</i></b>	<b><i>-2.0</i></b>

*Source: IMF Iraq Country Report, (2004), and own calculations.*

<sup>3</sup> For a review of the macroeconomic performance of countries post-conflict, see Saidi (2004, b).

<sup>4</sup> The change in the rate is assumed to be equal to (1/2) of the growth gap between actual and potential real GDP growth. In turn potential real growth is assumed to increase from 3% in 2005 to 6% in 2009.

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The growth assumptions are conditional on maintaining macroeconomic stability and the implementation of wide encompassing structural reforms. The resurgence of growth is fuelled by high investment spending totalling some US\$ 29.7 billion over 2005-2007, of which some US\$ 19.1 billion are non-oil investment expenditures. The gross investment ratio (GDI/GDP) is expected to peak at 44.8% in 2005, averaging 36.1%, over the initial reconstruction period, 2005-2009. Investment in the oil sector is front-loaded due to the important contribution of oil to overall GDP and to government revenue, helping to finance non-oil public investment spending. Note the importance of public versus private investment expenditures over the interim rehabilitation and reconstruction period. It is assumed that the public sector will play the leading role, given that –apart from the oil sector- the infrastructure underlying economic activity will have to be rebuilt.

Based on these projections and assuming that an Okun's Law type relationship will hold between unemployment and real economic growth, (with a 1% percentage change in the unemployment rate associated with each 2% growth in real GDP above its long-term potential (assumed to be 5.5%)), the unemployment rate could decline by about 12 percentage points over the next two years, stabilize in 2007-2008 and fall further by 2009. Effectively, the unemployment rate would be cut by more than half from current estimated levels. These 'back of the envelope' calculations illustrate the importance of generating economic growth to address the issue of unemployment and poverty.

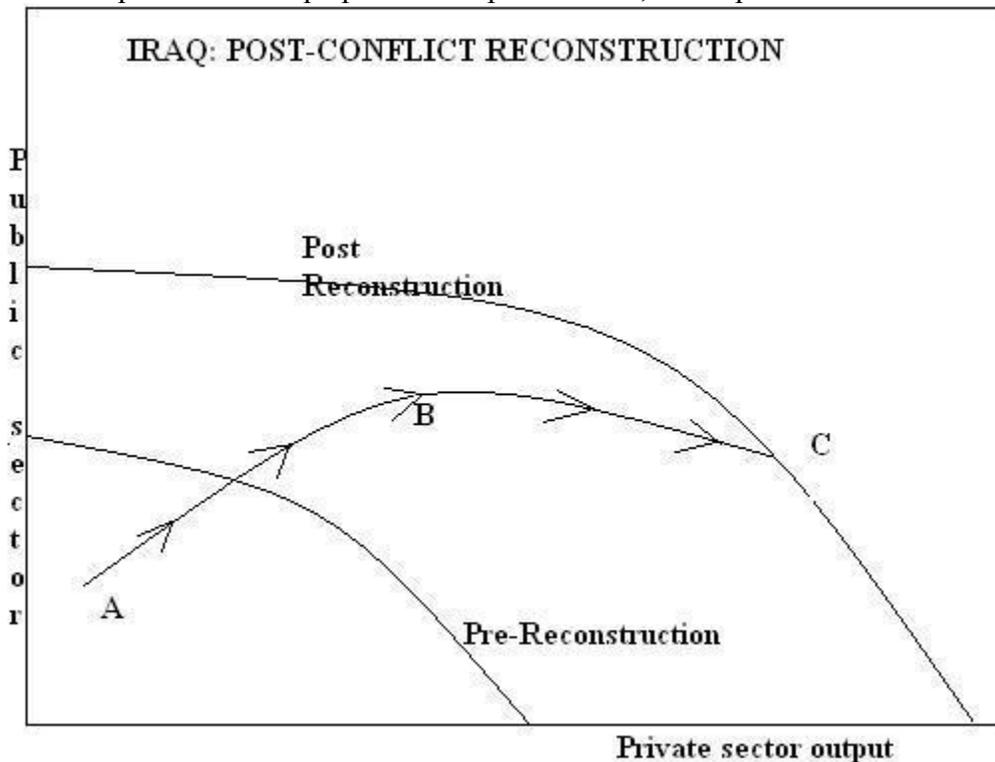
It should also be noted that the sectoral composition of growth and investment matters. A strong revival of agriculture and the construction industry which are labour-intensive industries, could increase employment growth and lead to a larger decline in the unemployment rate. Similarly, the mix of infrastructure projects undertaken by the public sector affects employment. Rehabilitating the capacity of the oil sector and building refining capacity while important in increasing oil production and distribution possibilities and exports, while reducing imports of refined oil products, will not be as effective as rebuilding road and transport networks, government and public sector buildings, water and waste management facilities and networks and other labour intensive activities, in creating jobs and reducing unemployment. Government will have to weigh the costs and benefits of alternative spending mix strategies and their impact on employment and labour market conditions, as well as the allocation of investment expenditures across the various regions of Iraq, in order to achieve balanced regional reconstruction and development.

An important assumption implicit in the growth and investment projections is that the absorptive capacity of Iraqi economy will have been restored and that the government has the institutional capacity and the governance ability to design and implement a reconstruction and development strategy on a sustained basis. This should not be a foregone conclusion. States in the process of rebuilding after conflicts need to rebuild their absorptive capacity and their economic governance.

- 9. Reconstruction implies rehabilitation, reconstruction and investment in infrastructure.** For Iraq, nation-building requires as a '*sine qua non*' restoring and strengthening national physical networking, and increased public sector investment in infrastructure. There are two main issues at stake here: (a) restoring the national political

and social fabric requires investment in national institutions and agencies; this includes - at least at the initial stage of the reconstruction process- national public sector infrastructure services and utilities extending across and integrating all the regions of Iraq; (b) a national infrastructure network will result in lower costs from economies of scale and, eventually, the additional benefits of cross-border regional infrastructure networking linkages to the Arab countries, such as through the linking of electricity networks. It is important in this context, to stress the national planning and integration of infrastructure for political as well as economic reasons: infrastructure is a national, cohesion building force, helping bridge the gap of regional development and income disparities. National infrastructure services and utilities, with cross-border links and integration, will ensure low cost infrastructure services (electricity, communications, transport, telecommunications, and water), thereby lowering production costs in the public and private sectors, encouraging expansion, increased investment and job creation.

10. **Reconstruction & Development.** A likely reconstruction and development scenario could unfold as illustrated in the accompanying graph, which highlights the respective roles of the public and private sectors. The current situation, assumed to be at point A which lies within the economy's production possibility frontier (PPF), as a result of unemployment and inefficient use of existing resources. The current pre-reconstruction PPF, [1], is shrunk in towards the origin as a result of violence, uncertainty, unemployment of labour and other resources, destruction and lack of maintenance and replacement investment. Reconstruction and infrastructure investment will lead to an outward expansion of Iraq's production possibilities, to the post-reconstruction PPF, [2].



A feasible dynamic path of the economy is illustrated by the line from A to point C which lies on the new post-conflict reconstruction frontier. In the initial years –say three to five years- recovery and investment take place in both the private and public sectors, but at a

more rapid pace in the latter. The economy moves from point A to point B, with an increase in the share of the public sector. Note that point B lies beyond and above the initial post-conflict production possibilities, reflecting a high level of investment by the public sector in infrastructure and restoring public services, in general.<sup>5</sup> In the second phase of reconstruction –the movement along the path B to C – it is the private sector which is assumed to be the engine of growth, expanding at a relatively faster pace than the public sector as a result of higher private sector investment rates and from a privatization of public sector entities, SOEs and SOAs. It is important to note that the availability of a higher public sector capital stock (infrastructure) leads to increased total factor productivity in the private sector, so the production possibilities curve expands unevenly, in favour of the private sector. As Iraq rebuilds and increases its production capacity, the private sector benefits from a modern infrastructure and networks which increases the productivity of private sector factors of production.<sup>6</sup> In particular, labour and total factor productivity will be rising throughout the period as the economy acquires and integrates new capital, technology and knowledge.

We should expect that the path of job creation and employment will be consistent with the overall path of investment and output outlined above<sup>7</sup>. Public sector and investment in infrastructure, construction (the rebuilding of housing, offices, factories), the revival of agriculture, are expected to be major sources of employment generation during the initial phase of reconstruction and rehabilitation. The second phase is one where the private sector will play a pre-dominant role in investment and job creation.

It is implicit that the increase in investment is accompanied by the implementation of structural reforms that move the economy away from a command economy to a market-based economic system. Security, political stability and the implementation of an effective anti-corruption strategy, the availability of infrastructure, and the ‘*soft institutional infrastructure*’ of an enabling framework of laws, a lower cost of doing business will attract domestic and foreign investment.

The successful transition to a market economy, private sector investment and related job creation is predicated on three issues:

- Reform of the SOEs and SOAs, with the implementation of a well designed and implemented privatisation programme.
- An enabling institutional framework for private sector activity with a focus on reducing the costs of business and employment logistics and the costs of doing business.
- Development of the SME sector. The costs of transition and adjustment to the economy can be reduced through the important contribution that the SMEs can make to economic growth, employment and poverty reduction.

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<sup>5</sup> See the Joint UN-WB Iraq Needs Assessment Report (October 2003), and the UNDP’s ‘The Way Forward’, (2004).

<sup>6</sup> The private sector production function is assumed to be represented by  $Y_p = F(K_p, L_p, T; K_g)$ , where  $K$  is capital,  $L$  is labour and  $T$  stands for technology; while the subscripts  $p, g$ , stand, respectively, for the private and government sectors. An increase in  $K_g$  is assumed to increase the marginal physical product of capital and labour in the private sector.

<sup>7</sup> See the discussion of Macroeconomic Performance and Unemployment in section 8 above.

11. **SMEs, Reform and Employment.** SMEs can be and should become a major source of employment growth –including self-employment- and investment in the Iraqi context. Apart from the large SOEs, the majority of businesses are SMEs, micro-enterprises and family-owned enterprises. Research and cross-country evidence accumulated in the past few years supports the view that SMEs can generate jobs on a sustainable basis in a wide variety of sectors and contexts. However, as in other countries of the MENA region, developing the full potential of SMEs as a source of economic growth and employment requires an *SME development strategy*. In particular, SMEs require an enabling framework with a low cost of establishing and maintaining a business –a low cost of doing business- since the various fees, minimum capital, and time spent, red tape, bureaucracy and procedures can represent a high and often prohibitive cost to establishing an SME and are an important barrier to entry. As a result of the high cost of doing business, SMEs do not register, going into the informal economy. The consequence is that they find difficulty accessing credit, benefiting from public utilities and other services and face the risk of expropriation, corruption and bribes. All these constraints and distortions can stifle SMEs as a source of job creation and employment growth. Second, establishing title to assets, real estate and property is an essential element for SMEs and the self-employed. Third, SMEs require access to finance and the availability of finance at competitive rates. The banking and financial system in Iraq is severely under-developed and repressed, with most of the credit, when available, going to SOEs and government agencies. The Iraqi authorities will need to invest in the lending infrastructure – the information environment, the legal, judicial and bankruptcy environment, and the tax and regulatory environments, in order to ensure that SMEs are not squeezed out from the credit and banking system. This requires developing and making available alternative lending technologies: asset-based as well as micro-credit and finance. Four, the property rights system needs development in order to provide collateral to SMEs and micro-enterprises, which facilitates access to the formal sector, the credit markets and asset-based lending to SMEs by the banking system. In particular, a major effort should be undertaken to survey land and property and modernize the land registry system.

12. **Micro-Credit & Micro-Finance.** The overall lack of banking and financial development in Iraq also reflects itself in the absence of finance directed at the needs of SMEs such as micro-credit and micro-finance. Micro credit and finance are more relationship lending and less reliant on collateral or asset-based credit. Relationship lending is the most relevant to the requirements of Iraqi SMEs as opposed to transactions lending which relies on the presence of collateral, is based on credit scoring, quantitative data and information, including from the financial history of the SME, and which is unlikely to be available. Government and the monetary authorities should give priority to reviving the credit system, increasing the fraction of banked households and businesses, and creating an enabling framework of laws, de-regulation and simplification of procedures that would encourage the establishment and growth of the SME sector. In particular, micro-credit and micro-finance are suitable financial technologies for the agriculture sector. Recent cross-country evidence by T. Beck, et. al. (2004) confirms that financial development fosters economic growth by relieving constraints on small firm growth and that “policy reforms that improve the operation of the financial system boost

the growth of small-firm industries more than large firm industries.” The sound development of the micro-credit and micro-finance industry in Iraq requires an enabling legal and regulatory infrastructure. The authorities may wish to consider passage of enabling legislation that organizes and facilitates micro-credit and micro-finance without the regulatory burden and bureaucracy that can stifle the growth of the sector.

13. **Cost of Doing Business.** While the attention of policy-makers is typically on the macro-economy and macroeconomic policy, equal attention should be given to the microeconomic aspects; in particular, the authorities should seek to reduce transactions costs related to the operation of the labour market and the costs of doing business which are an important barrier to entry and consequently to job creation. Recent research has shown that red tape, procedural costs and other transaction and ‘friction’ costs are major impediments to business formation, investment and job creation, and that these costs of doing business affect SMEs and micro-enterprises disproportionately. These costs of doing business<sup>8</sup> relate to the direct and time costs of Starting-a-Business (the procedures, time, cost, and minimum capital requirements to register a business formally), Hiring-and-Firing indicators (which include the degree of rigidity in employment laws), Enforcing-a-Contract Indicators (cover the procedures, time, cost, and degree of complexity in the procedures to resolve a payment dispute); Getting-Credit indicators (which measure institutions for credit information and legal protection of creditors); Closing-a-Business indicators (the procedures, time, and cost to go through insolvency proceedings as well as court powers in insolvency proceedings). Evidence has shown that higher transactions and friction costs: result in lower investment rates, are a major disincentive to the formation of new businesses, reduce business efficiency and negatively affect employment. In particular, labour market inefficiencies lead to lower labour mobility, increase the frequency of short-term employment thereby reducing job tenure and security, increase uncertainty and tax the formal sector as opposed to the informal sector in the economy. The policy implications are clear: reducing the cost of business and employment requires a major reform effort across Ministries and levels of government and can yield rapid results in terms of business and job creation.

**Labour Mobility and Social Safety Nets.** Trade liberalization and reform, and SOE reform imply major structural changes in the economy, resulting in a different industrial structure, composition of output and public-private mix. It will be important to (a) reduce the cost of mobility of labour between sectors and geographically; (b) provide compensation, and (c) reform and eventually abolish the Public Distribution System, replacing it by a well-designed social safety net. This requires social safety net measures, which will likely include redundancy and/or severance payments; retraining programs to impart or upgrade needed skills, tax and fiscal incentives for on-the-job training and other forms of investment in human capital, as well as a range of programs to assist workers to re-enter the job market – such as the establishment of employment agencies.

Labour mobility has been highly restricted and controlled in Iraq both between sectors and geographically. The Saddam regime aimed to restrict the mobility of the population

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<sup>8</sup> See the World Bank’s (2005), Cost of Doing Business and the related web site, [Home - Doing Business - The World Bank Group](#)

and the labour force, ostensibly for reasons of security and political control. The existing Public Distribution System (PDS) which evolved with the imposition of sanctions, was an important instrument of political control –since it controlled access to basic food and other requirements for the majority of the population (with an estimated 60% of the population reliant on the PDS) - and therefore, eventually, survival. The PDS is also an important contributory factor that restricts the mobility of labour between sectors of the economy, between neighbourhoods and regions. The PDS vouchers are personal non-transferable entitlements, and only valid within defined neighbourhoods and areas. Reconstruction, liberalization and reform will result in substantial structural and industrial changes, requiring mobility of factors of production, in particular labour. The authorities should aim to put in place policies that will lower the costs of transition, and related adjustment costs. In particular, The PDS should be replaced with a well designed Social Safety Net. This should start with a gradual replacement of the inefficient in-kind PDS with a cash equivalent, effecting a transition from the existing universal public distribution system to a targeted food assistance programme. The transition strategy should be based on: (a) creating the conditions for the distortion-free, sound functioning of food markets, (b) design of a social protection package, and (c) monetary (including cash) transfers based on an efficient, modernized payment system.<sup>9</sup>

It is important to note that this policy reform would not only improve labour mobility, but would also remove a major policy-imposed distortion on agricultural production and the operation of the food market. The PDS subsidizes the price of basic foodstuffs and therefore taxes food production and supply, acting as a major tax on agricultural production and the retail distribution system. The policy objective should be to transform the current food ration system into a monetary/cash distribution system targeted at the poor, the needy and the unemployed, as opposed to a generalized food distribution system. This monetization of the food basket would remove a major policy distortion, boost domestic agriculture, the re-emergence of the food market, and eliminate a pervasive source of price distortions, while at the same time ensuring that families in need are properly supported within the social safety net. However, the monetization of the social safety net requires the development of an adequate payment system infrastructure and a supporting banking and financial sector, so that transfers would be operated through the banking system. The authorities, government and Central Bank of Iraq should, in cooperation with the banking system, institute the set-up of a universal **Basic Bank Account** for all households, with minimum maintenance costs, through which all social safety net transfers would be undertaken. Individuals would be provided with a unique bank identification number, which would be linked to their social security identification number. Increasing the number of banked households would facilitate the implementation of reforms; provide an instrument for ensuring transparency and accountability of the reform process, and efficient operation of the social safety net.

14. **Social Security System.** The authorities should examine the design and set-up of a modern *Social Security System*, including some form of Unemployment Insurance with contributions by both parties to the labour contract, employees and employers. Social Security should be set-up as a separate agency, eventually creating a funded social

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<sup>9</sup> See UN/WB Joint Needs Assessment report (2003) and WB working paper on safety nets (2004)

security system. Iraq's demographics with a young and growing population are factors that would favour setting up a funded social security system, which can be a main institution underlying the development of the housing market. Owner-occupied housing provides security and safety for the population and reduces the costs of economic and social transition and the costs of adjustment of the economy during the period of reconstruction. As in the case of the other reforms, developing a housing market and facilitating a program of owner-occupied housing requires a well-functioning credit and banking system.

15. **Agriculture Sector Development Program.** The National Development Strategy correctly identifies the links between the previous policy of keeping food prices artificially low and the decline in agricultural production but does not explore the implications of a reversal of this policy. Revitalization of the agricultural sector needs to be closely aligned with reform of the Public Distribution System (PDS). The transition from the current situation of subsidized agricultural inputs and low output prices to a relatively free market will have to be gradual in order to avoid a breakdown in supply and food security and supplies. Small farmers will require assistance to operate effectively under the new policy environment. The basic thrust of reforms proposed for agriculture sector is in the direction of a more facilitating and regulatory role for government. However, the pace and sequencing of such reforms will require attention. The critical aspect is the need to *rebuild agriculture infrastructure*, including irrigation and water distribution systems and food distribution and transport networks. The public sector will need to undertake the major investments required to rebuild agriculture infrastructure, not merely to provide a facilitating and regulatory role or the removal of price distortions. Similarly, Iraqi agriculture requires modernization and mechanization in order to raise productivity and provide gainful employment. Reviving the agricultural sector is part of restoring the normal operation of the food market. Removing the existing policy-induced distortions due to the operation of the PDS will allow the growth and recovery of agricultural employment and incomes, and will be an effective way of combating rural poverty. However, access to credit will be important both for infrastructure and modernization of agriculture, highlighting the importance of developing the credit and payment system as an urgent policy priority.

16. **Tax and Fiscal System.** It will be important within the tax and fiscal reform analysis and during the reconstruction period to undertake and remove any tax or fiscal disincentives or distortions to employment and maintain income and payroll related taxes low. On the other hand, the authorities should consider providing positive incentives to investment in human capital and on-the-job training. Re-building human capital will prove critical to the reconstruction process and its sustainability, since it is a major determinant of the capacity of the country to rebuild and its absorptive capacity. The authorities could consider providing tax deductions for approved schemes for on-the-job training or general purpose training (i.e. non-job or firm specific training). This could be incorporated in a review of existing labour legislation or through the promulgation of a special purpose law. The law could also provide incentives for employment in rural areas or areas severely affected by conflict ('crisis zones'), or to encourage employment and reduce migration from under-developed regions. Similarly, provisions can be included for

youth training schemes and/or the employment of women. Such tax incentives can prove instrumental in encouraging employment, particularly for the youth and lesser-skilled, as well as reducing the cost of business entry and formation for SMEs.

**17. Governance, SOEs & Public Sector Reform.** The dominant role of the SOEs in Iraq can be a major impediment to successful reforms and transformation. There are some 192 SOEs in Iraq, with a further 43 mixed ownership enterprises covering all sectors and economic activities. As Table 2 shows, the bulk, 96 SOEs carry out industrial or military-industrial activities. A recent review of the status of the SOEs concludes that close to 90% of Iraq's industrial capacity, which represents the share of the SOEs, "is seriously de-capitalized, asset-starved, obsolescent, inefficient, saddled with high production costs, over-staffed, and -- as a result of looting -- in a state of physical degradation"<sup>10</sup>. The SOEs employ some 500,000 persons --about one in eight of the labour force- and successful reform of the SOEs will be critical in a transition towards a market economy and in dealing with the problem of unemployment.

- The key to reform and potential privatization is the introduction of sound corporate governance practices which will attract new, much needed investment to Iraq, because they improve the management of SOEs, reduce economic risk and increase the value of the SOEs. National institutions, laws, regulations, and practices based on international norms and standards would enable Iraq to modernize the SOE and SOA sectors, enabling them to attract technology and foreign investment and become internationally competitive. Furthermore, political and sovereign risk would be reduced and economic performance and outcomes would be de-linked from immediate political concerns and the dependence on oil and gas resources.
- A practical approach to designing and implementing a strategy to deal with the SOEs is to categorize them into SOEs providing public utilities services (electricity, water and other) and those with activities that can be undertaken by the private sector<sup>11</sup>. SOEs in critical sectors and providing basic infrastructure services should be: (a) Rehabilitated and (b) Financial and Operational framework and reporting strengthened in accord with good corporate governance principles, and with (c) Support to labour adjustment programs through redundancy and severance payments, and job retraining. SOEs in non-critical sectors may be put on an accelerated track towards privatization and private sector participation.

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<sup>10</sup> See WB Reconstructing Iraq, Working Paper, SOE Reform; September 2004.

<sup>11</sup> The Ministry of Industry and Minerals (MIM), which oversees the bulk of the industrial SOEs recently undertook (in Spring 2004) an assessment of its SOEs sorting them by 'survival' ability. The results are illustrative. Out of 53 SOEs assessed only 23 were deemed capable of break-even production to pay salaries. The others were listed as: Non-commercial institutional SOEs (unlikely privatizations): 6; SOEs capable of sustaining their salaries and operating costs: 14; SOEs, destroyed or economically unviable in any conditions: 10; SOEs, capable of break-even production to pay salaries: 23.

**Table 2: Summary of SOEs as Per Their Former Affiliation with Line Ministries**

<b>Ministry/Commission</b>	<b>No.</b>
<b>Agriculture</b>	<b>10</b>
<b>Electricity</b>	<b>11</b>
<b>Finance</b>	<b>9</b>
<b>Health</b>	<b>1</b>
<b>Housing and Construction</b>	<b>15</b>
<b>Industry and Minerals (MIM)</b>	<b>48</b>
<b>Military Industrial Complex (now with MIM)</b>	<b>48</b>
<b>Irrigation</b>	<b>11</b>
<b>Oil</b>	<b>19</b>
<b>Trade</b>	<b>8</b>
<b>Transport and Communication</b>	<b>12</b>
<b>Total</b>	<b>192</b>

Source: NDS, WB Working Paper (2004, a)

- **Privatization.** The privatization of SOEs and SOAs should be considered within the overall strategy of moving towards a market-based economy, and is a major element in the package of economic reforms to be implemented during reconstruction. In particular, privatization and private sector participation in providing infrastructure and networks is only one element within an overall market-oriented strategy, which requires institution-building to support a market-based economy. Privatization of SOEs and some SOAs and increased private sector provision of infrastructure services will be an important policy means toward greater efficiency, combating waste and corruption and increased production, and leading to higher investment, increase in economic growth and in employment. It can also be the source of long-term equity capital inflows, as well as of the development of Iraq's capital markets.
- The NDS proposes the institutionalization of the privatization process through the creation of a 'Privatization Board', and sets out 3 categories for SOEs and SOAs: for shut-down and disposal, for reform, and for privatization. This process would be well served by introducing the basic **Principles of Corporate Governance**<sup>12</sup> at the level of SOEs and SOAs that are candidates for privatization. Perhaps more importantly, the process of designing and implementing the basics of corporate governance – transparency and regular reporting, independent auditing, removal of conflicts of interest, ethics, protection of minority shareholders' rights – provides a foundation for meaningful reform of the SOEs and SOAs. In particular, a clear framework for disclosure and transparency and compliance with International Accounting Standards and the introduction of private sector management and accountability through the 'corporatization' of the SOEs should precede their privatization.
- An effective and transparent privatization strategy requires an enabling framework: a **Privatization Law** and a **Competition Law** (or anti-trust law) to enable government to undertake the privatizations, create the privatization board with the requisite powers, develop the regulatory framework, and authorities for privatized entities. In particular, a privatization law should make explicit the basis of redundancy payments and severance for employees of

<sup>12</sup> See OECD (2004) for a discussion of the corporate governance principles and Saidi (2004) for a report, analysis and policy recommendations on corporate governance in the MENA countries.

the SOEs and SOAs and the policy framework for the optimal structure of public utility prices. The privatization strategy should also establish labour rehabilitation and training schemes to reduce the costs of transition and overall cost of adjustment to economic reform. A modern **Capital Markets Law** would allow the development of the capital markets to allow wide participation by Iraqi citizens in the ownership of the privatized entities, so as to 'democratize' the privatization process.

In summary, a privatization strategy should be well designed and be the object of consensus, that will create the enabling framework. It requires a private sector able to participate in the provision of infrastructure services. Badly designed, prepared and executed, a privatization policy will result in inefficiency and increased transition and adjustment costs, potentially delaying recover and reconstruction.

18. **Labour Statistics, Information Costs and Mobility.** Rebuilding statistical capacity is an important building block of reconstruction and capacity building. In particular, the design, administration and management of the reconstruction and development process depend on the availability of regular, quality, reliable data and information. Labour policy and employment programmes have to be based on relevant, up-to-date information and statistics to guide policy-makers and labour market agents and participants – government, business and labour- in their choices, policy design and implementation, investment and business decisions. Government and its concerned Ministries should invest in new technologies (modern information and communication technologies and networks) to improve the efficiency of data and information collection, analysis, storage and dissemination. In particular, the authorities and labour market participants should disseminate information using modern media and ICT: news media, TV, radio, internet and other means of mass communication on both a national and regional basis. The use of modern ICT can substantially reduce information costs and make markets more efficient, reduce 'friction' in the labour market, the dispersion of wages, improve the job-matching process, increase the probability of finding a job and lower unemployment. The process of reconstruction and development requires the availability of information about labour market conditions, occupations, the structure and evolution of wages and prices, regional labour market conditions and their evolution. Regular labour market surveys should identify the current availability and distribution of skills in the labour force, its distribution by gender, socio-economic characteristics and regional distribution. Labour surveys and regular monitoring of the population, labour market and characteristics should be inputs in guiding investment in human capital formation, through schooling, on-the-job-training and the creation and development of Technical and Vocational schools and specialised institutes. Informed policy choices and options and feedback, require the availability of statistics on the labour market, its conditions and developments.

#### 19. **Concluding Remarks.**

- **Iraq faces a number of transitions.** One, from a State dominated economy, with extensive regulation, distortions, and barriers to competition and to labour mobility, towards a market based economy with a dominant role played by the private sector. Two, effecting a political transition from a one-party, authoritarian regime, to a pluralistic political regime, with effective protection of human rights and democratic representation. Three, moving from a closed economy to

increased openness, with lower tariff barriers to trade in goods and greater mobility of capital and assets. Four, achieving economic diversification by moving from an oil-sector dominated economy to a more diversified production and activity structure.

- **Restoring economic growth, job creation and employment should, next to security, be clear and urgent policy priority for the government.** Addressing the issues of the labour market and employment policy should be part of a comprehensive policy reform package. The government has to develop an employment policy as an integral part of the National Development Policy. This is critical in order to reduce the cost of transition and costs of adjustment.
- **The NDS needs to focus on employment and job creation explicitly.** In particular, the NDS needs to be translated into a multi-year macroeconomic framework, incorporating investment plans and projects. In turn, the investment programmes should be linked to job creation and employment whether directly as a result of the investment expenditure, or as a result of higher economic growth and increased employment in the private sector. Further, given the high current rates of unemployment, government should consider instituting a contra-cyclical policy aiming to reduce the unemployment rate through active fiscal policy, including selecting investment projects, their mix and regional distribution, based on employment generation criteria.
- **Public sector investment in infrastructure and public works can and should be a major source of employment over the short and medium run.** Priority should be given to rehabilitating and rebuilding the physical infrastructure of the Iraqi economy. Privatization and private sector participation in providing infrastructure services and utilities requires the development of a well-designed privatization programme, including the enabling privatization legislation, regulations and the institution of an effective regulatory structure and independent regulatory agencies with clear policy guidelines.
- **Liberalization of the economy and increased external openness require preparedness of the Iraqi economy to meet international competition, a ‘mise à niveau’** through investment to modernize plant and equipment, better management and governance, as well as programmes to train and rehabilitate labour to impart skills and knowledge allowing them to compete on a regional and international basis. In the absence of such investments in infrastructure, physical capital and human capital, Iraq will likely experience high costs of transition, with high unemployment rates and social unrest; a situation similar to that of the Former Soviet Union countries in the early 1990s.
- **Restructuring the Iraqi Economy and the Move towards a Market Economy** will require three basic programmes: (a) Establishing an enabling institutional framework (laws, regulations, and agencies) for the undertaking of private activity and (b) Better governance, Reform and Privatization of the State Owned

Enterprises (SOEs) and State-Owned Assets (SOAs), and (c) rehabilitation and rebuilding of infrastructure. The absorptive capacity of Iraqi economy will have to be restored and government will have to build the institutional capacity and the economic governance ability to design and implement a reconstruction and development strategy on a sustained basis.

- **Policy and decision making should be informed**; based on reliable, verifiable data and statistics. The authorities should give priority to rebuilding statistical capacity in labour and related social data and statistics.
- **Effecting the transition from a command economy to a market economy will require sustained macroeconomic and structural reforms, encompassing the labour market.** A workable programme should be on several tracks:
  - i. Creating an enabling framework for the private sector and focusing on reducing the cost of doing business and employment
  - ii. SOE reform and privatization
  - iii. Private sector and SME/Micro-enterprise promotion.
  - iv. Reviving and promoting the development of the Agriculture sector.
  - v. Enhancing and reducing the costs of labour mobility, between activities, sectors and geographical areas.
- The authorities should give priority to the **Development of the SME Sector** by:
  - (a) setting-up an enabling framework of laws and institutions designed to favour SMEs;
  - (b) reviewing and undertaking reforms to reduce the cost of doing business and job creation; and
  - (b) creating and reviving the credit system and developing micro-credit and finance.
- Designing and implementing a comprehensive **Social Safety Net** is an integral element of reducing the costs of transition and adjustment costs for the economy and population. Well designed and executed reforms can create a win-win situation on both the political level and in terms of economic efficiency. Reform of the current food distribution system and other controls and rationing systems should be a priority. Moving towards the ‘monetization’ of PDS benefits and targeting the beneficiary population would generate a number of benefits:
  - vi. Removes a tool of political control since cash or monetization frees the recipient population;
  - vii. Improves and facilitates labour mobility since the beneficiary population is no longer constrained to exercising its choice in a particular street, quarter, city or Mohafazat;
  - viii. Improves the welfare of the recipient population, since they would have the freedom to choose the goods and services, the freedom of spending the proceeds of the benefit as opposed to the distortion of having to accept a pre-determined selection of goods;
  - ix. Boosts the private marketing and retail sector and the private transport and distribution network;

- x. Reduces imports of food and other rationed products and leads to a revival of the Iraqi agriculture sector and improves the diversification of the diet and goods available. An increase in agriculture production would reduce rural-urban migration, and increase employment in a labour intensive sector.
- Reform of the PDS and the institution of a Social Safety Net, creation of a separate **Social Security System** and agency require the development and modernization of the payment system and rapid expansion of the bank branching network. The authorities, government and Central Bank of Iraq should, in cooperation with the banking system, institute the creation of a universal **Basic Bank Account** for all households, with minimum maintenance costs. Increasing the number of banked households would facilitate the implementation of reforms, including that of the PDS.

The Iraqi authorities and the international and regional community face a daunting task and multiple challenges in nation-building Iraq. The cutting edge of the challenge lies in restoring growth and generating employment. Employment generation should be at the centre stage, an integral part of Iraq's National Development and Reconstruction Strategy. Presently, a vicious cycle is in place, with violence and insecurity leading to low investment and economic activity, a near absence of job creation and rising unemployment, resulting in increased poverty and deteriorating social conditions. Higher unemployment and poverty, the lack of job prospects encourage participation in criminal activities and violent crimes, including in political violence and insurgency. The vicious cycle needs to be broken. Clearly, favourable outcomes to the political process, successful elections leading to parliamentary representation and a parliament approved government will enhance stability and generate expectations of economic recovery and reconstruction. However, focusing on job creation and responding to the population's basic requirements in terms of infrastructure services, basic utilities and social requirements are important means and measures to break the cycle of violence and destruction and put Iraq back on the path of rehabilitation, reconstruction and development.

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