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Kurdistan Regional Government
Ministry of Planning

Strategies for Private-Sector Development and Civil-Service Reform in the Kurdistan Region—Iraq



Michael L. Hansen
Howard J. Shatz
Louay Constant
Alexandria C. Smith
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Preface

This monograph presents strategies to increase private-sector employment and to reemploy civil-service workers in the private sector in the Kurdistan Region—Iraq (KRI). Prepared for and at the request of the Kurdistan Regional Government (KRG) under the auspices of Dr. Ali Sindi, Minister of Planning, this monograph is based on a variety of methods and analyses. These include a review of the existing literature, analyses of survey data, analysis of Kurdistan regional and Iraqi national documents and laws, and a qualitative assessment of numerous conversations with government officials and private-sector employers.

The findings should be of interest to those concerned with private-sector development and civil-service reform more generally and to those with a regional focus on the Middle East and North Africa.

This research was undertaken within RAND Labor and Population. RAND Labor and Population has built an international reputation for conducting objective, high-quality, empirical research to support and improve policies and organizations around the world. Its work focuses on children and families, demographic behavior, education and training, labor markets, social welfare policy, immigration, international development, financial decisionmaking, and issues related to aging and retirement with a common aim of understanding how policy and social and economic forces affect individual decisionmaking and human well-being.

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Summary

The Kurdistan Regional Government (KRG) currently employs a substantial number of people working in the Kurdistan Region—Iraq (KRI); of all the jobs in the region, only 20 percent are wage-paying jobs in the private sector. To ensure the long-term economic benefit of its citizens, the KRG is interested in pursuing an economic development strategy that rebalances the economy toward private-sector employment, including reemploying civil-service workers in the private sector. In this monograph, we analyze these issues and develop recommendations for private-sector development and both civil-service reform and downsizing.

The KRI has a very young population, with about 50 percent of the population age 20 or lower. Although some jobs will be vacated by people as they reach retirement age, there will soon be a large increase in the number of individuals who wish to work. Where will these people find jobs? One possible solution is government employment; however, policymakers *already* are concerned about the level of government employment. A more promising alternative is to develop a healthy and innovative private sector.

The KRG can develop its private sector by removing obstacles to starting or expanding a business, by identifying sectors for which conditions are particularly favorable for private-sector growth and supporting them, and by outsourcing and privatizing some functions that the KRG currently performs. However, private-sector growth does not guarantee that civil-service workers will leave for private-sector employment. Civil-service workers will need the qualifications necessary for private-sector jobs and will have to expect that the benefits of private-sector employment outweigh the benefits of civil-service employment. At the same time, as the KRG devises methods for encouraging civil-service workers to leave for the private sector, a key challenge will be to ensure that the KRG is able to retain the employees it needs in order to ensure the proper functioning of government.

Developing the Private Sector

There are three promising, complementary strategies for private-sector development:

- domestic entrepreneurship and new business formation
- foreign direct investment
- outsourcing or privatization of government functions.

There is strong evidence that the most rapid and sustainable path for growth involves entrepreneurs and entrepreneurial firms that develop new products and services or use new methods. Encouraging local businesses is also a key element of developing an entrepreneurial

economy. At the same time, foreign direct investment brings additional capital, new technologies, new management techniques and practices, and links to the global economy. Proponents of outsourcing and privatization argue that the private sector can perform many functions more efficiently and cost-effectively than governments can, easing the burden on taxpayers and freeing government resources for use on services that can benefit the whole population, such as security, education, health services, and some forms of infrastructure.

The KRI has a number of characteristics that make it a more favorable business environment than the rest of Iraq. Security is better; the investment law is often considered superior to that in the rest of Iraq; and infrastructure, such as roads and electricity, is generally considered better in the KRI than in the rest of Iraq and is improving. However, there are a number of barriers to private-sector development, including poorly developed financial markets, difficulty acquiring land for a business, burdensome and costly procedures for registering a new business, procedures for importing and exporting, availability of business information, and a lack of international arbitration in investment disputes.

The bottom line is that the KRI offers a mostly favorable environment for foreign investors but a difficult environment for small, local businesses. With the right project, foreign investors can find entry into the KRI to be fairly smooth. However, the environment for creating new, small, local businesses appears to be difficult. This could be a barrier for economic development because, despite the benefits of large foreign investments, local capital formation is also extremely important to long-term growth.

Recommendations for Private-Sector Development

The KRG should ease the formation of domestic businesses:

- Simplify procedures for starting formal small and medium-sized businesses.
- Start on legal reform of land titling and sale.

Greater openness to the international economy will encourage private-sector development:

- Remove import and export licensing rules and restrictions.

A more developed financial sector can help businesses form and grow:

- Consider having civil servants' salaries deposited directly into accounts in private banks.
- In any efforts to attract new financial service providers, target lenders that focus on medium-sized businesses.

There is room for further improvement in public services:

- Move to greater recovery of costs in electricity and water.

The legal environment for labor needs reform:

- In the reform of the labor law, consult international best practices—for example, by using experts from Organisation for Economic Co-operation and Development countries—rather than regional models.

- Consider new legal rules for foreign workers, including workers from Arab countries, that enable greater employment opportunities for nationals.
- Pending the reform of the pension law, enforce the payment of pension obligations by workers and companies under the current pension law.
- Concurrently, continue pension reform efforts to institute a retirement system that could make private-sector employment more attractive.

Domestic and foreign businesses will encounter a more congenial environment if they have a fair and trusted method through which to settle disputes with the government:

- The KRG should explore arrangements for resolving investor disputes in an international forum.
- Over the longer term, domestic dispute resolution mechanisms, such as the courts, should be strengthened so that all businesses can settle disputes fairly, whether those disputes are with the government or other businesses.

There are a number of activist policies that the KRG can employ to foster private-sector development:

- Aim investment incentives at the hiring and training of local labor, partnering with and training local businesses, and attracting industries that serve regional and global markets.
- However, requirements to use local labor, source inputs locally, or take on a local partner are likely to be counterproductive.
- Ease information barriers by collecting and making business and economic data publicly and freely available.
- Experiment with legal and regulatory reform by establishing special economic zones.

The KRG should consider two other steps toward creating a better business environment:

- Institute a modern competition law, also known as an antimonopoly law.
- Adopt a strategic plan showing a road map for policy adoption, the proposed timing, what resources will be necessary for accomplishing reforms, and the source of those resources.

Outsourcing and Privatization as Private-Sector Development

The KRG can also improve private-sector employment by outsourcing or privatizing. While some functions are inherently governmental, the private sector can perform others without compromising the ability of the KRG to serve its citizens. Furthermore, experience in other countries suggests that the private sector can often perform these functions more efficiently.

Governments outsource functions when they enter into a contract with a nongovernmental unit to provide services or carry out functions that the government would normally do itself. In contrast, privatization takes place with a state-owned enterprise (SOE) or an entity within government that produces goods or services usually produced by the private sector in a market economy. Full privatization is the complete sale of an SOE to the private sector; with partial privatization, the government retains some control.

Outsourcing and privatization do not always work well, and their success often depends on the function or service being transferred to the private sector, the ability of the private sector

to take on the responsibility of carrying out those functions or services, the specific contract conditions between the government and the outsourcing firm, and the ability of the government to monitor the outsourcing firm. In some cases, it is better not to outsource at all. Despite these problems, outsourcing or privatization can remove workers from the civil service and increase the efficiency with which functions or services are carried out.

Recommendations for Outsourcing and Privatization

One way to outsource is to consider whether specific ministries provide services that the private sector could provide:

- In choosing what to outsource, consider ministries that provide services similar to those provided by private-sector companies.

However, such functions in most ministries likely employ only a small number of government workers. It is likely that there are numerous workers carrying out the same functions in multiple ministries, and outsourcing those functions could bring greater reductions to the size of the civil service:

- Preferably, focus on outsourcing functions within the government that are found in multiple ministries and that also are carried out by private-sector firms and workers.
- Potential functions include office clerks, cleaners and launderers, motor vehicle drivers, messengers and porters, and library and mail clerks.

Deciding on functions and services to outsource will require a certain amount of knowledge about the KRG that might not currently exist:

- Lay the groundwork for outsourcing by improving the KRG personnel management system, in particular by writing job descriptions for civil servants. This will help KRG officials better identify functions to be outsourced.

These outsourced functions will still need to be performed well. Therefore, the KRG should maximize its chances of picking a good outsourcing firm:

- Ensure that tenders—formal government requests for offers to provide goods or services to the government—for outsourcing of services or functions are transparent and widely competed.

Regarding privatization, infrastructure is one candidate:

- Focus on sewerage and water. Although sewerage is less directly related to business development than electricity, the fact that the KRI does not have wastewater treatment plants or sewerage systems presents a privatization opportunity right from the start.
- Consider privatizing additional parts of the electricity system (beyond generation, which has already been privatized).

As with outsourcing, the KRG should maximize its chances of picking a good private-sector firm in a privatization:

- In any privatization, ensure that the process is transparent and invites competition.

The KRG has already privatized a number of firms, often through management contracts. If problems with these privatizations develop, there may be further opportunities for privatization:

- Reprivatize any previous privatizations that may have failed.
- Monitor the performance of the contracts under which the currently privatized entities are operating, perhaps through an independent oversight agency or a global accounting and evaluation firm, and use a transparent legal process to either encourage performance or reclaim the enterprises and then reprivatize if the contract is not being honored.

Civil-Service Downsizing and Reform

Expanding opportunities for private-sector growth does not guarantee that civil-service workers will leave government for private-sector employment or will be able to attain such employment. Private-sector employers will hire only qualified individuals who they believe will be productive employees. Government employees may need training to better align their skills with those in demand in the private sector and might also require an incentive to invest in this training.

The Ability and Qualifications of Civil Servants to Work in the Private Sector

About 20 percent of civil-service workers already work for *both* the government and private-sector employers. Furthermore, more than 90 percent of these workers have civil-service and private-sector jobs that are in different occupations. This suggests that civil-service workers can find a place in the private sector even if they cannot find a job exactly like the one they now hold.

In addition, civil-service workers appear to be more highly skilled than current private-sector workers on at least some dimensions. This is particularly true with communications skills, which employers report that they highly value. In addition, civil-service workers have higher education levels than private-sector workers. As with the data on current job patterns, this suggests that civil-service workers could hold positions in the private sector. However, they choose not to do so.

Civil Service Compensation and Personnel Policies

The main reason civil servants choose not to work in the private sector is that they find civil service work more rewarding. However, these rewards do not necessarily refer to the level of pay. Wages in the civil service are generally below those in the private sector for comparable occupations, while health care, retirement, paid vacation, and regular working hours are more prevalent in the civil service.

For these civil-service workers, the current private-sector wage premium is not enough to offset the value of civil-service benefits. An even greater wage premium or an increase in the relative generosity of private-sector benefits would provide incentives for these workers to consider private-sector employment more strongly.

Recommendations for Changing Civil Service Compensation and Personnel Policies

The KRG has a number of options for changing policies that will decrease the relative desirability of civil-service employment. Each of these has advantages and disadvantages, and so the specific mix of policies must be chosen with care. Furthermore, some strategies that help with downsizing in the near term could adversely affect longer-term reform:

- Develop a strategic human resource plan to ensure that these short-run policies are consistent with the long-term goals of the KRG.
- Establish a civil-service management agency with jurisdiction over all relevant personnel policies.

To help achieve downsizing, the KRG can take several steps to reduce civil-service employment:

- Impose a temporary hiring freeze for occupations that are not inherently governmental.
- Limit government hiring substantially while still ensuring that essential positions are filled.
- Reduce the financial benefits of civil-service employment.
- Slow the pace of civil-service promotions by increasing the number of years before a worker is considered for promotion, with exceptions for the highest performers.
- Promote only a fraction of eligible civil-service workers.

To hire qualified workers and promote them based on performance, the KRG will need to make further reforms in its personnel management system:

- Design and institute an appraisal system to measure and evaluate performance systematically.
- Develop career paths for civil-service workers in order to define worker expectations against which their performance can be measured.
- Develop written job descriptions of all occupations in the civil service.
- Strengthen the link between performance and promotion by awarding promotions only to the highest performers.
- Advertise all vacant positions openly as a way of finding qualified applicants, and hire the most-qualified applicants into each position.

Inducing Voluntary Separations from the Civil Service

Another option for altering the mix of civil-service and private-sector employment is to offer incentives that encourage civil-service workers to leave voluntarily. This option has two advantages. First, separations would be completely voluntary, minimizing the political costs associated with involuntary separations. Second, programs could be targeted to specific civil-service workers, helping the government keep its best performers and separate its worst.

Although such programs have worked elsewhere, it is not clear how well they would work in the KRI. In addition, such programs are costly, and workers who leave might attempt to return to government employment, negating the effects of the program. Therefore, careful design is essential, as is room for experimentation and adjustment.

Recommendations for a Voluntary Separation Program

Effective voluntary separation programs are those that are offered only to workers whom the government wants to leave. In addition, a flexible program allows policymakers to adjust separation incentives to ensure that the right numbers and types of workers separate. The KRG should consider the following options:

- Design a voluntary separation program that is both *targeted* and *flexible*. A performance appraisal system will help officials choose the workers to be targeted.
- Target the program to civil-service workers in occupations that are not inherently governmental and to excess, low-productivity workers in any occupation.
- Prohibit workers who accept severance packages from returning to civil-service employment for a specific period of time.
- However, be prepared to grant exceptions to this rule based on a clear set of criteria that include a demonstrated need for specific skills or leadership abilities.
- Test the program by piloting it in a few, select ministries, and then offer it throughout the KRG.

As workers leave the government, many will still need to find jobs in the private sector. The KRG should consider the following options:

- Work with the private sector to establish private-sector–run clearinghouses for employers seeking workers and for civil-service workers seeking employment.
- Experiment with and support training and job placement programs, but evaluate them periodically to ensure that they are accomplishing the objectives.

The Need for Data Collection and Analysis

Many of our recommendations for both private-sector development and civil-service reform imply the need for data collection and analysis. These include indicators on the skills and education of civil-service and private-sector workers, the specific requirements for and tasks of each kind of civil-service job within the KRG, and detailed information about the number and types of private-sector job openings throughout the KRI, among many others. In many of the areas on which we have focused, the KRG simply does not have the necessary data to enable more specific recommendations. Both data collection and analysis are necessary to ensure that the KRG maximizes the return on its investment in pursuing any of these recommendations.

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Abbreviations

DoD	U.S. Department of Defense
EDIP	Enterprise Development and Investment Promotion
ESX	Erbil Stock Exchange
FDI	foreign direct investment
GAO	U.S. Government Accountability Office
GDP	gross domestic product
HR	human resources
ICSID	International Centre for Settlement of Investment Disputes
IHSES	Iraq Household Socio-Economic Survey
IMF	International Monetary Fund
ISX	Iraqi Stock Exchange
IT	information technology
JTPA	Job Training Partnership Act
KRG	Kurdistan Regional Government
KRI	Kurdistan Region—Iraq
KRSO	Kurdistan Region Statistics Office
LLC	limited liability corporation
NGO	nongovernmental organization
OECD	Organisation for Economic Co-operation and Development
SME	small and medium-sized enterprise
SOE	state-owned enterprise

Introduction

Background

The central focus of the Kurdistan Regional Government's (KRG's) economic development strategy is to nurture and sustain an innovative private sector. Currently, the government employs a substantial number of people working in the Kurdistan Region—Iraq (KRI).¹ This feature of the labor force reflects the confluence of legal, institutional, and political developments in the modern history of Iraq. The KRG recognizes that a healthy and innovative private sector is essential for the long-term economic benefit of its citizens. Therefore, the goal of this monograph is to provide the KRG with a strategy to increase private-sector employment in the KRI. Given the large number working directly for the KRG, a necessary part of this strategy involves a way to successfully reemploy civil-service workers in the private sector.

The age distribution of the KRI's citizens illustrates the serious challenge facing KRG policymakers. The KRI has a very young population. According to data from the Iraq Household Socio-Economic Survey (IHSES) and the Kurdistan Region Statistics Office (KRSO), as of 2007, between 49.4 percent and 50.2 percent of the KRI's population was under 20 years old. This would place the KRI at a rank of 51st to 55th youngest among the 228 economies for which the U.S. Census Bureau produces demographic data. For comparison, the proportion of the world population in this age range in 2007 was 36.6 percent.²

The importance of this for the KRI economy is that there are relatively few older working-age people and a large population that has not yet reached working age. While some jobs will be vacated by people as they reach retirement age, there will be a relative increase in the number of individuals who wish to work. Twenty years from now, we estimate that the KRI will have a net addition of 850,000 to 1.1 million people who wish to work. This implies that an average of 43,000 to 54,000 new jobs *per year* have to be created just to keep pace with the changing demographics of the population.³

Where will these people find jobs? One possible solution is government employment; however, policymakers are *already* concerned about the level of government employment. Although the prime minister of the KRI in early 2011 announced plans to hire additional workers into government positions, the number of potential new hires was lower than the number of new

¹ Throughout this monograph, *the KRI* refers to the governorates Duhok, Erbil, and Sulaimaniyah.

² Chapter Two has a detailed discussion of the IHSES, and Appendix A discusses demographic data from the IHSES (Central Organization for Statistics and Information Technology, Kurdistan Region Statistics Organization, and World Bank, 2008) and the KRSO. Demographic data for other countries were drawn from U.S. Census Bureau, 2011.

³ These estimates are discussed in detail in Appendix A.

jobs per year that need to be created.⁴ As Iraq expands its oil production, especially in the super-giant southern oil fields, the contribution to the KRG's budget from the central government could expand, and the KRG *might* be able to hire many more workers. However, this option will just increase the dependence of the KRG on the central government of Iraq, besides increasing the government payroll and benefit liabilities.

Given the likely challenges associated with substantial increases in government employment, the alternative is to develop and sustain a healthy and innovative private sector. To foster a healthy private sector, there are two essential ingredients. First, the macroeconomic and business climates should be conducive to establishing and maintaining private-sector firms in the region. Second, private-sector employers need access to a pool of labor from which they can hire qualified employees. The surge in young workers is likely to be accompanied by a surge in demand for goods and services, including housing and cars, as these workers form families. If managed properly, the growing pool of young workers could help foster a growing private sector, and a growing private sector could help meet the employment and consumption desires of the growing pool of young workers.

One method for developing a robust economy is to understand obstacles that cut across all sectors when it comes to starting or expanding a business. For example, a lack of available credit is one of the reasons why private businesses in any sector might have trouble forming. In this example, working to revive business finance to support startups, fund working capital, or pay for equipment could have large, positive effects.

A second method is to identify sectors for which conditions are particularly favorable for private-sector growth and to provide a fertile environment to enable new businesses to form and foreign businesses to expand into the region. These sectors are likely to be those for which there is significant consumer demand, either locally or internationally, for their goods and services. Establishing a climate conducive to private-sector growth in these sectors may require special assistance to overcome obstacles.

A third method for achieving private-sector growth is to outsource or privatize some functions that the government currently performs. While some functions are inherently governmental, the private sector can perform others without compromising the ability of the KRG to serve its citizens.⁵ Furthermore, experience in other countries suggests that the private sector can often perform these functions more efficiently. Converting some government functions to private-sector pursuits is a direct way to create private-sector employment opportunities.

However, private-sector growth does not guarantee that civil-service workers will leave government for private-sector employment. Private-sector employers will only hire individuals whom they believe will be productive employees. If civil-service workers do not have the qualifications necessary for private-sector employment, businesses may not be willing to hire them. Alternatively, government employees may need significant training to better align their skills with those in demand in the private sector.

Similarly, civil-service employees will consider other employment opportunities only if the expected benefits of private-sector employment outweigh the benefits of civil-service

⁴ Prime Minister Barhim Salih has indicated that the KRG could hire an additional 25,000 government workers in 2011. See "Kurdish Govt to Hire 25,000 in 2011" (2011).

⁵ One type of function or service that is inherently governmental is security. More generally, such inherently governmental functions include what are known as "public goods." These are services or goods from which no one can be excluded and for which one person's use does not diminish another person's use.

employment. If civil-service compensation is more generous than that available in the private sector, civil-service employees may hesitate to relinquish their current positions voluntarily. Other characteristics of civil-service employment, such as relatively high job security, favored access to services, and subsidized housing, would exacerbate this situation. Furthermore, if the civil-service compensation system does not identify and reward superior performance, the KRG may find that it may lose the employees it needs to ensure the proper functioning of government.

Organization

In the next chapter, we describe the sources and methods we used to carry out our research and analysis. In Chapter Three, we present some basic, descriptive statistics on employment in the KRI. In Chapter Four, we provide an overview of potential methods of private-sector development and an assessment of the climate for business formation and expansion in the KRI. In Chapter Five, we discuss opportunities for government privatization and outsourcing in the KRG. Chapter Six compares selected characteristics of civil-service and private-sector employees in the KRI. In Chapter Seven, we analyze the civil-service compensation system and selected personnel policies that influence employment in the government and private sectors. Chapter Eight reviews different strategies to encourage civil-service employees to seek private-sector employment. In Chapter Nine, we summarize and conclude.

Methods, Information Sources, and Data

We used a number of different sources of information in our analysis and to formulate our policy recommendations. These include documents, such as published and unpublished research literature and KRG and Iraqi laws and regulations; interviews and conversations with KRG officials, domestic and foreign businesspeople inside and outside the KRI, and U.S. government officials; and quantitative data. We describe each of these sources in the following sections.

Documents

We sought documents on four broad topics: the KRI business climate; job creation in the private sector, privatization, and outsourcing; the efficient management of human resources (HR); and the KRI legal environment. For the business climate, we searched for publications or statements from multilateral organizations, consulting and accounting firms, U.S. government agencies, nongovernmental organizations (NGOs) and research institutes, regional entities, commercial firms, and the Arabic language press. Many of these sources did not have information specifically about the KRI but provided more general information about Iraq as a whole.

For the issues of job creation in the private sector and case studies of privatization and outsourcing, we searched for published literature in policy and research journals and for unpublished working papers. We paid particular attention to publications from such multilateral organizations as the World Bank, the Asian Development Bank, the International Monetary Fund, and the United Nations, since these organizations have played an influential role in shaping thinking about private-sector development and in implementing many of the policies. One liability of using these sources is that some of them review the evidence presented by original research. Although this is an efficient way to learn about numerous research efforts, it also relies on the author of the review to correctly represent the findings of each of those separate research projects.

To understand the efficient management of human resources and the civil service, we reviewed the published economics and HR literatures. This helped us to identify effective policies for evaluating worker performance, determining salaries and promotions, and providing incentives that retain productive employees. We also reviewed the economics literature to examine cross-national experiences with government-sector reform and downsizing. The World Bank, in particular, has focused on this issue and even funded civil-service reform efforts.

Finally, we needed to understand the legal environment for civil-service downsizing and private-sector development. We collected procedural and legal documents from both the KRG

and the rest of Iraq, courtesy of KRG officials; the Official Gazette of Iraq and the Official Gazette of the KRI; websites, such as those of the Kurdistan Parliament, the legacy website of the Coalition Provisional Authority, and the *Global Justice Project: Iraq* at the S. J. Quinney College of Law, University of Utah, among others; and other sources, such as the U.S. Law Library of Congress.

Interviews and Conversations

We conducted interviews and conversations with three different groups of people. The first consisted of KRG officials. The second included local and international businesspeople who were operating in the KRI or who were knowledgeable about investment conditions there, international businesspeople considering investment in the KRI, and NGOs in the KRI. The third included U.S. government officials. We discuss each of these groups in turn.

With a few exceptions, we met with officials from all non-security KRG ministries and offices and with the Kurdistan Parliament in order to gain as complete a picture as possible of the topics of our research. Our discussions covered five subjects, including

- the operations and management of the civil service
- individuals' reasons for choosing and staying in the civil service rather than seeking a private-sector job
- the enabling environment for the private sector
- government involvement in the economy and potential programs for boosting the private economy
- options for reform and downsizing of the civil service.

We tailored the subjects of the enabling environment and government involvement in the economy to the specific ministry. For example, when we met with the Ministry of Trade and Industry, we discussed business and industry registration procedures and trade formalities, among other topics. When we met with the Ministry of Electricity, we discussed electricity service throughout the KRI.

Ministries and government entities visited included

- Council of Ministers
- Department of Information Technology
- Erbil Branch of the Central Bank of Iraq
- Erbil International Airport
- Governor's Office, Duhok Governorate
- Governor's Office, Sulaimaniyah Governorate
- Kurdistan Board of Investment
- Kurdistan Parliament
- Kurdistan Region Statistics Office
- Ministry of Agriculture and Water Resources
- Ministry of Education
- Ministry of Electricity
- Ministry of Finance and the Economy

- Ministry of Higher Education and Scientific Research
- Ministry of Housing and Reconstruction
- Ministry of Labor and Social Affairs
- Ministry of Municipalities and Tourism
- Ministry of Planning
- Ministry of Trade and Industry
- Ministry of Transportation and Communications.

The non-security ministries with which we did not meet included Culture and Youth, Endowment and Religious Affairs, Justice, Martyrs and Anfal Affairs, and Natural Resources.¹ With the exception of Natural Resources, we judged these to be less germane to our research. Although meeting with Natural Resources could have been beneficial, our focus was on the non-oil economy, and so we believe our research was sufficiently informed without such a meeting. We also decided in discussion with our research sponsors that we would not analyze the security function of the government.

Our conversations with local and international businesses included businesspeople inside the KRI, in the Middle East, and beyond the Middle East. We also met administrators, faculty, and students of public and private higher-education institutions. Two key groups included the Erbil Chamber of Commerce and Industry and the Sulaimaniyah Chamber of Commerce and Industry. Beyond those groups, in order to elicit candid information, we promised anonymity.

We selected businesses through personal contacts, recommendations of U.S. and KRG officials, and the recommendations of the businesspeople with whom we talked. We requested additional assistance from our government contacts with meeting people from certain types of businesses, including diversified conglomerates, banks, and a privatized company.

For each of these businesses, we covered the following topics:

- procedures for doing business, including licensing and the cost of gaining necessary approvals
- market research challenges
- availability of finance for startups, working capital, trade, and business expansion, as well as requirements for collateral
- land tenure rules and land availability
- agricultural land tenure rules and land availability
- import and export rules and procedures
- quality of utilities and infrastructure
- labor, including skills and work habits of the local workforce, rules for hiring and firing, and rules for foreign labor
- taxes and incentives.

¹ *Endowment* refers to the Muslim religious endowment. Martyrs are generally those who were killed in the Kurdish nationalist struggle, for the most part by the government of Saddam Hussein but by previous governments as well. Anfal is the name given by the Iraqi government of Saddam Hussein to a series of campaigns in 1988 to exterminate the Kurds. It was part of a longer campaign by his government against the Kurds and included the use of chemical weapons, mass summary executions, and the destruction of thousands of villages (Human Rights Watch, 1993). Natural Resources deals primarily with oil and gas.

We also had a separate set of questions for financial firms, including the services they offered given the current legal environment and obstacles to offering more sophisticated financial services, such as equipment loans, working capital loans, and other types of financing to small and medium-sized businesses.

The third group of people with whom we met included U.S. government officials. Our focus with them was on KRI business issues, and we covered the same topics with them that we did with private businesses. Because of the long-term U.S. involvement in Iraq, these officials are particularly knowledgeable about KRI business issues. As with our conversations with private businesspeople, we promised U.S. government officials anonymity in order to elicit candid evaluations. We met with officials from agencies most involved in civilian economic assistance and economic policy, as well as officials who had served in the Coalition Provisional Authority—the occupation authority from 2003 to 2004—and in Iraq since 2004 at the embassy, on provincial reconstruction teams, and with the military.

There are a number of limitations to the interview portion of our research. For interviews with businesses and KRG officials, we were often accompanied by a representative of the KRG Ministry of Planning, and this may have inhibited candid conversation, especially with private businesses. Second, time, budget, and operating conditions did not allow us to select from a random sample of businesses in the KRI. We were reliant on our KRG sponsors to help us find appropriate businesses and to provide transportation and translation. Although the businesses we visited were not at all a random sample, they were known to have a variety of political views, and they provided a very consistent message regarding the topics we discussed. This consistency suggests an acceptable amount of validity in our findings, particularly when these individuals expressed dissatisfaction with current conditions. When possible, we also compared what was said to published laws (when legal issues were discussed) or business guides and media stories (when other issues were discussed) in order to validate the information we received. We applied this latter validation method to information from KRG and U.S. government officials as well.

Data Analysis

Our main quantitative data source was the 2007 IHSES. This survey was fielded to a nationally representative sample of Iraqi households and is a better source than any other we could have obtained for our analysis. Not only was it a carefully conducted representative survey, but, more than any other available survey, it covered topics and asked specific questions germane to this study. Furthermore, unlike any other survey, we were able to obtain the individual survey responses and conduct our own analyses, rather than relying on published tabulations.

There are some disadvantages to the IHSES that one should consider when interpreting our results. First, the data are from 2007, and so any changes in the KRI that have occurred since then will not be reflected in our analysis. Second, our contacts at the Kurdistan Region Statistics Office noted that, in their opinion, the survey was based on an old and potentially faulty sampling frame that excluded some areas of the KRI.

Finally, as with any household survey, answers to the survey questions on which we focus are based on participants' self-reports about their own employment, education, and earnings, and there is no way to verify independently whether these responses were accurate. In the context of our analysis, this will affect our conclusions if civil-service and private-sector workers systematically differ in the extent to which their responses are inaccurate or unbiased. For

example, if one group is more likely to overstate (or understate) its educational attainment than the other group, our comparisons of the two groups' education levels will not be valid.² Without an *a priori* reason to believe that one group is more or less accurate than the other, our analysis provides the best estimate of the differences between civil-service and private-sector workers.

² It could also be the case that the responses of both groups were inaccurate in the same direction, either overstating or understating the accurate response. However, this is less likely to affect our conclusions, since we focus on comparisons between the two groups.

Employment in the Kurdistan Region—Iraq

In this chapter, we present some basic, descriptive statistics on employment in the KRI using the IHSES. These include the distribution of jobs by sector and then the occupational distribution of jobs in the government and private sectors. We compare the distribution of jobs by sector in the KRI to that in the rest of Iraq and in select countries. These statistics provide important context for the remainder of our analysis.

Employment in the KRI and Selected Countries

Current Types of Jobs in the KRI

Figure 3.1 presents the distribution of jobs, by sector, held by workers in the KRI.¹ Thirty-nine percent of all jobs are nonwage jobs; individuals in these jobs are typically self-employed and receive irregular income, as opposed to a regular wage or salary, for the work they perform. The remaining jobs are wage jobs, where individuals receive cash or in-kind payments in return for labor. Approximately 35 percent of jobs are in the government; only 20 percent are wage jobs in the private sector. In contrast, the private-household sector and what is designated the “public sector” in the IHSES are a very small part of the KRI economy.² As Figure 3.1 shows, the private sector in the KRI, which includes both private-sector wage and nonwage jobs, employs more workers than does the government. Nevertheless, there is a large number of individuals working directly for the government.

Tables 3.1, 3.2, and 3.3 present the ten most common occupations in the government, private, and nonwage sectors, respectively.³ In each table, the occupations are listed in descending order by the number of jobs in each occupation. As Table 3.1 shows, civil-service workers are in a variety of occupations.⁴ The largest single occupation is that of police inspectors and detectives, which represents nearly 21 percent of all civil-service jobs. Protective service workers account for about 14 percent of all civil-service jobs. About 17 percent of civil-service jobs are held by preprimary, primary, or secondary school teachers. Office clerks and cleaners and

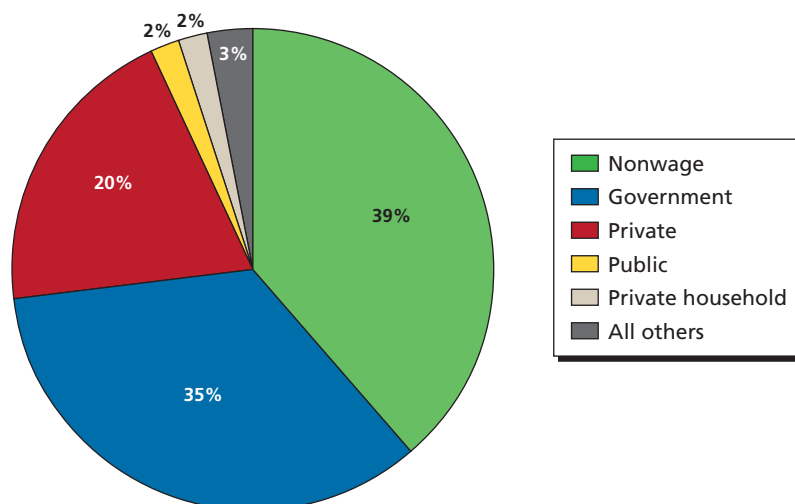
¹ In the figure, each job is counted once, so individuals with more than one job are counted more than once. Alternate analyses of the distribution of workers lead to similar conclusions.

² Public-sector jobs are those in state-owned enterprises. Private-household jobs are those where the person works out of the home.

³ Occupations are classified according to the International Standard Classification of Occupations.

⁴ In the KRI, civil servants are commonly known as *officers*. Throughout this monograph, we use standard international terminology and refer to government employees as civil servants and government jobs as civil-service jobs.

Figure 3.1
Distribution of Jobs in the KRI, by Sector



SOURCE: Data from IHSES-2007.

NOTE: Percentages do not total to 100 because of rounding.

RAND MG117-3.1

Table 3.1
Distribution of Civil-Service Jobs, by Occupation

Occupation	Percentage of Civil-Service Jobs
Police inspectors and detectives	20.8
Protective services workers	13.6
Primary and preprimary teachers	12.1
Office clerks	6.5
Cleaners and launderers	5.1
Secondary teachers	4.9
Motor vehicle drivers	2.5
Messengers and porters	2.3
Library and mail clerks	2.3
Business professionals	1.8
All other occupations ^a	28.1

SOURCE: Data from IHSES-2007.

^a Each occupational category included in this group of “all other occupations” has less than 1.8 percent of civil-service jobs.

Table 3.2
Distribution of Private-Sector Wage Jobs, by Occupation

Occupation	Percentage of Private-Sector Wage Jobs
Building frame workers	33.1
Building finishers	10.3
Motor vehicle drivers	6.8
Messengers and porters	5.4
Housekeeping and restaurant services workers	3.9
Stall and market salespersons	2.7
Machinery mechanics and fitters	2.4
Shop salespersons and demonstrators	2.3
Blacksmiths and tool makers	2.2
Food processing workers	2.2
All other occupations ^a	28.8

SOURCE: Data from IHSES-2007.

NOTE: Percentages do not total to 100 because of rounding.

^a Each occupational category included in this group of "all other occupations" has less than 2 percent of private-sector wage jobs.

Table 3.3
Distribution of Nonwage Jobs, by Occupation

Occupation	Percentage of Nonwage Jobs
Market gardeners and crop growers	25.4
Animal producers	15.2
Motor vehicle drivers	9.8
Shop salespersons and demonstrators	8.0
Stall and market salespersons	7.9
Street vendors	6.1
Textile and garment workers	2.4
Machinery mechanics and fitters	2.1
Business services agents and trade brokers	2.0
Building frame workers	1.9
All other occupations ^a	19.4

SOURCE: Data from IHSES-2007.

NOTE: Percentages do not total to 100 because of rounding.

^a Each occupational category included in this group of "all other occupations" has less than 1.9 percent of nonwage jobs.

launderers each have slightly more than 5 percent of all civil-service jobs; all other occupations each employ less than 1.8 percent of all civil-service workers.

In contrast, the wage-paying private sector (Table 3.2) is dominated by construction occupations, with nearly 45 percent working as building frame workers or as building finishers. The nonwage private sector (Table 3.3) is dominated by agriculture: Forty percent of nonwage jobs are held by market gardeners and crop growers or animal producers. There are a few other fairly sizable nonwage occupations, with motor vehicle drivers, shop salespersons and demonstrators, staff and market salespersons, and street vendors each accounting for between 5 and 10 percent of all nonwage occupations.

A comparison of Table 3.1, Table 3.2, and Table 3.3 suggests that there is very little overlap between the types of jobs available in government and those in the private sector. In fact, the only occupations that are included in the ten largest civil-service *and* private-sector job categories are motor vehicle drivers (Table 3.1, Table 3.2, and Table 3.3) and messengers and porters (Table 3.1 and Table 3.2). These two occupations represent only 5 percent of all civil-service jobs. This implies that, if civil-service workers were to be reemployed in a private sector that resembles the current one, these workers would need to find work in occupations other than the ones in which they are currently working.

This has implications for the speed with which the KRG can downsize and still maintain social stability, to the extent that larger pools of unemployed people will lead to a less stable society. With an underdeveloped private sector, the most promising way to decrease government employment would be to outsource activities into which downsized government employees could work. Such outsourcing could not continue forever, however, highlighting the need to also develop a robust private sector.

Table 3.4 lists the proportion of civil-service workers by the department in which they are employed. For clarity, departments are listed, in descending order, by the proportion of workers. As Table 3.4 shows, three ministries—the Ministry of Education, Ministry of Peshmerga (the Kurdish defense forces), and Ministry of Interior—employ approximately 60 percent of all civil-service workers. The Ministry of Health, Ministry of Finance and the Economy, Ministry of Municipalities and Tourism, and Ministry of Higher Education and Scientific Research also employ large numbers. Taken together, these seven ministries employ 80 percent of all civil-service workers.

It is important to note that there is not necessarily a one-to-one correspondence between these ministries and the occupations listed in Table 3.1. For example, while all teachers are employed by the Ministry of Education and the Ministry of Higher Education and Scientific Research, these ministries employ more than just teachers. Similarly, office clerks are employed in a number of different ministries.

A Comparison with Selected Countries

Table 3.5 compares the distribution of jobs across sectors in the KRI with select countries, including the rest of Iraq.⁵ The countries are sorted, in descending order, by the total percentage of workers in the government sector. As Table 3.5 clearly shows, the KRI has a higher proportion of jobs in the government sector than any of these countries, with the exception of Botswana. Denmark, Norway, the rest of Iraq, and Syria are close to the KRI in the pro-

⁵ For the KRI, the data in Table 3.5 are the same as in Figure 3.1.

Table 3.4
Employment in the KRG, 2009

Division	Percentage
Ministry of Education	24.0
Ministry of Peshmerga	19.9
Ministry of Interior	15.4
Ministry of Health	6.2
Ministry of Finance and the Economy	6.1
Ministry of Municipalities and Tourism	5.3
Ministry of Higher Education and Scientific Research	3.1
Regional Security (Erbil)	2.9
Regional Security (Sulaimaniyah)	2.8
Ministry of Electricity	2.5
Ministry of Agriculture and Water Resources	2.3
Ministry of Endowment and Religious Affairs	2.3
Ministry of Construction and Housing	1.1
Ministry of Industry and Trade	1.0
Ministry of Culture and Youth	1.0
Ministry of Transportation and Communications	1.0
Ministry of Labor and Social Affairs	0.8
Council of Ministers	0.4
Ministry of Justice	0.4
Ministry of Natural Resources	0.4
Municipal, Provincial, and Local Councils	0.4
Ministry of Planning	0.2
Ministry of Martyrs and Anfal	0.2
Presidency of the Region	0.1
Ministry of Human Rights	0.1
All others	0.2

SOURCE: Ministry of Planning.

NOTE: Percentages do not total to 100 because of rounding.

portion of workers in government. However, other countries in the region, including Jordan, Iran, and Turkey, have a lower concentration of workers employed by the government. Among some countries with economies formerly run by the government (such as Poland, Slovenia, and Slovakia), the share of employment in state-owned enterprises is more than 10 percent of the workforce, while more than 70 percent is employed in the private sector. In contrast, Western

Table 3.5
Employment, by Sector, KRI and Select Countries

Country	Government (%)	State-Owned Enterprises (%)	Nongovernment (%)
Botswana	37.8	4.9	57.3
Kurdistan Region—Iraq	34.5	2.1	63.4
Denmark	30.3	3.0	66.8
Norway	29.1	4.9	66.1
Rest of Iraq (excludes KRI)	28.6	2.1	69.3
Syria	27.9	—	72.1
Jordan	21.8	9.9	68.4
Iran	18.5	—	81.5
Slovenia	18.0	10.2	71.8
Ireland	15.6	2.0	82.5
Turkey	13.9	—	86.1
Spain	13.4	0.8	85.7
Slovakia	13.2	10.8	76.0
Czech Republic	12.8	6.6	80.6
Poland	11.9	14.4	73.7
Mexico	10.7	1.4	87.9
Germany	10.2	4.1	85.7
Greece	8.9	13.7	77.5

SOURCES: Data for Iraq come from IHSES-2007; data for other countries come from the International Labor Organization, 2007.

NOTE: The countries and territories in the table are sorted in descending order by the total percentage of workers in the government sector. Some percentages do not total to 100 because of rounding.

European countries with a longer history of private-sector ownership and operation (such as Ireland, Germany, and Spain) have more than 80 percent of jobs in the private sector.

The KRI's high proportion of jobs in the government sector presents a current and future fiscal challenge as these workers receive wages, benefits, and future pensions. Furthermore, the rising number of young workers entering the labor force, combined with these fiscal challenges, suggests that employment opportunities must be created outside the government. The next two chapters present analysis on how the private sector in the KRI can be expanded.

Fostering Private-Sector Development: Taking Advantage of Private Investment and Reforming the Enabling Environment

This monograph discusses the principles of and presents a strategy for reducing the size of the KRG civil service and rebalancing the economy away from the government sector to the private sector. One way to do this is to *foster private-sector development*. Even if the KRG made no changes to the way in which it manages the civil service, rapid private-sector growth would help rebalance the economy away from the government. However, fostering private-sector development could also have a direct effect on the absolute size of the government sector by providing expanded opportunities in the private sector that could attract some civil-service workers because these are jobs in which they want to work. To the extent that the KRG follows our recommendations for private-sector development, this should lead to some reductions in civil-service employment. It will also limit *future* growth of the civil service as the coming waves of job-market entrants find new opportunities that did not previously exist in the private sector.

There are two primary advantages to this strategy. First, separations from the civil service would be completely voluntary. This would minimize the likely political consequences associated with involuntary separations. Second, the financial costs of this strategy are relatively low in terms of direct financial outlays by the government. These costs are limited to the cost of implementing our recommendations for private-sector development; since any separations from the civil service would be completely voluntary, additional financial incentives would not be necessary.

Despite these advantages, there are three main disadvantages. First, the actual response of civil-service workers to these expanded opportunities is unknown. Simply put, there are no data for us to estimate how many civil-service workers, if any, would voluntarily leave for the private sector if more jobs were available. Second, it will take years for a vibrant private sector in the KRI to develop, and, until these separations occur, the financial impact of maintaining a large civil-service payroll will be considerable. Finally, this strategy could result in what is known as *adverse selection*, a phenomenon that occurs when the people taking an action are not the people the policymaker hoped would take the action; in this case, adverse selection would occur if the best civil-service workers were to leave for the private sector.¹

¹ Throughout this monograph, the issue of adverse selection will frequently arise. In the context of our discussion, adverse selection occurs when a civil-service worker has more information about his job market prospects than the government. Absent any steps to counteract it, adverse selection leads civil-service employees with the best private-sector job prospects to leave and those with the worst prospects to remain. However, the government would prefer that the *least* productive employees leave. If private-sector job opportunities are correlated with civil-service productivity, those most likely to leave the civil service are precisely the ones whom the government wishes would stay.

In this chapter, we discuss the benefits of domestic investment, focusing on entrepreneurship and self-employment, and foreign direct investment (FDI) for private-sector development. We then consider the business climate and its effect on domestic and foreign investment. In the next chapter, we review government outsourcing and privatization as methods of fostering the private sector. We conclude each chapter with specific policy recommendations.

Entrepreneurship

Encouraging local businesses via entrepreneurship lies at the core of economic growth and development and job creation. There are “several levels of meaning for the term entrepreneurship” (Gutierrez, 2008, p. 235). The term may refer, for instance, to “small firms,” “firm formation or the addition of new enterprises to the economy,” entailing “innovation (rather than imitation),” and resulting in an increase in “the wealth of a nation or region” (Gutierrez, 2008). We refer to a composite of all these shades of meaning. Entrepreneurial activity may stem from domestic or foreign-invested businesses, although in this section we give additional emphasis to domestic businesses.

Although the study of the relationship between entrepreneurial businesses and growth is relatively new, there is strong evidence that the most rapid and sustained path for growth involves entrepreneurs and entrepreneurial firms that develop new products and services or use new methods (Baumol, Litan, and Schramm, 2007). Entrepreneurs contribute to economic growth by creating new industries, increasing productivity through competition, identifying viable new technologies, working efficiently and intensively, and creating jobs (U.S. Small Business Administration, 2011; OECD, 2006; Haltiwanger, Jarmin, and Miranda, 2010). Indeed, this evidence indicates that developing countries can benefit from entrepreneurship both by borrowing technology from abroad, such as through FDI, and through the innovative activities of local businesses.

A report by the United Nations Development Programme’s Commission on the Private Sector and Development (2004) identifies three constraints to private-sector growth. The first is widespread informality, especially for microenterprises—businesses that operate outside standard laws and regulations, such as by not registering or not making pension payments. Second is the absence of a level playing field for small and medium-sized enterprises due to constraints on market entry, the lack of access to financing, and a weak institutional environment that gives advantages to larger firms that are already in the market. Finally, the report identifies the lack of competitive pressure on large companies as an impediment to growth.

The report also suggests six actions in the public, private, and public-private spheres that would encourage entrepreneurship and private-sector development:

- Reform regulations and strengthen the rule of law.
- Formalize the economy.
- Engage the private sector in the policy process.
- Facilitate access to broader financing options.
- Assist skill and knowledge development.
- Improve delivery of basic services, particularly energy and water.

Depending on the existing institutions and incentives, entrepreneurship can sometimes be directed toward unproductive activities, such as spending time lobbying the government for special favors, or even socially destructive activities, such as participation in organized crime (Baumol, 1990; Sautet, 2005). Therefore, it is important to ensure that entrepreneurs are engaged in socially beneficial, productive activities. The main means to achieve this is to reduce the relative cost of engaging in socially beneficial entrepreneurship.

One important aspect of this is to make it easier for new companies to establish themselves formally through registration with the proper government entities. Several studies show that reducing the cost of registration of new firms substantially increases the rate of new business entry and promotes entrepreneurship (Klapper, Laeven, and Rajan, 2006; Mullainathan and Schnabl, 2010). Streamlining procedures also decreases the possibility of irregular payments.

Another aspect of enabling entrepreneurship is to ensure that entrepreneurs can capture the rewards of their activities. Measures are similar to those mentioned earlier and include secure property rights, the rule of law, predictable contract enforcement, a reasonable level of taxation, and a stable macroeconomic environment. Not all of these measures are under the control of the KRG. In particular, the KRG has little control of the macroeconomic environment, since it does not control the money supply and has only modest taxing authority. However, it does have a strong role in other aspects, such as securing property rights and the rule of law and ensuring contract enforcement.

Finally, new local businesses and the expansion of existing local businesses can help improve the environment for foreign investment. Most studies agree that economic policies aimed at encouraging productive, domestic investment are similar to policies to attract FDI. In fact, a poor domestic business environment can have a negative effect on FDI by limiting the availability of business services that all companies, both foreign and domestic, need (Tornell, Westermann, and Trigueros, 2004).

FDI and Private-Sector Employment in the KRI

In principle, FDI is attractive to a host country for several reasons.² First, it brings additional capital, which countries with a less-developed financial system frequently lack. Lack of capital leads to high interest rates or lower access to credit, constraining investments to projects with higher risk-adjusted rates of return than would be the case with more available credit and pushing out other less-profitable but possibly still beneficial projects.

Second, FDI can bring better technologies, new management techniques and practices, and even completely new activities. These technologies and techniques then tend to be adopted by local suppliers and competitors, creating spillover effects that are often used to justify public-policy interventions that encourage FDI.

Finally, and closely related to the above two factors, FDI can increase private-sector employment. Indeed, one of the reasons capital-rich countries undertake FDI in emerging economies is to gain access to resources, such as labor (in addition to natural resources and markets).

² There is an extensive literature on the benefits and costs of FDI, and research is still ongoing. A comprehensive summary can be found in Chapter Nine of Caves (2007). A second valuable contribution is Chapters Seven and Eight of Navaretti and Venables (2004).

As a result, many countries have come to see FDI as an important tool to contribute to economic development and to advance technological modernization. Many countries now compete vigorously for foreign investment by creating investment promotion agencies, undertaking advertising campaigns, and showering investors with subsidies and tax breaks.

However, the literature shows that the benefits of FDI to a country are far from uniform and do not accrue automatically. For example, researchers have found no universal relationship between the size of FDI inflow and the rate of economic growth in a country (Moran, Graham, and Blomström, 2005). However, most studies conclude that FDI contributes to both productivity and income growth beyond what domestic investment would normally trigger, even if the magnitude of this impact is difficult to assess (OECD, 2002). Also, in the least-developed countries, FDI seems to have a somewhat smaller effect on growth.

The KRG is well aware of the potential benefits of inward FDI and has been quite open to foreign investors. The Investment Law (Law No. 4 of 2006) in the KRI allows foreign investors to own land and exempts them from noncustoms taxes and duties.³ The ability of foreign companies to own land in the Middle East region is viewed as a unique provision (“Iraq’s Economy,” 2007).

Policies adopted by the KRG have resulted in high levels of announced inward foreign investment. Between August 1, 2006, and July 10, 2011, the Kurdistan Board of Investment licensed 22 purely foreign-invested projects with total announced project capital of almost \$2.3 billion and 18 joint-venture projects with foreign and domestic investors and announced project capital of almost \$700 million (Kurdistan Board of Investment, 2011).⁴ The board also licensed 283 purely domestic projects with announced project capital of \$12.7 billion between August 1, 2006, and July 10, 2011. Of this announced project capital, the purely foreign and joint-venture capital comprised 18.8 percent of all licensed project capital.

News reports indicate that the count of foreign investors in the KRI is much greater than the number of investors that have received a license through the Board of Investment. Receiving such a license is not a requirement for investment in the KRI. In early July 2011, citing data from the Kurdistan Companies Registering Directorate of the Ministry of Trade and Industry, AK News reported that 1,602 foreign companies had branches in the KRI, up from 1,027 in January 2010. Also in July 2011, there were 10,100 local companies (Hasan, 2011).

A few remaining issues need to be addressed if this foreign investment is to have a positive impact on the region. First, the Investment Law provides very generous tax breaks for investors in the KRI. These incentives might be effective in attracting foreign investment and might even seem necessary to attract it in the first place. However, the KRG should constantly reevaluate incentives to ensure that they do not have unintended, negative consequences, such as limiting competition by favoring some types of companies, and should be prepared to change these provisions if conditions require.

Second, foreign investors typically employ a foreign labor force. These foreign workers might provide a quick and easy fix for problems related to the availability of suitable labor in the KRI, but, according to the KRG officials and investors with whom we spoke, these workers

³ See Articles 4 and 5 of the Law on Investment in the Kurdistan Region, an English translation of which can be found on the website of the Kurdistan Board of Investment (Kurdistan Regional Government, 2006).

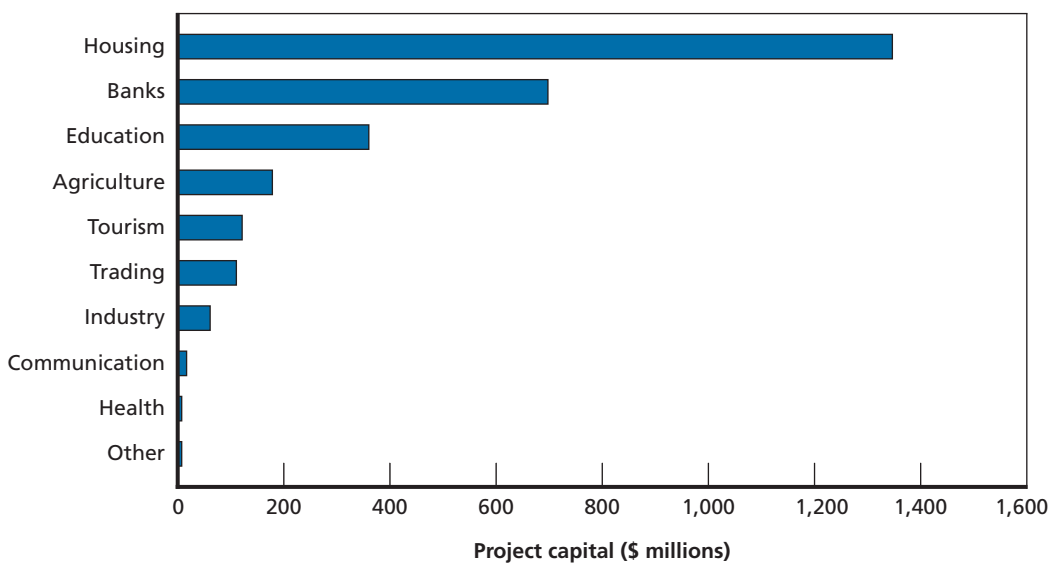
⁴ The Kurdistan Board of Investment is a governmental agency started in 2006 to promote domestic and foreign investment in the KRI; its chairman holds ministerial rank.

normally save and remit a large percentage of their earnings to their home countries. This limits the multiplicative effect of foreign investment, through dampened spending by foreign workers in the KRI, on the region's economy and on the training of local labor by foreign companies. Domestic employees at foreign firms are one of the channels by which know-how and technology spill over to the domestic business sector (OECD, 2002). Therefore, availability of more suitable foreign labor does not, in any way, eliminate the difficult task of improving the skills of the local labor force and of creating appropriate incentives for private-sector employment.

Third, as Figure 4.1 shows, among Board of Investment–approved projects, most foreign and joint venture investment in the KRI has been in nontraded sectors—housing, finance, and education—with almost 46 percent in housing alone. These sectors are protected from competition in global markets. In fact, only 2.2 percent of all Board of Investment–approved project capital from foreign and joint-venture investors was in industry. As with foreign investors, 46.5 percent of all Board of Investment–approved project capital from domestic investors was in housing, but industry captured 23.1 percent. The KRI economy is likely to benefit from investment in the nontraded sectors, but it could also gain great benefits from the missing sectors, specifically investments aimed at serving international markets. There is likely a variety of reasons that the KRI is not attracting export-oriented foreign investment and investment that competes with traded goods, such as difficult foreign trade rules, high transportation costs to global markets, and low labor productivity. This foreign investment pattern suggests that policy interventions related to trade or labor markets could be useful.

While investment aimed largely at serving the host market can have a positive economic impact, at least in the short term, the longer-term effect on employment is mixed (see, for example, McKinsey Global Institute, 2003). This is particularly relevant in the KRI, where most of the foreign investment is in construction-service provision, which does not result in the long-term presence of foreign companies or in long-term employment generation.

Figure 4.1
Foreign and Joint Venture Project Capital, by Sector, August 2006 to July 2011



SOURCE: Kurdistan Board of Investment, 2011.

RAND MG1117-4.1

More generally, FDI can amplify both the underlying strengths and weaknesses of the host economy (OECD, 2002). In other words, policies related to FDI cannot be considered separate from those governing business in general. As we will discuss in the next section, while the KRG has many business-friendly policies in place, further improving the KRI's business climate is crucial.

Key Business Climate Issues in the KRI

Against this backdrop, we now turn to the current business and investment climate in the KRI. Our analysis suggests that the KRI has a number of characteristics that currently make it a more favorable business environment than the rest of Iraq. Security is immeasurably better than elsewhere in the country and is often one of the most-cited advantages. The Investment Law (Law No. 4 of 2006; see Kurdistan Regional Government, 2006) is often named as superior to that in the rest of Iraq, particularly because it allows foreign investors to own land.⁵ However, there are other favorable characteristics, such as the tax incentives the KRG provides to all investors (“Rajul A’māl ‘Irāqī: Sharikāt Khalījīyya Tataṭala’ lil ‘Irāq Lakin Qānūn al-Istithmār Yu’wiquha” [“An Iraqi Businessman: Gulf Companies Are Looking to Iraq but the Investment Law Hinders It”], 2009; “Mustathmir Yadwu’ ila al-Ifāda min Tajribat Kurdistān” [“An Investor Calls for Benefiting from Kurdistan’s Experience”], 2009). In addition, infrastructure, such as roads and electricity, is generally considered better in the KRI than in Iraq as a whole. Electricity improvements, in particular, are notable, with electricity provision improving dramatically in autumn 2008 (U.S. Department of State, 2010). These characteristics have made the KRI a good base for operations in the rest of Iraq (UK Trade and Investment, 2010).

Although the KRI has these advantages now, it is not guaranteed to always have them. Therefore, progressing along other lines will be necessary if the KRG wishes to maintain a more favorable business environment than that of the rest of Iraq. This will also be necessary if the KRG wishes to achieve a more promising goal for long-term development and employment generation: maintaining a more favorable business environment than that found in the Middle East and Central Asia.

Despite the KRI's favorable characteristics, there are a number of important business disadvantages, some of which can be changed and others that cannot. The most important impediment is that the KRI is landlocked, with no seaports and with only a few land ports of entry. However, this issue can be mitigated somewhat with good air links, well-functioning borders, and good road links to seaports in Turkey or the rest of Iraq. The new Erbil International Airport is a good example of how better infrastructure might be used to overcome geographic barriers. The second impediment is that the KRI is a small market of between 4 million and 5 million people. This too can be overcome through increased openness to the world economy, as well as viewing all of Iraq as a potential market.

There are a number of other important barriers that may take time to overcome, but these can be successfully addressed. The first is that the legal environment is still unsettled, with a lack of clarity regarding the application of central Iraqi versus KRI laws and procedures and with some laws that are antiquated or detrimental to business formation. Furthermore, it

⁵ The national government of Iraq in late 2009 amended its own investment law to allow land ownership by foreigners. It appears that these conditions are still not as generous as those in the KRI Law of Investment.

appears that some laws, such as the labor and pension laws, are not well enforced. In addition, Iraq is not a signatory to the New York Convention on Foreign Arbitral Awards, meaning that international companies do not have recourse to the most-accepted forum for international arbitration. There are other accepted forums for international arbitration, but none of these are in force regarding investment in the KRI.

Second, it appears that, with the right project, foreign investors can find entry into the KRI to be fairly smooth. However, the environment for creating new, small, local businesses appears to be difficult across a number of dimensions, including finance, access to land, acquisition of permits and licenses, and government assistance in solving such problems. The lack of entrepreneurial activity or incentives could be a barrier to the development of the KRI because, despite the benefits of large foreign investments, as noted earlier, local capital formation is also extremely important to long-term growth.

Subsequent sections discuss the overall role of government in private-sector development and then specific aspects of the KRI business climate, including

- finance
- land tenure
- utilities and infrastructure
- labor
- procedures for opening a business
- trade policies
- access to business information
- government capacity and partnering for success.

The Role of Government in the Development of a Sound Business Climate

The role that governments should play in developing the private sector and, indeed, the economy as a whole continues to be at the heart of many policymaking debates. One issue is the level of involvement. At one end is the view that governments should play an active role in orchestrating the moves of the private sector. At the other end is the view that, beyond setting and enforcing the rules, such as regulation essential for the orderly functioning of businesses and property rights protection, the government should take a hands-off approach to private-sector development. Between these two extremes is a continuum of views about how actively the government should be involved in the economy. A second issue is the speed of reforms. Some governments believe that, at the nascent stages of an economy's development, they should be more firmly in control and should gradually let the private sector take on a more active role as the economy develops. Others move rapidly based on the idea that numerous reforms are complementary and that moving slowly will just empower interest groups opposed to reforms.

The debate on the government's role in private-sector development is far from settled. In part, it depends on the institutional quality of the government—how well it can carry out the functions it has taken on for itself.

There is widespread agreement that the KRG has developed very strongly since the KRI was first protected by a no-fly zone in 1991. However, there is still progress to be made. Iraqi law is in effect in the KRI, but the KRG also can pass its own laws and has done so, most notably in the case of the investment law of the KRG. Although there is a general rule of law, there is still “a lack of transparency as to which laws are in effect in Kurdistan, and particularly as to their application and enforcement” (Donovan, 2010). Getting information about the

legal environment is also reported to be difficult, and there is legal risk from potential conflicts between Iraqi laws and KRG laws. As part of the development of an improved legal infrastructure, the judiciary needs to develop its independence (All Party Parliamentary Group on the Kurdistan Region, 2011). Improvements are also needed in the operations of Parliament and in limiting corruption. Despite those problems, there is evidence of progress in institution-building, with, for example, U.S. and UK organizations working with the Parliament and the judiciary, and the KRG sponsoring its own transparency initiative (All Party Parliamentary Group, 2011); one outcome is that the KRI is developing more rapidly than the rest of Iraq in both the social and economic realms (Donovan, 2010).

We suggest that, given the pressing need to restore or create such basic services as electricity, potable water systems, and sewerage systems; to expand basic health services; and to improve its educational system, the KRG might not have the capacity to become actively involved in shaping the region's private sector. Although the government may want to set strategic priorities, a heavy dose of industrial targeting may not be a fruitful development strategy. Instead, the KRG might want to focus on its core competencies of providing a secure and sound enabling environment and on ensuring the provision of public goods, such as basic health, basic education, and a solid infrastructure.

Finance

The lack of available financing is one of the most serious difficulties facing local businesses. This does not appear to be a problem for foreign companies; they can access capital from abroad.

Retail banking in the KRI is functional, and account holders can carry out basic transactions. However, the reports that we received were consistent in asserting that formal finance for businesses, in particular for midsize companies, is nearly nonexistent. Early-stage loans are unavailable, as are working capital and equipment loans for ongoing businesses. There is no lending based on the cash flow of the business. Although there may be lending through the use of land for collateral, the amount of land needed is high relative to the value of the loan. Instead, companies draw on profits (which slows their expansion) or friends, immediate family, or other prominent families.

Just as accounts of the lack of available finance are consistent, reports of the reasons for this are largely uniform as well. The combination of both war and international sanctions levied against Iraq has cut the country off from the rest of the world, limiting the exposure of KRI bankers to modern banking methods and technology. Furthermore, expropriation of banks in the past has reduced the trust of the local population in banks, and the ordinary citizen is not familiar with modern banking services.

Along with history and lack of knowledge, there are institutional reasons why banking is not advancing. The most important appears to be the difficulty of getting acceptable collateral. For example, inheritance laws result in plots of land with multiple owners. A bank will therefore find it difficult to claim the collateral on a failed loan. Other complications with land titling may make it unavailable for collateral. Difficulties with land ownership extend to land in both municipalities and rural areas. The *tasarruf* system of rural land ownership makes it hard to use this land for nonagricultural purposes.

Because of continuing problems at the state-owned banks Rafidain and Rashid, improvements in services in the near term will likely come from private banks; new, state-owned banks; or new, nonbank financial institutions. The success of the Trade Bank of Iraq shows that new, state-owned institutions can work. However, its dominance of the letter-of-credit

market—with the inability of private banks to write large letters of credit and the difficulty small firms have in getting letters of credit—also provides a cautionary lesson regarding the activities of state-owned banks and prospects for future bank development and competition.

Aside from commercial banking, other financial markets are missing. These include insurance and mortgage industries. However, there are a number of financing mechanisms that hold promise, including microfinance, business development programs, and the Erbil Stock Exchange. All are helpful, or have the potential to be helpful, but none solves the gap in financing that the KRI needs to fill in order to achieve better levels of private-sector development.

As of March 2010, there were at least four microfinance institutions serving customers in the KRI: the Bright Future Foundation, CHF, al-Thiqa, and Relief International. Average loan size ranged from \$570 to \$2,440. In at least one case, for the Bright Future Foundation, payback rates were reported to be on the order of 99 percent (Louis Berger Group, Inc., and Implementing Partners, 2010; Bright Future Foundation, 2010). An additional program filling the financing gap was the \$3 million United Nations Industrial Development Organization program, funded by Italy, on Enterprise Development and Investment Promotion (EDIP) for the small and medium-sized enterprise (SME) sector in Iraq. This program, which focuses on training entrepreneurs and includes the KRI, has included a pilot SME credit facility (“Special Feature: A Closer Look at Post-Crisis Iraq,” 2010). Launched in 2007, it trained 348 entrepreneurs, of which about 175 were from the KRI, and was expanded by the Italian government in 2010 (Arab Regional Centre for Entrepreneurship and Investment Training, 2010). Finally, the Erbil Stock Exchange (ESX) was expected to start operating in the first quarter of 2011 with startup capital of \$10 million (“Erbil Stock Market to Start in 2011 with Startup Capital of \$10 Million,” 2010). However, as of early December 2011, we have seen no public confirmation that it has started. It is not clear, however, whether the KRI needs its own stock market. The Iraqi Stock Exchange (ISX), as of November 2010, had total market capitalization of only \$3 billion, with a daily trading volume of about \$1 million, quite low by international standards (O’Neill, 2010, p. 57).⁶ There are reports that the purpose of the ESX was for listings by local companies (“Erbil Stock Market to Start in 2011 with Startup Capital of \$10 Million,” 2010). If carried out, this suggests that volume and liquidity on the ESX will be very low. In contrast, small as it is, participation in the ISX would give companies a deeper market, with access to more capital and more buyers than would be available on a KRI exchange. One way to improve the volume and liquidity of the ESX would be to link it to the ISX and allow for cross-listings. A December 2010 agreement between the ISX and the ESX establishes cooperation in technical fields, training, operations, and financial and legal issues and allows the ESX to use the electronic systems of the ISX market and depository center, so cross-listings may be a possibility as well (“Ittifāq Ta’awun bayn Sūq al-’Iraq lil Awrāq al-Maliya wa Būrsat Irbil lil Awrāq al-Maliya” [“A Cooperative Agreement Between the Iraqi Stock Market and the Erbil Stock Exchange”], 2010).

Land Tenure

Finding land for a new, local business can be a serious problem. Reports are consistent that foreign investors who go through the Kurdistan Board of Investment process usually succeed

⁶ In contrast to the ISX’s daily volume, the average daily volume of the Saudi exchange for the 50 days up to January 31, 2011, was 3.2 billion Saudi riyals, or 865 million U.S. dollars (average daily volume is from Gulfbase, 2011; the dollar-riyal exchange rate is from OANDA, 2011).

in receiving land appropriate to their venture. However, this is not the case for local businesses, and getting land can take months, or longer.

Part of the difficulty is that the land registry system is in poor shape and that it is not easy for a prospective buyer to discover exactly who owns a specific plot of land. Fixing this will require legal reform. It has also been reported to us that irregular payments are occasionally necessary to obtain land.

We note that recent legal reforms allowing ownership of agricultural land to increase from 75 hectares to 250 hectares increases the viability of farming with modern methods and is therefore a promising reform. However, much more progress is needed. At the extreme, lack of clear land titling has been noted as a contributing factor in Egypt's January and February 2011 unrest (de Soto, 2011).

Utilities and Infrastructure

The improvement in electricity production is one of the most notable events in the delivery of infrastructure services for business. Water service is reported to be slightly better than in the rest of Iraq, as are roads, although telephone service is reported to be worse, and potable water is insufficient.

In electricity service, the KRI has changed from being below the Iraqi average for the amount of demand met to well above average. New generators with private participation and new transmission lines have improved electricity service throughout the KRI. Indeed, it is conceivable that the KRI could be an electricity *exporter* within the next five years, selling to both Turkey and the rest of Iraq.

Despite these improvements, electricity is still insufficient for private-sector needs. Businesses in the KRI need to have private provision of both electricity (through their own generators) and water. This has real costs, as private generation can add significantly to production costs, making products uncompetitive on world markets or expensive for domestic markets.

The KRG also reportedly has fallen short on delivering promised infrastructure for projects, resulting in several cancellations. Although some developments have built their own infrastructure, this is not a sustainable model for most developments in the KRI.

Finally, although the information technology (IT) and Internet infrastructure is rapidly expanding its reach across the KRI, the population is still relatively undercovered, and, even across the major cities, service is reported to vary in quality. This may affect the willingness of existing businesses to expand into areas outside those with adequate IT and Internet infrastructure. Furthermore, even within the KRG, the IT infrastructure is still developing, and only a fraction of government employees actually use these tools in a substantive manner. This affects the coordination across agencies and ministries, resulting in delays in the registration and licensing of new businesses and difficulties by potential investors in obtaining access to reliable data on the sectors in which they are interested.

We note that there are a number of efforts to continue to improve utilities in the region, including the building of new water treatment plants, the development of a river basin management plan, and the continued improvement of the electricity system. Other efforts are lagging, such as the creation of sewerage systems. Completion of modern infrastructure systems will be an important element of an improved KRI business climate.

Labor

There are three issues regarding labor that are important to the business climate—the quality of labor in terms of skills and training, work effort while on the job, and the legal conditions of employment. Most of the information we have gathered indicates that employers find that the quality of labor in the KRI is currently problematic.⁷ In particular, employers report that job-specific skills are low.⁸ Furthermore, employers report that the work ethic of those they hire is not of a sufficiently high standard.⁹ Some of these assertions may stem from the possibility that employers often want more out of their workers, regardless of their level of productivity. However, the reporting is consistent across virtually everyone with whom we discussed this issue. While workers are criticized, we were also told that it is very difficult to find residents of the KRI who can succeed as middle managers or entrepreneurs.¹⁰

There are a number of reasons for the purported lack of labor force skills. Education has been poor, stemming in part from many years of war and upheaval. This is true not just for primary and secondary school but also for university education. For universities in particular, centralized admission (which removes choice for students and competition between universities), the curriculum, and textbooks have all been cited to us as problems, along with a lack of linkages between university faculties and their international counterparts through access to leading journals. In addition, vocational education is reported to be weak, both in formal vocational schools and in vocational training centers. In many cases, this educational gap has left workers in the KRI with substandard skills and without the educational base necessary to absorb new skills. The centralization of higher-education institutions has slowed them from responding to market forces.

There are also a number of reasons for the purported lack of work ethic. A large share of the labor force is connected to the government, either through direct employment or through a relationship with an employed family member. Although government salaries are low, benefits are reported to be excellent, acting as an incentive against working exclusively in the private sector. Rather, working in both the civil service and in the private sector seems to be common. Furthermore, many report a surplus of civil-service employees relative to the amount of work to be done.¹¹ The result is that many workers are not used to working hard and are not used to the expectations of higher productivity in the private sector. Furthermore, the generous benefits accorded by the government may provide a disincentive for skill formation, since they will be received with little relationship to skills.

Consequently, private-sector employers in the KRI often prefer to use foreign workers. This holds true not only for foreign businesses (where a preference for labor from their native country might be expected) but for Kurdish-owned businesses as well.

⁷ We revisit these issues in Chapter Six.

⁸ Some report that worker quality is better in the KRI than in the rest of Iraq. However, others note that the population of the KRI has lower levels of education and literacy, on average, than in the rest of Iraq.

⁹ Work ethic was a concern of both private- and public-sector managers, but in this section we focus on our findings regarding the private sector.

¹⁰ We note that the difficulty that entrepreneurs have getting land acts as an incentive against anyone wanting to become an entrepreneur.

¹¹ Many who report a surplus of civil-service employees also report a *shortage* of *qualified* civil-service employees. The result is that the few qualified workers in the civil service end up working very hard.

With respect to the legal conditions of employment, employers report that it is very easy to both hire and fire workers in the KRI. Although firing workers is never pleasant for the worker or for the economy in the short run, the ability to release labor easily is an important factor in providing employers with the incentive to risk hiring someone. The inability to fire means that the employer will be less likely to hire. On this dimension, at least on the surface, the KRI provides a very flexible labor market.

However, there is some question as to whether this is actually the case. The employment of KRI labor is still governed by Law 39 of 1971 (Workers Pensions and Social Security), as amended by Law 155 of 1971 and by Law 71 of 1987 (the Labor Code). Law 71 in particular lays out fairly strict rules both about how an employer can fire a worker and about how a worker can quit (Government of Iraq, 1987a). These rules suggest that, if employers were to follow the law exactly, the labor market would be much less flexible.

Having a situation in which employers and workers appear to have labor market flexibility but in which, in reality, there are more inflexible legal requirements is inconvenient for both parties. Everything can run smoothly until the law is enforced, either because the employer has run afoul of an important official or because an aggrieved employee has good connections, or because fair administration of justice requires action. If this happens, the situation can become difficult for both employers and workers, harming potential investment as investors learn about the developments.

We were also informed that there are a number of problems with the pension law. Specifically, we have been told that private companies sometimes do not pay into the pension system, and that the legally mandated pension amounts are low compared to current standards of living and to government pension benefits. The KRI does not have a social security system covering all workers, as do most advanced countries. Therefore, if pensions are not collected or not adequate under Law 39 of 1971, private-sector workers are unlikely to have retirement benefits when they have finished their careers.

As of 2011, the KRG was revising both the pension law and the labor code. Although it may be useful to consult experts from the region and follow regional models, we suggest that the KRG focus more on best-practice labor laws from around the world. It is not clear to us that labor laws in the region are the best model for helping KRG leaders create the kind of economy that is desired. In fact, most countries in the region have a strikingly poor record of job creation, and the legal environment has been a part of this problem.

A final legal issue related to labor is the use of foreign workers. By *foreign workers*, we mean workers from both Arab countries and non-Arab countries, but not workers from the rest of Iraq, who generally appear to be active in the KRI with no formal barriers. Our interviews and anecdotal reports indicated that the use of foreign labor in the KRI is widespread. The legal basis for this use is unclear, however. Our understanding is that the relevant laws include Iraqi law, as well as the KRG Investment Law (Kurdistan Regional Government, 2006).¹² Iraqi law gives almost completely free entry to workers from Arab countries but is quite strict about workers from non-Arab countries, including a permitting system run by the government, a requirement that skilled foreigners must train their Iraqi counterparts, and a requirement that there should be an absence of an Iraqi with similar qualifications. The KRG Investment Law

¹² The relevant Iraqi laws are Law 71 of 1987 (Government of Iraq, 1987a); Instructions on the Practice of Foreigners Working in Iraq, No. 18 of 1987 (Government of Iraq, 1987b); and Instructions Revising the 1987 Instructions (No. 18) on the Practice of Foreigners Working in Iraq, No. 4 of 1989 (Government of Iraq, 1989).

is freer, allowing investors in projects approved by the Board of Investment to employ foreign staff as needed, with priority given to local workers.

We cannot verify that all non-Arab foreign workers in the KRI have followed the standard legal process or work for projects that have been approved by the Board of Investment. We note instead that the jobs held by foreign workers appear to be at all skill levels, including low-skilled levels. It also appears that at least some of these jobs could be filled by residents of the KRI. The main uncertainty for employers is what they will need to do to ensure that the work effort of KRI residents matches the work effort of foreigners.

Procedures for Opening a Business

Recent research on private-sector development has focused on business regulations and their enforcement, in particular regarding the ease of starting a business, dealing with construction permits, employing workers, registering property, getting credit, protecting investors, paying taxes, trading across borders, enforcing contracts, and closing a business. This research has shown that numerous and costly procedures can have a negative effect on private-sector development.¹³

Iraq as a whole has fared very poorly on these dimensions. The 2011 *Doing Business* report (Doing Business, 2011a) ranked Iraq 166th out of 183 countries and last out of 18 in the Middle East and North Africa region—worse than Syria, Iran, the West Bank and Gaza, and Djibouti.

To the extent that KRI laws and procedures mirror the laws and procedures of the rest of Iraq, it too does very poorly relative to both the surrounding region and the rest of the world. However, in some dimensions, such as the ease of getting land, the KRI is clearly superior. We cannot assess how it compares with the rest of Iraq across all dimensions, although we think this is important enough that the KRG should consider negotiating with the World Bank for a separate analysis of the KRI.¹⁴

We also focused on the rules for registering a business in the KRI. In general, people told us that, once the paperwork was in order, it was not difficult to register on the commercial registry at the Ministry of Trade and Industry or on the industry registry under Law 25 at the Ministry of Trade and Industry. However, there are three additional points worth discussing.

First, we were informed that approvals for new investments depend in part on the extent to which the KRI currently imports significant amounts of the goods that are to be produced. With each application, the KRG assesses the current level of imports and decides whether the goods need to be produced in the KRI. If the new business is considered to be necessary, approvals can be granted quickly. The consequence is that some applications might be granted in sectors in which it would be more efficient to import, while other applications might not be granted in sectors in which consumers are currently underserved by both domestic and foreign suppliers. Other conversations with KRG officials suggested that there are currently shortages in *every* sector, so this might not be a binding constraint at this time. As the KRI economy

¹³ The leading organizations ranking countries on these dimensions are the World Bank and the International Finance Corporation (a part of the World Bank Group) in their annual *Doing Business* reports. See Doing Business (2011a) for more information.

¹⁴ The Doing Business program has completed 20 subnational reports as of April 10, 2010. Although most of them look at all regions in a country, at least one has reported on conditions in a single region in a country: a report on Veneto, Italy, in 2009 (for more information, see Doing Business, 2011b).

expands, however, it is possible that consideration of the level of imports when granting registrations could stifle private-sector development in certain areas.

Second, getting the paperwork in order may be burdensome and time-consuming for small and even medium-sized businesses. For completing all procedures, we received cost estimates of between \$3,500 and \$10,000, with one estimate as high as \$25,000. These may be relatively small sums for foreign investors, but even the lowest estimate amounts to about 166 percent of the per capita Iraqi gross domestic product (GDP) (IMF, 2010).¹⁵ Even if per capita GDP in the KRI is much higher than per capita GDP in the rest of Iraq, this is still an enormous sum. We have also learned that domestic companies can sometimes avoid these fees through personal connections, but this just means that there is not a level playing field for business ventures and that the best ideas may not get tried.

Third, depending on the sector or whether the company is going through the Board of Investment, there may be a need for approvals from multiple ministries. This lengthens the time required to get the investment approved, thereby increasing the cost. One person with whom we spoke discussed attempts to create an integrated system across ministries, with web-based application forms that would be routed electronically to the appropriate ministries. Despite the desire by some to streamline the approval process, this has not, as of yet, been accomplished.

Trade Policies

We also investigated the ease of importing and exporting. This is important to private-sector development because open economies grow faster than economies with high or complex trade barriers, and growth is an important factor in job creation (Wacziarg and Welch, 2008). In fact, even unilaterally liberalizing trade—rather than lowering barriers only if others lower them—can be better for society than focusing only on substituting local production for imports (Puga and Venables, 1999). Even with these distinct advantages, trade liberalization can create winners and losers, so moving to a more open trade regime must be well managed politically (Edwards and Lederman, 1998).

Most businesspeople and officials with whom we talked said that importing and exporting was relatively easy. However, we identified a number of problems. The most important is that, formally, one must obtain a license to export, and obtaining this license depends on a committee ruling that the item to be exported is in surplus in the region. Although this policy is a holdover from the days when Iraq tried to become self-sufficient, this limit on exports can be devastating to a small economy because it blocks sales, profit, and growth opportunities for farmers and businesses in the KRI.

People we talked to said that, in general, no one who wants to export has been stopped. However, they noted that the law provides an opportunity for irregular payments in order to get permission. If this is the case, then the law is taxing the KRI's most productive businesses—those that can compete in the international marketplace—and harms their ability to compete by raising their costs.

Importing also requires a license and commitments regarding the quantity to be imported. This may invite irregular payments and create impediments to obtaining necessary imported inputs, intermediate products that are used in the process of producing final goods.

¹⁵ See Table 1 in IMF, 2010, p. 27.

Relations with the rest of Iraq regarding trade have proved to be an occasional problem. We have received credible reports that officials at checkpoints have placed additional burdens on shipments of goods into the KRI from the rest of Iraq and that central government authorities have cut off supplies of industrial inputs into the KRI, although we have not been able to verify the frequency of such occurrences. We have also received reports of the central government blocking or discouraging exports from the KRI to locations abroad. There may be little that KRG officials can do about the actions of authorities in the central government of Iraq, but it does make doing business in the KRI more difficult.

Finally, although border procedures at the port of entry with Turkey tend to run smoothly, there are reports of occasional irregular fees.

Access to Business Information

Both businesspeople who have invested in the KRI and those who have considered investing in the KRI report that the lack of reliable data on the market potential of the sectors in which they might invest is a significant barrier to both foreign investment and the creation of new, local businesses. When these data have been collected, they are not always easily accessible by potential investors.

The draft statistics law, if approved in its present form, may present an additional barrier to the collection of business information. As of January 2011, although it permitted nonofficial parties to collect data related to marketing their own products and services, it also stipulated that nonofficial parties would require prior approval from the KRSO before collecting data and that the KRSO would have the right to examine the collected data.

It is certainly appropriate for the law to enforce confidentiality of such privately collected data in terms of protecting identities, and it would be appropriate as well to stipulate that no private organization may represent itself as collecting data on behalf of the KRSO (unless that were true). However, private data collection is a normal part of any dynamic economy. Requiring prior approval from the KRSO could deter the collection of useful data that facilitates the functioning of such an economy—and could burden the KRSO as well.

Government Capacity and Partnerships with Private Investors

Some investors find that the capacity of the government to execute its promises is still low. This is due to several factors: the delay of getting the budget from the central government, the lack of multiyear budget planning, the skills and capabilities of some government officials, and ministerial coordination.¹⁶ As of late 2011, the KRG had been engaged in an active effort to finalize a five-year regional development strategy, but correcting budget issues will, in part, depend on improvements in the operations of the central government in Baghdad as well.

In most developing countries and regions, foreign businesses find it useful and even necessary to have a local partner in order to have a successful venture. Such partners can provide important local knowledge, particularly in terms of how to do business and what the market is like. The KRI is no different. The KRI can safeguard and improve its business environment if its government and political leaders can ensure the reality and the perception that such partnering is free of political interference. To facilitate this, the government should set as a goal the development of arbitration mechanisms, perhaps in international venues, through which dis-

¹⁶ We note, however, that ministerial coordination in the KRG is reported to be better than in the rest of Iraq.

putes can be fairly adjudicated. An alternative would be to develop an independent monitoring and investigatory agency that would evaluate disputes and publicly release assessments. If the KRG were to go this route, however, it would need to ensure that not only would the agency be independent but also that investors perceived it to be independent.

Even the *perception* of political interference can have serious reputational considerations for the KRI in the most developed countries, from which the majority of the world's foreign investment originates. There will always be companies willing to invest in politicized environments, but these may not be the companies most beneficial to the KRI's development and job creation. Previous research has shown that perceptions of corruption tend to depress the level of FDI and that the absence of some aspects of the rule of law tends to depress investment from more-advanced companies.¹⁷

Recommendations for Private-Sector Development

There are a number of ways to look at business climate issues, and the concept of one business climate is a bit simplistic. A region that has rules favorable for farming may have rules unfavorable for manufacturing, just as a region that is welcoming to wholesale distribution may be unwelcoming to mining.

Even though sector-specific assessments are useful, there are notable advantages to focusing on, reforming, and improving conditions that are applicable to all businesses. Doing so may unleash entrepreneurial opportunities in sectors that analysts and government officials would not have considered. Therefore, in this chapter, we have chosen to look cross-sectorally by focusing on the enabling environment for business and investment, with a special focus on the formation of local businesses.

As a newly secure region with only its second unified government, the KRI has taken great strides in improving its business environment. However, a number of challenges and opportunities remain. In implementing the development of a more robust economy with large amounts of private-sector job creation, KRG leadership has the potential benefit of significant levels of oil revenues, either from their own region or from the rest of Iraq. However, the serious challenges remain of an unsettled legal environment and old laws and regulations that have carried over from previous periods of Iraq's history. The KRG also has the long-term mission of educating a new generation of KRI residents to take full advantage of modern technology and international opportunities. A well-educated, young population can pave the way toward greater formation of local businesses, greater involvement of international companies in the KRI, and greater involvement by the KRI with the international economy. In this section, we present the steps that the KRG can take to improve its chances of having a private sector that creates jobs and drives the economy of the KRI.

Domestic Business Formation

The KRI has developed an environment that is somewhat friendly to foreign investors and yet still difficult for new business formation by domestic investors. If not fixed, this will present

¹⁷ For investment and corruption, see Wei (2000). For investment and the rule of law, see Campos and Kinoshita (2003). For a special application regarding the composition of FDI and one aspect of rule of law, intellectual property rights, see Lee and Mansfield (1996).

a long-term barrier to creating the number of jobs the KRI needs. Government-job creation and foreign investment likely will not be able to fill the gap. As noted earlier in this chapter, improving the environment for domestic business formation will also improve the environment for FDI. The World Bank offers some practical toolkits for policymakers on improving specific aspects of the business environment, such as inspections, business licensing, customs reform, and dispute resolution (see World Bank, 2011). We recommend two concrete steps in this area.

Simplify procedures for starting formal small and medium-sized businesses. Starting a business takes a great deal of time and requires a large expenditure relative to average income levels. Systematic evaluation of such procedures and costs has become common at the country level through the Doing Business program of the World Bank and the International Finance Corporation, but such a systematic evaluation appears to be absent for the KRI. Lack of such knowledge can be an important contributing barrier to reform. We first recommend that the KRG negotiate with the World Bank to have that institution conduct a Doing Business–type survey for the KRI, that the Ministry of Planning contract for such a survey with an independent organization if arrangements with the World Bank are impossible, or that the Ministry of Planning conduct its own survey as a benchmarking exercise. Once all the steps for starting a business are known, the aim will be to eliminate or combine as many as possible.¹⁸

Start on legal reform of land titling and sale. Lack of availability of land is one of the major barriers to starting a new, formal business. Buying land or assembling a large-enough parcel for an enterprise can be difficult because of the current legal environment. As with any legal reform, reforming landholding law and procedures could be a multiyear process. However, easing the process of buying land and establishing clear title will help the formation of new businesses, the expansion of existing businesses, and even the formation of large farms that can be internationally competitive—an important benefit, given that agriculture is a priority sector for the KRG. This can also help improve the financial sector by enabling the use of land for collateral for loans.

Openness to the International Economy

International openness is not a panacea for private-sector development and economic growth, and openness takes many forms. Despite this, some KRG policymakers and higher-level civil servants appear to be focused on a pure import-substitution strategy, policies that were largely discredited about 30 years ago. There may be security reasons for embarking on import substitution, but, if so, policymakers are making an explicit choice to safeguard security at the expense of economic growth and job creation, not to have both security and job creation.

The KRG should remove its import and export licensing rules and restrictions. These requirements present, at a minimum, a procedural barrier and create unnecessary uncertainty. They should be removed. Even beyond creating a trade barrier, the system uses valuable civil-service time and runs counter to the KRG policy of having a smaller, more efficient government. In addition, being open to international trade is complementary to being open to international investment, an important KRG policy goal. We recognize that some restrictions may be of value for reasons other than the economy. If any trade restrictions are kept, the KRG

¹⁸ It is likely that many agencies or ministries that now are part of the approval process will argue that they should remain part of the approval process. It is also likely that their arguments will be unrelated to job creation.

should move to what is known as a negative list: All goods and services can be exported and imported, except for a short list of goods and services for which trade is regulated.

There is evidence, primarily from South Korea and Brazil, that import substitution can be economically helpful in some cases (Dornbusch, 1992). However, these countries had a number of advantages, not least of which was their size. There is “massive evidence that small countries will wither behind protective barriers” (Dornbusch, 1992, p. 80). With a population of 4 million to 5 million people, the KRI is unlikely to benefit from high trade barriers.

Finance

The KRI is missing a number of financial markets that will be helpful for private-sector development and job creation. Among these are all types of insurance, as well as business lending. Regarding business lending, despite the programs we have cited, there is little capital available for working capital, equipment, or expansion for small and medium enterprises. This is partly due to the legal environment regarding collateral that can be used for bank loans. However, it is also due to an underdeveloped banking sector. It is unlikely that the state-owned banks can become active in business lending in the near and medium terms because they are essentially bankrupt and few concrete steps have been taken either to restore them to financial viability or to liquidate them. Therefore, we recommend that the KRG take steps to foster the private banking system.

To expand the financial sector, the KRG should consider having civil-servant salaries deposited directly into accounts in private banks. This would serve two purposes. First, it would increase the loanable funds held by banks. Second, it would familiarize a large portion of the KRI population with banking in general, and private banks in particular. As noted earlier in this chapter, there are low levels of trust in banks in the KRI. Successful use of banks can help increase this trust.

In its efforts to attract new financial service providers, the KRG should target lenders that focus on medium-sized businesses. While the microlending market in the KRI appears to be quite active, there is an important financing gap for businesses that want to grow beyond a small size or that are currently medium sized and want to continue to grow.

Public Services

Although the KRI has far surpassed the rest of Iraq in electricity generation, utilities still present a barrier to business development and job creation. Civil servants responsible for the electricity and water systems note that they are operating under constrained investment budgets. Unreliable electricity, in particular, leads to the use of costly generators and increases business costs.

The KRG should move to greater recovery of costs for electricity and water. The KRG should aggressively pursue metering and charge rates that cover a greater share of the cost of providing electricity and water. Doing so will provide the ministries responsible with more money to improve the system or outsource to qualified firms.¹⁹

¹⁹ Some might argue that electricity and water should be free to consumers, but they can never be completely free. If the KRG provides them for “free,” then it is merely deciding to pay for the service by cutting back on service quality and failing to invest in electricity and water or in other activities. There is also no reason for the poor to be harmed by full-cost recovery. Low tariffs for small amounts of initial use can be instituted, as can direct income support for the very poor. Economic theory suggests that as long as the average cost of providing electricity or water is declining, it is more economically efficient for the utilities not to recover their full costs. However, not recovering the full cost means that the cost of provision is subsi-

Labor

A number of labor issues are present in the KRI related to job creation. The KRI has a labor law from another era, although this was being reformed during 2010 and 2011, and the pension law may be inadequate but was also currently being reformed. In addition, there are few formal mechanisms for matching job seekers and employers, such as services in which employers list job openings or programs at universities that bring in employment recruiters to meet students.

In the reform of the labor law, we recommend that the KRG consult international best practices—for example, by using experts from countries of the OECD. We recommend that any new labor law *not* be based on labor laws from the Middle East and North Africa region, as the economies in this region are not among the most successful at creating jobs.

We also recommend that the KRG consider its own legal rules for foreign workers, including those from Arab and non-Arab countries, if it can do so under the Iraqi constitution.²⁰ The aim should be to ensure that foreign workers are doing jobs that residents of the KRI cannot or will not do. One way—but certainly not the only way—to do this is to set up a labor exchange, discussed in Chapter Eight in this monograph, in which job seekers register and list their skills. When an employer wants to hire a foreign worker, the skills of that worker can be matched against the skills of workers in the jobs registry to see if the job is one that can be filled with a local worker. As with the new labor law more generally, any provisions regarding foreign workers should be written along the lines of best practices globally, not regionally. In addition, there should be some appeal mechanism for employers who are denied their request to hire foreign labor, as not all relevant skills can be codified in writing.

The KRG should enforce the payment of pension obligations by workers and companies. This relatively short-term step can increase confidence by workers that they will receive pensions when they retire from private employment. **We also recommend that the KRG continue its pension reform efforts to institute a retirement system that could make the private sector more attractive to workers.** Statements by the Minister of Labor and Social Affairs show a commitment to make benefits in the private sector more similar to those offered to civil-service employees, noting that the KRG “will take responsibility for 30 percent of the cost of a retirement fund to help those in the private sector” (Doosky, 2011).

However, we have two cautions. First, this may not have a large effect on the choice of employment by people entering the labor force (Kleinman and Hansen, 2005). Even though older workers are concerned about pensions, there is at best mixed evidence that new, young workers are concerned about pensions. Second, these policy reforms could increase labor costs to businesses, thereby actually decreasing private-sector employment in the short term.

Dispute Resolution and Safeguarding the Returns to Entrepreneurial Effort

The KRG’s open investment law has proved attractive to many foreign investors. The generally good security situation has also proved a draw. In an open investment environment in which foreigners are pursuing business opportunities actively, it will be inevitable that disputes arise

dized by the government with money that could be used for other purposes, such as education or health, and that too might be inefficient. What is certain is that the KRG would benefit by recovering far more of the cost of providing utilities than it is currently recovering.

²⁰ The Iraqi labor law, No. 71 of 1987 (Government of Iraq, 1987a), differentiates between foreign workers from Arab countries and those from non-Arab countries.

between foreign investors and the KRG. The KRG is not currently part of any international dispute arbitration mechanism. Although it will be difficult to join such a mechanism unless Iraq as a whole joins, other arrangements might be possible.

The KRG should explore arrangements for resolving investor disputes in an international forum.²¹ No matter how good the local courts are, there will always be distrust between foreign investors and local authorities. Unresolved disputes can lead to official actions by foreign governments and rumors in the marketplace, both of which end up suppressing investment. Agreeing to an international dispute resolution mechanism can help build investor confidence and resolve any unfounded perceptions.

Over the longer term, domestic dispute resolution mechanisms, such as the courts, should be strengthened so that all businesses can settle disputes fairly, whether those disputes are with the government or other businesses.

Activist Policies to Support the Private Sector

Although much economic theory and some empirical findings support a minimal role for government in the development of the private sector, this stance is certainly not universally agreed on. Indeed, officials from some of the most successful economies, such as South Korea and Malaysia, would argue that government interventions have been important. Recognizing that the KRG might want to engage in some activist policies, we present a menu of possibilities that could help foster private-sector employment.

The KRG should aim its investment incentives at the hiring and training of local labor, partnering with and training local businesses, and attracting industries that serve regional and global markets.

- **Local labor.** Investors, both foreign and domestic, have shown a taste for hiring foreign labor. Besides enforcing laws regarding who may work in the KRI, the KRG can tilt the balance more in favor of local labor by providing incentives for hiring or training local workers. These incentives could include tax reductions, which would decrease the cost of labor to the firm, or training grants, which would increase the capabilities of the targeted workers. As with all such government deals, we recommend that these agreements be published and transparent. Provided that firms are operating within their legal rights, we counsel against *requiring* the use of local labor. Introducing strict requirements could impose substantial costs and might force some investors to leave the KRI. Such a program would need to be carefully designed and would need to ensure that (1) the workers hired or trained were, in fact, native to the KRI and (2) the firms that received the incentives actually used the native workers rather than releasing them and then using foreign workers. Faulty implementation could drain money from the government without bringing about higher employment.
- **Partnering.** One of the benefits of foreign investment is that these businesses have the potential to bring new technology, techniques, management skills, and information to

²¹ Among the standard international forums and agreements are the International Centre for Settlement of Investment Disputes (ICSID), part of the World Bank Group, and the Convention on the Recognition and Enforcement of Foreign Arbitral Awards, also known as the New York Convention. As of the end of 2010, Iraq was not an ICSID or New York Convention signatory. Because these treaties are among countries, the KRG does not have the option to sign. Therefore, it will need to seek alternative, credible dispute-resolution mechanisms.

the local economy. Incentives could accelerate this by providing benefits for using local suppliers or helping establish such suppliers. We recommend against *requiring* the use of local suppliers, as this could decrease the efficiency of the investment and the long-term health of the business. We also note that the KRI Chambers of Commerce and Industry can independently promote foreign investor–supplier relationships.

- **Industries that serve regional and global markets.** The KRG should tilt its investment efforts in favor of businesses that have the potential to serve the Iraqi, regional, and global markets. Serving those markets provides much greater expansion opportunities. This could be especially important in agriculture, a priority sector for the KRG.

The KRG should ease information barriers by collecting and making business and economic data publicly and freely available. Private businesses face a lack of market information in the KRI. The government can alleviate this by collecting relevant economic data, establishing a public information portal, and publishing timely data about the economy of the KRI. It can also ensure through legislation that businesses are free to collect their own market-related data. A separate RAND study goes into far more detail about this issue (Berry et al., 2011).

The KRG can experiment with legal and regulatory reform by establishing special economic zones. Countries around the world have benefited by setting up special zones that may provide better infrastructure than the economy at large, more streamlined approval processes, higher incentives, or a more business-friendly regulatory environment. Among the most well-known examples are the coastal zones of China, the Mexican *maquiladora* program, and the Mauritius Freeport. If these laws and regulations spur job creation, there is a valid question as to why they are not applied economywide, as Ireland did with its 10-percent corporate tax rate for manufacturing. However, setting up special zones allows policymakers to experiment and learn better which policies will be most effective for job creation. Setting up such zones could also allow for legal reforms that might not be possible economywide because of interest group opposition. As with all policies, the rules and incentives should be transparent and published.

Legal Reform

Despite all the advances it has made since 2003, the KRI still has a complicated legal environment without the benefit of the laws that a market economy needs. We discussed some of this earlier, in the context of land and labor laws. Other laws that need reform include competition policy, consumer protection, and company law. Carrying out this reform will be a long-term effort—one that the KRG has already started.

The KRG will need a modern competition law, also known as an antimonopoly law. With the provision of incentives to investors, and with privatization or long-term contracting embarked on with state enterprises, there could be tremendous pressure to favor dominant market positions held by some enterprises. Yet, for robust job creation for many, rather than robust profit creation for a few, competition between businesses is essential.²² We recommend

²² For example, Porter and Sakakibara (2004) and Porter, Takeuchi, and Sakakibara. (2000) note that Japan's most internationally competitive industries were the industries that faced the most competition within Japan. Likewise, based on a long-term study of a number of industries in 13 countries, Lewis (2004a and 2004b) reports, "Economic progress depends on increasing productivity, which depends on undistorted competition" (Lewis, 2004b, p. 103).

that the reform of competition law be accelerated and that enforcement mechanisms be put into place, perhaps involving courts that specialize in competition policy. We also recommend that such a competition law be based on the competition laws in force in advanced economies.

These recommendations provide comprehensive guidance for spurring private-sector development and job creation. The KRG can accomplish some over the short term, such as removing licensing requirements for imports and exports or investigating procedures for establishing a new business, but others will take much longer, such as improving educational systems. To stay on track, **we recommend that the KRG adopt a strategic plan** showing a road map for policy adoption, the proposed timing, what resources will be necessary for accomplishing reforms, and from where those resources will come. Requiring an analysis of what resources will be required and what their source will be can anchor the plan in reality and increase the probability that it will be carried out.

Fostering Private-Sector Development: Outsourcing and Privatization of Government Functions

As we discussed in the previous chapter, one method to improve private-sector employment is to identify sectors for which conditions are particularly favorable for private-sector growth and to provide a fertile environment in which new businesses can form and foreign businesses can expand into the region. Another method for achieving private-sector growth is to outsource or privatize some functions that the government currently performs. While some functions are inherently governmental, the private sector can perform others without compromising the ability of the KRG to serve its citizens. Furthermore, experience in other countries suggests that the private sector can often perform these functions more efficiently. Converting some government functions to private-sector pursuits is a direct way to create private-sector employment opportunities.

In this chapter, we provide a brief review of the literature on government outsourcing and privatization. We examine the different approaches taken by various countries and the general findings in the literature concerning both effects and outcomes. We then summarize some important considerations for governments as they think about outsourcing and privatization. Finally, we discuss opportunities for privatizing and outsourcing services currently provided by the KRG.

Outsourcing and Privatization

Although outsourcing and privatization are similar, there are fundamental differences.¹ Governments outsource functions when they engage a nongovernmental unit (for-profit or non-profit) to provide services or carry out functions that the government would normally do itself. When outsourcing, government entities usually enter into a contract with an external provider to provide services.

Governments have generally outsourced functions that support mission-critical and core functions, including certain administrative services, IT, and certain HR functions, while continuing to perform their main functions or core responsibilities. Other functions that governments may choose to outsource include those that require specific skills and competencies that the government does not possess or have the capacity to develop.

Full or partial privatization has been a major part of government reform and restructuring around the world, especially in Latin America, Eastern Europe, and the former Soviet

¹ The literature often considers outsourcing to be a specific type of privatization (see, for example, Brudney et al., 2005).

Union, where a large number of state-owned enterprises (SOEs) were privatized after major political and economic upheavals. Full privatization is the complete sale of an SOE to the private sector; with a partial privatization, the government retains some control.

Why Outsource or Privatize?

Proponents of outsourcing and privatization argue that the private sector can perform many functions more efficiently and cost-effectively than governments can. The rationale is that because government managers face what are known as “soft” budget constraints, they tend to rely on the central government as a cushion during budget shortfalls. The term *soft budget constraint* is used because even though the manager is given a budget, if he or she commits to spending more, or actually spends more, the government usually steps in to make sure all the bills are paid. The effect is that spending can mount with little oversight. On the other hand, the private sector is more likely to operate under what is known as a “hard” budget constraint, and managers cannot rely on the government or even private financiers to bail them out in the event of a budget shortfall.² Therefore, a manager who faces a hard budget constraint has more of an incentive to be cost conscious and efficient than one who faces a soft budget constraint (Auriol and Picard, 2009; Chong and Lopez-de-Silanes, 2004; Sheshinski and Lopez-Calva, 2003). We note, however, that in some government contracting situations the private contractor does not face a completely hard budget constraint, and this may reduce the advantage of outsourcing.³

Proponents of outsourcing, in particular, argue that the private sector can do a better job at providing some of the same services that government provides and that the result will be a leaner and more efficient government.⁴ This, in turn, will ease the burden on taxpayers. Allowing the private sector to carry out certain functions or provide services can also allow government greater flexibility to adapt services to consumer needs, since it does not have to invest in its own capacity to deliver specific services but can procure those services from the private sector (Levac and Wooldridge, 1997).

There are a number of arguments against outsourcing. One involves the potential for opportunistic behavior by the contractor—that is, actions taken with bad intent to change the contract in the contractor’s favor. For example, if something unforeseen occurs and the government needs a change in the contract, the contractor could try to change other terms or increase its profits before agreeing to make the changes the government wants, a phenomenon known

² If a bailout has to occur, there are usually undesirable consequences, including a government takeover.

³ One of these situations occurs with contracts that are based on the contractor’s costs plus a specific profit margin. In this case, the contractor has no incentive to hold down costs—and may have an incentive to raise them. Another situation may occur if the contractor cannot be replaced, perhaps because of specialized skills or methods, and then comes back to the government to argue for an increase in the contract value.

⁴ Selected arguments in favor of outsourcing to private businesses include the following: (1) private businesses face competition that will spur innovation and technological development more quickly than in the government sector; (2) private businesses typically have more-flexible work rules and employment policies, allowing them to be more responsive to changing needs and more efficient than government; (3) private businesses generally have simpler procedures for sourcing inputs, allowing them to find greater cost savings; and (4) private businesses often have to stick more rigorously to a budget than do government entities.

as “hold-up” (Jensen and Stonecash, 2004).⁵ More generally, there are costs to negotiating the contract, to negotiating changes in response to new events, to monitoring, and to dispute resolution (Vining and Globerman, 1999).

Given the arguments in favor and against outsourcing, the literature identifies three main factors that governments consider when deciding to outsource or to privatize (Avery, 2000; Ferris and Graddy, 1986; GAO, 1998). First, governments generally do *not* outsource or privatize services that are critical to the effective functioning of the state; these are referred to as “inherently governmental functions.” There are certain goods and services that governments are best positioned to provide. These include defense, education, and public health services. Governments that provide these goods and services may outsource certain functions, but they retain their essential role as the main provider. On the other hand, if an SOE’s main function is to provide a service that can be provided effectively by the private sector, the entire SOE is considered a potential candidate for privatization (Grossi and Mussari, 2008).

Second, governments consider the availability, stability, reliability, and capacity of private-sector providers. Complete privatization of a service will remove the government as a provider; if the private sector is not sufficiently developed or stable, a more gradual approach may be warranted. For example, governments can outsource certain functions as the private sector develops and then fully privatize a function once the private sector has the capacity to provide the service.

Finally, governments examine the private-sector market structure of the function to be outsourced or privatized. Certain types of markets, such as “natural monopolies,” require a regulatory framework to ensure that firms in these markets do not extract inordinate profits. A market is a natural monopoly if the cost structure of the industry is such that only a monopolist can achieve the minimum efficient cost of providing the service.⁶ If completely privatizing a function would create this type of market structure, it may not produce the desired cost savings or improved service quality without regulation. The unregulated natural monopolist could keep costs low enough to drive out all competitors but higher than is socially efficient. On the other hand, some functions can be competed for in the private sector and require minimal additional regulation.

Recent History with Outsourcing and Privatization

Beginning in the 1980s, both outsourcing and privatization became more widespread as market-based solutions were advocated over government provision of services. Outsourcing experience can be exemplified by the actions of the United States, which followed an approach different from that of many other countries because the U.S. government owned a relatively

⁵ Jensen and Stonecash (2004) note that actual hold-up events have been difficult to identify empirically, largely because intent is difficult to identify empirically. As yet, there is no ideal solution to the hold-up problem.

⁶ The set of industries thought to be natural monopolies has changed as technology has changed. For example, in the United States until the 1970s, long-distance telephone services were thought to constitute a natural monopoly. However, changes in technology have enabled the long-distance market to become quite competitive, with numerous firms charging low rates.

smaller share of enterprises.⁷ In other countries around the world, especially in developing economies where governments owned a relatively large share of enterprises, privatization was a more common approach and involved the sale or transfer of assets to private individuals or organizations (Brudney et al., 2005).

Outsourcing

In the United States, many local and state governments, as well as the federal government, have outsourced various functions (Ferris and Graddy, 1986). For example, many U.S. city and county governments outsourced waste removal but retained revenue collection and oversight control. These governments have also outsourced different public works services (for example, street repair, tree planting), public safety (vehicle towing, ambulance services, emergency medical services), health and human services (child day care, government-provided housing), and recreational services (museums, libraries, and other programs). States have outsourced transportation, prisons, and social services (GAO, 1998; Council of State Governments, 1997). Up to 70 percent of state agencies have engaged in outsourcing (Brudney et al., 2005).

At the federal level, the U.S. Department of Defense (DoD) looked to outsourcing as a way to improve services and drastically cut costs. It did so through what has been referred to as “competitive sourcing” in the literature, since both government and private entities were allowed to compete for the right to provide these services. Organizations that bid for a service contract were asked to demonstrate their ability to meet cost, performance, and time targets (Kleinman, 2003). Competitively sourced functions included supply and logistics, as well as maintenance work on aircraft, vehicles, and housing (Clark, Rosenblum, et al., 2001).

The United States has not been alone in its efforts to outsource. During the 1990s, local governments in Italy, for example, resorted to outsourcing under mounting fiscal problems and financial and political scandals, as well as to address what was considered widespread government corruption and cronyism (Grossi and Mussari, 2008). India outsourced through the development of Information and Communication Technologies and Development Centers; these centers provide a range of government services, such as e-governance, education, and health services (Kuriyan and Ray, 2009). The government and private entities partnered in the development of these centers, and, in some cases, the government remains a major stakeholder in these partnerships.

Privatization

Privatization began at a relatively small scale in the 1980s and then grew rapidly through the 1990s and 2000s. World Bank estimates suggest that proceeds from privatization sales rose more than fivefold between the early 1990s and more-recent years.⁸ During the past 20 years, countries in almost all regions of the world have engaged in privatization activities, which cov-

⁷ According to the Cato Institute, an advocate for government downsizing and privatization, there are only a few examples of full privatization in the form of sale of assets in the United States (for example, the sale of the Consolidated Railroad Corporation in 1987) (Edwards, 2009).

⁸ World Bank data show that proceeds from privatization efforts around the world rose from approximately \$24 billion in 1991 to \$133 billion in 2007 (World Bank, undated).

ered infrastructure, manufacturing, services, and financial services (Kikeri and Nellis, 2004; Kikeri and Kolo, 2005; World Bank, undated).⁹

Approaches to Outsourcing and Privatization

In this and the following sections, we discuss the key elements of any effort to outsource or privatize government functions. We emphasize outsourcing because, as explained later, the KRG has already taken advantage of many privatization opportunities.

Outsourcing

When outsourcing services, there are a few different methods that governments use when choosing a provider. For example, local governments often outsource to large producers, since certain functions require significant capital investments that only these producers can provide (Ferris and Graddy, 1986). On the other hand, governments often wish to foster growth of small business and restrict the opportunity to bid on providing services to small-scale producers (Clark, Atkin, et al., 2003).

In general, governments that plan to outsource establish a set of criteria used to evaluate competitive bids. These criteria include cost, time line, and some measure of service quality. The relative weights of these criteria in determining the winning bid vary from one situation to the next. Furthermore, the way in which contractors are paid for the services they provide can also vary. These methods of payment include cost-plus contracting, fixed-price contracting, and incentive contracting (Prager, 1994).¹⁰

Privatization

Several different approaches to privatization are documented in the literature (Quan and Huyghebaert, 2004). The first is the *sale of state property*, which is the most common approach employed across countries. This typically involves the sale of an enterprise on the capital market or the selling of assets to small groups of investors through a direct asset sale. The second is *mass or voucher privatization*, in which the public bids for share ownership of a privatized SOE at low cost or through the distribution of vouchers. This approach was largely employed in Russia, other former Soviet republics, and some countries in Central and Eastern Europe during the mass-privatization movement in the 1990s. The third is *property redistribution*, which involves the return of property currently held by the government to its original owners or heirs. This approach has not been commonly used, since governments have found it difficult to indisputably identify the original owners.

The pace of privatization can also differ. Some Eastern European countries and the countries of the former Soviet Union committed to rapid ownership change (Quan and Huyghe-

⁹ Infrastructure includes telecommunications; electricity generation, transmission, and distribution; natural gas transmission and distribution; transportation; and water and sewerage. Manufacturing and services includes agribusiness, cement, chemicals, construction, steel, hotels, tourism, airlines, maritime services, and miscellaneous subsectors that are not related to infrastructure or finance.

¹⁰ In a cost-plus contract, providers are reimbursed for their allowable costs and paid an additional fee or percentage margin, sometimes based on cost savings. Fixed-price contracts involve a lump-sum payment agreed on by the contracting agency and the contractor. Incentive- or performance-based contracts specify additional rewards for meeting certain targets.

bart, 2004). Russia's effort of rapid and mass privatization reflected its goals of attracting foreign investment, raising government revenue, and reducing the administrative burden on the state bureaucracy (Perevalov, Gimadii, and Dobrodei, 2000; Kikeri and Nellis, 2004).

In contrast, China's privatization effort took place in stages (Quan and Huyghebart, 2004). Initial efforts in the early 1980s opened up government enterprises to be administered by the private sector, which could then keep a share of the profits. By the mid-1980s, privatized SOEs no longer received government funds, but had to borrow from state-owned banks. This was followed by increased operational autonomy under a contractual management system, in which the firm was required to pay taxes. Beginning in 1992, privatized SOEs in China were restructured into limited liability corporations (LLCs) with more clearly defined ownership rights. All but the largest and strategically important SOEs were privatized. The government proceeded to sell the smaller and weaker enterprises and transferred medium-sized and large SOEs into publicly listed companies.

Effects of Outsourcing and Privatization

Outsourcing

The literature that reviews U.S. outsourcing finds that the effects on quality and cost are mixed: Outsourcing has achieved significant cost savings for some government agencies, but not for all. It should be noted that empirical studies in this area have been criticized as poorly executed and with unsubstantiated conclusions (Boyne, 1998; Brudney et al., 2005).

Hirsch (1995) reviews studies that have examined the impacts of outsourcing by municipal urban governments in the United States and concludes that the benefits of outsourcing have been overstated. In surveys of state governments, about half indicated that the quality of services improved with outsourcing; about a third reported that there were cost savings (Brudney et al., 2005). In earlier surveys, a majority reported very modest (5 percent or less) cost savings from outsourcing (Brudney et al., 2005; Council of State Governments, 1997).

On the other hand, DoD has achieved major cost savings from competitive sourcing (Kleinman, 2003; Clark, Rosenblum, et al., 2001). These studies found significant savings—up to 30 to 40 percent—and satisfaction levels among both customers and contracting officers were high and rose over time. Clark, Atkin, et al. (2003) extended this analysis to determine whether an increase in the number of positions being outsourced confers additional savings and concluded that there was a positive correlation between the number of positions and savings. Kleinman (2003) also concludes that competitions attracting many bidders have produced larger cost savings than those that attract only a few. In addition to cost savings, projects were generally completed on time and received positive performance ratings by the contracting agency and its customers. These findings suggest that it is *possible* for the KRG to achieve significant cost savings from competitive sourcing. Furthermore, the number of outsourced positions need not be large to generate cost savings. For example, Clark, Atkin, et al. (2003) show expected savings exceeding 30 percent with as few as 50 positions being outsourced in the competition.

Clark, Atkin, et al. (2003) also examined the effects on small business, given concerns that large, multifunction, and multisite competitions would effectively exclude small businesses from competing. However, they found little evidence that small businesses were actually hurt as a result of the program. Of the 16 competitions they examined, six were restricted to

small businesses, and an additional three open competitions that included large bidders were also awarded to small businesses. Furthermore, small businesses reported that large competitions created *additional* opportunities, such as mentoring from large businesses, improved cash flow, and business growth.

Privatization

Although the impacts of outsourcing are mixed, the international evidence is much more supportive of privatization. The literature generally finds that privatization of SOEs improves firm profitability, efficiency, and quality, which then have spurred productivity, economic growth and development, and foreign and domestic investment (LaPorta and Lopez-de-Silanes, 1999; Megginson, Nash, and van Randenborgh, 1994). Other work concludes that privatization increases transparency and improves accountability in an economy. It also improves the financial health of the government sector by reducing budget deficits, increasing revenues through taxes on private-sector activity, and promoting development of the financial sector (Sheshinski and Lopez-Calva, 2003; Chong and Lopez-de-Silanes, 2004). Full—as compared with partial—privatization tends to result in greater enterprise profitability and productivity and reduced government involvement in business decisions (Sheshinski and Lopez-Calva, 2003; Chong and Lopez-de-Silanes, 2004).

Considerations for Outsourcing and Privatization

Outsourcing

One consideration when outsourcing is the importance of careful monitoring by the contracting entity of the services that are being provided by the contractor. One of the major criticisms of outsourcing is that governments do not sufficiently monitor the provision of services, increasing the likelihood of poor service delivery. Outsourcing does not work as well when information asymmetries exist between government and the private sector about the cost and quality of the service. If the government sector has poor knowledge about these, it may not achieve the desired efficiencies when outsourcing. Research suggests that challenges to outsourcing occur when the government is unable to monitor the performance of outsourced services and when ambiguity exists about roles and responsibilities of the various parties involved. It also suggests that outsourcing works well when there is competition through the presence of many providers (Khan, 2010; Warner and Hebdon, 2001; Ingraham, 2005).

Brown and Potoski (2006) advise that the provisions of monitoring and management should be spelled out in a contract, as vendors may not have the incentive to initiate monitoring activities on their own. Furthermore, because certain performance areas in the government sector are difficult to measure or collect evaluative information on, they need to be articulated explicitly in the contract. In underdeveloped markets, it may be necessary for government to engage in direct oversight and monitoring of outsourced services (Quan and Huyghebaert, 2004).

One caution about monitoring is that monitoring outsourced services can be costly and might drive up the actual costs of providing the service (Marvel and Marvel, 2007). Effective monitoring may take up a significant portion of the contract budget, so it becomes an important determinant in whether to move forward with outsourcing the function (Globerman and Vining, 1996).

In an evaluation of DoD's outsourcing efforts, Clark, Atkin, et al. (2003) conclude that there is a greater need for coordination and planning in the transition by both the contracting agency and the contractor with large multifunction or multisite competitions. They also recommend that to monitor outcomes effectively and make improvements, where necessary, robust quality assurance mechanisms should be established to ensure that appropriate performance metrics are defined, collected, and analyzed.

Reflecting on three decades of competitive-sourcing programs in government, Kleinman (2003) advises governments to streamline the competition and outsourcing process to minimize workplace disruptions. Often, these programs are long and drawn out and significantly hamper workplace processes. He also recommends establishing a centralized management system to help locally based agencies run competitive-sourcing competitions. The locally based agencies would benefit from the experience of the centrally based management team but would still be able to provide the more specific expertise required throughout the process. Another improvement would be to ensure that a system that monitors cost and performance is established from the outset to track progress and make necessary changes. Finally, he recommends that generous separation programs should be put in place to ease the transition for government employees displaced as a result of outsourcing.¹¹

Privatization

An adequate regulatory framework is necessary to ensure that newly privatized entities operate in a properly functioning market (Zhang, Parker, and Kirkpatrick, 2005). This is especially important in circumstances in which natural monopolies exist—industries in which the most efficient form of production might be to have just one firm because the average cost of providing a service declines as market size increases—and could require regulatory updating and reform.

There is also support for concentrated ownership by new buyers, when the state either maintains a majority stake or reduces its stake significantly so that new stakeholders own a sufficient share to engage in performance monitoring (Perevalov, Gimadii, and Dobrodei, 2000; Qi, Wu, and Zhang, 2000). Kikeri and Nellis (2004) conclude that one of the reasons privatization did not succeed in some countries of the former Soviet Union was that a large number of insider owners were reluctant to engage in the necessary restructuring to bring about better performance results.

Recommendations for Outsourcing and Privatization in the KRG

The KRI's greatest opportunities for reducing the size of government through greater involvement by the private sector lie in outsourcing, rather than privatization. Hybrids of the two may also present opportunities, such as by establishing management contracts for the operation of government-owned facilities—hospitals, for example. In this section, we provide recommendations regarding opportunities for outsourcing and privatization.

¹¹ We discuss this issue in Chapter Eight.

Outsourcing

Despite apparent support for outsourcing among many ministry officials with whom we spoke, the KRG has not engaged in widespread outsourcing of the functions that it currently performs. One approach to thinking about outsourcing is to first focus on the ministries with the largest employment bases, such as the Ministry of Education or the Ministry of Peshmerga (see Table 3.4 in Chapter Three). Outsourcing functions in those ministries would have the biggest effect on government payrolls. However, many of the functions performed by these ministries (education and security) are functions that many consider to be inherently governmental. Alternatives include focusing either on *services* or on *functions* that are not inherently governmental.

Focus on ministries that provide services similar to those provided by private-sector companies. An alternative is to focus on ministries that provide services that are similar to those offered by the private sector. For example, some aspects of the Ministry of Electricity could be outsourced, such as bill collecting for distribution, as well as maintenance for both distribution and transmission. Private-sector entities already collect bills for their own accounts, and carrying out maintenance of technical systems, such as the electrical grid, can also be done by private companies. The extent to which these functions could be outsourced successfully in the KRI depends on the existence of qualified private-sector firms in the KRI or in other countries and the ability of such foreign companies to do business in the KRI.

Preferably, focus on outsourcing functions within the government that are found in multiple ministries and that also are carried out by private-sector firms and workers. Outsourcing specific services is likely to have only a small effect on the level of government employment. Outsourcing functions that take place in numerous ministries is likely to have a much larger effect on government employment. Inspection of Table 3.1 in Chapter Three suggests that there are many civil-service workers in occupations that are not clearly inherently governmental. For example, office clerks, cleaners and launderers, motor vehicle drivers, messengers and porters, and library and mail clerks are all occupations that have clear nongovernmental counterparts. Furthermore, among the civil-service workers who participated in the IHSES, about 19 percent work in these occupations. Although an argument could be made to retain some workers in these occupations as civil-service employees, these occupations are obvious candidates for outsourcing to the private sector.

Lay the groundwork for outsourcing by improving the KRG personnel management system, in particular by writing job descriptions for civil servants. Components of a personnel management system, such as job descriptions and employee evaluations, are discussed in later chapters. However, at least one of these components, job descriptions, will be necessary to a successful outsourcing effort. This is because the KRG will need specific job description information to identify which functions can be outsourced and to write tenders detailing what functions the outsourcing firm must provide.

Ensure that tenders for outsourcing of services or functions are transparent and widely competed. One of the goals in outsourcing is to lower government costs. Nontransparent or uncompetitive processes for choosing the outsourcing firm are more likely to end up in higher-cost contracts, defeating the purpose of outsourcing. Another essential element is having a private-sector–enabling environment in which potential domestic outsourcing firms can be formed, and potential foreign outsourcing firms can enter the market. These issues were discussed in Chapter Four.

Privatization

In many countries transforming from state-controlled economies to the market system, the reform and privatization of SOEs is a centerpiece of reform. However, nearly all information available to us indicates that the KRG has taken advantage of most opportunities for privatization of entities that produce goods and services usually provided by the private sector in market economies. This has involved transferring some amount of control to the private sector, generally through a long-term management contract or sale, and, in at least some cases, in a combination of partial sale and management contract.¹² In addition, available evidence indicates that the preponderance of SOEs in Iraq were not in the KRI.¹³ The fact that some form of privatization of SOEs has taken place does not mean that the process was handled efficiently or that it maximized the benefit to the KRI's economy. Nor does it mean that these privatizations were successful. Nonetheless, the KRG has taken steps to involve the private sector with what had been state enterprises before 2003. Despite these efforts, there may be at least three continued opportunities for privatization. These include infrastructure, failed previous privatizations, and long-term management contracts that are not being fulfilled.

Among potential infrastructure privatization opportunities, focus on sewerage and water. Although sewerage is less—directly related to business development than electricity, the fact that the KRI does not have wastewater treatment plants or sewerage systems presents a privatization opportunity right from the start. Inviting private-sector participation from the beginning could help provide the service while forestalling the further expansion of government. As with many other types of utilities, there would need to be a regulatory structure set up for such a venture to succeed. The distribution of water, currently done by the government, is also a candidate for privatization. With current tariffs quite low, privatizing the distribution of water could be politically difficult, given the inevitable increase in water tariffs that would ensue. But it could also result in efficiency gains and a reduction in wastage, helping alleviate water shortages.

Consider privatizing additional parts of the electricity system. The Ministry of Electricity has contracted with MASS Energy Group Holding of Jordan, a private company, to provide private generation of electricity from new power stations in Erbil, Sulaimaniyah, and Duhok. Transmission and distribution of electricity could be candidates for privatization, in whole or in part, as well. It should be noted that the Ministry of Electricity employs only about 2.5 percent of all civil-service employees (see Table 3.4 in Chapter Three). Therefore, the KRG cannot expect to reduce government payrolls by a large amount through the privatization of the transmission or distribution of electricity.¹⁴ However, the potential efficiency gains could still be a rationale for pursuing this approach.

In any privatization, ensure that the process is transparent and invites competition. If the KRG wishes to privatize these enterprises, it may choose to find a strategic buyer, hold an auction, or privatize by other means. Whichever means is chosen, transparency will be important. For example, we were unable to find a complete, publicly available list of all previous privatizations and the private entities that now own the privatized enterprises. Such informa-

¹² Conversations with Ministry of Trade and Industry officials, April 2010 and January 2011.

¹³ For example, of 56 state-owned companies in Iraq that the U.S. Task Force on Business and Stability Operations had evaluated by early March 2007, only four were in the KRI (Task Force on Business and Stability Operations in Iraq, 2007).

¹⁴ Not all employees in the Ministry of Electricity are responsible for electricity transmission and distribution; the reductions in civil-service employment are likely to be extremely small.

tion is of value because the demonstration that privatizations proceeded fairly can build public confidence in markets and a private-sector–led economy. In addition, ensuring competition among firms that want to carry out the privatization is one way to make sure that the KRG gets the best price for its assets or for the new services that will be provided.

Reprivatize any previous privatizations that may have failed. Such failures give the KRG the opportunity to learn from previous setbacks and try again. Such reprivatizations can be in the form of finding a strategic buyer, holding a competitive tender, or another process, once again with the emphasis on transparency and competition.

Monitor the performance of the contracts under which the currently privatized entities are operating. One means of doing this is through an independent oversight agency or a global accounting and evaluation firm. If contract terms are not being fulfilled, the KRG should proceed through a transparent legal process to either encourage performance or reclaim the enterprises. The latter action will again provide an opportunity for privatization.

Skills and Education of Civil-Service Employees

Expanding opportunities for private-sector growth, as discussed in the previous two chapters, does not guarantee that civil-service workers will leave government for private-sector employment or will be able to attain such employment. Private-sector employers will hire only individuals they believe will be productive employees. If civil-service workers do not have the qualifications necessary for private-sector employment, businesses may not be willing to hire them. Government employees may need significant training to better align their skills with those in demand in the private sector and might also require an incentive to invest in this training. In this chapter, we first discuss the perceptions held by KRI businesspeople of the quality of private-sector employees. We then use the 2007 IHSES to describe and compare selected characteristics of civil-service and private-sector employees, Arabic and English proficiency, and educational attainment.

Perceptions of Private-Sector Employers

We spoke with several private-sector employers in the KRI about their experiences with hiring and about their perceptions of and attitudes about the local labor force. These conversations suggest that there could be some challenges for civil-service workers as they transition to private-sector employment. The employers with whom we spoke have little experience with hiring civil-service workers. Rather, the applicants that approach these employers about vacant positions typically hold other private-sector jobs. Private-sector employers believe that this reflects individuals' preference to work in government, despite the higher wages that are typically offered in the private sector. Without actual experience with hiring civil-service workers, these employers did not have a sense as to whether their quality would be better or worse than the local labor they have actually hired. Therefore, private-sector beliefs about local labor in general correspond to perceptions about civil-service workers who might eventually seek private-sector employment.

Many private-sector employers have negative perceptions and attitudes about the quality of local labor. There is a general belief that workers do not like to work and are mostly low-skilled and not technically qualified. These negative perceptions will act as a constraint on any efforts to reemploy civil-service workers in the private sector. On the other hand, there are some positive perceptions and attitudes among the employers with whom we spoke. Many local employees who have been hired have demonstrated both an ability to learn the necessary skills and a willingness to be trained. Furthermore, employers expressed a desire to hire *qualified* local labor. This was true of all domestic and most foreign employers with whom we spoke.

In other words, there does not appear to be a bias against hiring local labor *per se*, but rather a reluctance to hire workers without the requisite skills and qualifications. Since most private-sector employers, both foreign and domestic, believe that local workers are not as qualified as their foreign counterparts, the consequence is that these employers often prefer to use foreign workers.

Given these perceptions and attitudes, we then asked private-sector employers about the specific characteristics that they looked for in potential hires. Naturally, all employers are interested in workers with qualifications specific to the occupations they are trying to fill. For example, construction firms are interested in workers with direct experience in construction; banks are interested in workers with direct experience in banking. However, a few general characteristics were cited by most private-sector employers. Some of these characteristics, although clearly important, are difficult to measure, such as analytic skills, critical thinking, and decisionmaking ability.

However, we do have data on the extent to which workers have other important characteristics. For example, all employers cited the need for workers with communication skills—the ability to read, speak, and write clearly and effectively. Foreign employers were more specific, citing the need for their employees to communicate effectively in English. Furthermore, many employers felt that higher education in a field relevant to the positions they are trying to fill was also important, although this was not sufficient to ensure that a worker would be high-quality. In the remainder of this chapter, we discuss the extent to which civil-service employees are already working in the private sector. We then describe and compare self-reports about Arabic and English proficiency and educational attainment of civil-service and private-sector employees.¹

Characteristics of Civil-Service and Private-Sector Employees

Civil-Service Employees Working in the Private Sector

The data presented in Figure 3.1 in Chapter Three reflect the distribution of *jobs* within the KRI and might give the impression that workers are employed in a single sector. However, many civil-service workers work both for the government and for private-sector employers. Our analysis of the data suggests that about 14.6 percent of civil-service workers also hold a nonwage job. Furthermore, about 9.3 percent of civil-service workers have another wage job, and approximately 62 percent of these workers are employed in the private sector. Combining both the prevalence of nonwage and private-sector employment of civil-service workers, the data suggest that about 20.4 percent of civil-service workers also work for private-sector employers.²

¹ As we discussed in Chapter Two, there is no way to verify independently whether these self-reports are accurate. Self-reports might be biased, and we do not know whether they are overstated or understated. Nonetheless, this is the best information available. Furthermore, we have no evidence suggesting, nor an *a priori* reason to suspect, that civil-service and private-sector workers have different standards for measuring and reporting their own language proficiency or educational attainment.

² We arrive at the 20-percent figure by the following computation: (14.6 percent of civil-service workers have non-wage jobs) + [(9.3 percent of civil-service workers have an additional wage job) × (62 percent of civil-service workers with an additional wage job work in the private sector)] = 20.4 percent of civil-service workers also work for private-sector employers.

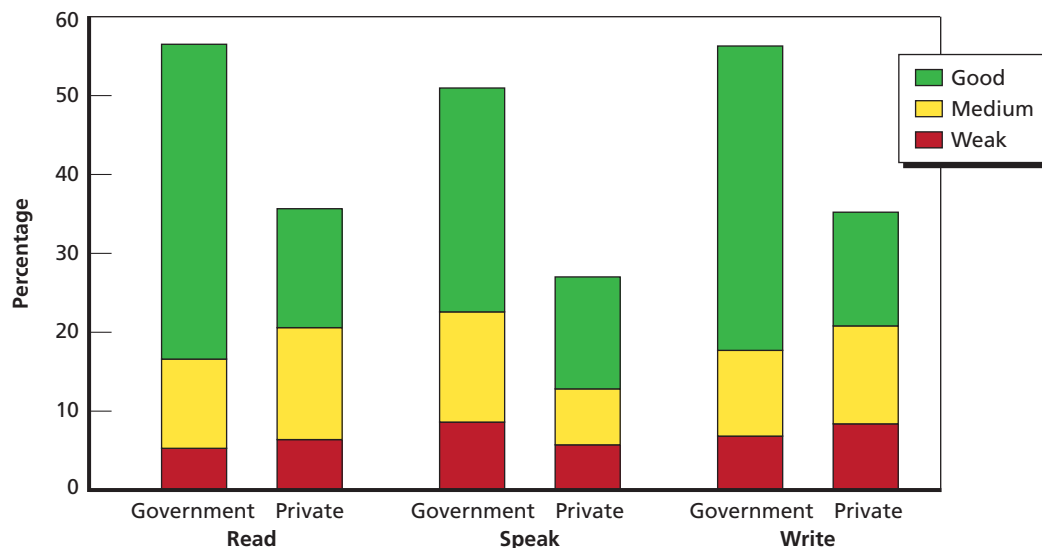
Furthermore, our analysis suggests that these workers' civil-service and private-sector jobs are in different occupations. Of civil-service workers who also hold private-sector wage jobs, only 8 percent work in the same occupation in both sectors. Similarly, of the civil-service workers who also hold nonwage jobs, only 5 percent work in the same occupation in both sectors.

We draw two conclusions from these data. First, private-sector employers have already shown a willingness to hire some civil-service workers, since there are some individuals working in both sectors. Second, some civil-service workers have general skills that are useful in multiple occupations, since so few of them working in the private sector are working in the same occupation that they hold in the government. It is also possible that other civil-service employees, not just those who currently work in the private sector, also have skills that are transferable. If this is the case, the small overlap between civil-service and private-sector occupations, outlined in Chapter Three, might not be as large a barrier to civil-service reform as the aggregate data suggest.

Language Proficiency

Figure 6.1 and Figure 6.2 display the percentage of civil-service and private-sector workers who report being able to read, speak, and write Arabic and English, respectively. For each language, workers were asked to assess the extent to which they can read, speak, and write; those who had some level of proficiency were asked to characterize their ability as weak, medium, or good. Each figure displays the percentage of workers at each reported level of proficiency. The total height of the bars shows the percentage of workers who reported *any* level of proficiency. As Figure 6.1 shows, civil-service workers reported substantially higher Arabic proficiency than private-sector employees. More than 50 percent of civil-service workers reported being able to

Figure 6.1
Reported Levels of Arabic Proficiency, by Sector

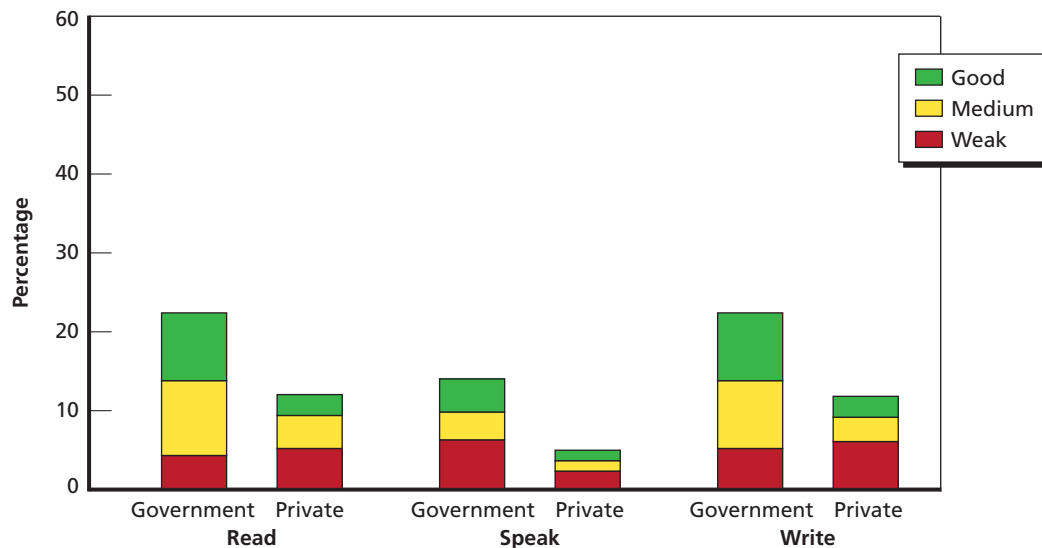


SOURCE: Data from IHSES-2007.

RAND MG1117-6.1

In our discussions in the KRI, it was apparent that the common perception is that the proportion of government workers holding private-sector jobs is much higher than the figures we present. However, the data do not support these perceptions.

Figure 6.2
Reported Levels of English Proficiency, by Sector



SOURCE: Data from IHSES-2007.

RAND MG1117-6.2

read, speak, and write Arabic; in contrast, about 25 percent of private-sector workers reported being able to speak Arabic, and about 35 percent reported being able to read and write Arabic. The disparity between civil-service and private-sector workers is especially evident among those who characterize their ability as good. Nearly 40 percent of civil-service workers reported a good level of reading and writing proficiency; only 15 percent of private-sector workers reported proficiency this high.³

Figure 6.2 displays qualitatively similar results for English language proficiency. Although the levels of English proficiency are much lower than those of Arabic, civil-service workers reported much higher English proficiency than private-sector employees. In fact, civil-service workers were almost twice as likely to report being able to read and write English, and three times as likely to report being able to speak the language. The disparity between civil-service and private-sector employees is also evident in the proportion who characterized their reading, speaking, and writing ability as good.

We performed additional analyses to examine the extent to which other individual characteristics could explain some of these differences in language proficiency.⁴ These analyses suggest that other differences can *partially* explain some of the differences in language proficiency. In other words, if civil-service and private-sector workers were otherwise identical, the gap in language proficiency would be substantially smaller.

For reading and writing proficiency, while the gap narrows, it is not eliminated; other individual characteristics can partially, but not completely, explain differences in proficiency. However, for speaking proficiency, the gap is not statistically different from zero; other individual characteristics can completely explain differences in proficiency. Specifically, differences

³ A comparison of workers' ability to speak Arabic leads to similar conclusions.

⁴ See Appendix B for details of these analyses.

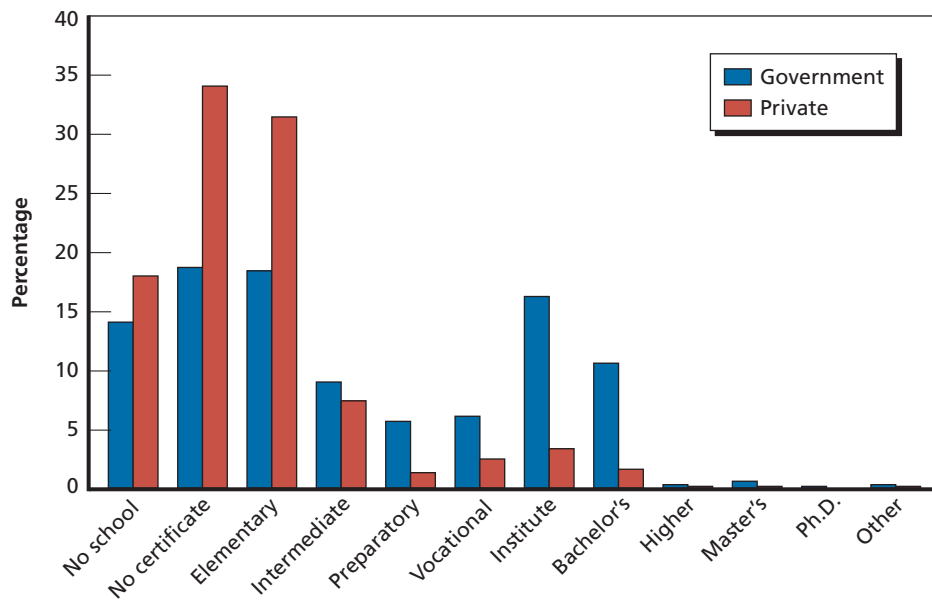
in the educational attainment and, to a lesser extent, the age distribution of civil-service and private-sector workers explain much of the difference in language proficiency.

Educational Attainment

Figure 6.3 displays the highest level of educational attainment reported by civil-service and private-sector workers.⁵ As Figure 6.3 clearly shows, civil-service workers reported higher levels of education than private-sector workers. More than half of all private-sector workers reported either no formal schooling or no educational certificate whatsoever; slightly more than 15 percent reported any education above an elementary certificate. In contrast, the percentage of civil-service workers without an educational certificate, while still high, is much lower (33 percent), and Figure 6.3 clearly shows a much greater percentage of these workers with higher levels of educational attainment. The data suggest that about 85 percent of the wage workers who have at least a bachelor's degree work for the government.

As with language proficiency, we performed additional analyses to examine the extent to which other individual characteristics could explain some of these differences in educational attainment.⁶ In contrast with language proficiency, however, accounting for other individual characteristics explains very little of the difference between the educational attainment of civil-service and of private-sector workers.

Figure 6.3
Highest Level of Educational Attainment, by Sector



SOURCE: Data from IHSES-2007.

RAND MG1117-6.3

⁵ Unfortunately, the data do not indicate the field in which individuals earned their degrees, so we are not able to explore the relationship between the specific, formal training that private-sector workers have had and the occupations in which they are employed.

⁶ See Appendix B for details of these analyses.

Discussion

Our analysis of the IHSES data suggests both an opportunity and challenges for the KRG as it seeks to reemploy civil-service workers in the private sector. The data on Arabic and English proficiency and on educational attainment reveal that many civil-service workers have skills and characteristics desired by private-sector employers. Furthermore, the proportion of civil-service workers with these characteristics is *higher* than that of private-sector workers. In other words, private-sector employers have chosen to hire workers who are less likely to have the characteristics that they have indicated they look for in potential hires.⁷ This suggests that private-sector employers might be willing to hire some civil-service workers who choose to leave the government—and that additional training or education might not be as necessary as the conventional wisdom might suggest.

There are, however, three challenges. First, our conversations with private-sector employers suggest that the quality of education in the KRI is poor. This spans all education levels, including primary and secondary school, university education, formal vocational schools, and vocational training centers.⁸ Second, many private-sector employers feel that higher education, even in a field relevant to the occupations they are trying to fill, is not sufficient to ensure that a worker would be high-quality. It is also likely that there is a mismatch between the types of fields studied by college graduates and the qualifications needed for private-sector job openings. The implications are that despite the relatively high levels of educational attainment among civil-service employees, this might not translate into private-sector hiring at the levels the KRG desires.

Finally, despite having characteristics valued by private-sector employers, most civil-service employees have chosen *not* to work in the private sector, even as a second job to supplement their earnings. Without any changes to the incentives faced by these workers, or to the characteristics of private-sector jobs, it is unlikely that civil-service workers will voluntarily flow in large numbers to an expanded private sector. In the following chapter, we analyze the factors contributing to the choice to work for the KRG.

⁷ The data are consistent with the government being the employer of choice for local labor and with the KRG being able to choose workers with more skills. If this is the case, although private-sector employers desire certain characteristics, they hire workers who are less likely to have these attributes because workers with these characteristics are able to find civil-service jobs.

⁸ See Chapter Four for a discussion of these issues.

The Civil-Service Compensation System and Personnel Policies

Despite having characteristics valued by private-sector employers, most civil-service employees have chosen *not* to work in the private sector. An important issue to consider, then, is *why* so many workers choose civil-service over private-sector employment. Economic theory predicts that when choosing a sector in which to work, individuals evaluate the expected rewards from working in each sector and their relative taste for the characteristics of each sector and then choose the sector with the highest expected benefit.¹ Therefore, civil-service employees will consider other employment opportunities only if the expected rewards of private-sector employment outweigh those of civil-service employment.

These rewards include wages and salary, benefits, and other nonpecuniary aspects of employment (such as job security and an individual's relative taste for working in each sector). For example, if civil-service compensation is more generous than that available in the private sector, civil-service employees may hesitate to voluntarily relinquish their current positions. There is also the issue of *moral hazard*; if workers can more easily shirk in one sector without the employer observing it, the expected effort to be exerted in that sector is lower, and workers are willing to accept lower pay to work in that sector.²

Furthermore, if the civil-service compensation system does not identify and reward superior performance, the KRG may find that its most productive employees are those who leave for private-sector opportunities. Economic theory predicts that linking civil-service compensation to performance will raise average productivity by inducing lower-ability workers to leave and higher-performing workers to remain and by providing stronger incentives to exert effort (Lazear, 2000). These are not necessarily problems in the short run, where the KRG faces the challenge of reducing the size of the civil service and transitioning some of these workers to the private sector. In the longer run, however, the KRG will want this smaller civil service to be one that is more efficient and productive.

In this chapter, then, we analyze the civil-service compensation system and related personnel policies to better understand the incentives workers face when choosing between civil-service and private-sector employment. Following this analysis, we offer specific recommendations for the KRG as it pursues short-run reductions in the size of its civil service and as it considers, in the longer term, the development of a strategic HR plan for managing the civil-service workforce.

¹ See, for example, Blau et al. (1956), Warner and Asch (1995), and Gottschalk and Hansen (2003).

² In the context of our discussion, *moral hazard* refers to the incentive workers have to be unproductive. This can occur when a worker's compensation or employment is not dependent on their own productivity. Since the worker is not rewarded for higher productivity, there is no incentive to exert the additional effort to be more productive.

Earnings and Benefits in Civil-Service and Private-Sector Jobs

Wages and Salaries

Although in principle it is straightforward to compare wages in civil-service and private-sector jobs, the lack of overlap between the two occupational distributions makes it difficult to estimate these differentials precisely. Therefore, we aggregated the more-detailed occupations that were reflected in Tables 3.1 and 3.2 in Chapter Three into broader occupational categories. For each of these categories, we calculated the wage that each individual typically receives.³ Within each occupational category, we estimated the percentage difference in wages for the median private-sector worker and the median civil-service employee. This percentage difference is referred to as the *private-sector wage premium*. If this premium is positive, wages in the private sector are higher than those in government; if it is negative, wages in the civil service are higher.

Figure 7.1 displays the private-sector wage premium by occupational category.⁴ As this figure shows, for most occupational categories, private-sector workers earn more than their civil-service counterparts.⁵ At the extreme, low-skilled laborers in the private sector earn 50 percent more than civil-service workers in the same occupations. There are, however, two exceptions. For service, shop, and market sales workers, civil-service workers actually earn about 10 percent more than their private-sector counterparts.⁶ The premium paid to civil-service senior officials and managers is even larger, although a very small number of workers (in both sectors) work in this occupational category.

Benefits

Figure 7.2 displays the percentage of civil-service and private-sector workers who report receiving health care benefits, retirement benefits, and paid vacation as part of employment. As the data clearly show, there is an extraordinary disparity between the two sectors. Virtually all civil-service workers reported that they receive retirement benefits; in contrast, virtually no private-sector workers indicated that they have these benefits. Similarly, very few private-sector workers reported that they receive health care benefits. Although the percentage of civil-service workers who receive these benefits is much less than that receiving retirement benefits, the disparity between the government and the private sector is still extraordinary.

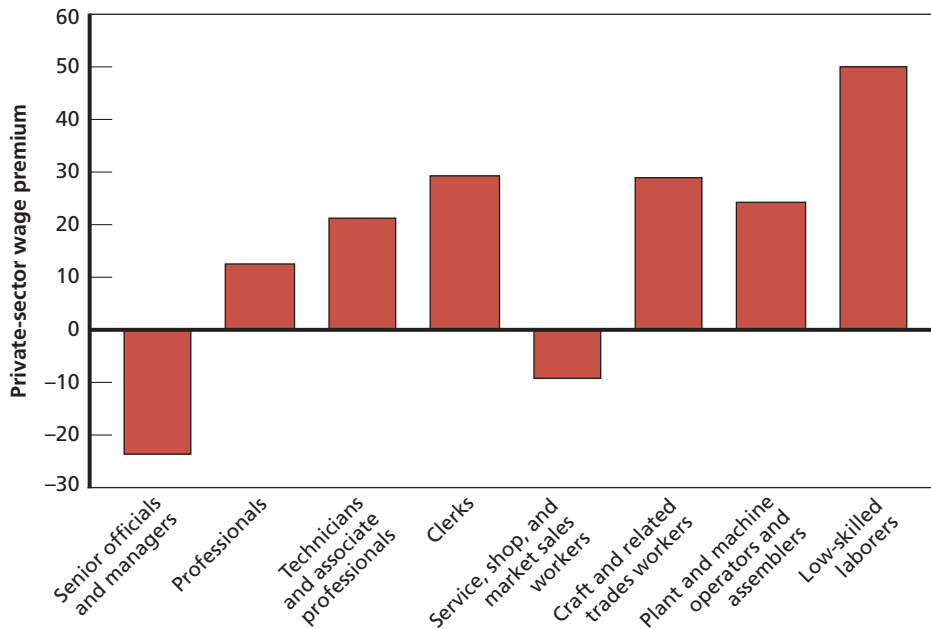
³ We used several variables in the IHSES to compute wages. Workers reported the cash they typically received (after tax and retirement deductions), how many units of time this pay covered, and whether these units were days, weeks, fortnights, or months. We divided the total amount they typically earned by five if paid weekly, ten if paid fortnightly, and 20 if paid monthly to arrive at a typical daily wage earned by an individual. To ensure that we were comparing workers with similar levels of work, we also restricted the sample to individuals who reported working a continuous schedule of 30 or more hours per week.

⁴ Because there are almost no civil-service workers in agriculture, we were not able to compute a private-sector wage premium for this occupational category.

⁵ We also estimated these premiums using quantile regression and adjusting for age, education, and gender. Regression analysis is a type of statistical analysis. Quantile regression is similar to the most basic form of regression analysis, known as ordinary least squares regression, but it allows us to instead estimate the conditional median (ordinary least squares regression estimates the conditional mean). The results from this analysis are very similar to the unadjusted results reported in Figure 7.1.

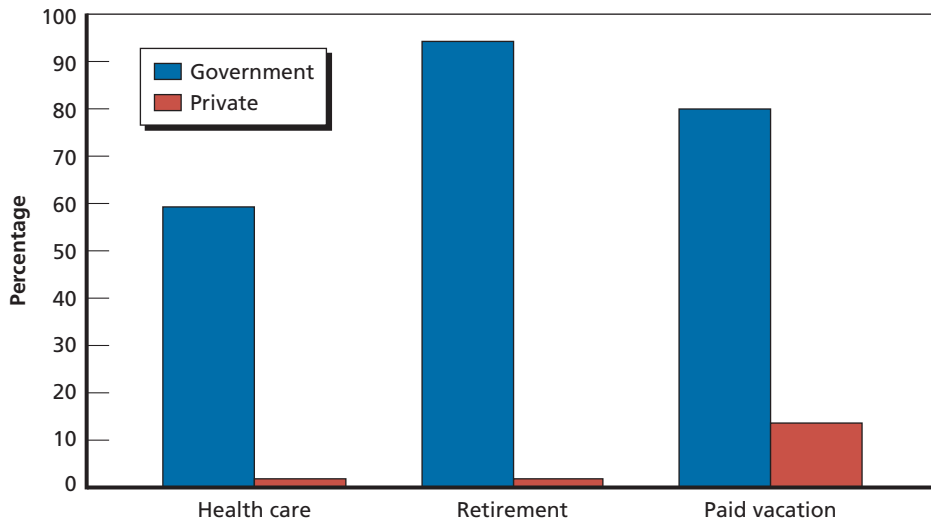
⁶ Virtually all civil-service workers in this occupational category are in protective services occupations, a job that does not exist in the private sector. This illustrates the challenges associated with estimating differences in wages when there is little overlap between the civil-service and private-sector occupational distributions.

Figure 7.1
Private-Sector Wage Premium, by Occupational Category



SOURCE: Data from IHSES-2007.
RAND MG1117-7.1

Figure 7.2
Percentage of Workers with Nonwage Benefits, by Sector



SOURCE: Data from IHSES-2007.
RAND MG1117-7.2

About 15 percent of private-sector workers did report receiving paid vacation. Again, however, the vast majority of civil-service workers enjoy paid vacation.

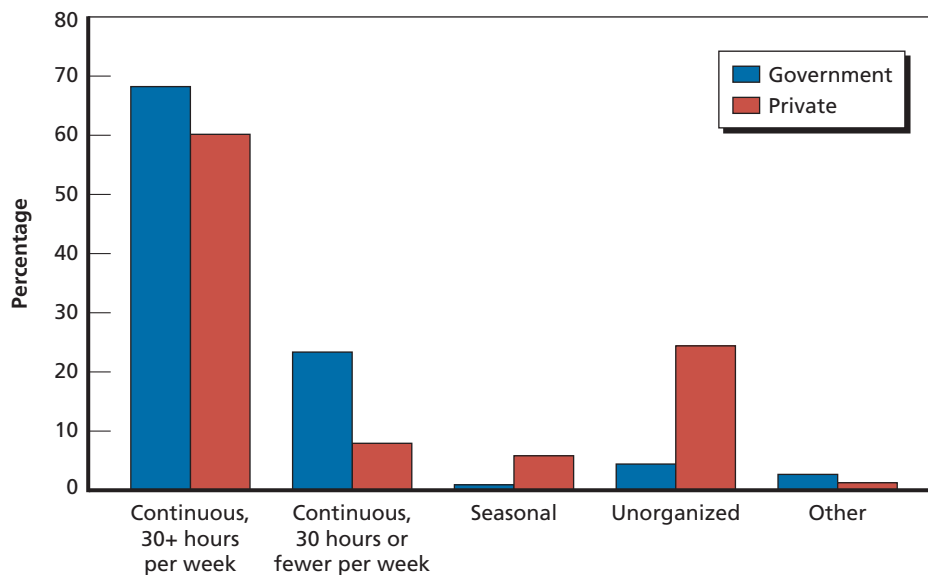
We also examine the extent to which individuals' jobs have regular or intermittent schedules. To the extent that the predictability and amount of work are desirable, regular full-time

employment can be thought of as an additional benefit of employment. In our data, individuals characterize their employment as 30 or more hours per week on a continuous basis, less than 30 hours per week on a continuous basis, seasonal, or unorganized, meaning that the work period is irregular and not continuous, as is typical for construction workers who work intermittently. Figure 7.3 displays the percentage of workers, by sector, who reported each type of work schedule.

As Figure 7.3 shows, a majority of civil-service and private-sector employees work 30 or more hours per week on a continuous basis. For civil-service workers, a smaller, but still sizable, percentage works less than 30 hours per week on a continuous basis. Approximately 92 percent of civil-service workers are employed on a continuous basis, and only 8 percent work intermittently. In contrast, about 30 percent of private-sector employees work intermittently, whether due to irregular work schedules (24 percent) or seasonal unemployment (6 percent). The data in Figure 7.3 suggest that stability of work is an additional benefit of civil-service employment, since these workers are substantially more likely to have continuous, full-time employment.

To summarize, our analysis suggests that, although private-sector employers generally offer higher wages than the government, benefits and the availability of continuous, full-time employment are better in the civil service. Since most civil-service employees have chosen not to work in the private sector, the implication is that the current private-sector wage premium is not sufficient to offset the value of civil-service benefits and the relative characteristics of civil-service versus private-sector employment, including work schedules. However, economic theory predicts that an even greater private-sector wage premium or an increase in the relative generosity of private-sector benefits would provide incentives for civil-service workers to consider private-sector employment more strongly.⁷ In the next section, we explore additional

Figure 7.3
Percentage of Workers with Different Work Schedules, by Sector



SOURCE: Data from IHSES-2007.

RAND MG1117-7.3

⁷ An increase in the *relative* generosity of private-sector benefits could be achieved by a decrease in the *absolute* generosity of civil-service benefits, rather than an increase in the absolute level of private-sector benefits.

characteristics of civil-service employment and compensation to better understand the incentives individuals face when choosing from these different employment options.

Personnel Policies: Hiring, Compensation, Promotions, and Performance Evaluations

In this section, we analyze the KRG's current hiring, compensation, promotion, and performance evaluation processes. This allows us to better understand the incentives individuals are facing when choosing between civil-service and private-sector employment. More generally, this analysis provides insight into the incentives faced by civil-service workers who could be reemployed in the private sector and leads to recommendations of options for the KRG to consider as it seeks to stimulate private-sector development.

Hiring

One option for altering the mix of civil-service and private-sector employment in the KRI is to *limit government hiring substantially* and let natural attrition reduce the size of the civil-service workforce. Although the KRG would still need to hire qualified individuals into essential positions,⁸ limiting hiring is a direct way to limit the size of the civil-service workforce.

There are two primary advantages to this strategy. First, it is easier to limit the growth of the civil-service workforce than to encourage existing employees to leave. This is because individuals not yet employed by the government are not subject to any constraints of the civil-service law. Second, natural attrition from the civil service would be completely voluntary. This would minimize the likely political consequences associated with involuntary separations.

We have limited data on recent growth of the civil-service workforce in the KRI. Although some ministries have seen relatively substantial growth, the proposed size of the civil service in 2010 was 1.5 percent larger than it was in 2009.⁹ It should be noted, however, that *actual* growth in 2010 was larger than that which was initially proposed. Furthermore, we do not have data comparing the size of the civil service in 2010 with its size in 2006, when the Fifth Cabinet took office as the first unified government, or in 2003, when the Iraq War led to the downfall of Saddam Hussein.

Despite the advantages of limiting government hiring, there are four main disadvantages. First, there could be political pressure to continue hiring some workers. If this occurs, it could be extremely difficult for the KRG to limit hiring in a substantive way. This is consistent with the actual growth in 2010 exceeding what was originally planned. This pressure is likely to be exacerbated if the KRG finds that it still needs to hire large numbers of individuals into essential positions, such as teachers, since there could be pressure to classify numerous positions as "essential."

Second, it could take years for natural attrition (for example, individuals reaching retirement age) to substantially reduce the size of the civil-service workforce, and, until these separations occur, the financial effect of maintaining a large civil-service payroll will be consider-

⁸ For example, in a separate study, RAND estimated that the KRG will need to hire 5,000 to 7,000 new teachers annually to meet expected student enrollment growth over the next decade.

⁹ The percentage increase in the civil service is calculated using the 2009 data in Table 3.4 and the proposed increase in hiring by ministry, provided to us by the Ministry of Planning.

able. Paying pensions to those who retire as civil servants would exacerbate the financial effect. Third, limiting hiring in the short run can create a shortage of experienced civil servants in the long run (Congressional Budget Office, 1999). As relatively small cohorts are hired into the civil service, this will eventually result in relatively small numbers of midcareer personnel. Finally, it is possible that this strategy could result in adverse selection, with the best potential civil-service workers not joining government in the first place.

We also note that limiting civil-service hiring does not, in and of itself, lead to increases in private-sector employment. Without improvements in private-sector job creation, there will not be enough private-sector positions to absorb workers who would otherwise have joined the civil service. If the KRG uses this strategy to reduce the size of the civil service, it will need to do so in combination with other strategies.

In limiting hiring, it is necessary to ensure that all hiring that does occur is done in a way that ensures that candidates are hired only into vacant positions for which they are qualified. Table 7.1 presents the different ways in which workers attain their jobs in the KRI. These data are presented separately for civil-service and private-sector workers, and the main ways in which jobs were attained are listed in descending order by the proportion of private-sector workers who listed them.

As Table 7.1 shows, many civil-service workers appear to have gotten their current jobs by contacting the government directly; more than 45 percent claim to have attained their job in this way, whether it is through calling a government employment center or contacting a governmental institution. However, more than one-fourth of all civil-service workers attained their current job after inquiring with relatives or friends. These data suggest that a wider dissemination of information about vacant positions could help ensure that the most-qualified individuals are hired.

Note, however, that the proportion of private-sector workers who used these personal connections is substantially larger, at about 74 percent. Although this is an indication of the

Table 7.1
Main Way in Which Job Was Attained, by Sector

Method	Percentage	
	Government	Private
Asked relatives or friends	27.3	74.3
Contacted employer directly	1.2	8.3
Called private employment center	1.3	5.3
Called government employment center	33.7	1.0
Filled out application	16.6	0.7
Promoted self by an advertisement	0.2	0.6
Followed up on advertisement	0.2	0.2
Contacted governmental institution	12.1	0.1
All others	7.4	9.5

SOURCE: Data from IHSES-2007.

strength of family ties in the KRI, it is not indicative of well-functioning labor markets where job information is freely available. We will return to these issues in Chapter Eight.

Compensation, Promotions, and Performance Evaluations

Another option for altering the mix of civil-service and private-sector employment in the KRI is to *reform the civil-service compensation system and personnel policies* to make civil-service employment less attractive. There are two main ways to achieve this. First, reducing the financial benefits of civil-service employment would make private-sector employment more attractive. Second, slowing the pace of civil-service promotions and strengthening the linkage of these promotions to performance could provide an incentive for some civil-service workers to move to private-sector employment. This second option would lower the likelihood that low-performing individuals would be promoted, which would lower their expected future compensation associated with civil-service employment. For new labor market entrants considering employment opportunities, this would have similar effects on expected compensation.

There are three primary advantages to this strategy. First, separations from the civil service would be voluntary, and this would minimize the likely political consequences associated with involuntary separations. Second, both slowing the pace of civil-service promotions and strengthening the linkage of these promotions to performance would limit wage growth in the civil service, allowing the KRG to use its scarce resources elsewhere. Finally, to the extent that the KRG is able to strengthen the link between performance and promotion, this could help mitigate the adverse selection problem and ensure that its highest performers do not leave for the private sector.

Despite these advantages, there are four main disadvantages. First, the actual response of civil-service workers to lower expected compensation is unknown. There are no estimates of how many civil-service workers, if any, would voluntarily leave for the private sector if civil-service promotions were limited or if the financial benefits of promotion were reduced. Second, in order to strengthen the link between performance and promotion, it is first necessary to evaluate performance systematically. As we will discuss, the KRG does not have a rigorous performance-appraisal system, and others' experiences suggest that the design and implementation of a good system is both expensive and time-consuming. Third, the civil-service compensation system is codified in Iraqi law, and any changes would require legislative change—not only in the KRI but also possibly in Baghdad.¹⁰ Finally, it is possible that lowering expected civil-service compensation would have political consequences if civil-service workers were to express dissatisfaction over lower salaries.

There may also need to be complementary policies of enforcing working hours for government officers. Faced with lower compensation, civil-service workers might choose to retain their government jobs but arrive much later than required and leave much earlier than required to put more effort into a second, private-sector job. Enforcing timeliness and penalizing absenteeism may be part of a performance-evaluation system, but they also can be instituted on their own.

The basic structure of the Iraqi civil-service compensation system resembles that of many countries. Civil-service salaries depend on two factors: the grade, or rank, of the individual and the number of years an individual has served in that grade. Higher grades have higher salaries,

¹⁰ We do not know what leeway the KRI has in terms of shaping its own legislation. Our impression is that this is still a gray area to many KRG and Iraqi officials as well.

and civil-service salaries also increase with the number of years an individual serves in a grade. There are 12 different grades, ascending from Grade 10 to Grade 1 and then to Grade B and Grade A, the two highest grades. All civil-service employees at a given grade and number of years in that grade are paid the same salary.

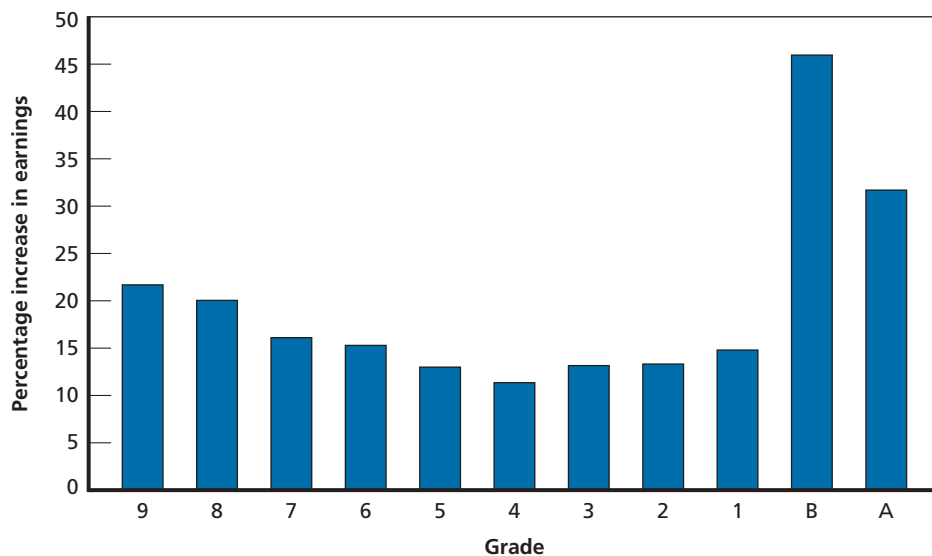
The initial grade of the individual is meant to depend on his or her education at the time he or she is hired. For example, an individual without any educational certificate is supposed to start at Grade 10; in contrast, someone with a bachelor's degree is supposed to start at Grade 7. Individuals can also be promoted to higher grades.

To better understand the civil-service compensation system, we analyzed, in detail, the 2008 salary schedule, which is applicable to 2010.¹¹ Specifically, we assessed the salary increases associated with promotion and compared them with the salary increases associated with additional time within a grade. For each grade, we calculated the percentage increase in salary associated with being promoted from the next lowest grade. We also calculated, for each grade, the average percentage increase in salary associated with an additional year of service.

Data on the increase in earnings from promotion from one grade to the next are presented in Figure 7.4. For promotions to Grade 9 through promotions to Grade 1, increases range from about 10 percent (for promotions from Grade 5 to Grade 4) to 20 percent (for promotions from Grade 9 to Grade 8). Percentage increases in salary for promotion to the two highest grades are even larger.

The patterns displayed in Figure 7.4 are generally not consistent with the optimal pattern suggested by the literature on compensation in hierarchical organizations (Lazear and Rosen, 1981; Asch and Warner, 2001). Several factors affect the ideal increase in earnings associated with promotion, including the probability of promotion, the heterogeneity of ability among workers, the value of ability at each grade, and the number of promotions remaining before one

Figure 7.4
Increase in Earnings from Promotion, by Grade



SOURCE: 2008 KRG Employee Salary Schedule.

RAND MG1117-7.4

¹¹ These data were provided by the KRG Ministry of Planning.

reaches the maximum grade. This literature suggests that, in hierarchical organizations that promote from within, the financial benefits of promotion should generally *increase* with rank. In contrast, the KRG salary schedule exhibits *decreases* in the percentage increase in earnings through promotion to Grade 4, and again from Grade B to Grade A. It is only for promotions to Grade 3 through Grade B that the structure of the salary schedule mirrors the ideal pattern identified in the literature.

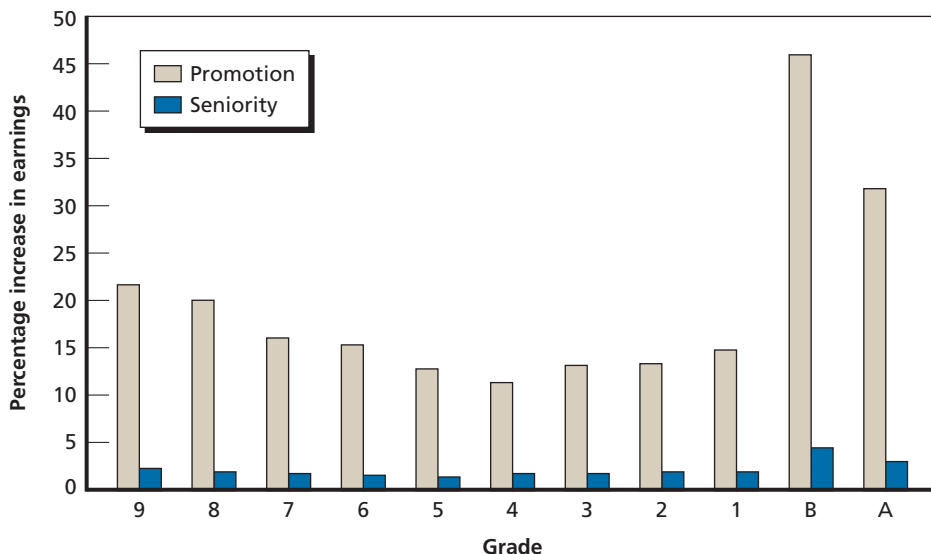
The increases in earnings from promotion are larger than the increases that are due to an additional year of service within each grade. In Figure 7.5, we reproduce the data from Figure 7.4 for promotion and, for each grade, also include the average percentage increase associated with an additional year of service. For Grade 9 through Grade 1, increases from an additional year of seniority range from about 1.5 to 2 percent. Percentage increases in salary from an additional year of service are slightly larger in the two highest grades. Clearly, however, increases due to promotion are substantially higher.

If promotions are based on performance, the literature suggests that this feature of the civil-service compensation system would be ideal. That is, the rewards associated with merit-based promotions *should* be larger than the benefits of serving an additional year. Therefore, we turn now to the issues of promotions and performance evaluations.

The 1960 civil service law (Law 24, as amended) clearly specifies the conditions under which a civil-service worker can be promoted. There are three necessary conditions that must be met before an individual may be promoted to the next higher grade:

- There exists a vacant position at the next higher grade.
- The employee is considered capable to fill the position and is the most qualified candidate.¹²

Figure 7.5
Increase in Earnings from Seniority, by Grade



SOURCE: 2008 KRG Employee Salary Schedule.
RAND MG1117-7.5

¹² At the national level, this is determined by the Council of Public Service and is based on a recommendation of the employee’s ministry or department.

- The employee has served a requisite number of years in his or her current grade.¹³

Consistent with these legal requirements, the KRG officials with whom we spoke noted that civil-service employees are typically promoted every three to five years. However, these same officials did not believe that the connection between performance and promotion is as clear as that implied by the civil service law. Rather, civil-service workers view promotion as automatic, subject to the time-in-grade constraints, and expect to be promoted as soon as they have satisfied these constraints.

Making promotions more difficult to achieve would provide an incentive for some civil-service workers to move to private-sector employment. It would lower the likelihood that an individual would be promoted, which would lower the expected future compensation associated with civil-service employment. For the KRG, this change would also have the added benefit of limiting wage growth in the civil service, allowing it to use its scarce resources elsewhere.

In addition to reducing the size of the civil service, the KRG has an additional goal of improving performance incentives for workers who remain in the civil service. By establishing a stronger link between performance and promotion, the KRG could provide higher-performing workers with higher-than-average promotion opportunities. This would have two additional benefits. First, the economics literature suggests that linking promotions to performance improves the productivity of the workforce, since individuals have a clear motivation to perform well (Lazear and Rosen, 1981; DeVaro, 2006; Lazear and Shaw, 2007).¹⁴ The literature also shows that these increases in productivity are greatest when the worker is also given new responsibilities when promoted (Fairburn and Malcomson, 2001). That is, promotions are not merely financial rewards for the work being done in the current position, but are tied directly to new, more-challenging and interesting tasks. In addition, identifying and rewarding superior performance helps mitigate a concern that the KRG's most-productive employees will be those who leave for private-sector opportunities.

In order to strengthen the link between performance and promotion, it is first necessary to evaluate performance systematically. However, the KRG officials with whom we spoke felt that few civil-service workers have their performance rigorously evaluated. While some workers do receive evaluations, and there is a belief that positive evaluations lead to promotions and higher pay, it is not clear whether these evaluations accurately reflect a worker's actual performance. In other words, there is a belief that workers receive positive evaluations in order to justify promotion and that these positive evaluations are not always given to the highest performers.

Although measuring and evaluating performance is conceptually straightforward, assessment of employee performance in practice can be difficult, and a large academic literature has arisen that examines performance measurement. The literature concludes that some elements should *always* be used when developing a performance-appraisal system (Latham et al., 2005). First, the appraisal system should be based on a *written job description*. By knowing the behav-

¹³ Workers in Grades 2, 3, and 5 must complete at least five years of service in that grade; workers in Grades 4 and 7 must complete at least four years of service in that grade; workers in Grades 6 and 8 must complete at least three years of service in that grade; and workers in Grade 9 must complete at least two years of service in that grade. There are also conditions under which workers can receive credit for more years of service than they have actually worked. For example, individuals who successfully complete a training program and score well in that program receive credit for three to six months of service.

¹⁴ Lazear and Rosen (1981) suggests that linking promotion to relative, rather than absolute, performance improves incentives for performance and expected productivity.

iors expected by workers in a job, the appraisal system can be better developed around job performance. Similarly, these systems should be *behaviorally based*. In other words, ratings of performance should be made with reference to specific examples of work behavior. Third, the rating system should have *demonstrable fairness*. This can be achieved through detailed instructions on how to evaluate and rate performance, helping to ensure that each rater will have the same approach and framework. Another facet of this is to review the ratings with employees and to allow the individual to voice opposition. Finally, it is important to *demonstrate and document the reliability and validity* of performance ratings. If workers do not believe that performance evaluations accurately reflect actual performance, the system will not be accepted as credible. A key to demonstrating reliability and validity is the systematic and consistent collection and analysis of performance and ratings data.

Policy Recommendations

The KRG must make difficult choices about *how* to achieve civil-service downsizing and reform. At the outset, it is important to distinguish between the short-term issues—reducing the size of the civil service and transitioning some of these workers to the private sector—and the longer-term issues—a civil service that is more efficient and productive.

Some strategies that help address the short-term issues could have adverse consequences in the long term. What is needed, then, is that **the KRG should develop a strategic HR plan to ensure that its short-term policies are consistent with its long-term goals**. This would give the KRG flexibility to manage the civil service and the ability to retain high-quality personnel where needed and to induce high work effort. Although developing a comprehensive HR plan is beyond the scope of our current analysis, it remains an important, necessary step for the KRG.

Furthermore, we are unaware of any existing civil-service management agency in the KRG. In most countries, centralized agencies are responsible for managing civil-service employees, including setting salaries, approving the number of positions, establishing the grade for each position, and monitoring performance reviews and the promotion process. These agencies play a critical role in any strategic HR plan.

We note that establishing such an agency would create more bureaucracy in the KRG, and staffing the office might lead to *increases* in civil-service employment. Nevertheless, given its likely importance in the implementation of many of our recommendations, we recommend that **the KRG should establish a civil-service management agency with jurisdiction over all relevant personnel policies**. Within the KRG's current organizational structure, this agency could be placed in the Ministry of Labor and Social Affairs, the Ministry of Planning, the Ministry of Finance, or the Council of Ministers. In addition, forming such an agency need not expand the size of government, as it could be staffed with civil servants who currently work in the personnel functions of the various line ministries.

Without this comprehensive HR strategy and centralized management agency in place, we do offer some recommendations that will help the KRG achieve civil-service downsizing through changes in its hiring, compensation, and personnel policies. Some of these recom-

mendations address the short-term issue, while others focus on the long term; we also highlight areas in which these two are potentially in conflict.

Limiting Civil-Service Hiring

The KRG will still need to hire qualified individuals into essential positions (e.g., teachers). Furthermore, there likely will be pressure to continue hiring into the civil service, given the current political unrest in the Middle East and North Africa.¹⁵ Therefore, we do *not* recommend that the KRG impose an across-the-board hiring freeze. However, we do recommend a hiring freeze in some specific occupations.

The KRG should immediately impose a temporary hiring freeze for occupations that are not inherently governmental. As we discussed in Chapter Five, our analysis of the IHSES data suggests that there are many civil-service workers in occupations that are not clearly inherently governmental. For example, office clerks, cleaners and launderers, motor vehicle drivers, messengers and porters, and library and mail clerks are all occupations that have clear nongovernmental counterparts. These occupations are candidates for outsourcing to the private sector and, therefore, are natural candidates for occupations into which the KRG should limit hiring. We recommend this as a short-term option while the KRG develops a more-rigorous method for identifying occupations that are candidates for outsourcing.

Our analysis was not able to identify concrete guidelines for how long a temporary hiring freeze should last. However, we recommend this as a temporary measure, since short-term reductions in hiring can create long-term shortages of experienced civil servants. The intent behind this recommendation is to achieve a quick reduction in the growth of the civil service.

In the longer term, it is necessary to have a better understanding of the specific tasks and responsibilities that are expected in each position in the civil service. This will help the KRG better identify positions that are not needed, but it will take time, given the number of civil-service occupations and the different positions and areas of responsibility within each of these occupations. Specifically, **the KRG should develop written job descriptions of all occupations in the civil service.** To capitalize on the expertise associated with developing job descriptions, we recommend that the KRG contract with an external specialist in this area. Once these descriptions have been developed, KRG policymakers should revisit the occupations into which hiring has been frozen and adjust this list if necessary.¹⁶

One concern with a hiring freeze for some occupations but not others is that workers who would have been hired into the frozen occupations would still continue to be hired but would be classified as working in other occupations. If this occurs, our recommendations will not succeed in limiting civil-service hiring in a substantial way. Therefore, it is necessary to ensure that all other hiring is done in a way that ensures that candidates are hired only into vacant positions for which they are qualified.

As we showed in Table 7.1, many civil-service workers appear to have gotten their current jobs by contacting the government directly, and more than one-fourth of all civil-service workers attained their current job after inquiring with relatives or friends. These data suggest that a wider dissemination of information about vacant positions could help ensure that the most-

¹⁵ This unrest is likely driven, in part, by discontent about employment opportunities.

¹⁶ Creating written job descriptions is also the first, essential element in developing a performance-appraisal system, a recommendation we will discuss later.

qualified individuals are hired. Therefore, we recommend that **all vacant positions should be advertised openly, and the most-qualified applicant should be hired into each position.**

There are a few important principles that should guide the implementation of this recommendation. The intent behind openly advertising vacant positions is to ensure a wider dissemination of information about these positions. The advertisement should be placed in a forum (or multiple forums) that is easily accessible by a large number of potential applicants and that reaches across the political spectrum. Furthermore, it is important that the position be held open for a sufficient period of time to ensure that enough qualified individuals learn about the opportunity and submit an application. For example, the U.S. government typically keeps the application window open for a few weeks to a few months, depending on the specific position, suggesting that this does not need to be a one-size-fits-all approach. Finally, an open and transparent process for hiring the most-qualified applicant—and, for most civil-service positions, without regard to political affiliation—needs to be in place in order to ensure that those who are hired are best suited to work in the vacant positions.

Civil-Service Compensation and Personnel Policy Reform

Our recommendations for civil-service compensation and personnel policy reform have two objectives. The first is to reduce the advantages of civil-service employment relative to those associated with working in the private sector. The second is to ensure that the KRG is able to retain its highest performers. Therefore, it is first necessary to be able to identify *who* these highest performers are.

The KRG should design and implement a performance-appraisal system for civil-service employees. The first, essential element in this process is creating written job descriptions: When the behaviors expected by workers in a job are known, the appraisal system can be better developed around job performance. Therefore, if the KRG adopts the recommendation to develop these job descriptions, it will have already begun the process of designing a performance-appraisal system.

The design and implementation of a performance-appraisal system is a labor-intensive process, and this system will take a long time to develop and refine. To capitalize on the expertise associated with developing performance appraisal systems, we recommend that the KRG contract with an external specialist in this area. Furthermore, given the importance of this system for several of our recommendations, we recommend that the KRG begin this process immediately.

Related to performance appraisal, we recommend that **the KRG should develop career paths for civil-service workers.** This would be a necessary component of the strategic HR plan we have recommended. This would outline expectations for civil-service workers against which their performance can be measured. This is a longer-term solution that will help the civil service be more efficient and productive. Ideally, promotion policies would be tailored to each occupation to ensure that the KRG has the flexibility to manage the civil service and retain high-quality personnel where they are most needed.

In the near term, **the KRG should slow the pace of civil-service promotions by increasing the number of years before a worker is considered for promotion, with exceptions for the highest performers.** Our interpretation of the 1960 Civil Service Law is that civil-service employees must complete a *minimum* number of years of service in a grade before becoming *eligible* for promotion. There is nothing in this law that precludes the KRG from setting policy that raises the number of years before which an individual is *considered* for promo-

tion. Therefore, we recommend that the KRG develop a policy that sets the number of years before a worker is considered for promotion *above* the legislated minimums. The advantage of this approach is that the KRG may not need to go through the legislative process, which can be time-consuming and does not have a certain outcome.

Our analysis was not able to identify concrete guidelines for how far above the legislated minimums these should be. However, as we have noted, civil-service employees are typically promoted every three to five years. Increasing these typical promotion points by at least a year or two could have a substantial effect on expected civil-service compensation.

One concern with mandating longer times for promotion is that the highest performers would be subject to these same constraints. Therefore, our recommendation includes a limited exception for these highest performers. For example, the policy could allow for a fraction of workers to be promoted early. It is important that the conditions under which workers can be promoted early be transparent and explicitly articulated in policy. Of course, without a performance-appraisal system, the KRG will not be able to systematically identify who these high performers are.

In addition to slowing the pace of civil-service promotions, reducing the number of these promotions would also help reduce the relative advantages of civil-service employment. Therefore, **the KRG should limit the number of civil-service promotions by promoting only a fraction of eligible workers.** We recommend that the KRG develop a policy that explicitly articulates targets for the fraction of workers that can expect to be promoted. This will help change workers' expectations of automatic promotion and, consequently, lower expected civil-service compensation.

Our analysis was not able to identify concrete guidelines for how far below 100 percent these fractions should be. However, these fractions can, and likely should, vary by grade and by occupation. In setting these targets, policymakers should revisit the number of positions needed at each grade to identify whether it is necessary to have as many positions at higher grades as there currently are.

The final step in reducing the speed and number of promotions is to identify the civil-service workers who will actually be promoted to higher grades. We recommend that **these limited promotions should be given only to the highest performers.** With a performance-appraisal system in place, this recommendation will be straightforward to implement: The available promotions, the number of which would be determined by the previous recommendation, should be given to the highest performers in each occupation and grade combination. Explicitly linking promotions to performance would address the possibility of moral hazard, reducing the possibility that civil-service workers will shirk in their jobs, since workers' compensation would be based, at least in part, on their productivity.

Without a rigorous way to evaluate performance, this becomes more difficult to implement. According to the 1960 Civil Service Law, an individual is promoted if he or she is considered capable of filling the position and is the most qualified candidate; at the national level, this is determined by the Council of Public Service and is based on a recommendation of the employee's ministry or department. Until a performance-appraisal system is in place, limited promotions will need to be awarded in the same manner currently used. The burden, then, is on each employee's ministry or department to carefully identify its highest performers and recommend only those workers for promotion. An open and transparent process is critical.

Finally, **the KRG should work with the central government to reduce civil-service salaries. If it can do so on its own, it should.** This may be a longer-term recommendation.

One option would be to directly reduce civil-service salaries by lowering the amount paid at all grades and seniority levels. Another option would be to reduce the *growth* over time in the amount paid to civil-service workers. Further analysis will be needed to identify concrete guidelines for the extent to which civil-service salaries should be reduced, including whether the financial benefits of promotion should be adjusted.

Strategies for Voluntary Civil-Service Separation

Changing the civil-service compensation and personnel policies is one way to reduce the size of the civil service. Another option for altering the mix of civil-service and private-sector employment in the KRI is to *offer incentives that encourage voluntary separation*. There are two primary advantages to this strategy. First, separations would be completely voluntary, minimizing the political costs associated with involuntary separations. Second, as we will discuss, these programs can be targeted to specific civil-service workers, helping to mitigate the adverse selection problem.

Despite these advantages, there are four main disadvantages. First, the actual response of civil-service workers to these programs is unknown. There are no estimates of how many civil-service workers, if any, would voluntarily leave for the private sector if offered voluntary separation incentives. Second, the short-term financial costs can be considerable, placing pressure on a KRG budget already stressed by competing demands for resources. Third, if these programs are not carefully targeted, offering voluntary separation incentives could result in the KRG's best workers leaving for the private sector. Finally, it is possible that workers could accept compensation to leave, fail to find suitable private-sector employment, and ask to be rehired. If this were to take place, the KRG's budget would increase without a commensurate reduction in the size of the civil-service workforce.

A final option is to *involuntarily separate some civil-service workers*. The main advantages are threefold. First, by targeting involuntary separations to specific civil-service workers, the KRG can control the number and, in principle, the quality of workers who leave. Second, these reductions can be achieved quickly, relative to the speed of the options discussed above. Finally, involuntary separation programs typically have lower financial costs than voluntary programs. The main disadvantage is that these programs are involuntary. The political costs associated with forcing civil-service workers to leave can be considerable, particularly if there are not private-sector jobs readily available for these individuals.

Governments around the world have exercised different strategies to encourage civil-service employees to seek private-sector employment. We review the literature on this topic, drawing in large part from World Bank work in this area.¹ We also draw from other literature, including from the experiences of the U.S. military in its downsizing efforts. We pay particular attention to voluntary separation strategies but also discuss other options for motivating labor movement from the civil service.

¹ The World Bank was involved in gathering data and evaluating downsizing efforts around the world. It developed a website (currently archived), titled "Helping Governments to Downsize Efficiently," to serve as an information and data clearinghouse on downsizing efforts (World Bank, 2008).

This chapter is organized as follows. To begin, we review a set of principles for government-sector downsizing identified from the literature that assesses the effects of government downsizing efforts. Because the literature has focused mostly on strategies involving voluntary separation with severance pay, we discuss, in the following section, countries utilizing this approach. Training, job matching, and other job placement strategies are explored next, followed by a discussion of other types of restructuring efforts and the importance of the context in which these efforts occur.

Lessons Learned from Government-Sector Downsizing

The 1980s and 1990s witnessed large-scale efforts by many countries to downsize government. Countries in Latin America, Africa, and Asia all implemented major government-sector restructuring programs. Large-scale restructuring also occurred in Eastern European countries and those of the former Soviet Union. A strong driving factor for many of those countries was the political and social upheaval that resulted from the wane of the Soviet Union's influence and its eventual collapse. Other countries were faced with severe budget shortfalls and had no choice but to reduce the size of government. Many of those same countries simultaneously pursued government-sector downsizing and pushed for privatization as a way to ensure greater efficiency and long-term economic growth.

The World Bank has examined the experiences of different countries with downsizing and restructuring government (Rama, 1999; Kikeri, 1998; Chong and Lopez-de-Silanes, 2002). These considerations provide a framework that governments can use to establish their approach to and implementation of civil-service downsizing.

The first step is often to agree on a set of feasible objectives that downsizing is intended to achieve. Competing or infeasible objectives can derail restructuring efforts, as can objectives that are poorly matched to the strategies chosen to achieve the restructuring (Rama, 1999). These feasible objectives shape the approaches to be taken and the types of supports that need to be available to facilitate that transition. For example, it might be appropriate to link reductions in civil-service employment with an education and training strategy for workers. If redirecting resources to develop the private sector is another objective, downsizing could free up resources for private-sector investment and development.

Economic theory argues for a role for government in this process. Governments are needed to provide essential public goods; for example, defense and security, education, and health care require some government involvement when markets do not provide them at desired levels. However, this does not preclude some downsizing in these sectors, if the intent is to reduce overstaffing.

In addition, any downsizing efforts can fail if they do not account for local labor market conditions. Studies have found, though, that impacts on local labor markets are a function of the degree of integration between the government sector and local labor markets, as well as the composition of skills in the labor force (Dardia et al., 1996). For example, in communities where there is sizable dependence on the government sector as an employer, drastic downsizing efforts can dramatically increase the number of unemployed workers, creating political backlash. However, these can sometimes be mitigated through planning both the timing and the scale of civil-service downsizing efforts (Rama, 1999).

In some countries, the government has tried to directly involve the private sector in restructuring efforts. For example, when state enterprises are being privatized, some countries

have pursued reductions in employment before privatization in order to increase the value of the entity targeted for privatization or to signal commitment to reform (Rama, 1999; Diaz, 2006). In other cases, the new private-sector owners are invited to play a role and even manage the process; in certain cases, the new private-sector owners may be better at assessing the quality of the workforce than the government is (Kikeri, 1998; Rama, 1999; Chong and Lopez-de-Silanes, 2002; Diaz, 2006). The specific strategy depends on a number of factors, including the size of the state enterprise's staff and local labor market conditions.

One of the most critical issues is to select the appropriate mechanism by which to achieve reductions in civil-service employment. There are implications of downsizing for both the government and the population. Some workers are likely to experience financial losses when moving from civil-service to private-sector employment. Later in this chapter, we discuss some of the approaches that have been taken to determine these losses and account for them in designing supports for affected workers.

Governments can mitigate political backlash and conflict by developing effective communication channels with organized labor and other stakeholders in the process. One of the major problems cited in civil-service downsizing efforts is a failure to clearly communicate the goals, structure, and process to key stakeholders (Martin, 1997; Kikeri, 1998; Diaz, 2006). For example, employees are often presented with a large array of different severance packages and find it difficult to choose among them; developing an effective means of communicating options to organized interests can help ease that process. Keeping organized stakeholders out of the process can also increase the costs of implementing civil-service restructuring. Key stakeholders include groups other than organized labor, such as political parties with vested interests in maintaining employment for their members.

The international literature on the effectiveness of training and job placement programs is mixed. Nonetheless, the findings do suggest that these types of programs can have modest positive impacts on employment in the long run (Blundell et al., 2004; Heckman, LaLonde, and Smith, 1999; Kikeri, 1998). Properly implemented, training and job placement support can help released civil-service employees acquire the skills needed to find new jobs in the private sector. The varied experiences of countries suggest that there is no one-size-fits-all training program; rather, these programs are more effective when they are tailored to meet the specific needs of civil-service workers and private-sector employers.

Finally, as with any major restructuring initiative, governments need to develop a feasible implementation timeline. In many countries, civil-service restructuring has been implemented over a period of several years. This can help ease any adverse impacts on the labor market and allows time to assist workers with a transition to the private sector.

Effects of Civil-Service Downsizing

Downsizing civil-service workers can have economic, political, and social effects. Job loss is a key concern, and the restructuring of large government entities can substantially increase the overall unemployment rate. If the released workers are organized under a powerful union, government officials are likely to face political ramifications. In general, poor economic performance can lead to both political and social unrest. Moreover, understanding the economic costs to the various stakeholders affected by the downsizing is important in delineating the intended and unintended consequences.

Effects on the Individual Worker

The literature in this area concludes that education tends to be a better predictor of earnings and benefits loss than civil-service wages or experience; higher education is generally associated with lower earnings losses after separation (Rama, 1999; Assaad, 1999).² Some studies have estimated that each additional year of schooling reduces losses by 15 percent (Rama and MacIsaac, 1999). The literature also concludes that severance packages have historically been more generous for men, despite the fact that losses in flexible working hours and maternity benefits disproportionately affect women (Rama, 2002).

Assaad (1999) finds that severance payments that do not account for differences in the opportunities women face are likely to result in fewer women participating in the program. Other research concludes that women remain unemployed for longer periods of time after job loss (Cazes and Nesperova, 2001). On the other hand, Rama (2002) concludes that in Vietnam, where women make up a large percentage of the workforce in some industries, civil-service downsizing had a *positive* impact on their earnings.

The effect of geographic location is less clear. Lower costs of living in rural areas (resulting in a relatively low adverse effect from job loss) can be offset by fewer private-sector job opportunities in these areas (resulting in a relatively high adverse effect from an inability to find a job to replace lost wages). For example, Assaad (1999) uses the Egyptian Labor Force Sample Survey of 1988 to simulate losses from civil-service downsizing and compares these losses with the value of various compensation programs. He finds greater adverse effects for civil-service workers in rural areas, as compared with those for workers in urban areas.

Although much of the literature has focused on wage and benefit losses of affected workers, it is important to note that there are other, intangible losses that also adversely affect workers. These intangible losses, which are difficult to quantify, include the prestige and status that can be associated with civil-service employment (Stasz et al., 2007; Gonzalez et al., 2008). The literature on organizational restructuring also identifies a number of additional issues that could arise, including reduced loyalty and commitment to the employer (Brockner, 1988), conflict between employees (Buono, Bowditch, and Lewis, 1985; Greenwood, Hinings, and Brown, 1994), and reduced morale and productivity (Buono, Bowditch, and Lewis, 1985; Cascio, Young, and Morris, 1997; Wah, 1999).

Effects on Government

In many developing countries, governments have pushed for civil-service downsizing as a way to reduce the overall government wage bill (Kikeri, 1998; Haltiwanger and Singh, 1999; Diaz, 2006). In addition, reducing civil-service employment can reduce the government's long-term pension liabilities. There are, of course, costs associated with any severance payments to affected workers, as well as administrative costs associated with managing the system. From a financial standpoint, if the reduction in the compensation bill more than offsets the costs associated with severance payments and their administration, then there are net financial benefits to civil-service downsizing.

However, affected government entities might resist attempts to downsize because smaller numbers of employees can lead to diminished power and control. Local governments, for example, have an incentive to resist downsizing, since it can mean increases in unemployment

² One exception is Egypt, where higher education was positively correlated with earnings loss. This could be due to distortions in the returns to education as a result of government hiring practices (Assaad, 1999; Diaz, 2006; Rama, 1999).

rates in their communities, loss of political power, and loss of revenue flow (Diaz, 2006). On the other hand, local governments could also see positive effects if resources originally held at the central level are diverted to local government control. This could happen, for example, if provision of education, health care, and other services were decentralized.

Effects on Economic Growth

The effects of civil-service downsizing on economic growth are more difficult to quantify. However, in many cases, these effects can be substantially larger than any budgetary savings associated with reducing civil-service employment. In principle, a better allocation of labor between the private and government sectors can lead to a more efficient economy and, consequently, faster economic growth. Nonetheless, there are also costs associated with downsizing, particularly in the short term. For example, service providers under contract with the government sector can be adversely affected by a smaller government.

More generally, if the government sector is a major source of revenue for small and medium-sized businesses, they will be adversely affected by civil-service downsizing. While government restructuring has been argued to stimulate economic growth (Li, 1998), policymakers should factor in both the budgetary consequences and the likely effects on economic growth when deciding whether, and by how much, to reduce civil-service employment (Rama, 1999; Diaz, 2006).

Mitigating Adverse Effects of Downsizing in the Reform of State-Owned Enterprises

Here, we discuss two types of transfer of control of functions from the government to the private sector. One is a transfer of management control, in which government retains ownership, but some or all of the operations are run by private management through a management contract. This could be considered a special case of outsourcing. The second is full divestiture to the private sector (World Bank, 1995).

In the case of a management contract, contractual arrangements can mitigate some of the adverse effects discussed earlier—for example, by requiring that new management not make major reductions in the workforce. However, this is likely to dampen some of the potential economic efficiency gains expected from private-sector control. Limiting the ability of management to reshape the firm could put sizable constraints on future growth. A management contract arrangement could restore some of these benefits by converting enterprise employees to coverage by private-sector labor rules and regulations rather than by civil-service laws.

Major downsizing is more likely to occur with the second type of transfer, where there is a full-fledged transfer to private ownership. It is important to note that privatization does not always lead to major downsizing. There are cases where former civil-service employees are successfully retained under the new, private management, especially when these employees already have the requisite skills (Kikeri, 1998; Diaz, 2006). This argues for allowing the private sector to play a substantive role in decisions about whether to retain or reduce employment in the entity being privatized, in order to avoid unnecessary layoffs and displacement. Furthermore, our review of government downsizing efforts finds that employment has, in some cases, actually *risen* as a result of efficiency gains after privatization (Kikeri, 1998).

The decision to privatize raises the question of exactly when to involve the private sector in the process. In sectors with small levels of overstaffing, restructuring could more readily be accomplished by the private sector after privatization if the new managers are in a better position to evaluate their HR needs and carry out any downsizing (Kikeri, 1998). However, this

may not be an option in severely overstaffed sectors where restructuring may improve the value of the enterprise that is going to be privatized. Significant overstaffing may reduce the value of the enterprise—or even prevent the government from being able to sell it. In these cases, the government may have no choice but to engage directly in downsizing. In addition, government engagement in downsizing may signal a commitment to private investors for reform (Kikeri, 1998; Diaz, 2006; Fretwell, 2004).

Considerations in Structuring a Financial Severance Package

Providing voluntary separation incentives is a common method used by governments to mitigate the consequences of civil-service downsizing. The large-scale government restructuring initiatives in other countries during the 1980s and 1990s included different approaches to designing voluntary separation programs (Kikeri, 1998; Diaz, 2006; Rama, 1999; Chong and Lopez-de-Silanes, 2002; Haltiwanger and Singh, 1999; Diaz, 2006). These studies have categorized approaches to civil-service downsizing into three basic groups. First are voluntary programs: Workers are offered a severance package and are free to accept or reject it. Because this option allows workers to separate regardless of their productivity, the most-productive workers, with the best outside prospects, are generally more likely to leave. Voluntary programs have been widely used, but they account for less than a quarter of the ultimate reduction in the workforce across the countries examined in the literature (Rama, 1999; Haltiwanger and Singh, 1999; Diaz, 2006).

Alternatively, some governments have used what are known as involuntary, soft programs. Ghost workers, civil-service workers who are on the payroll but who do not show up to work or who may not even exist, are removed from payrolls. Other workers are also involuntarily removed from payrolls but are generally offered generous compensation payments and additional supports, such as training and job placement assistance, when they separate. Involuntary, soft programs account for 30 percent of the workforce reduction in the countries examined in the literature (Haltiwanger and Singh, 1999; Diaz, 2006).

Finally, many governments use what are known as involuntary, hard programs. Workers are required to leave but do not receive generous compensation. Separation may or may not be accompanied by significant training or job placement assistance. Involuntary, hard programs account for the largest reductions, just under half of the total, in the countries reviewed in the literature.

Countries often implement combinations of these approaches, simultaneously offering some workers one option and others another, or offering voluntary programs followed by involuntary programs if the former do not achieve the desired result (Haltiwanger and Singh, 1999; Diaz, 2006). Voluntary programs are considered to be more politically and socially palatable than involuntary programs.

Haltiwanger and Singh (1999) examine government downsizing programs in 37 countries. Table 8.1 displays a subset of these countries to illustrate the different strategies chosen and the number of civil-service workers separated using these programs. As Table 8.1 shows, some countries chose to rely exclusively on involuntary, hard separation programs. In the case of the Brazil civil service, the number of affected workers was fairly small, but in Poland, more than half a million public-enterprise workers were involuntarily separated. At the other extreme, India, Pakistan, and Turkey all relied exclusively on voluntary separation. The other

Table 8.1
Number of Workers Separated, by Type of Separation

Entity	Number of Workers Separated	Type of Separation (%)		
		Voluntary	Involuntary, Soft	Involuntary, Hard
Argentina public enterprises	72,818	41	59	0
Brazil civil service	4,599	0	0	100
Ghana civil service	73,810	81	19	0
India public enterprises	69,466	100	0	0
Kazakhstan public enterprises	172,959	0	76	24
Pakistan public enterprises	7,495	100	0	0
Poland public enterprises	547,300	0	0	100
Senegal civil service	6,100	70	30	0
Turkey public enterprises	35,000	100	0	0

SOURCE: Haltiwanger and Singh, 1999.

countries reviewed by Haltiwanger and Singh (1999) chose a mix of these approaches when selecting a strategy to reduce the number of employees.

The amount of compensation offered in severance packages varies by country but, in general, is considered to be generous (Kikeri, 1998). Examples in the literature range from six months to several years of the civil-service worker's salary. According to Kikeri (1998), these separation payments generally compare well with average wages. Offering voluntary separation incentives that are explicitly tied to a civil-service worker's salary is straightforward to implement and has, for the most part, helped mitigate any political backlash. Furthermore, governments have seen financial savings, through reductions in their payrolls, within two to four years.

Nevertheless, voluntary separation programs have had their opponents, especially to the ways in which they have been implemented. In some cases, the ways in which these programs have been structured and administered have led governments to rehire many of the workers who chose to leave with a severance package. Those government entities felt compelled to hire the workers back in order to continue to provide an expected level of services. Restructuring civil-service employment in SOEs prior to privatization is particularly prone to this phenomenon, because the government prioritizes the immediate goal of downsizing to attract investors rather than to ensure that services can continue to be provided even after privatization (Rama, 1999; Haltiwanger and Singh, 1999; Diaz, 2006).

One of the biggest concerns with regard to voluntary separation incentives is the problem of adverse selection, which can result in the government retaining its low-productivity workers and losing its best employees. A performance evaluation system would help mitigate the adverse selection problem. If the government had reliable data on employee performance, vol-

untary separation programs could be targeted to civil-service workers with the lowest levels of performance. More generally, severance packages could be structured in such a way that the least-productive workers would choose to leave voluntarily and the most-productive workers would choose to stay (Hansen and Husted, 2005).

Determining Who Is Eligible to Participate in Separation Programs

There are at least four different ways in which civil-service workers are typically identified as eligible to participate in separation programs (Rama, 1999; Diaz, 2006). The first is where all employees are eligible to participate. The relatively simple implementation is offset by the fact that this method is highly vulnerable to adverse selection. Alternatively, governments have used randomization. Downsizing is done proportionally: The separated and retained workforces have identical compositions. With a randomized approach, all employees have an equal chance of being separated from the civil service. The disadvantage of this approach is that it is not strategic. If, for example, the government wishes to eliminate some functions completely, a randomized approach is not feasible (Rama, 1999, 1997; Diaz, 2006).

Third, governments sometimes use paired methods. Participation depends on three factors: local labor market conditions, the employee's productivity, and the government unit with which he or she is associated. Employees are then provided with a menu of separation options that are determined by the three factors. For example, a civil-service worker in a unit producing a valuable service could have good private-sector opportunities even if his or her individual productivity was relatively low. He or she would be offered lower financial incentives than a worker in the same unit with worse private-sector opportunities. The menu would be designed to induce these low-productivity employees to voluntarily separate at a low cost to the government. While this approach is theoretically appealing, it is difficult to implement (Jeon and Laffont, 1999; Rama, 1999, 1997; Diaz, 2006).

Finally, some governments use a targeted approach. Workers are classified into different categories (for example, high productivity, low productivity, and in between), and decisions to retain or separate are based on the category in which a worker is placed. If designed appropriately, these approaches are more likely to mitigate the adverse selection problem and the need to rehire workers (Haltiwanger and Singh, 1999; Rama, 1999; Diaz, 2006).

The Implications of Involuntary Separation

Many countries have chosen to involuntarily separate civil-service employees. This approach has its advantages: It is relatively simple to implement, and governments have found that the civil-service downsizing can be accomplished at lower financial cost (Diaz, 2006). However, involuntary separation also can have high political and social costs and may not be an option in many contexts (Hansen and Husted, 2005). The power of organized interests, such as unions or political parties, local customs and practices, and the types of precedents set might preclude using involuntary separation. In the KRG, civil-service employees are currently more likely to be transferred within government rather than be involuntarily separated, even if their performance is unacceptably low.

Countries that have resorted to involuntary separations often do so after trying voluntary separation programs and concluding that too few civil-service employees voluntarily participate. In other countries, severe budget constraints have prevented governments from offering voluntary separation incentives. Kikeri (1998) cites two examples in Latin America where employees who did not initially separate voluntarily were involuntarily separated with reduced

compensation. Involuntary separations were based on performance evaluations, work attendance, and other job-related factors.

The Costs of Separation Incentives

Not surprisingly, the costs of separation incentives can vary considerably. There is agreement, however, that properly structured separation programs will cost less in the long term than allowing civil-service workers to remain in government until they retire. Employees with long periods of service remaining before being vested in a retirement system will accept smaller separation incentives than workers who are closer to being vested in the retirement system (Hansen and Husted, 2005). Governments can take advantage of this when structuring voluntary separation incentives if they are willing to pay different amounts to different employees.

Training and Job Matching Programs

Training Programs

The empirical evidence on the effectiveness of job training programs is mixed, primarily because of the variation in benefits by program and demographic group (e.g., income, education, age) affected (Heckman, LaLonde, and Smith, 1999). A review of training programs in both the United States and Europe found positive effects for certain job training programs but negative effects for others. In the United States, there has been considerable variation by demographic group. For example, in the case of the federal Job Training Partnership Act (JTPA), adult males benefited significantly more from this program compared with adult women and youth.³ Similarly, experimental evaluations of job training programs have found positive effects on both employment and wages for both women and men, but not for youth.⁴ In Europe, evaluations of job training programs conducted in the 1980s and 1990s showed wide ranges (both negative and positive) in the estimates of the effects on employment and wages (Heckman, LaLonde, and Smith, 1999).⁵

Studies that have looked at job training in the context of government downsizing are similarly mixed (Kikeri, 1998; Rama, 1999; Fretwell, Benus, and O'Leary, 1999). However, policymakers remained concerned about upgrading the skills of former civil-service workers to assist them in transitioning to the private sector. Many workers have spent a large portion of their careers in civil service and therefore may lack the requisite skills to compete for private-sector jobs. Thus, despite agreement on the interventions that consistently work, policymakers felt that these workers often required assistance with upgrading their skills (Rama and MacIsaac, 1999; Diaz, 2006).

³ The JTPA supported training and job placement assistance for low-income individuals. One evaluation of the JTPA revealed an internal financial rate of return for adult males between 68.9 and 200 percent. The rate of return for women was positive but less than that for men, and the rate was negative for youth (Heckman, LaLonde, and Smith, 1999).

⁴ A review of experimental studies of job training and job search programs targeting socioeconomically disadvantaged women revealed salary benefits ranging from several hundred dollars to more than \$1,000 annually (Heckman, LaLonde, and Smith, 1999, p. 2055).

⁵ Studies reviewed by Heckman, LaLonde, and Smith (1999) showed impacts, measured as the percentage effect of the program on employment and wages, ranging from -40 percent to 70 percent.

One option would be to try different approaches to upgrading skills and conduct evaluations to see what works and under what circumstances. For example, training programs and supports might include training that upgrades any existing skills that are in demand and provides downsized workers with new skills to enhance their human capital, self-employment and entrepreneurship training, and training and guidance in starting and sustaining a business venture for those who are inclined toward entrepreneurship (Kikeri, 1998). In Brazil, for example, the Brazilian Support Service to Small Companies provided training and consulting in accounting, finance, and law related to establishing and operating small and medium-sized businesses to employees leaving the downsized railway sector (Estache, de Azevedo, and Sydenstriker, 2000).

In addition, employees can be offered job placement assistance and counseling. As a complement to training, job placement assistance may be particularly helpful to civil-service employees who have not had to search for work for many years. Related to this are apprenticeship placements and support. Younger workers, in particular, can acquire a new trade or skill through apprenticeship programs. These programs are full-time training opportunities under the guidance of a master tradesman and are often subsidized by the government.

Workers can also be offered subsidies to purchase materials, equipment, and other resources with which to start a business. Access to credit and capital are critical to small business development. Since the up-front costs of equipment and materials can be a substantial barrier to market entry, subsidizing some of these costs could help facilitate and ease entry of new entrepreneurs.

Finally, some workers can benefit from continuing education opportunities, including vocational education, to further enhance their education credentials. These could be an effective means of targeting promising individuals toward particular fields of study in high demand.

The focus in the literature on why these programs have had a mixed record of effectiveness is primarily related to implementation shortcomings. Criticisms of these programs include questions about their quality, execution, and cost-effectiveness. According to some sources, participation rates are quite low, with only 10 percent to 20 percent of eligible workers taking part. The cost to the released worker does not appear to be the issue. Even when these programs are offered at no cost to the individual, most do not participate, and, among those who do, there is significant attrition before training is completed. An alternative could be to give workers the option to receive government-provided training or to receive an equivalent cash payment in lieu of participation (Kikeri, 1998; Rama, 1999; Diaz, 2006).

High-quality training programs may be especially difficult to implement in developing countries with weak institutional capacity. Instead, these countries benefit more by reforming policies that create obstacles to private-sector job creation. However, the role for the private sector does not have to be limited to job creation. The government may consider a partnership between the government and private sectors in which the private sector assumes an important role in the provision and coordination of training (Kikeri, 1998). This method is also one way to better ensure that the trainee has a chance of finding a job, since the training program is likely to be better structured to match the needs of private-sector employers. If the government offsets some of the costs of this training, the private sector may be more willing to absorb civil-service employees.

There is additional evidence that training should be targeted and should provide specific (as opposed to general) skills, and that resources should also be devoted to job placement (Kikeri, 1998). In the KRI, our discussions with private-sector representatives revealed that more voca-

tional skills are needed and that vocational training centers could help meet that demand. These employers also recommended KRG-subsidized apprenticeship programs.

The literature also recommends that training be demand-driven and targeted to those who are the most likely to take advantage of it. The training should also be linked to the needs of the job market, utilize technology that workers are expected to use in the private sector, and impart new skills. Demographic and educational characteristics of workers could also be an important consideration in targeting training programs: Workers near retirement age may benefit less from training programs and more from cash payments and adequate social services; in contrast, young and middle-aged workers have many years of labor force participation remaining. Similarly, workers with vocational skills may benefit from training that is focused on assisting them in securing self-employment opportunities (Kikeri, 1998; Rama, 1999; Fretwell, 2004; Fretwell, Benus, and O'Leary, 1999).

Winter-Ebmer (2001) examined training and job placement as combined mitigating measures during the privatization of the steel industry in Austria and the subsequent workforce downsizing starting in the 1980s. He found positive effects, over the course of ten years, on both employment and the wages of participants, compared with a control group that did not participate in the program. The program, partially funded by the steel industry, required potential trainees to deposit a share of their severance pay in order to participate and also to commit full time for the duration of the training.⁶ It is hypothesized that these requirements led some workers not to participate in the program, despite the positive effects for those who did participate.

Job Matching and Placement Services

A number of countries have established centers that provide job placement services to complement training programs. These centers provide both employers and employees with a central coordinating point to minimize search costs. The United Arab Emirates (UAE) and Qatar, for example, have centers that provide training, career counseling, and placement services for both first-time job seekers and former civil-service employees.⁷ For long-term civil-service workers, both job search assistance and counseling are particularly important, and some researchers have concluded that they are cost-effective (Kikeri, 1998; Martin, 1997; Dar and Gill, 1995; Fretwell, 2004; Fretwell, Benus, and O'Leary, 1999; Fretwell and Goldberg, 1993; Leigh, 1990). For workers who lack the knowledge and experience to look for work, these types of services are likely to be of most benefit when they can help bridge gaps between jobs (Kikeri, 1998). Despite these findings, systematic empirical evidence of the efficacy of these programs remains somewhat limited.

Job placement and counseling services are generally more demand-oriented than government-provided training programs because they are better linked to job market needs (Kikeri, 1998). This suggests the need for a strong private-sector role in providing training, although there is still a need for government-provided training in certain skills that the private sector may require as a prerequisite (for example, general communication abilities and other skills). Career counseling may also help address shortcomings in terms of work ethic, a willingness to tolerate longer working hours, and an understanding of the role of performance evaluations in the private sector.

⁶ Trainees could collect unemployment benefits while they were participating in the training and job placement program.

⁷ In the UAE, Tanmia maintains a database of employees, matches them to job opportunities, and coordinates training. The Institute of Administrative Development performs the same functions in Qatar.

In the KRI, job placement services might be beneficial to a burgeoning private sector, especially when employers and job searchers have otherwise limited information about each other. The UAE and Qatar have utilized these types of services to place local labor in positions that might otherwise be offered to foreigners. In both countries, for example, job placement services have assisted in raising the share of local labor employed in the private banking sector (Gonzalez et al., 2008).

To illustrate the extent to which job placement services might facilitate private-sector employment in the KRI, recall Table 7.1, which presented the different ways in which workers had attained their jobs.

As this table showed, almost three-fourths of all private-sector workers relied on relatives or friends to find their jobs. The proportion of civil-service workers who used these personal connections, while still large, is substantially smaller, at about 27 percent. Typically, developed labor markets depend on a free flow of information regarding employment opportunities, which encourages a hiring process based largely on credentials and merit. The recent research literature has argued that a relatively higher number of social ties between non-family members is positively associated with economic development, while a relatively higher number of social ties between family members is negatively associated with development (Anchorena and Anjos, 2009; Kumar and Matsusaka, 2009).

In contrast, the typical strategies used to find private-sector employment in other countries—contacting employers directly, calling private employment centers, filling out applications, or following up on advertisements—are much less common in the KRI. According to Table 7.1, only 14.5 of private-sector workers relied on these methods to obtain their private-sector jobs. Taken together, the data suggest that more information needs to be made available on job openings in the private sector to facilitate job searches and eventual job matches.

Other Approaches

In addition to severance packages, the literature identifies additional approaches to facilitate civil-service downsizing, both voluntary and involuntary. For example, early retirement programs are an important option and usually include financial compensation in return for separation from civil-service employment. The difference between early retirement and other separation programs is that these civil-service employees are close to retirement age and, therefore, the impetus to ensure that they find private-sector employment is relatively low. Despite this difference, many of the same considerations that apply to structuring voluntary separation programs also apply to early retirement programs. The literature concludes that employees generally will not participate in early retirement programs if the financial payout is less than the value to the individual of the retirement benefits (Hansen and Husted, 2005).

Sometimes, governments maintain some benefits for separated employees for a period of time while the individual searches for private-sector employment. This portability of benefits (such as health care, for example) can ease the transition from the civil service to the private sector, encourage more workers to participate in voluntary separation programs, and lower resistance to civil-service downsizing. Alternatively, some governments provide civil-service employees extended leave or furloughs while searching for private-sector employment, with the option to return to the civil service within a specified period of time.

In addition, governments can ease access to credit, provide subsidized or guaranteed microenterprise loans, and make business-advisory services available (Martin, 1997; Kikeri, 1998). This option was used successfully in Argentina during the privatization of the steel industry (Kikeri, 1998).

Some governments contract out services to former civil-service employees, whether through contracting with cooperatives made up of former employees or assisting such cooperatives in acting as contractors for the private sector (Kikeri, 1998). In Argentina, for example, former civil-service employees formed cooperatives that entered into service contracts with large companies; in this case, the government assisted in the formation of these cooperatives. In the Republic of Congo, former civil-service employees formed cooperatives to provide services in the privatized railroad sector. Other examples include water enterprise cooperatives in Guinea and beverage distribution cooperatives in Egypt and Benin. In Peru, a significant proportion of former civil-service workers were able to reorganize as subcontractors to provide services in various sectors of the economy.

Under the right conditions, civil-service downsizing in SOEs can be supported by providing workers the opportunity to own shares in a newly privatized enterprise (Martin, 1997; Diaz, 2006). This acts as a self-selection mechanism, enabling the new owner to affiliate with only those employees who are willing to take responsibility for ensuring that the enterprise performs efficiently. Implementing such programs is also a potentially effective means of garnering support for civil-service restructuring.

Furthermore, some governments provide tax breaks and other financial incentives to hire civil-service workers and to provide training. Countries such as the UAE and Qatar have implemented these types of programs, albeit with mixed results (Gonzalez et al., 2008). Fretwell, Benus, and O'Leary (1999) finds limited support for short-term wage subsidies, but these remain an additional option to complement training and job placement services.

Finally, governments engage organizations like the World Bank and the International Monetary Fund, which have provided technical assistance on restructuring efforts in other countries. These organizations draw from their network of expert advisers in this area and provide assistance to governments that engage in these types of efforts.

Additional Policy Issues

The Social Safety Net

One important consideration is whether a supporting social safety net is in place for both civil-service and private-sector workers (Martin, 1997). Civil-service restructuring efforts have generally been accompanied by some enhancement of social safety net supports in order to increase the likelihood of success (Rama, 1999).

The absence of a social security system—or one that is poorly functioning—can be an important barrier to implementation. A government or privately administered national pension or social security plan is likely to make it easier for governments to convince civil-service workers to participate in a voluntary separation program. Furthermore, careful consideration needs to be paid to the implications of early retirements in countries that do not have a national pension plan or safety net in place. Early retirement programs require governments to compensate workers earlier than initially planned, and many countries find the budget implications to be considerable in the short term (Kikeri, 1998).

In the KRI, it is important to consider some of the advantages of civil-service employment. Private-sector employers with whom we spoke suggested that the lack of private-sector employee access to various civil-service employee benefits limits interest in private-sector employment. These benefits include low-cost land, housing, cars, and other subsidies; income supplements (family, social, transportation); and access to subsidized basic, postsecondary, and continuing education.⁸ Our discussions with KRG officials and private-sector employers in the KRI suggest that individuals tend to gravitate to civil-service employment in part because of access to the government pension plan and other benefits. As we showed in Chapter Seven, the same benefits are not available to private-sector workers.

Reform of Laws and Regulations

One of the major obstacles to increasing private-sector employment is policies that place restrictions on the management of HR. Many countries have labor policies that afford reasonable protections to private-sector workers but also allow the private sector some autonomy with respect to hiring, evaluating, and terminating workers. The KRI should have in place internationally benchmarked labor policies that articulate standards with respect to wages, such as minimum wage and overtime pay; benefits, including leave time and employee and employer contributions into plans; working hours and conditions; and rightful dismissal and job termination and adjudication procedures. Along with the appropriate infrastructure, these laws and their enforcement should promote healthy competition between the government and private sectors for labor.

Legal and regulatory reform can also help ease the transition under civil-service restructuring. Kikeri (1998) cites examples in which restrictive labor policies—specifically, barriers to laying off or firing workers—in some countries made it difficult for the private sector to absorb separated workers because the private sector was reluctant to hire workers who could not be dismissed for poor performance. For civil-service downsizing to be effective, the private sector also needs to be sufficiently viable to absorb the separated workforce. Kikeri (1998) notes that labor market reforms implemented at the same time as the civil-service downsizing efforts in Argentina, Chile, and Peru in the 1990s helped ease the downsizing process. In addition to labor market policy reform, the 1990s also saw many countries with large bureaucracies eliminate such practices as guaranteed government employment; automatic, non-merit-based promotion; and state guarantees of benefits (Kikeri, 1998).

Evaluating Civil-Service Restructuring

As the KRG considers options for civil-service downsizing, a mechanism should be established to monitor and evaluate progress toward achieving its goals (Fretwell, 2004). Data should be collected on the administration of the program, the number of participants, and the costs of the program; follow-up data collection should also be in place to assess the impacts of the program on private-sector employment and earnings. Case studies and lessons from other countries can offer useful information, but they are no replacement for analysis of the KRG's own experience as it implements civil-service downsizing.

⁸ As an example of income supplements, KRG teachers get additional allowances as civil-service employees.

Policy Recommendations

Voluntary Separation Programs

Economic theory provides two general principles for designing an efficient voluntary separation program. First, effective voluntary separation programs are those that are offered only to workers whom the government wants to leave; without targeting, the KRG runs the risk of having the civil-service workers it wishes to retain actually leave. Second, a flexible program can be more cost-effective, as it would allow policymakers to adjust separation incentives to ensure that the right numbers and types of workers separate. Our recommendations closely follow these principles, and we recommend that **the KRG should design a voluntary separation program that is both *targeted* and *flexible*.**

With a performance-appraisal system in place, voluntary separation incentives should be targeted specifically to the lowest-performing workers.⁹ However, these programs can also be targeted to employees in specific ministries, in specific jobs, in specific grades, and with specific levels of experience. Furthermore, the KRG could use combinations of these categories to narrowly target specific workers for voluntary separation. With targeting, there are two options. Voluntary separation incentives can be offered only to individuals identified as candidates for separation (for example, the least productive). Alternatively, separation incentives can be offered to all workers, but additional incentives (for example, retention bonuses) can be offered to individuals identified as candidates for retention (for example, the most productive).

This voluntary separation program should be targeted to civil-service workers in occupations that are not inherently governmental and to excess, low-productivity workers in any occupation. In discussing our recommendations to limit civil-service hiring, we identified occupations that are natural candidates into which the KRG should limit hiring. These same occupations are natural candidates to which the voluntary separation program should be targeted. Furthermore, our discussions with KRG officials suggest that there are low-productivity workers in all occupations. To the extent that these individuals can be objectively identified, the program should also be targeted to them.

In addition, policymakers should be able to change the terms of the program without having to go back to Parliament or through a full legislative cycle. This flexibility would allow the KRG to adjust the details of the voluntary separation program over time as it gains experience with how well the program is working. For example, policymakers might determine that too many employees are choosing to accept voluntary separation, which implies that the size of the severance package could be lowered. Alternatively, they might determine that too few employees are choosing to separate, and policymakers could then increase the size of the severance package. Having built-in flexibility allows the KRG to make program adjustments without additional legislative action.

In addition, flexibility can allow the KRG to change the groups that the voluntary separation program is targeting, if necessary. The most flexible type of voluntary separation program would even allow the KRG to offer different levels of financial incentives to the different groups that are targeted.

⁹ One concern with targeting only the lowest performers for separation is that private-sector employers will know that these individuals have been identified as the lowest performers. This could decrease the extent to which they are willing to hire any of these workers. However, as Chapter Six shows, the average civil-service worker is more likely to have the skills and characteristics in demand by employers than the average private-sector worker. This suggests that this problem will not manifest itself as severely.

Despite these advantages of a flexible system, there are some potential disadvantages. If workers anticipate that separation incentives might, in the future, become more favorable, they could delay accepting them and effectively force the KRG to increase the amount of the incentive. This risk is minimized if separation incentives are not targeted too narrowly; this gives each individual worker less power in influencing the government's decision. Second, it is possible that flexibility could be used inappropriately to reward some employees at the expense of others.

Therefore, we recommend that **any legislation or policy authorizing the use of a voluntary separation program should include language that authorizes the program to be targeted and specifies the dimensions at which the program is allowed to be targeted.** Furthermore, **this legislation or policy should also authorize the ability to adjust the details of the program within clear boundaries.** Having a flexible voluntary separation program is useful only if the KRG has information that allows it to use this flexibility. Having data from monitoring the program would allow the KRG to measure the number of individuals who accept voluntary separation and the number of individuals who successfully find private-sector employment. Both data collection and analysis are necessary to ensure that the KRG maximizes the return on its investment in voluntary separation incentives. We discuss these issues in greater detail in our recommendation for a pilot program.

It is possible that workers will accept compensation for separating, fail to find suitable private-sector employment, and return to the KRG, asking to be rehired. If voluntary separation programs are targeted to specific ministries, it is possible that workers will accept compensation and then seek employment in another ministry. A willingness to rehire would improve participation of civil-service employees in the separation program but would potentially yield little benefit (reductions in the civil-service workforce) at substantial financial cost (a large number of civil-service workers accepting financial incentives) when the separated workers just return to new government jobs.

Therefore, we recommend that the legislation or policy authorizing the use of voluntary separation programs contains **clear language prohibiting workers who accept severance packages from returning to civil-service employment for a specific period of time.** However, the KRG should consider **granting exceptions to this rule based on a set of criteria that include a demonstrated need for specific skills or leadership abilities.** These exceptions provide the KRG with additional flexibility consistent with a comprehensive HR strategy.

A voluntary separation program should be tested with a pilot program in a few selected ministries and then offered throughout the KRG. A pilot program within a small number of ministries would allow the KRG to evaluate its successes and failures before voluntary separation incentives are offered throughout the KRG. Simply put, it could mean the difference between program success and costly failure. A successful pilot program would also provide other ministries with direct evidence of any successes and will likely be more effective at convincing others to participate than relying on theoretical arguments that voluntary separation programs *should* work.

We offer a few broad suggestions for structuring a voluntary separation incentive pilot program. First, the KRG needs to identify the ministry, or group of ministries, in which the pilot program would be implemented. One possibility is the Ministry of Planning, given its cooperation with our study and the minister's understanding of the issues. Implementing reform within this ministry will signal to other ministries the Ministry of Planning's leadership and commitment to reform, including a willingness to downsize and to accept the risk of any unintended consequences.

As Table 3.4 in Chapter Three showed, however, the Ministry of Planning is relatively small, employing only about 0.2 percent of all civil-service employees. There is an advantage to conducting a pilot program in a small ministry, since any unintended negative consequences can be mitigated. The downside to using a relatively small ministry, however, is that substantial reductions in civil-service employment will not be possible. As an alternative, the ministries that participate should be those that will be involved in implementing a broader program.

Second, the pilot program should establish some initial parameters, and policymakers should adjust these parameters throughout the pilot as conditions dictate. These parameters include

- the occupations to be targeted for separation incentives
- the number of workers in each occupation who will be offered incentives
- the size of the financial severance package.¹⁰

The ministry should then monitor the acceptance rate of these incentives and revise the size of the severance package if acceptance is higher or lower than desired.

In order to design and implement a successful voluntary separation program, the KRG lacks reliable information about a number of factors. These include

- the amount and types of incentives that should be offered to individuals
- the number of workers who will accept these incentives
- the number who will find private-sector employment
- the occupations and industries in which these workers will find employment
- the effect on earnings for those who find employment
- any unintended consequences.

Although other countries' experiences can help in the design of the KRG's own program, they are no substitute for direct evidence on how the proposed program would work within the KRI. A pilot program offering incentives on a limited basis could provide empirical data on these issues and allow the KRG to make any necessary adjustments before expanding the program to the entire civil service.

Easing Transitions to the Private Sector

The literature suggests that improving workers' access to information about private-sector opportunities, and private-sector employers' access to information about individuals looking for work, can facilitate better matches between employer and employee. In designing a voluntary separation program, then, there are strong arguments for incorporating this type of assistance as a support for easing the transition to the private sector. The intent is for the KRG to work toward removing barriers that impede the smooth functioning of labor markets, including a lack of information about jobs and access to the acquisition of skills to fill these jobs.

The KRG should work with the private sector to establish private-sector-run clearinghouses for employers seeking workers and for civil-service workers seeking employment. Establishing this clearinghouse will require close cooperation between the KRG and the private sector. Furthermore, since the private sector has the best information about its

¹⁰ For example, workers could be offered compensation based on their current salary (such as 12 months of current salary).

job opportunities, this clearinghouse should be established by the private sector. Given that each governorate has a Chamber of Commerce and Industry, these are obvious candidates to partner with the government; other alternatives could exist.

Once the KRG identifies civil-service workers who wish to accept voluntary separation and seek private-sector employment, it should work with these workers to collect detailed information on their educational attainment, skills, job history, and career aspirations. Simultaneously, the private sector would need to identify employers with vacant positions who are looking to hire workers. The private sector should then work with these employers to collect detailed information on the skills and qualifications that are necessary for individuals to fill these positions. This information should mirror the data collected by the KRG on the civil-service workers seeking private-sector employment, including the necessary and preferred levels of educational attainment, skills, and work history.

Once this information has been collected by the KRG and the private sector, it would need to be made available to both job seekers and employers. Ideally, civil-service workers would be able to access the employer information to determine whether there are job opportunities in which they have an interest. Similarly, private-sector employers would be able to access the civil-service workers' information to determine whether there are potential employees in which they have an interest.

In principle, there is no reason for this clearinghouse to be limited to civil-service workers. It would be of benefit to *all* citizens seeking private-sector employment, and private-sector employers would benefit from having access to an expanded pool of potential workers. With a private-sector–run clearinghouse, however, the KRG would have a minimal role in expanding it to all potential private-sector employees.

Our analysis in Chapter Six reveals that many civil-service workers have skills and characteristics desired by private-sector employers. This suggests that these employers might be willing to hire some workers who choose to leave the civil service. However, if voluntary separation programs are targeted effectively, the civil-service workers who separate might not necessarily be those with the skills and characteristics in demand by private-sector employers. Implementing the above recommendation, a clearinghouse for civil-service workers and private-sector employers, could reveal that additional training or education might be necessary to reemploy these workers in the private sector successfully.

Finally, **training and job placement programs may be helpful as supports to ease the transition to the private sector, but they should be evaluated to ensure they are accomplishing the objectives.** Training programs are most effective if the private sector is involved in the provision and coordination of training, since this helps ensure that the training being provided is actually in demand by private-sector employers. Recent reports from the KRG indicate that several training programs have recently begun as part of an effort to reduce the overall unemployment rate.¹¹ Given the overall mixed evidence of the effectiveness of these programs, however, we recommend that the KRG review the extent to which these programs are used by civil-service workers and result in successful transitions to private-sector employment. As with voluntary separation programs, both data collection and analysis are necessary to enable review of these programs.

¹¹ Attendees receive loans directly from the KRG to participate in these programs. See Doosky (2011).

Conclusions

In this monograph, we have outlined concrete steps and broader policy directions on which the KRG should embark to reform its civil service and to develop employment in the KRI's private sector. As we have noted throughout our analysis, many of these changes might involve legal reform, and the interactions between the KRG and Iraqi legal systems are beyond the scope of our work. Nonetheless, having talked to hundreds of people in the KRI during 2010 and early 2011, we are convinced that the KRG has people with the creativity and the knowledge to navigate this legal environment.

Our analysis suggests that foreign investors can find entry into the KRI to be fairly smooth but that the environment for creating new, small, local businesses is relatively difficult. While we have offered recommendations to improve this environment, many require a steady commitment on the part of policymakers and, in some cases, a complete reversal of current practices. With respect to civil-service downsizing and reform, there are both short- and long-term issues, and some strategies to help address the short-term issue could have adverse consequences in the long term. What is needed, in both cases, is a comprehensive strategy to ensure that any short-term policies are consistent with the KRG's long-term goals. The heart of such a strategy is the creation of an improved civil-service system, with job descriptions, performance evaluations, and a formal civil-service agency.

The reader will also observe that we have not recommended a single approach to private-sector development and civil-service reform, but that our recommendations combine several strategies into a single, overarching strategy. Two themes emerge from our approach. First, many of our recommendations have a *voluntary* component associated with any civil-service downsizing. The implication is that involuntary separations should be used only as a last resort. This will help limit any negative political consequences associated with reducing the size of the civil-service workforce. Second, although many of the strategies identified in this monograph have their disadvantages, using them in combination can help minimize these costs. For example, developing the private sector will create private-sector jobs that can be filled by new labor market entrants who do not enter the civil service because of reduced hiring.

Our recommendations represent a first step toward private-sector development and civil-service reform, and the KRI will continue to face challenges in these areas. Our analysis shows that if civil-service workers were to be reemployed in a private sector that resembles the current one, these workers would need to find work in occupations other than the ones in which they are currently working. It is also likely that there is a mismatch between the types of fields studied by college graduates and the qualifications needed for private-sector job openings. Both of these factors probably limit the speed with which the KRG can downsize and still maintain social stability. As the KRG implements these recommendations, ongoing analysis can help

policymakers identify structural imbalances that impede a smooth transition to higher private-sector employment.

Finally, as many of our recommendations imply, data collection and analysis are very important to successful private-sector development and civil-service reform. In many of the areas on which we have focused, the KRG simply does not have the necessary data on which we could offer more-specific recommendations. For example, a flexible voluntary separation program is useful only if the KRG has information that allows it to use this flexibility. Both data collection and analysis are necessary to ensure that the KRG maximizes the return on its investment in any of these recommendations.

Estimates of Necessary Job Growth in the KRI

To illustrate the magnitude of the challenge facing KRG policymakers, we provide an estimate of the amount of job growth that could be necessary in the next few years. This estimate is a straight-line projection of demographic trends and labor market statistics, and it rests on a number of simplifications. Throughout, we note where there are points of uncertainty.

In simple terms, the number of necessary jobs depends on the number of individuals who wish to work. This, in turn, depends on two factors: the number of individuals in the population and the fraction of the population that wishes to work. This second statistic is referred to as the *labor force participation rate*. Over time, the number of needed jobs will change if the number of citizens who wish to work changes, either through an increase or decrease in the size of the population, an increase or decrease in labor force participation rates, or some combination of the two.

The KRG has a very young population, so there are relatively few older working-age people and a large population that has not yet reached working age. For example, as of 2007, the KRI had between 1.8 million and 2.3 million people between the ages of 20 and 64, a rough approximation of working age.¹ However, the region had between 1.9 million and 2.4 million people between the ages of 0 and 19. This means that in the 20 years following 2007, more people will become working age than are currently working age.

As our discussion of labor force participation rates implies, not all citizens who are of working age will wish to work. To illustrate this, Table A.1 displays estimates of labor force participation rates by gender and by age categories, calculated using the IHSES.² As Table A.1 clearly shows, these rates vary significantly both by gender and by age. Regardless of age, labor force participation rates are substantially higher for men than for women. Furthermore, although the specific timing of the pattern differs by gender, labor force participation rates initially increase as workers age and then begin to decline as workers approach retirement age.

Using these data, we can estimate the amount of job growth that will be necessary over the next 20 years. To do so, we keep labor force participation rates constant, within gender and age categories, over time. In other words, as individual cohorts age, they exhibit the same

¹ The lower bound of these estimates comes from the IHSES; the upper bound comes from the KRSO. As of February 11, 2011, the KRSO data were available at KRSO (undated). In the KRI, as in many countries, individuals are considered to be of working age at 15. However, it is common to focus on slightly older individuals in analyses of labor force participation, since attachment of younger individuals to the labor force is very low. Therefore, we follow the practice of focusing on slightly older individuals.

² We chose these age categories because the KRSO's population estimates are provided for these categories. In the literature, individuals are considered to be in the labor force if they are working and if they are not working but are looking for work.

Table A.1
Labor Force Participation Rates,
by Age and Gender

Age Category	Labor Force Participation Rate (%)	
	Men	Women
20–24	71.4	14.5
25–29	89.9	20.6
30–34	93.4	21.6
35–39	97.1	19.3
40–44	95.2	18.1
45–49	92.4	18.2
50–54	89.5	12.1
55–59	78.5	19.8
60–64	61.6	12.2

SOURCE: Data from IHSES-2007.

labor force participation behavior as the cohorts that are currently older. This is a simplification because we do not know whether labor force participation rates in the KRI will rise or fall as the region develops. If they rise, then the number of jobs needed will be higher than we estimate. If they fall, then the number of jobs needed will be lower than we estimate.³

If labor force participation rates remain constant, we estimate that 20 years from now, the KRI will have an additional 850,000 to 1.1 million people who wish to work. This implies an average of 43,000 to 54,000 new jobs *per year* that would need to be created, just to keep pace with the changing demographics of the population.

Suppose that female labor force participation rates increase by 10 percent from the levels shown in Table A.1. If we incorporate this assumption into our estimates of labor-market entrants, an average of 44,000 to 56,000 new jobs per year would need to be created. The point here is not that labor force participation *will* or *should* change, but that the KRI's needs will depend on these factors.

³ A simple statistical test indicates that labor force participation rates are broadly U-shaped when compared to the per capita GDP of a country. Specifically, they appear to fall as per capita GDP rises from under \$1,000 and then hit a minimum somewhere in the \$5,000 to \$10,000 range. Then they appear to rise. We base this conclusion on a simple cross-country regression of labor force participation on the per capita GDP and the square of per capita GDP in 2007.

Differences in Language Proficiency and Educational Attainment

In Chapter Six, we demonstrated that civil-service workers had higher levels of Arabic and English proficiency and educational attainment than did private-sector workers. In this appendix, we discuss factors other than the sector of employment that can explain these differences.

We use a statistical technique known as logistic regression to examine the extent to which language proficiency or educational attainment is correlated with other characteristics of the individual. For simplicity, we examine whether individuals characterize their ability to read, write, and speak English and Arabic as medium or good, as opposed to weak or nonexistent. The other individual characteristics on which we focus are

- educational attainment
- age
- gender
- governorate in which the individual resides
- residence in an urban, suburban, or rural area
- whether the individual was born within the KRI, the rest of Iraq, or another country.

Language Proficiency

Table B.1 summarizes the results of our analysis for language proficiency. The second and third columns of this table list, for civil-service and private-sector workers, respectively, the percentage that reported medium or good proficiency. These data are identical to what was presented in Figures 6.1 and 6.2 in Chapter Six. In the fourth column, we calculate the difference between civil-service and private-sector proficiency. As we have discussed, civil-service workers consistently report higher proficiency than private-sector employees.

The fifth and sixth columns of this table list, for civil-service and private-sector workers, respectively, the predicted percentage that would report medium or good proficiency *if all other characteristics of civil-service and private-sector workers were identical*. In the seventh column, we calculate the difference between these predicted levels of civil-service and private-sector proficiency.

A comparison of column four and column seven reveals that, if civil-service and private-sector workers were identical in the dimensions listed above, the gap in language proficiency would be substantially smaller. For reading and writing proficiency, although the gap narrows, it is not eliminated; these other individual characteristics can partially, but not completely, explain differences in proficiency. However, for speaking proficiency, the gap is not statistically

Table B.1
Differences in Language Proficiency, by Sector

Language	Unadjusted			Adjusted		
	Government	Private	Difference	Government	Private	Difference
Arabic						
Read	51.1	29.2	21.9***	44.4	40.7	3.7**
Speak	42.2	21.1	21.1***	34.8	33.6	1.3
Write	49.5	26.8	22.7***	42.2	39.3	2.9*
English						
Read	18.2	6.7	11.5***	14.8	11.6	3.1**
Speak	7.7	2.6	5.0***	5.7	6.1	-0.4
Write	17.2	5.6	11.6***	13.7	10.4	3.3**

SOURCE: Authors' analysis based on IHSES-2007.

NOTES: Asterisks denote statistical significance at the 1% (***), 5% (**), and 10% (*) levels. Discrepancies in differences are due to rounding.

different from zero; these other individual characteristics can completely explain differences in proficiency.

Our statistical analysis also provides information about which specific characteristics help explain these differences in language proficiency. For all six measures of proficiency, educational attainment is a key factor. Education is positively correlated with language ability; in other words, individuals with higher levels of educational attainment are more likely to be proficient in reading, speaking, and writing Arabic and English. Furthermore, as we showed in Figure 6.3, civil-service employees tend to have higher levels of education than private-sector workers. Our regression results, then, indicate that some of the difference in language proficiency is due to the relatively high levels of education among civil-service workers. If private-sector workers had higher levels of education, our analysis predicts that their language proficiency would also be higher.

Although education is a significant driver of language proficiency, there are other factors that help explain the differences between civil-service and private-sector workers. For Arabic language proficiency, some of the difference can also be explained by age. Age is positively correlated with Arabic language ability; older individuals are more likely to be proficient in reading, speaking, and writing Arabic. Note that this relationship between age and Arabic language proficiency is measured *while holding education constant*; it is the relationship between age and language ability, above and beyond any relationship between education and language proficiency.

As we show in Table B.2, civil-service workers tend to be older than private-sector workers; approximately 60 percent of civil-service workers are older than age 30, compared with approximately 40 percent of private-sector workers. Our regression results, then, indicate that some of the difference in Arabic language proficiency is due to the fact that civil-service workers are generally older. If private-sector workers were older, our analysis predicts that their Arabic language proficiency would also be higher.

Table B.2
Age Distribution of Workers,
by Sector

Age	Percentage	
	Government	Private
<16	0.3	4.6
16–20	3.9	19.1
21–25	17.1	19.9
26–30	18.3	15.8
31–35	16.2	14.7
36–40	13.8	10.1
41–45	9.3	5.2
46–50	5.7	3.9
51–55	8.0	2.4
>55	7.6	4.4

SOURCE: Data from IHSES-2007.

NOTE: Percentages do not total to 100 because of rounding.

Similarly, governorate; residence by urban, suburban, or rural area; and native origin also help explain the difference in Arabic language proficiency. Individuals working in Duhok are most likely to be proficient at speaking Arabic, whereas those working in Sulaimaniyah are least likely to be proficient. Similarly, those working in Duhok are more likely to be proficient at writing Arabic than those working in the other governorates.¹ Individuals who live in urban areas are more likely to be proficient at reading, writing, and speaking Arabic than those living in suburban or rural areas. Finally, as one might expect, individuals born in the rest of Iraq are more likely to demonstrate Arabic language proficiency than those born in the KRI or outside Iraq. Differences between civil-service and private-sector workers in each of these dimensions contribute to the observed differences in Arabic language proficiency.

For English language proficiency, age does not help explain differences between civil-service and private-sector workers. Rather, in addition to education (discussed earlier), governorate, residence in an urban, suburban, or rural area, and native origin help explain different dimensions of English language ability. Individuals working in Duhok are more likely to be proficient at reading and writing English than those working in the other governorates.² Individuals who live in urban areas are more likely to be proficient at speaking English than those living in suburban areas. Finally, individuals born in Iraq are more likely to be proficient at reading and writing English than those born outside of Iraq. Differences between civil-service and private-sector workers in each of these dimensions contribute to the observed differences in English language proficiency.

¹ There were no statistically significant differences by governorate in Arabic reading proficiency.

² There were no statistically significant differences by governorate in English speaking proficiency.

Educational Attainment

Differences between civil-service and private-sector workers can also explain some of the differences in educational attainment. Again, we use logistic regression to examine any correlations between individual characteristics and educational attainment. For simplicity, we aggregate educational attainment into four categories: none, elementary, intermediate, and high. Individuals with elementary education include those who report completing elementary school or who are currently enrolled in, but have yet to complete, intermediate education. Individuals with intermediate education include those who report completing intermediate, preparatory, vocational, or institute education, as well as those who are currently enrolled in, but have yet to complete, a bachelor's degree program. Individuals with high education are those who have received a bachelor's degree or higher.

The other individual characteristics on which we focus are the same as those we used in our analysis of language proficiency, with the exception of language proficiency itself. This exclusion is consistent with our hypothesis that educational attainment is partially responsible for language proficiency. Table B.3 summarizes the results of our analysis.

In contrast with language proficiency, accounting for other individual characteristics explains very little of the difference between the educational attainment of civil-service and of private-sector workers. With the exception of elementary education, the unadjusted and adjusted differences between civil-service and private-sector workers' levels of educational attainment are similar. This means that the reasons civil-service workers have higher levels of education than private-sector workers do *not* include age, gender, governorate of residence, level of urbanization of residence, or place of birth. Instead, other reasons are driving the difference.

One possible reason for the difference is that civil-service jobs demand higher levels of skill than private-sector jobs. Another possible reason is that the government favors higher-education workers in its hiring, regardless of job requirements. A third hypothesis is that workers with higher education have better connections or the job search skills needed to land a government job. Without further data, however, we cannot identify which of these possibilities is most likely.

Table B.3
Differences in Educational Attainment, by Sector

Level	Unadjusted			Adjusted		
	Government	Private	Difference	Government	Private	Difference
None	32.5	51.7	-19.2***	32.4	51.2	-18.8***
Elementary	17.6	25.4	-7.8***	19.3	22.0	-2.7
Intermediate	36.6	19.8	16.8***	35.5	21.4	14.1***
High	12.3	2.4	9.9***	11.7	2.7	9.0***

SOURCE: Authors' analysis based on IHSES-2007.

NOTE: Asterisks denote statistical significance at the 1% (***), 5% (**), and 10% (*) levels.

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OBJECTIVE ANALYSIS.
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Kurdistan Regional Government Ministry of Planning

This product is part of the RAND Corporation monograph series. RAND monographs present major research findings that address the challenges facing the public and private sectors. All RAND monographs undergo rigorous peer review to ensure high standards for research quality and objectivity.

This monograph provides strategies to increase private-sector employment, including ways to reemploy civil-service workers in the private sector, in the Kurdistan Region–Iraq. Prepared for and at the request of the Kurdistan Regional Government (KRG), this monograph is based on a variety of research methods and analyses. These include a review of the existing literature, analyses of survey data, analysis of Kurdistan regional and Iraqi national documents and laws, and a qualitative assessment of numerous conversations with government officials and private-sector employers.

The KRG can develop its private sector by removing obstacles to starting or expanding a business, by identifying sectors for which conditions are particularly favorable for private-sector growth and supporting them, and by outsourcing and privatizing some functions that the KRG currently performs. However, private-sector growth does not guarantee that civil-service workers will leave for private-sector employment. Civil-service workers will need the qualifications necessary for private-sector jobs and will have to expect that the benefits of private-sector employment outweigh the benefits of civil-service employment. At the same time, as the KRG devises methods for encouraging civil-service workers to leave for the private sector, a key challenge will be to ensure that the most productive employees stay with the KRG in order to ensure the proper functioning of government.

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