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MINISTRY OF PLANNING – REPUBLIC OF IRAQ

"ENHANCING INVESTMENTS IN IRAQ THROUGH INDUSTRIAL ZONES DEVELOPMENT"
ROADMAP FOR INDUSTRIAL ZONES DEVELOPMENT IN IRAQ

December 2014

Foreword

This document was prepared by UNIDO within the framework of its project "Enhancing Investments to Iraq through Industrial Zones Development", funded by the Italian Cooperation for Development. It aims at addressing certain of the most critical aspects governing the establishment and administration of Industrial Zones in Iraq's current legal, institutional and policy circumstances.

It was formulated under the supervision of Mr. Tidiane Boye, Industrial Development Officer at UNIDO. Drawing upon contributions from international experts, Mr. Asif Hasnain and Mr. Maximilien Pierotti undertook the overall design and elaboration of this document. Area-based inputs were collected from Mr. Michael McCandless and Mr. Yasar Hidmi, land and finance specialists.

The document also benefits from consultations with and inputs provided by Iraqi project partners, representing the Ministries of Planning, Industry, Finance, Transportation and Municipalities and Public Works, the National Investment Commission, the Prime Minister's Advisory Commission, the Governorates of Najaf and Basra, and the Iraqi Federation of Industries which all endorsed the present document.

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Introduction

Scope and Uses of Industrial Zones

1- Industrial Zones: Concepts and approaches

Over the past ten years, both the Government of Iraq and its development partners have been working systematically to assist Iraq's economic transformation from a state run, oil revenue dependent economy to one which is oriented to the development of the private sector, open to world trade and investment flows and diversified from its prevailing heavy reliance on the oil sector.

The scope of efforts have encompassed policy reform with regard to the restructuring of state owned enterprises, the liberalization of the Iraqi trade regime and the creation of an investment climate that is conducive to domestic and foreign private investment. Overall, the tenor of both the development assistance provided as well as the economic reforms undertaken by the Government of Iraq have been towards realigning the role of the state from the owner/operator of productive assets to a facilitator of the efforts of the domestic and foreign private sectors.

Experience has shown that the state can and does play a useful role as the promoter and initiator of economic and industrial transformation and in stimulating the growth of the private sector. The experience in the MENA region, in the emerging economies in other regions and even in post conflict societies has shown that well designed initiatives by the state have been instrumental to stimulating private sector led investment and growth. Those initiatives range from confidence building efforts to the promotion of investments at the national, regional or even the project levels. The development of industrial zones should be seen as part of this cluster of state led initiatives.

In the simplest terms, industrial zones are pieces of real estate, with dedicated infrastructure and services that allow businesses the long-term assurance of stable working conditions to undertake investment and conduct business. In addition to land and infrastructure, fiscal incentives are sometimes provided, land and services are priced at preferential rates and the private sector involved in the design and management of the zones.

Industrial Zones are one amongst many types of zones that offer dedicated facilities designed to stimulate investment, achieve economic diversification or stimulate domestic or local development. The concept of zones as nodal points for economic growth encompasses[1]:

- Special Economic Zones—which are dedicated to creating secure facilities and service infrastructure so that productive activities could be undertaken across a variety of sectors, or to allow clusters to be established and grow. In some instances these zones are regulated by a specific legal regime, governing such aspects as investment licensing and asset ownership, that create incentives for boosting economic activity.

- Export Processing/Free Zones—dedicated to the efficient processing of goods destined for export markets. Such facilities furnish not only the physical facilities, bonded warehousing and infrastructure, but are also governed by customs duty, tax exemptions and streamlined administrative procedures suited to the needs of exporting enterprises

- Industrial parks—these are usually focussed on a key sector, deemed to be of critical national importance, in order to attain the development or deepening of that sector

- Science or technology parks—designed to facilitate research and development to support the deepening of one or more sectors of industry

- Business incubation centers—facilities targeted at the development of domestic entrepreneurship, especially for small and medium scale enterprise, with business support and facilitation services provided to the enterprises and entrepreneurs operating in those centres.

These various types of zone, while being similar physical facilities, have significantly different characteristics with regard to the development policy objective that governs them.

2- Objectives and policy focus of Industrial Zones

Industrial zones have been created for several policy purposes. A non-exhaustive list is:

- Establishment/expansion of value chains by clustering similar or linked industries
- Deepening, stimulation or absorption new technologies
- Incubation of new businesses
- Catalysing economic activity in specific locations
- Enterprise development through the provision of stable and competitively priced land and services for businesses
- Stimulation of export industry through establishment of duty exempt zones, streamlined customs administration, bonded warehouses and efficient trading and transport infrastructure and trade related services
- Assurance of security for business investments and assets through the establishment of a secure location and specific provision of security services.
- Concentrating the location of industries for improved municipal zoning, urban planning and/or environmental impact management.

These objectives are not mutually exclusive. Typically, the creation of such zones is a meso-economic effort to stimulate business activity.

Industrial zones are a useful adjunct to wider economic reform. By defining a streamlined or business friendly policy regime for businesses located in the zone, a government can test approaches to rationalizing the rules, regulations and administrative practices required to liberalize investment and trade regimes. If proven effective these policy revisions and administrative improvements can be applied more generally through the economy.

Industrial zones are also tools for government efforts to promote investment into the economy, by both domestic and foreign investors. This aspect is particularly important in post conflict economies since these zones offer the possibility of creating a secure environment for business assets and enable the provision of stable infrastructural services in situations where the overall infrastructure may be damaged or degraded. As such, industrial zones are one among a mix of initiatives that governments can employ to kick start private sector activities in post conflict situations.

As just discussed, IZs are flexible instruments which can fulfill several development objectives. *However, a clear policy conception and a focussed objective for a zone will enhance the chances for the zone to achieve its purpose*.

The point regarding focus cannot be over emphasised. The Iraqi government and its partners will invest tangible and intangible resources to the development of the zone (s). The effectiveness of the use of the resources and the development impact of the zones will have a lot to do with clarity of purpose, just as the success of any business plan largely depends on the clarity of the objectives of a business, its definition of the target market etc.

Both the analysis and the recommendations of this Roadmap intend to underscore the sharpening of the policy focus motivating the creation of the two pilot zones covered by the project, as also for future zones that the GOI may want to develop in other parts of Iraq. The project itself, or external development partners are not in the position to define the policy focus. This would be the primary responsibility of the GOI, taking into account the technical inputs provided by external partners, as well as the GOI's overall development objectives.

Once the policy focus has been defined there is a need for the central government to consult, validate and share its thinking with all concerned stakeholders in the development of the zone, most notably the target clients and target investors for the zone and also the local authorities in the area that will host the zone. This would enable all stakeholders to buy into the broader thinking behind the creation of the zone, enhancing its chances of financial success and development impact.

3- Relevance of Industrial Zones in the Iraqi Context

During the course of the project, information was gathered on quantitative (e.g. surveys of the private sector) and qualitative (e.g. surveys of the literature and interviews with stakeholders) bases. That information showed that there was broad support for the development of Industrial Zones amongst existing Iraqi enterprises and potential private sector investors. Furthermore, the sources of information established key motivating factors for investors to consider locating business operations in such zones. These were:

4- Improved security for hosted businesses

Given the prolonged turbulence in the country, it would not at all be surprising that the Iraqi private sector, whether located in Iraq or in the diaspora, considered the possibility of a more secure working environment as a major potential benefit from locating assets and business operations in Industrial Zones. The provision of a secure operating environment in itself should be a cardinal consideration for the GOI undertaking the developments of IZs.

5- Improved access to land, infrastructure and utilities

Most of the currently operating private sector enterprises in Iraq are in the micro and small scale sector, and a great proportion of these are informal enterprises that suffer from tenuous land rights—either they are operating on land and premises that are not zoned for industrial or commercial activity, or they do not hold clear rights to land and premises, or they are working on leased land or premises that cannot be regarded as part of their business asset base. To overcome these hurdles to business development, a clearly demarcated and designated Industrial Zone, with clear lease or ownership title, would ensure that business is afforded a stable real estate base from which to operate without threat of eviction or expropriation. Furthermore a title to designated and demarcated land would offer the occupant enterprise a well-defined asset that could be transacted in the case they need loan financing for business expansion. *Thus the regularization of location and of lease or ownership title in an industrial zone would offer a major stimulus to long-term investment by domestic enterprises*.

Similarly the degraded infrastructure, especially energy supplies, and (to a lesser degree) the transport and water infrastructure, imposes a severe cost burden and constraint to business and enterprise. Sporadic or unpredictable energy supplies necessitate the acquisition of auxiliary electricity generators that are not only an avoidable investment burden on enterprise, but they are cost inefficient and environmentally damaging. Industrial zones, with dedicated power supplies and distribution infrastructure, would help ensure stability of supply while ameliorating the costs of fragmented, atomized generation of electricity. In fact private sector surveys undertaken under this project identified the irregularity of energy supply being the most important operating impediment faced by businesses and also a major incentive for businesses to locate in an Industrial Zone.

In addition to electricity, the improved efficiency and predictability of water supply, transport, warehousing and other ancillary services would improve business efficiency and therefore provide a compelling incentive for business to undertake operations in a well-functioning industrial zone.

6- Improved provision of business support services and access to finance

UNIDO's findings, as those of all international development agencies dealing with economic development, point to the three critical facts that inhibit the development of the private sector in Iraq.

First, the Iraqi financial system is desperately in need of modernization, to cater to the needs for capital formation and business development, particularly in the Small and Medium Scale sector. At present the Iraqi financial sector confines itself to trade based lending for selected clientele, as well as holding Government debt. There is virtually no role played by the financial sector in offering credit for long-term private sector capital formation.

Second, there are virtually no business support services, either public or private, that can support the incubation and development of the private sector. This is not surprising, given the traditional state-owned nature of the productive sectors of the Iraqi economy. Recent development efforts and strategies call for a switch of policy to restructuring of the state owned enterprises, and to enable the private sector to grow and propel economic growth.

Third, the productive sectors of the Iraqi economy were dominated by large scale state owned enterprises that captured most of the market for industrial products. Therefore, Iraq suffered the “missing middle” due to the fact that the productive economy was dominated by a few large enterprises leaving the majority of small and micro enterprises locked into low value added business activity.

These three factors—the absence of bank financial intermediation, the dominance of large SOEs and the consequent stifling of small scale enterprise—can be redressed to some extent by the development of Industrial Zones. If the IZS are clearly targeted as tools for the development of the private sector, they can combine industrial agglomeration, the stability of land asset ownership as well as facilitate the provision of financial and non-financial support services to client enterprises operating in the zone. Were this to occur, the zones would not only become an instrument for consolidating domestic enterprise but an active tool for the development and diversification of the Iraqi economy.

7- Macroeconomic context and consistency with Iraq’s development objectives

There are significant assets that the Iraqi economy can capitalize upon. Prior to the period of sanctions and conflict, Iraq had a strong industrial base, which offers an historical experience on which future development can be based. Iraq disposes a young and skilled labour force and the Iraqi domestic market is quite significant. The riparian system of the Tigris and Euphrates was a mainstay of the historical civilizations in what constitutes present day Iraq. With careful management of water resources, Iraq offers the possibility of revitalizing a significant agricultural sector. Additionally, Iraq has a considerable potential for the development of tourism, not least from Islamic pilgrims visiting the historical sites situated within the country.

Despite enjoying these assets, the challenges confronting Iraq are clear -- oil revenue is still the mainstay of external earnings, investments, government budgets and the engine of economic growth. As a result, oil prices determine the national economic outlook, and the variations of oil prices constrain long term planning and public budgeting. While domestic demand and economic activity increased over the past two or three years, there was a surge in imports over the same period, with lagging domestic investment. Thus, increased revenues and effective demand in domestic markets have had little impact on the prospect for long-term growth in the non-oil producing sectors of the Iraqi economy, with the exception of the construction and telecommunication (mobile telephony) industries.

The volatility of exchange rates (based on trends in oil prices) creates an inherent disadvantage for non-oil industry that needs to work with predictable and relatively stable exchange rates to attain international standards of efficiency and cost competitiveness. The hallmarks of a heavily state run economy is the lack of firms' profitability, low productivity of labour and a lack of demand and employment generated by the private sector. In addition, in the Iraqi context, the heavy state subsidies to SOEs pose a significant deterrent to the growth and the competitive ability of private enterprises as investors are reluctant to invest in sectors dominated by state owned companies.

There is nothing intrinsically "wrong" in possessing a resource-based economy in which the state captures resource based rents, organizes production and redistributes revenues as wages or a social dividend among state employees or citizens. Several economies, especially oil producing ones, have survived under such a regime.

However, in Iraq's case, the imperative to diversify from oil arises from at least four factors. First, the Iraqi state might be too weak to undertake the role demanded by this resource based/distributive economic model. Second, state employment, employment offered by the oil producing sector and redistribution of revenues will be inadequate means of ensuring employment for the growing national labour force. Thus under- and unemployment may contribute to prolonging a volatile social and political situation. Third, in the absence of investment and diversification of domestic supply capacities, net earnings from oil exports will be dissipated by paying for the import of consumer goods, with little to show in terms of increased domestic savings, investment and fixed capital formation. Fourth, as recent experience has shown, oil prices can be volatile depending on numerous external economic or political circumstances, thereby making public revenues and national income unpredictable.

The long-term solution in this situation, therefore, lies in stimulating private investment and engendering the growth of a healthy business structure that would shift Iraq from an oil based and statist economic model to a modern, diversified and market based economy. This challenge remains the imperative.

Five major constraints face the Iraqi economy in the context of private sector development. First, the fragile security environment that increases business risk and inhibits long-term investment; second, weak national entrepreneurial capabilities caused, in large part, by a statist development model; third, a difficult legal and regulatory regime that inhibits the establishment and operation of private business; fourth, the absence of the business support infrastructure, particularly a modern financial system; and fifth, the acutely degraded physical infrastructure that prevents or increases the costs of business in Iraq.

As mentioned previously, all these issues can be dealt with by the creation of policy focused industrial zones that would allow the Government of Iraq to develop its approaches to policy and administrative reform intended to redress these shortcomings.

8- Past and Current Status of Iraqi Experience in Industrial Zones

Iraq has had considerable experience with Industrial Zone since the early 1970s.

9- Petrochemical complexes and State-Owned-Enterprises (SOE)

In its earliest stages of industrial development since the first oil price adjustments of the 1970s, extensive state investments were made in oil refining and further downstream processing of hydrocarbon resources. Thus, oil refineries and downstream hydrocarbon based industries (basic petrochemicals and fertilizer industries) were clustered in Basra and elsewhere to create integrated state owned complexes. These were nodes of industrial growth but were degraded due to the prolonged period of war and economic sanctions. Existing facilities were reduced and the technological base of these complexes deteriorated due to a lack of investment and upgrading. Consequently these complexes, like other parts of the SOE sector suffer low productivity and cost inefficiency. In some cases, the degradation of physical productive facilities is so acute as to render the facilities technically non-operational and commercially non-viable. Whether these complexes can at all reemerge as a nucleus for hydrocarbon based industrial diversification remains a matter of uncertainty, given the extensive investments required to bring them up to current operational, technological and commercial standards.

10- Free Zones

In order to re-enliven economic development since 2003, the Iraqi Ministry of Finance pioneered the creation of Free Zones that would facilitate trade and investment. Three free zones were contemplated, Khor al Zubair in the South, Nineveh in the North, and al Qaem in the west. In addition there have been numerous expressions of interest by trade and investment partners in the Region to develop Free Zones in other parts of Iraq.

The Khor al Zubair zone was perhaps the most advanced initiative, centering on the oil and gas sectors in Basra, in a bid to re establish Iraq's capacity in the processing of hydrocarbon resources. It combined the features of a sectorial/cluster focus with fiscal incentives provided to stimulate investment in a sector where Iraq enjoys a natural comparative advantage.

The other Free Zones were contemplated as facilities that would offer investment, trade and tax incentives across a broad base of sectors in order to facilitate trade between Iraq and neighbouring trading partners.

These initiatives all confront varying degrees of uncertainty in the light of recent re escalation of conflict, especially in the west of Iraq.

11- Industrial cities

Similarly, the Ministry of Industry and Minerals initiated a programme to create industrial cities—integrated facilities that would offer land and support infrastructure to investors, along with residential facilities and social infrastructure to accommodate labour. These cities would create semi urban settlements that could be the location for industrial development. The emphasis was placed on heavy, resource-based industries (such as construction and building materials) that could service the domestic Iraqi markets. The initial phase of this plan, in 2011, envisaged the creation of five such cities, one each in Baghdad, Basra, Ninawa, Najaf and Babil. While funded by the Government, the cities were supposed to be developed by foreign contractors responsible for constructing the physical facilities. None of these zone projects has materialized yet.

12- Investment zones

The National Investment Commission, in partnership with OECD, has analysed the possibilities and policies required to set up Investment Zones in Iraq. Progress was made in developing a policy and legal approach to such Zones targeted at attracting DFI into Iraq. In late 2014, an investment zone regulation was being established. In parallel, several pilot sites have been identified across the country and preliminary information has been collected for each of them. The National Investment Commission has also initiated discussions with private sector investors with a view to entering into Public Private Partnership agreements for the financing, development and management of the investment zones.

13- Informal business concentration and municipal zones

Numerous survey conducted by UNIDO and others have analysed the most common type of industrial zone found in Iraq. These zones house small scale productive and commercial activities in almost every urban or semi urban center in the country. These zones are either formally demarcated by municipal authorities or have grown spontaneously. The enterprises in these zones are mostly informal in nature and comprise small scale or micro enterprises. By concentrating their activities in a location, these enterprises can enjoy some benefits from agglomeration, especially in terms of the supply of electricity, and a degree of security brought about by the common location. However, as previously observed, these zones usually offer little else and operating enterprises suffer from weak infrastructural support, unreliable utilities, virtually no support from business development agents and hardly any access to formal credit mechanisms.

Despite the current weaknesses in these clusters or zones, the zones tenants offer a key target group as clients that could locate in well managed and more supportive zones. Also, such clustering of small and micro enterprise could stimulate the growth of entrepreneurship, production and employment offered by the MSME sector as a vital component of the emerging Iraqi economy.

14- Key Issues Confronting Iraq in the Future Creation of Industrial Zones

The conclusion drawn from this brief review of Industrial Zones and Iraq's experience points to certain strategic issues that need to be kept in mind while considering the subsequent, more technical, sections of the Road Map:

- Industrial Zone could be an instrument used for the improvement of the investment climate and business environment in Iraq. This can be multifaceted. The government can commit itself to supporting the development of the private sector by investing in the support infrastructure for locating private investment; stable and transparent investment guarantee and asset ownership regimes can create predictability and security for business assets; common security arrangements offered by a zone would help overcome the security issues confronting private investors in Iraq; the provision of physical infrastructure and utilities would enable the private sector investor to operate in a stable and economically efficient business environment; in the limiting case, the government and the IZ management could become effective instruments of change and development by organizing or facilitating the provision of financial and non financial services to private sector zone tenants thereby changing business conditions and showing the way ahead for a more business supportive economic environment throughout the country.

- In order to achieve its objective in developing Industrial Zones the government needs to have a clear policy focus and strategy for the development of zones. The policy focus could be at different levels, from a simple effort to attract private investment regardless of sector to more complex approaches that target specific sectors or regional potentials within Iraq. The choice and depth of the policy and strategy is something that needs to be deliberated within Iraqi Government circles and simultaneously based on pragmatic considerations and the planning capabilities available to the government.

- There is a need to have an institutional framework and regulatory structure that draws in all stakeholders in public and private sectors to develop an overall national strategy for the zones and to define the roles and responsibilities of different actors in developing and managing the zones. Also there need to be clear demarcations in roles and responsibilities between Federal Authorities and local government in the planning, development and establishment of the zones.

- In addition to apportioning responsibilities at various levels of government, there is a clear need to engage with the private sector at all stages of the zone development cycle. This engagement should start from the planning phase, where an assessment of the target private sector needs should be a cornerstone of the strategic approach to zone planning. Private sector engagement should also be envisaged in zone development, construction and management so as to make the zones more attuned to the needs of, and efficient service providers to, the private sector client investors in the zone.

The ensuing sections of the roadmap deal with the technicalities of the establishment of industrial zones: the allocation and management of land resources; financing the construction of the zones; management of the industrial zones; and attracting investments in the zones. The elaboration and recommendations of the technical sections are guided by the strategic considerations that have been outlined in this introduction. It is intended that the broader strategic issues, outlined here, and the detailed technicalities of subsequent sections will together mark the way ahead for the Government of Iraq in its intentions on utilizing Industrial Zones as a tool for Iraq's future development.

ROADMAP FOR INDUSTRIAL ZONE DEVELOPMENT IN IRAQ

LAND ALLOCATION AND MANAGEMENT SECTION

1 - Introduction

Besides incentives in matters such as repatriation of profits, customs, tax and labour, a crucial aspect of industrial zone (IZ) development relates to land allocation and administration.

This section discusses land administration and management as they relate to IZ development in Iraq. It reviews the current land regime, points out constraints and recommends long- and short-term actions in support of IZ development. Annex I presents examples of international best practices in land allocation policy and management in IZ development.

The land issue is dealt with at two levels. At the initial level, there is the issue of land allocation and rights for development, sale or lease of land for the zone as a whole to a developer and/or zone manager (whether that developer or manager is a public sector or a private sector entity). At the second level there is the issue of the award and acquisition of rights of ownership or use of land by the client investor/enterprise in the zone. The analysis of this chapter reviews the common land issues and their impact on either level. It concludes with recommendations on how those issues can be successfully resolved.

2 - Requirements/concerns of industrial investors

Any private sector industrial investor—whether domestic or foreign—requires the availability of land in the right location, with the appropriate offsite infrastructure, and under acceptable terms. Equally important are secure land rights and a sound land administration system.

<u>Clear, secure land tenure</u>: Ideally private rights in land should include minimal restrictions on use, sale, lease, mortgage or granting other rights. There must be adequate rights to use the land, especially with regard to construction. In addition, land and fixed capital assets form a critical part of the capital base of industrial enterprise for purposes of debt based financing, which is critical to the operation and expansion of most modern enterprises.

It is important to note that clear, secure land tenure is possible with leasehold tenure. However that tenure would need to provide a clear definition of the tenant's rights, including fixed duration with unambiguous renewal conditions. If state land is involved, the price would ideally be based on an independent valuation of the land. Lease terms on land use and building need to offer flexibility for the lessee/operator. Finally, there needs to be protection against unilateral interruption of the lease agreement.

<u>Protection from arbitrary state intervention</u>: The state's power to expropriate must be circumscribed by law and transparent procedure, and the taking of land must be fully compensated. Restrictions on the owner's rights, such as land use requirements, must not be arbitrary. They must be law-based and imposed under transparent procedures.

<u>A sound land administration system:</u> There should be a well-functioning state administration encompassing land registration, surveyed boundaries, urban planning, land use control, land taxation and land information. Allocation of state land and licensing procedures should be efficient and transparent. Transaction costs must be based on market values and not on arbitrary rates.

<u>Availability of land in the right location:</u> In private sector led development, industrial investors must be left to make business decisions as to the location of industrial

operations. Designation of industrial areas by the government master planners should be based on planning studies that place the needs of business and industry as a prime consideration.

The aforementioned concerns form the basis for the analysis of land related issues in the rest of this chapter.

3 – Legislation-current practices and land related issues in Iraq

Scope of land legislation: For the most part Iraq has a sound and complete legislative regime covering land rights and administration. Although some legislative adjustments may be necessary, wholesale changes are not required. More important are the need to follow the rule of law, rehabilitation of administrative systems, and government policy that provides direction to the various ministries in collaborating to meet policy objectives such as the development of IZs.

With minor exceptions, in the legal framework there is no separate or preferential regime for land administration within industrial areas, free zones or IZs.

Private land rights: Article 23 of the *Constitution of Iraq* (2005) provides for the protection of private property and states that the owner shall have the right to benefit, exploit and dispose of his property within the limitations of the law. This article also states that expropriation is only permissible for the purposes of public benefit and in return for just compensation.

Lesser rights to land, such as usufruct rights, are private property for the purposes of constitutional protection. Under the *Civil Code 40/1951*, every right having a material value is considered property (Art. 65). Therefore, if expropriated by the state, land must be acquired for public benefit, and compensation must be just and fair.

The *Civil Code 40/1951* is the most important single source of the codified law affecting land tenure. It recognizes private land ownership equivalent to the western concept of freehold. It also recognizes the right of *tassaruf*, derived from Ottoman land law. In the Ottoman system all arable land was owned by the state. A person farming the land was given a right called *tassaruf*. The holder may cultivate it, plant orchards and vineyards, and build houses, shops and factories for agricultural purposes. The holder has exclusive possession of the land. The *tassaruf* right may be sold, leased or mortgaged. However, the underlying title to land is retained by the state.

Foreign ownership of land was prohibited by *Revolutionary Command Council Order 23/1994*, still in force. An exception to this prohibition was introduced by an amendment in 2009 to the *Investment Law 13/2006*, which gives foreign investors in real estate development projects the opportunity to own land for housing projects that will be sold to Iraqis.

Thus foreign investors in industrial projects may not own the land. Instead, under the *Investment Law* foreigners may be granted 50-year leases, which are renewable if the investor is in good standing under the conditions of the investment licence.

It is observed that the restriction on ownership of land by foreign investors is common to several countries and has not proved to be a major impediment to attracting foreign investment in international experience. The investor may find adequate security in a land lease that is transact able and long enough to allow return on investment. Alternatively, the foreign investor takes on a local partner who owns the land, the value of which represents the local partner's equity investment in the joint venture.

Although, as noted at the beginning of this section, there is constitutional protection for private property and expropriation must be for public purposes and with due compensation, the *Expropriation Law 12/1981* does not meet international standards in the elaboration of just compensation or the procedures for expropriation.

<u>Land use and development control:</u> Land use master plans are regulated by the *Physical Plans Law 25/1995*. Land use and development must be consistent with approved plans. Urban planning is the responsibility of the General Directorate for Physical Planning (GDPP), a unit of Ministry of Municipality and Public Works (MMPW). GDPP prepares structure plans for governorates and master plans and detailed plans for cities and villages. MMPW has approval authority for such plans. Reclassification of land use is governed by regulations issued by MMPW and the local Municipality Directorate. Baghdad is a special case: Amanat Baghdad decides land use within its boundaries.

If the land is designated for agricultural purposes, master plans may not be changed by MMPW or Amanat Baghdad without prior approval from Ministry of Agriculture (MoA), which will decide whether the land can be removed from agricultural designation.

Under the *Law on Municipalities 165/1964*, municipalities are administrative units of MMPW rather than self-governing institutions. The superseding *Law on Governorates Not Incorporated into a Region 21/2008* transfers responsibility for master planning from MMPW and Amanat Baghdad to governorate and municipal councils. In practise this change has not been recognized by the government. MMPW and Amanat Baghdad continue to exercise authority under the earlier law.

Master planning is not linked to industrial policy, such that there is not enough industrial land available where it is attractive to investors. Outside municipal boundaries, most provinces do not have master plans and therefore there is no basis for allocation of land for industrial purposes. Similarly, it is difficult to re-designate agricultural land to industrial or commercial purposes

<u>State land:</u> The Ministry of Finance (MoF) is responsible for recording and protecting state land and other property, while the Baghdad Mayoralty Properties Directorate is the custodian of land and properties within its boundaries. The State Properties Directorate of MoF has the mandate to oversee the sale, lease or other assignment of government properties. MoF distributes state lands by order to ministries and to municipalities (through MMPW). Much agricultural land is held by Ministry of Agriculture (MoA), which leases it out. For land outside the boundaries of a city plan,

an inter-ministerial land allocation committee (including Finance, Planning, MoA, MMPW, MIM, NIC and others) considers applications for sites for investment, with each member expressing an opinion on the basis of its mandate. The ministries control and manage the land allocated to them. The ministries too have land committees that make decisions on allocation.

The *Selling and Leasing State Property Law 32/1986* applies to all land allocations, with certain exceptions mentioned below. Under *Law 32/1986* land may be sold or leased for private purposes. Public auctions are required to be held under prescribed procedures. Ministries that control land are bound by these procedures. Each has a sale and lease committee that manages the auction process.

No public auction is required for state land in free zones or in industrial estates governed by the *Organisation of Industrial Services Law 30/2000*, administered by Ministry of Industry and Minerals (MIM). The *Investment Law* (discussed below) provides a good legal framework for industrial investment, with the possibility of land provided for free or at concessionary rates. An investor can negotiate the terms, without having to be subject to the auction process.

While the legal provisions are fairly clear with respect to allocation of state land, there is a lack of coordination among ministries and between governorates and ministries, confusing procedures, and lack of information about them. Information is unavailable as to the location of state land and which ministry controls it. After a decision to allocate is made by NIC and the body that controls the land, it may be ineffective because other approvals are not forthcoming.
Furthermore, state land that could be allocated for investment may be occupied by squatters. There is no solution to address this issue.

The *Investment Law*: The most significant exception to the public auction requirement of *Law 32/1986* is under the regime of *Investment Law 13/2006*, amended in 2009. The purpose of the law is to promote investment by the private sector (this does not apply to oil and gas extraction and production industries). The Law establishes the National Investment Commission (NIC) whose role is to award investment licences for strategic projects worth at least USD 250 million. Provincial Investment Commissions (PICs) are responsible for investment licensing of projects that are not reserved to NIC as strategic projects under *Regulation No. 2 of 2009*. The investment licence carries certain benefits, including tax exemption for ten years. Iraqi nationals can acquire state land and foreigners are entitled to leases of land for up to 50 years, renewable for a further 50 years. Under the *Law*, award of land titles or leases can be part of the incentive for the investor.

An investment licence does not allocate land. This remains the function of the ministry (or Municipality) that controls the land. Also, there is the necessity to obtain all other necessary approvals despite issuance of an investment license: industrial licence, master plan designation, building licence, service infrastructure, etc. There is no institutional coordination among the various decision-makers. NIC is supposed to operate a one-stop window to assist investors, but it acts as a coordinator rather than a single licensing/sanctioning authority, and it suffers from weak capacity. An investor is left having to obtain approvals separately from different government bodies, all of which are in a position to deny the approval. There is no government policy that mandates cooperation among agencies and requires them to support industrial investment.

In December 2010 the Council of Ministers issued an order (7/2010) under the *Investment Law* concerning the sale and lease of state property for investment purposes. The main purpose is stated as the promotion of projects, particularly residential projects to address the serious housing shortage. It calls on MoF, MMPW, municipalities and other bodies to provide land suitable for projects. Land may be leased out for agro-industrial, service, tourist, recreational and other uses at rents significantly below market rates.

The transact ability of the investor's right is an issue. Although the investor can transfer ownership or the leasehold right, the Investment Commission needs to approve the proposed transfer if it is within the period of tax exemptions awarded to the project. This issue would apply to enforcement of debt collateral. It may be possible to negotiate prior approval by the Commission of Collateral Enforcement, with the terms incorporated into the land lease and investment licence.

The underlying study, by UNIDO, of land issues has not examined lease contracts used under the *Investment Law*, so it cannot assess how they affect security of tenure. However it is noted that leases of this length usually provide adequate security of tenure for the foreign investor, depending on the conditions of the lease. It could not be ascertained whether the leases are transact able; i.e. the lessee has the right of sale or use the land title as a capital asset. It was also not ascertainable whether the investor/lessee had sufficient flexibility to adjust building and construction plans, or to make other adjustments necessary to adapt to changing conditions.

The issues just listed are of significance to the Iraqi context, since, under the *Investment Law*, in the case of non-fulfillment of certain project obligations, the registration of ownership or lease can be revoked and the land returned to its former owner – the state body. This introduces insecurity, particularly for lenders to the project. The power of the state to revoke land rights in any case of non-fulfillment of the conditions of investment approval, no matter how minor, can be out of all proportion to the significance of the default, and makes no allowance for unforeseen circumstances. For land allotted to industrial investors, in the case of such expropriation, the investment in project development as well as plant and machinery will be lost. In these circumstances an opportunity is created for improper treatment of the investor. The effect on a lender is even more significant: the holder of security needs to be protected against the consequences of the investor's non-fulfillment. From the point of view of the state, there is no need for this power of revocation in order to monitor non-fulfillment of the conditions or obligations of an approved investment.

<u>Valuation:</u> Valuation of real estate for the purposes of allocation of land under the *Investment Law*, whether by way of ownership or lease, is governed by the *Real Estate Valuation Law 85/1978*. Land is valued by an assessment committee consisting of three directors or other high-level officials, plus a real estate agent and a

representative from MoF. This is done under a uniform procedure of inspection and application of relevant factors.

It is reported that the parameters prescribed for valuation of land produce prices that are too high, thus discouraging investment. The difficulty in establishing fair and consistent valuations is exacerbated by the lack of readily available market information on which to base estimates of value.

<u>Devolution to provincial governments:</u> According to the *Law on Governorates Not Incorporated in a Region 21/2008,* Provincial Councils can issue local legislation, regulations and instructions to organize administrative and financial affairs. While devolution may be desirable, in practise central authorities have resisted it. This produces uncertainty, since an initiative by provincial government may be thwarted by central authorities, and vice versa. From a practical point of view, an investment must be accepted by both the governorate and national bodies.

<u>Institutions for IZs and investment:</u> There is no government entity with overall authority to establish industrial zones, see that they are served with infrastructure, and allocate land. There is not even a body that is responsible for coordination of the different Government departments and Ministries involved. However individual Ministries (Ministry of Industry and Minerals, the Free Zone Commission etc.) are awarded land and development authority for zones that are conceived within their individual mandates and plans.

NIC was to be assigned land by MoF, MMPW, and Baghdad and other governorates, and to have the authority to allocate land for investment purposes. This has not happened. In the current situation an investor can have a proposal that is acceptable to NIC but may not be able to access land for it.

<u>Private sector led investment:</u> There is insufficient recognition by state bodies that development should be led by the private sector. Private sector commentators say the government is not responsive to the needs of industrial investors. For example, master plans can frustrate investment by designating industrial land in locations that are unattractive for the private sector. Also, in relation to the country's needs and development objectives, too much land is designated for agricultural uses.

Furthermore, NIC wants to be able to allocate land for investment where the land is subject to the right of *tassaruf*. It is frustrated because *tassaruf* holders will not sell their rights at the price offered. A market-based approach would involve the state transferring its underlying title to *tassaruf* holders, rather than the other way around.

It should be possible to locate agricultural processing factories in agricultural areas, on the basis of *tassaruf* rights. However, it is not contemplated by state bodies that *tassaruf* holders should acquire the state's title to the land, and there are no procedures under which a *tassaruf* holder can apply for title, therefore neither can the state acquire *tassaruf* land for reuse by industry nor can the *tassaruf* holder acquire land to sell to industrial investors on a freehold basis.

4 - Summary of best practices

An analysis of country case studies[2] yields the following considerations as best practice:

- The location and promotion of IZs is linked to government economic, industrial and trade policy, and master plans designate IZs in accordance with such policy.
- The location of IZs is targeted to the needs of industrial investors.
- IZs are served by superior infrastructure (roads, water, wastewater treatment and removal, electricity, telecommunications) and services.
- An autonomous government entity is given planning control over the area and the authority to allocate land under a streamlined process.
- The government entity is corporatized and enabled to operate like a business with adequate human resource capacity. Private investment in the corporation may be possible, with the government retaining majority control.
- It is possible for a private sector partner to plan, finance, develop, market, and operate the IZ. The private sector partner may be granted ownership of the land or a concession that is established on clear and stable terms.
- Foreign industrial investors may obtain ownership of the land or long leases (50 years or more) with the right to sell, mortgage and sub-lease.
- Plots within the IZ are sold or leased at market prices. Reduced prices or free land may be awarded in order to support government policies to promote development in disadvantaged areas or to develop certain kinds of industry.
- In the ideal situation, the IZ administrator offers a one-stop shop, with all license and approval decisions made by the IZ administrator. The IZ administration providing assistance to investors in obtaining approvals, coordinating and facilitating the provision of licenses and permits issues by other Government entities at the national and lower levels. Licensing and land allocation are linked.
- In either case, approval procedures are streamlined in order to enable investors to start operations with the minimal possible bureaucratic procedure.
- Uses of land within IZs are flexible, allowing commercial operations that complement and support industry.

5 - Options and Recommendations

To implement IZs fully under international best practice in Iraq would require adjustments in existing legislation and, more important, improvement in decision-making processes, changes in institutional structures and administrative regulation. It has proven difficult to achieve the consensus needed to pass new laws in Iraq in recent years, and administrative reform is a long-term undertaking. Therefore the road map proposes as a first step pilot projects that do not depend on legislative changes. In the longer term, institutional and legislative changes can be foreseen that could consolidate the experience gained in the pilot projects.

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[2] See Annex 1.

Furthermore, there are two contrasting options for the development of Industrial Zones, (i) a public sector approach, with the Government – federal and/or local - taking the exclusive role in developing the IZ and allocating/selling that land to private enterprises and investors; or (ii) a Public Private Partnership, with the Government –federal and/or local - and a private sector partner engaged in designing, developing, financing, marketing and managing the zone.

The road map advocates a graduated approach to the land issues in IZ development in Iraq. In the short term, a pilot project should be undertaken with a governmental agency holding land title to the industrial zone. Investment in land and off site and basic on site infrastructural development should be undertaken from GoI budgetary resources, but the zone managed and marketed to clients by a concession arrangement established as a Public Private Partnership. In this partnership, the Government partner would act as a facilitator for client investors in the zone, helping establish land titles/leases, operating licenses and so forth. The private partner would act as zone manager, vetting investment applications by prospective zone clients and managing all land allocation issues including the collection of land sale/lease fees. The private zone manager could work on a fee-cum commission basis or on a profit sharing basis. This would enable both the GoI and the private partner to gain experience in working together on relatively simple terms, and without burdening the private partner with excessive investment requirements/risk exposure. This would also bring to the forefront, through practical experience, the possibilities and constraints on land legislation/administration that need to be dealt with in the context of establishing a PPP arrangement for zone development. In order to ensure a more effective approach, it would be critical to have the Governorate fully involved in the development of the zone in all its phases, and to have the concerned Governorate as a shareholder and member of the board of directors that oversee the development of the zone. In case the Government derives revenues from the concessionaire arrangement a revenue sharing arrangement should be established between the Central Government and the Governorate to create and equitable financial arrangement between the two levels of Government.

In the intermediate time frame, based on the first model, Central or provincial Governments could deepen the PPP approach by launching IZs on the basis of land transfer to a joint public-private partnership (e.g. a corporation established as land allottee) to develop the zone and manage the development/sale/lease of real estate on a normal market based commercial basis.

Over the long run, with the build up of experience and restoration of investor confidence in Iraq, the Government could gradually step out of the development and management of land allocated to the zone. An inter-ministerial body could be established to elaborate a development strategy for IZs and the policy parameters for land allocation. The Government could then coordinate with local authorities to identify zone sites that are suitable for investment and within the policy parameters and auction them to private developers who could invest in the zone and assume management/lease/sale of the land as an authorized corporate entity.

The last sketched model would be the targeted operating model where the Government steps out from its role as owner, investor, developer and manager of the land in Industrial zones, to that of a regulator and policy maker. It would devolve the responsibilities for investment, development and management to the private sector.

National strategy and legal framework for IZ development
The UNIDO-supported Working Group on Legal Issues has supported the development of a draft IZ law to addressing, to the extent possible, numerous legal gaps, including land. In addition, UNIDO has drafted and transmitted to Government partners terms of reference for a High-Level Committee for IZ Development in Iraq. This activity should continue in conjunction with the pilot projects.

The lessons learned in implementation of the pilot projects will inform the nature and extent of legislative reform required. Nevertheless, a legal framework for IZ development should be designed. With respect to land administration, it is recommended that the legislation provide for the following:

- All land within the IZ is allocated to the body in charge of IZ administration, which has autonomous authority to reallocate it to investors.
- The IZ administrative body is the master planning and building license authority within the IZ.
- Approvals required by outside authorities such as investment and environmental licenses are coordinated by IZ administration. Outside authorities are required to participate in a one-shop window for this purpose.
- Private sector participation in IZ planning, development, financing, marketing and operation is possible.
- Land lease and license conditions for the zones clients/tenants are designed for maximum transactibility, including as loan collateral, and flexibility in light of changing business and other factors.

Pilot projects
The chosen sites for IZ pilots must be state land (not including *tassaruf* land) that is unencumbered by claims. It must be unoccupied or occupiers reach an agreed settlement as to relocation, prior to the land being designated a site for the IZ. The ministry that holds the land must agree to release the land for the purpose. Regardless of these factors, the location must be suitable for industrial purposes and attractive to investors, with good access to transport and other support facilities. The necessary infrastructure must be available or provided at reasonable cost.

Further zone management arrangements are discussed in the relevant section of the present document.

Intermediate term, for policy consideration
Successful implementation of the pilot projects may very well indicate that the legislative and institutional framework for land administration does not need to be changed dramatically. However, the lessons learned will no doubt point out where some change is needed.

This section has identified land-related constraints to investment – not only industrial investment – in the current situation. The relevant ministries of the government may consider addressing them.

State land policy and administration

- Mandate coordination and cooperation among ministries by adopting state land policies and establishing a legal and institutional system for their implementation.
- Carry out an inventory of state land and identify what is needed for ministerial purposes and what should be made available for private purposes, particularly industrial investment. Make this information public, together with the procedures involved in allocating it.

Devolution to provincial governments

- Implement the *Law on Governorates Not Incorporated in a Region* to give governorates their appropriate role in land administration.

Institution for IZs

- Consider the establishment of a government entity with overall responsibility for the establishment of industrial zones, including land allocation.

Private sector led industrial investment

- In master planning consult with industry and take its needs and requirements into account. Suggested measures include:
    - Terms of reference for master planning studies should include the engagement of experts in industrial planning and a methodology for information-gathering and consultation with industry on demand for industrial land and requirements of investors.
- Be responsive to the initiatives of industrial investors. Not all industry needs to be located in planned industrial areas. Suggested measures include:
    - An administrative regime under which an investor that identifies land has a right to apply for a licence and land allocation. The application would be circulated to all approving bodies or, alternatively, to a committee of all approving bodies.
    - If private land is involved, the owner's consent would be required for the application (if the investor doesn't already own it). If state land is involved, no consent needed, with the controlling ministry being one of the approving bodies.

      The aforementioned factors imply streamlining the workings of the Land Allocation Committee.
- Permit agro-industrial developments, including IZs, on the basis of *tassaruf* rights and permit agro industrial investment in land designated as agricultural land.

Security of land tenure

- Ensure that leases under the *Investment Law* are secure, allow the investor to make changes needed to adjust to market or other changes, and are acceptable as bank collateral.
- Amend the *Investment Law* to de-link the investor's land tenure from licence conditions.
- Design and adopt an expropriation law that meets international standards in the elaboration of just compensation or the procedures for expropriation.

Master plans and land use designations

- Link master planning to national industrial and energy policy, so that industrial land is available where it is attractive to investors.
- Residential development should be sited where conflicts will not arise from operation of industrial facilities.

ANNEX I- Regional and international best practices

1 - Jordan

In 2004 the Jordanian government, under special legislation, established the Aqaba Special Economic Zone (ASEZ), with the Aqaba Development Corporation (ADC), a private corporation with the government as the major shareholder, mandated to implement the ASEZ master plan and develop the necessary infrastructure. ADC is an autonomous body, holding all relevant authority, including Municipal Affairs and the regulation of construction.

ADC owns the port, airport, strategic land parcels, and certain utilities. It partners with the private sector in the Aqaba International Industrial Estate (AIIE), a 175-hectare site east of the airport. AIIE is a 30-year concession to a joint venture between Parsons Brinckerhoff (US) and SUTA, a Turkish construction and property developer. The private sector partner plans, finances, develops, markets, and operates AIIE.

Jordan permits foreign ownership of industrial land. In AIIE buildings and land are sold and rented to investors at market prices.

A true one-stop shop exists, as all land allocation, license and approval decisions are made by the zone administration, which has municipal authority. Approval procedures are streamlined. Private sector participation is key, as the development and operation of an integrated IZ in a market-based economy is beyond the capacity of government agencies and best left to experienced operators.

Aqaba illustrates the following best practices:

- A special law establishing a separate authority for the territory.
- A true one-stop shop, with streamlined business and administrative procedures.
- Private sector planning, financing, development, marketing and operation.
- Sustainability: plot owners pay market rates for land.
- Foreign ownership of land is possible.

2 - Malaysia

In Malaysia the establishment of IZs was aimed at attracting foreign investment in export-oriented industries in order to alleviate unemployment. Starting in 1971, there are now more than 200 IZs. There are specialized IZs, such as for hi-tech industries.

IZs are developed and run by state-owned corporations, at national, regional and municipal levels. Commercial zones, usually at ports, are run by privately owned port authorities.

Incentives offered in IZs include minimal customs control, no import/export duties, and income tax reductions targeted to the number of employees and the type of industry the government wants to attract, and also to encourage investment in underdeveloped regions. An important incentive for investors is the provision of infrastructure serving the IZ (road, drainage, electricity, water, telecommunications).

Industrial lots are then sold or leased to investors directly by the IZ authority at market-based prices. Leases are either 60 or 99 years. Foreign ownership requires approval by state bodies, but recently the rules have been relaxed.

Malaysia illustrates the following best practices:

- The planning and location of IZs is linked directly to national and state economic and industrial strategies.
- Leases are very long, transferable and may be used as collateral.
- Plot owners pay market rates for land.
- Foreign ownership of land is possible.
- Incentives are linked to government policies.
- A key incentive is provision of infrastructure and services within the IZ to client companies.
- The same fiscal, customs and labour incentives are available to individual industrial sites that are located outside IZs.
- IZ authorities assist investors in government liaison and licence approvals. Many have a one-stop-shop facility.

3 - Vietnam

From 1991, IZs have been an important component of the government's industrial strategy. An impetus for the approach was a desire to avoid the existing government bureaucracy. By the end of 2011 there were 267 IZs, with foreign companies employing more than 300,000 people.

Foreigners invest in and develop IZs. Others are owned and operated by local authorities. IZs offer superior infrastructure, subsidized land rents and possible cluster effects, as well as preferential income tax rates.

Private ownership of land is not permitted in Vietnam. The law allows Vietnamese citizens to own a Land Use Right (LUR). Foreign investors may lease LURs from the state or from a private party. For state allocation, the investor pays land use rent, which can be an annual payment or a one-time advance payment. The lease term must be consistent with the duration of the approved project, to a maximum of 50 years. The price is within a range set by the Government, related to market prices. Land rents may be reduced or eliminated in areas that are economically disadvantaged. If paid in advance, the investor has the right to sell, mortgage or sublease the property.

Most provinces have an IZ Authority (IZA), overseeing all IZs in the province. Each IZ has Management Board. IZAs and Management Boards do not have licensing authority. Rather they assist investors in obtaining approvals.

The majority of IZs are public-private partnerships (PPPs), with management and operation by private partner.

Recent UNIDO and Dutch Government[3] studies identified the following strengths in Vietnam's approach:

- IZs were located at the periphery of big cities, with good access to transport and logistic facilities (highways, airports and rivers / harbours). They were attractive locations for industry.
- Physical infrastructure was a key factor.
- Land rights for foreign investors may be sold, subleased and mortgaged.
- Public private partnerships ensured sound management.
- The prohibition of foreign ownership of land was not found to be an impediment.

However, weaknesses were revealed that should be a lesson for Iraq:

- Many IZs are not up to standard with regard to design and infrastructure.
- Many are poorly managed. There is a shortage of human resources to manage the zones and facilities.
- Unproductive bureaucracy and burdensome regulations hamper zone development.
- IZs have no autonomous authority and no state coordinating body. Approval of many agencies is required.
- Permitted uses are too inflexible in IZs, discriminating against commercial activity that supports industry.

As a result the Government has urged its ministries to focus on infrastructure, capacity building and the legal regime.

4. Tunisia

Tunisia offers one of the most private investor friendly environments in the Maghreb region. Industrial zones have been an instrument of industrial and investment policies for the past four decades.

The Industrial Land Agency (AFI) is a public establishment, created in 1973, and placed under the authority of the Ministry of Industry, to promote the industrial sector and contribute in the economic and social development of Tunisia. The Agency is responsible for developing and promoting investments in industrial zones. AFI is not the only actor in the development of zones or the provision of industrial land. Regional Councils or private parties can also develop industrial land, whether as part of a zone or whether as locations for individual sites for enterprise.

For foreign investors, the acquisition of land and/or pre-built facilities within an industrial/free zone in Tunisia for industrial or commercial projects is allowed and does not require pre-authorization from the Government. Also, the acquisition of land

[3] UNIDO, *Viet Nam Industrial Investment Report 2011*, and Netherlands Embassy in Vietnam, http://www.hollandinvietnam.org/doing-business/industrial-zones.html (executive summary)

and/or pre-built facilities by foreign investors, in the framework of integrated projects approved by the Foreign Investment Promotion Agency does not require pre-authorization. Outside these zones however, land and premises do require pre-approval by the Tunisian authorities.

The Tunisian Foreign Investment Promotion Agency has access to a land and industrial premise database to assist all investors in their search for a location, site or building.

Tunisia has about one hundred industrial zones, including 83 zones created by AFI covering a total area of 2,300 hectares in different locations over the country. New industrial zones are regularly planned so as to meet the increasing demand for industrial land.

Foreign investors are not permitted to own agricultural land. However, agricultural lands may be leased and managed by Limited Companies with, at most, a 66% share ownership by foreigners. State owned lands can be leased on a long term basis for up to 25 years. A system of land price incentives is established to encourage investment in areas of the country targeted by the government for preferential development efforts.

The Tunisian example illustrates three critical factors:

- The zone development agency works in close coordination and policy consistency with other parts of the government. It has clear authority over land allocation and can act effectively as the allocating and licensing agency;
- Even though a Government agency is the main party responsible for zone development, it does not maintain a monopoly. Local authorities and private developers can freely engage in industrial zone development;
- Even though the development of zones is highly friendly to the private sector, the Government can use the land pricing and taxation mechanism to provide market-based incentives to investors in support of its broader economic, regional and social development programmes.

Roadmap: Finance Chapter

1- Introduction

This chapter presents and examines various financing scenarios for the development of Industrial Zones in Iraq. It reviews the general advantages of private sector participation in the financing of the zones, the prospects for private financing of the zones in the Iraqi context, the sources of risk and risk management in public-private partnerships and concludes with recommendations for the structuring and strategy for such public-private partnerships.

The investment financing of industrial zones covers two broad areas (i) the acquisition of land and the development of that land and (ii) the requisite infrastructure for the establishment of those zones. The acquisition of land is a relatively simple transaction, which could be an outright purchase of land by a private developer, the contribution of the land on a grant/subsidized basis by the Government with the assessed land market value being the Government's contribution to the equity of a public-private partnership etc. This is a one-time transaction.

The development and establishment of the infrastructure is altogether a more complex issue, since in most cases it involves the bulk of the investment and, consequently, long-term investment commitments and assumption of long-term risks by the investor.

For considerations just stated, the chapter concentrates on financing infrastructure, the far more complex aspect of investing in the development of the zone. In any case the financing of land purchase/lease/transfer and the security guarantees associated with this are discussed in the chapter on land issues.

2- Benefits from for Private Sector Participation in IZ and Infrastructure Finance

Private sector participation in infrastructure projects can offer a number of potential benefits. The realization of these benefits depends largely on the particular conditions of the public sector and may not materialize to the same extent in different countries. Generally, however, the following benefits can be expected:

- For cash-strapped governments, private sector investment can overcome budget constraints and deliver social and economic services that could not be otherwise be made available due to lack of financing;

- By contracting the private sector to implement public projects, a government can release its financial and human resources to meet other priorities. There could be a division of effort, with the private sector developing and implementing bankable projects, while the government undertaking projects with high social value but with lower commercial return, such as public hospitals, schools, and roads;

- The efficiency of project management could be improved and the costs of project implementation could be lowered. In many countries, the government has little incentive to maximize financial and operational efficiency in implementing infrastructure projects. Private sector partners, on the other hand, tend to ensure lowest cost/highest efficiency in the implementation of projects in order to maintain and maximize their profits.

- Private sector participation in infrastructure development realigns the government's role from that of project implementation to regulation, supervision and strategic planning.

3- Requirements in accessing PS Finance/Investment

Availing of the benefits of the private sector's participation and securing the debt financing or equity participation of the private sector in infrastructure projects needs certain financial conditions in order to facilitate the establishment of a public-private partnership. This section provides an overview of some of the pre-requisites that impact on securing private sector participation in the development of industrial zones. These conditions are perceived as key enablers for establishing sustainable and efficient industrial zones.

- ***Access to corporate lending***
  Given the risks associated with infrastructure investment and the potentially low appetite for investment from foreign banks, a strong and effective local banking system is vital to secure long term financing at the terms that are reasonable for private sector developers.

- ***Currency convertibility***
  If the projected revenues generated by industrial zones are denominated in local currency, investors need assurance of the convertibility of local currency to other hard currencies. This is especially important when there is a foreign equity or loan component in project financing.

- ***Currency transferability***
  Foreign investors need to have reasonable assurances of the ability to repatriate their capital and accumulated profits with no restrictions.

- ***Investment guarantees***
  Due to the high sovereign, legal and regulatory risks inherent in the project, long term and credible government investment guarantees are needed to ensure the attractiveness of the investment. This would reduce the perceived investor risk and maintain project financing costs at manageable levels.

- ***Efficient and reliable offsite infrastructure***

  Industrial zones development requires heavy investments in offsite infrastructure, the responsibility of which falls with the central or local government directly or with government-run entities. There should, therefore, be a clear demarcation of the financial and development responsibilities for the offsite infrastructure (to be provided by the host public authority) and the onsite infrastructure (to be financed by the zone developer).

4- Private finance in the Iraqi Context

- ***Banking and Finance Sector Overview***
  Currently there are 54 commercial banks operating in Iraq out of which 7 are state-owned. The state-owned banks (specifically Rafidain, Rasheed and the Trade Bank of Iraq) are the cornerstones of the Iraqi banking system. Collectively, state owned banks account for 91% of total assets of commercial banks,[4] 89% of total deposits (including 100% of public sector and 66% of private sector deposits)[5]. State owned banks also dominate lending activities with nearly 100% of government, and 67% of private sector cash credit (82% of total lending) being extended by them as of end 2011.[6] Liquidity is extremely high among Iraqi banks as they tend to keep significant portion of their assets in cash and deposits with the Central Bank of Iraq (CBI).[7] There is very little (if any) lending by the banking system to long-term investment projects.

- ***Access to Corporate Lending***
  Lending by the banking sector in 2012 accounted for only 8.5% of the country's GDP[8] compared with the MENA overall average of over 50%[9]. Corporate lending activity of Iraqi banks is limited due to concentration limits and capital adequacy ratios that banks are required to maintain. These limit the amount of credit that can be extended. Concentration limits for all borrowers should not exceed 8 times the bank's capital and reserves while capital adequacy ratio should not go below 12%.[10] Capital adequacy ratios at

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[4] Iraq Central Bank "*Financial Stability Report 2011*" Table 1 page 21
http://www.cbi.iq/documents/Financial%20Stability%20Report%202011.pdf
[5] Iraq Central Bank "*Statistical Bulletin 2011*" Table 8 page 27
http://www.cbi.iq/documents/Annual_2011f.pdf
[6] Iraq Central Bank "*Statistical Bulletin 2011*" Table 9 page 29
http://www.cbi.iq/documents/Annual_2011f.pdf
[7] World Bank "*Republic of Iraq Financial Sector Review*" page 19
http://siteresources.worldbank.org/INTMENA/Resources/Financial_Sector_Review_English.pdf
[8] Iraq Central Bank "*Annual Economic Report 2012*" page 32
http://www.cbi.iq/documents/AnnualEconomic_report%202012_f.pdf
[9] World Bank Open Data Catalogue
https://www.google.com.om/publicdata/explore?ds=d5bncppjof8f9_&met_y=ny_gdp_mktp_cd&idim=country:IRQ&dl=en&hl=en&q=iraq%20gdp#!ctype=l&strail=false&bcs=d&nselm=h&met_y=fs_ast_doms_gd_zs&scale_y=lin&ind_y=false&rdim=region&idim=region:MNA&ifdim=region&hl=en_US&dl=en&ind=false
[10] Iraq Central Bank "*Financial Stability Report 2011*" page 45
http://www.cbi.iq/documents/Financial%20Stability%20Report%202011.pdf

state-owned banks (at 42%) are significantly lower than private banks (at 136%) and thus the capacity to extend credit by the state-owned banks is limited.[11]

It should be noted that the CBI has requested Iraqi licensed commercial banks to increase capital to reach a minimum of 250 billion Iraqi dinars by end 2013. This plan will further reduce the ability of Iraqi private commercial banks to satisfy requests for credit by the private sector. With respect to state-owned commercial banks, a plan is underway to restructure the capital of Rafidain and Rasheed banks to reach 400 and 300 billion Iraq dinars respectively.[12]

The syndication of large transactions is not practiced among private commercial banks to overcome the concentration limits.

Iraqi banks charge high interest rates on loans denominated in Iraqi dinars and USD. As of April 2013, interest rates charged by state-owned banks on IQD and USD denominated loans ranged between 9% to 12% and 8% to 10% respectively. Interests charged by private commercial banks are significantly higher. In addition to this, the banks impose high collateral requirements of up to 200% of advanced amounts.[13]

Thus the Iraqi commercial banking system is not an effective financial intermediary for long term capital formation by the private sector. Instead of private loans, its asset base is dominated by short-term maturities. Consequently the domestic banking system, in its current configuration, cannot be considered a source of financing of long-term infrastructural projects, especially those undertaken by the private sector.

- ***Currency convertibility***
  CBI manages foreign currency exchange rates through auctions of foreign currencies. In these auctions, CBI offers certain quantities of USD for sale to licensed banks and financial institutions at official exchange rate. In turn, banks sell the foreign currency to cover wire transfers or redemption of letters of credit for their clients. On the positive side, and despite the attempts to manage the exchange rate regime through administrative procedures, the country enjoys strong levels of foreign exchange reserves as well as high

[11] Iraq Central Bank "*Statistical Bulletin 2011*" Table 27 page 59
http://www.cbi.iq/documents/Annual_2011f.pdf
[12] Iraq Central Bank "*Financial Stability Report 2011*" page 5
http://www.cbi.iq/documents/Financial%20Stability%20Report%202011.pdf
[13] Sansar Capital Management page 15"*A Closer Look at The Iraqi Banking Sector*"
http://www.iraq-businessnews.com/wp-content/uploads/2013/05/Sansar-Capital-Iraq-Bank-Sector-Report-May-June-2013.pdf

current-account surpluses. These reserves support the management of exchange rates of the local currency.[14]

- ***Currency transferability***

  Investment Law 13 of 2006 allows foreign investors to repatriate capital and accumulated earnings, subject to CBI instructions and Iraqi laws and settlement of all dues to the Iraqi government.

  In practice, CBI has issued a number of executive orders that has effectively set a limit on the amount of foreign currencies that banks could buy at the official exchange rate. These instructions created a shortage of foreign currencies, which eventually caused the decline of the Iraqi dinar, and created difficulties to businesses in processing wire- transfers. The instructions set a higher ceiling on letters-of-credit as compared to wire transfers (which were capped at USD 500,000 per transfer) due to the relatively higher risk associated with transfers.[15] It should be noted that preapproval of CBI is required for all transfers over 15 million Iraqi dinars (approximately 12,000 USD).

- ***Limited use of alternative dispute resolution mechanisms***

  While arbitration is allowed by Iraqi laws (specifically Investment Law 13 of 2006, Government Contracts Regulation 1 of 2008, Code of Civil and Commercial Procedures of 1969), the value derived by these clauses is curtailed by the fact that arbitration law is not modern and in parts different from the UNCITRAL Model Law on International Commercial Arbitration. Furthermore, the enforceability of rulings passed by arbitration tribunals is subject to review by Iraqi courts of law, which enjoy vast powers to annul an arbitration ruling on grounds not stipulated under most modern arbitration laws.[16]

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[14] Economist Intelligence Unit website http://country.eiu.com/article.aspx?articleid=260866610&Country=Iraq&topic=Risk&subtopic=Credit+risk&subsubtopic=Overview

[15] Foreign Exchange Selling & Purchasing Instructions 9/3/72 of 2013 issued by CBI on 24/3/2013 http://www.cbi.iq/documents/Instructions%20Auction%202013.pdf

[16] Law Update by Al Tamimi & Co. http://www.tamimi.com/en/magazine/law-update/section-5/march-4/arbitration-in-iraq-what-you-need-to-know.html

5- The sources of risk and risk management in IZ/Infrastructure projects

Managing risk in infrastructure transactions is crucial to the successful conclusion of projects. Risks arise as a result of uncertainties surrounding future outcome of certain key parameters that may cause actual results (profits and cash flows) to materially differ from projections. Managing these risks within the context of infrastructure finance is vital given the fact that financiers have limited or no recourse to project sponsors' own assets or cash flows, which is a point of difference from conventional asset-backed financing.

A PPP would require a risk sharing strategy between the public and private sectors, whereby certain risks are allocated to either public or private sector. This section illustrates the sources of risk, highlighting peculiarities in the Iraqi context, and provides indicative suggestions on risk allocation strategies that could guide contractual agreements between the parties negotiating a PPP.

Design Risk

Overview

This refers to the risk that project designs do not meet the required scope of work. This risk is more relevant to large and complex projects. Design risk could arise due to the improper definition of the project's objectives that subsequently results in non-conforming designs. Design risk contributes to such other types of risks as completion and cost overrun risks.

Despite the fact that the contracting authority has a better knowledge of its objectives and desired outcome of the project, the developer, given his responsibility in managing the project to the standards set by the contracting authority, will bear the consequences for not meeting the project objectives. Therefore, engaging the developer in the detailed design phase adds value to the development process, and enforces his accountability for the outcome of the project.. It is therefore recommended that the responsibility of this risk is allocated to the developer on conditions just enumerated, i.e.: that the developer is associated with the project design phase.

Risk Mitigation

This risk can be mitigated through proper risk allocation. No further measures are needed.

Completion Delay Risk

Overview

Delay in project completion may be due to various factors related to the contractor, the operator or the contracting authority.

Delay factors caused by the operator may be attributable to a host of conditions such as poor coordination among various sub-contractors, faulty design or use of inappropriate technology and so on.

On the other hand, delays in project completion may be caused by actions (or non-actions) by the contracting authority, such as delays in issuing permits by central or local governments, delays in off-site constructions and infrastructure (such as water, electricity, public works) the majority of which are provided by state-owned entities.

Completion delay imposes a lost opportunity cost due to the consequent delay in the realization of revenues, as well as additional financing charges incurred as a result of a construction period that is longer than originally envisaged.

It is vital at the time of contracting between the contracting authority and the developer/operator to set the project start date realistically allowing both public and private sectors to fulfill their respective obligations under the project rollout plan.

Risk Mitigation

a) Contractually, responsibilities of the contracting authority (i.e. the government), and of the developer should be clearly defined and time bound especially with respect to land allocation and issuance of permits,. Should either party fall short of its obligations, remedial actions, consequent liabilities and timelines should be contractually defined.

b) Punitive measures (penalties, late charges, confiscation of performance guarantees) and the conditions for invoking such measures should, similarly, be clearly defined.

c) If delays are caused by acts of sabotage, terrorism, civil disturbances, etc. these may be covered under political violence insurance. Force majeure clauses should be clearly defined as should the causes of delay that can invoke this clause.

Construction Cost Overrun Risk

Overview

Cost overruns are mostly driven by actions of the developer such as waste, inefficient utilization of material and poor budgeting. Faulty designs (which the contracting authority is usually responsible for) may also contribute to cost overruns. Engaging the project developer/operator in the design phase reduces the cost overrun risk.

Risk Mitigation

a) The construction delay and cost overrun risks should be borne by the Engineering-Procurement-Construction (EPC) contractor under fixed price contracts, given certain deadlines.

Performance Risk

Overview

Performance risk refers to the risk that the completed project does not meet the planned standards, resulting in higher than expected operating and maintenance costs and / or lower than expected output or productivity, thus lowering than planned project cash flow and asset utilization.

Risk Mitigation

a) Contracting authority should seek performance guarantees from the developer.
b) Contracting authority may ask the developer to sign off-take agreements with other government agencies providing offsite infrastructure to protect government investments/anticipated cash flow against the risk of lower than expected utilization.
c) Developer should seek performance guarantees from all subcontractors. If applicable, vendors of machinery should also provide performance guarantees.

Commercial Risks

Overview

These risks relate to the possibility that actual revenues may be lower than planned. Material deviations may be caused by lower than expected demand for service or lower than expected price of service. Under conditions of monopoly, this risk is at minimal.

Within the context of industrial zones in Iraq, the following factors may cause this risk to arise:

a) Actions by contracting authority / public sector:
    i. Excessive licensing of competing facilities by central government and offering almost identical services.
    ii. Competition between central and provincial governments may drive provincial governorates to license similar facilities with little or no coordination with central government.

Risk Mitigation

a) Granting the local governorate a stake in the rewards of the project, either in the form of equity or other long-term financial consideration as annual licensing fees, revenue sharing reduces the chances of competing against the project.

b) Developer to enter in long-term lease or outright sale to prospective investors in the industrial zone. In this case commercial risk is all averted and what is left is merely risk of collection of lease payments from IZ tenants.

c) If commercial risk is perceived to be high, government can guarantee a minimum revenue for the developer.

Legal and Regulatory Risks

Overview

Unstable legal and regulatory regime contributes to this type of risk. In the case of Iraq, this risk is particularly critical. These risks are driven by actions or lack of action by a public sector entity at central or provincial government levels.

Risk Mitigation

Undertakings by central government on behalf of all other government agencies should be sought against any adverse change in laws and regulations, for a stated period of time.

Financial Risks

Overview

This term refers to a number of risks related to currency convertibility, currency transferability, interest rates fluctuations, and inflation among others. These risks are more relevant to foreign investors and foreign financiers whose investments and anticipated revenues are denominated in foreign currencies. Given the special circumstances of Iraq, the probability of occurrence of these risks is high.

Risk Mitigation

a) Commitments of developer and contracting authority can be contractually entered in foreign currency, thus eliminating the risk of foreign exchange.

b) Contracts entered into between developer and prospective investors to be denominated in foreign currency.

c) If contracting in foreign currency is not possible, commitments can be entered in Iraqi dinar subject to adjustment in the exchange rate. This will address the currency convertibility risk but it will not address the risk of currency transferability.

d) If currency convertibility and transferability risks are perceived to be high, local financing, despite its scarcity, should be sought by the developer.

e) Government undertakings guaranteeing the Iraqi dinar convertibility and transferability of foreign exchange. Understandably this undertaking is time bound as governments cannot fix rates indefinitely but at minimum the undertakings need to cover the loan repayment period.

f) Treasury management functions such as hedging can be explored by developer. However, given the circumstances of Iraq, it is unlikely such hedging strategies and bank products can be offered by banks. If hedging is possible at all, it will be prohibitively expensive. Instead of entering into a hedging contract at a high cost, the developer can gradually build foreign currency reserves in anticipation of payment.

Political Risks

Overview

Political risks refer to actions taken by central governments that adversely affect the viability of a project. Such actions include expropriation, breach of contract by the government and material change to regulatory regimes.

Risk Mitigation

a) Undertakings by contracting authority on behalf of government against political risks.
b) Third party political risk insurance from institutions such as those described in ANNEX II.

1. Transaction Structuring

The review of risks in the previous section illustrates significant legal, regulatory, and political risks that can neither be transferred to the private sector nor hedged against. It will take some time before business confidence and financial sector reform could improve the investment climate for private investment to flow to infrastructure projects. All this leads to the conclusion that a structuring strategy with the public sector as a central actor stands a better chance to effectively implement the industrial zone project in the short and medium term.

This road map, then envisages a two-stage implementation plan:

- ***Stage 1 (short-medium term): Industrial zones developed, funded and owned by public sector with management, operation and maintenance outsourced to a private sector operator/concessionaire.***

This stage involves a state-owned company[17] operating under the Companies Law 21 of 1997 (as amended 2004) that takes ownership of land and assets with powers to delegate authorities to other entities, and for the company to operate under the direct supervision of the competent authority.

The features of this structure are outlined below:

i. A single regulator needs to be identified and have exclusive powers to regulate the industrial zone.
ii. No other government entity would operate inside the industrial zone. A one-stop-shop or a one-stop-window approach would be adopted

[17] This is the recommended option. A corporate structure would facilitate the exit of the Government at some point should conditions become conducive for Stage 2.

whereby the Regulator is the sole interface point with industrial zone investors.

iii. A state-owned company (NEWCO) is formed with joint ownership between the Ministry of Industry and Minerals (or any of its agencies or investment arms) and the local municipality or governorate council to develop the industrial zone.

iv. Shareholder agreement between the central and local governments would set equity breakdowns and mode of payment (cash or in-kind). It is important to commit both parties to a non-competition clause.

v. NEWCO will be granted exclusivity rights over a given geographical area and for a set period of time.

vi. NEWCO to enter into a concession agreement with the Regulator to develop the industrial zone.

vii. By its founding charter and concession agreement, NEWCO would be allowed to delegate any of its authorities and obligations to third parties.

viii. NEWCO would outsource the management of the industrial zone to an international operator under competitive bidding rules. Operator would receive fixed fees and performance-based remuneration.

ix. NEWCO would remain responsible for the construction of the industrial zone.

x. Land ownership would be transferred to NEWCO. This transfer should be final and not subject to contention by central or local governments or third parties.

xi. Financing would be through government budgetary allocations and/or loans advanced by state-owned banks, backed by government guarantees.

xii. NEWCO would enter into agreements with other government or state-owned companies responsible for offsite infrastructure.

The above structure offers the following benefits in the short to medium terms:

i. Access to finance from the largest state-owned banks.
ii. Should a need emerge for external funding, it would be easier for the government to extend guarantees to a state-owned entity rather than to a private investor.
iii. A corporate structure allows the public sector to exit at a future point in time through privatization.
iv. Engaging the local government in the ownership structure eases the chances of local competition against the Project.

v. Value added can be expected by involving the private sector in the management of the industrial zone, and providing the private sector operator a (partial) performance based remuneration.

On the other hand, the possibility of exposure to delay and cost overrun risks is high.

- ***Stage 2 (long term): Private sector develops, funds and manages through a PPP[18] agreement with the public sector.***

Under this stage the public sector, over a number of years, would gradually grant the private sector concession rights to design, construct, finance and operate industrial zones while retaining ownership of assets. The public sector would be relieved from operational functions and would be focused on performing its regulatory responsibility. This step would leverage private sector expertise and efficiencies in construction and management. However, these superior efficiencies must be weighed against the additional cost attributable to the private partner's required return on equity.

Significant legal and regulatory amendments need to be made before this stage becomes possible. Among amendments to be made, most prominent are:

i. Implementation of a one-stop-shop model including full delegation and consolidation of authorities of all government entities into a single regulatory authority.

ii. Enactment of a legal framework governing public-private-partnership transactions. This is not a necessary pre-requisite for implementing PPP to the extent that legal framework can be established through other laws such as Investment Law 13/2006 or Regulations for Implementing Government Contracts 1/2008. However the existence of a dedicated PPP law offers consistency in evaluating and awarding concessions.

iii. Drafting and enactment of a new arbitration law that is based on UNCITRAL Model Law and joining the New York Convention. Would greatly facilitate foreign investments in Iraq's infrastructure.

In addition to legal and regulatory amendments, significant improvement in security conditions and stability would result in increase in private sector participation and drop in return on investment risk premiums required by private sector investors.

Annex I: Sources of Multilateral Financing

[18] Annex VI presents the Jordanian examples of a structured PPP and the lessons learned from this experience in that country.

Multilateral Development Banks (MDB)

Public and Private sectors in Iraq are eligible for funding by a number of regional and international donor agencies in the form of debt, equity or grants.

1.1.1. World Bank Group - International Development Association (IDA)[19]

The World Bank supports Iraq through the Iraq Reconstruction Fund Facility (IRFF) and its two sub funds World Bank Iraq Trust Fund (WB-ITF) and United Nation Development Group Iraq Trust Fund (UNDG-ITF) as well as through the IDA. Approximately USD 1.83 billion were committed and programmed for spending by IRFF. The industrial zones project can access funds administered by IDA which has supported programs of Iraqi Ministries of Education, Construction and Housing, Electricity, Municipalities and Public Works and Kurdistan Regional Government..

1.1.2. Islamic Development Bank (IDB)[20]

The objective of IDB is to foster the economic development and social progress of member countries and Muslim communities individually as well as jointly in accordance with the principles of Shari'ah, i.e., Islamic Law.

The bank achieves this objective by participating in equity capital and grant loans for productive projects and enterprises besides providing financial assistance to member countries in other forms for economic and social development.
In 2005 IDB approved a USD 500m funding plan to finance infrastructure projects in Iraq out of which USD 13 million were advanced in 2006 to implement 15 public schools in the form of soft loans and technical assistance.

1.1.3. International Finance Corporation(IFC)[21]

IFC is the private sector lending arm of the World Bank Group. It provides investments and advisory services to build the private sector in developing countries. IFC provides a number of products ranging from direct loans, equity and quasi-equity to structured and trade finance. It has often taken equity positions public private infrastructure projects and it may offer an avenue for securing equity investments into IZ infrastructure development.

[19] IDA website http://www.worldbank.org/ida/
[20] IDB website http://www.isdb.org/irj/portal/anonymous
[21] IFC website
http://www.ifc.org/wps/wcm/connect/corp_ext_content/ifc_external_corporate_site/home

In 2011 IFC arranged a USD 400m loan package to Zain Iraq, out of which USD 205m extended by IFC, with sub participation by other international private sector institutions as DEG, PROPARCO and FMO.

1.1.4. Promotion et Participation pour la Coopération économique (PROPARCO)[22]

PROPARCO is a development financial institution partly held by **Agence Française de Développement** (**AFD**) and other private shareholders. PROPARCO finances private sector projects which are economically viable, socially equitable, environmentally sustainable and financially profitable. Zain Iraq received USD 75m funding from Proparco in 2011.

Annex II: Sources of credit and credit risk/investment guarantee

Various types of guarantees are available to hedge against risks inherent in industrial zone development in Iraq. Risks that investors seek protection against can be driven by political or operational factors. A number of third party products are designed to address political risks. Furthermore this annex presents a number of securities that the project developer can provide or seek, to protect against operational risks.

1. Providers of Political Risk Guarantees

1.1. Multilateral Investment Guarantee Agency (MIGA)[23]

MIGA's guarantees protect investments against non-commercial risks. Namely MIGA insures against following risks:

i. Currency Inconvertibility and Transfer Restriction
ii. Expropriation
iii. War, terrorism, and civil disturbance
iv. Breach of Contract
v. Non-honoring of Sovereign Financial Obligations.

In 2013 MIGA insured **Sabeel Al Safa Manufacturing Petrochemicals and Water Filling,** an Iraq-based company in the amount of USD 5m. for 5 years against the risks of transfer restriction, expropriation, war and civil disturbance.

1.2. International Bank for Reconstruction and Development Partial Risk Guarantee (IBRD PRG)[24]

PRG insures private lenders, or investors through shareholder loans, against the risk of a government (or government-owned entity) failing to perform its contractual obligations with respect to a private project. International Bank for Reconstruction and Development (IBRD) PRGs are available for all

[22] Proparco website http://www.proparco.fr/lang/en/Accueil_PROPARCO
[23] MIGA website http://www.miga.org/
[24] IBRD website http://treasury.worldbank.org/bdm/htm/credit_enhancement.html

countries eligible for IBRD and IDA loans, Iraq included. A counter-guarantee from host government is required. IBRD provides protection against following risks:

i. Changes in law
ii. Failure to meet contractual payment obligations
iii. Obstruction of an arbitration process
iv. Expropriation and nationalization
v. Foreign currency availability and convertibility
vi. Non-payment of a termination amount or an arbitration award following a covered default
vii. Failure to issue licenses, approvals, and consents in a timely manner.

1.3. The Arab Investment & Export Credit Guarantee Corporation (Dhaman)[25]

Dhaman provides insurance against non-commercial risks for Arab and non-Arab investments in Arab countries, as well as insurance against both commercial and non-commercial risks for Arab export credit to Arab and non-Arab countries. Namely Dhaman insurance covers the following non-commercial risks:

i. Expropriation and Nationalization
ii. Currency Transferability
iii. Breach of Contract
iv. Wars and Civil Disturbances

1.4. The Islamic Corporation for the Insurance of Investment & Export Credit (ICIEC)[26]

ICIEC (a member of Islamic Development Bank Group) provides protection against non-commercial risks for eligible investments in Islamic countries. While Iraq is not currently a member country it is expected to become member in 2014. Risks covered under ICIEC insurance:

i. Currency Inconvertibility and transfer restrictions.
ii. Expropriation.
iii. War and civil disturbance.
iv. Breach of Contract.

Non-honoring of Sovereign Financial Obligations

[25] Dhaman website http://www.dhaman.org/
[26] ICIEC website http://www.iciec.com/

Annex III: Methods and Sources of other risk guarantees

Following is a list of securities that Government of Iraq can offer to the private sector developer.

1.1. *Escrow accounts*

To protect against risk of default by public sector, government may make a partial deposit of availability payment due the private sector with an international banking institution outside the country. Payments to private sector will be effected upon reaching milestones as stipulated in agreements and receipt of duly approved acceptance reports.

1.2. *Additional government support*

For projects that are economically and socially significant for the country in general, the government can offer to reduce the cost overrun risk by covering any shortfall in financing. This is especially relevant for long term projects where the cost of raw material is likely to increase by rates higher than inflation.

Such pledges are limited by amount and are conditional upon drawing all committed funds in terms of equity and lines of credit. Furthermore it cannot be invoked if cost overrun is caused by a private partner's own mismanagement such as waste or corruption. Depending on terms of agreement with a private sector partner, the government can use these additional funds to dilute the private sector share and thus gain more power in management of project or provide the additional funding as grant with no effect on the management structure.

Having this undertaking in place assists the private sector in securing financing at rates lower than otherwise possible. At the same time, by reducing the cost overrun risk government can demand the private sector partner reciprocates by lowering its required return on equity.

1.3. *Revenue Guarantees*

If commercial risks are too significant to be handled by the private sector, the government can offer to cover any shortfall in revenue (up to a ceiling). Understandably such shortfall should be due to events not under the control of the developer such as sudden drop in occupancy rates or lease rates, say, due to a sharp drop in business confidence.

1.4. *Undertakings*

To protect against currency convertibility and transferability risks, government can make an undertaking against these risks.

1.5. *Government funding subordination*

In the extreme case of project insolvency and in order to protect the rights of creditors, government can subordinate its own loans vis-a-vis other lenders (by converting government loans into equity of insolvent project company). This will allow external creditors priority over government in satisfying their claims.

1.6. Alternative Dispute Resolution Procedures

By consenting to international arbitration procedures, government can greatly reduce the legal risks. Iraq's current legal framework allows the use of international arbitration, under certain circumstances, as stipulated in Investment Law 13 of 2006 and Code of Civil Procedures 83 of 1969. However the enforceability of foreign awards is not as certain.
Foreign judgments or arbitral awards should be issued in a country with which Iraq has signed a bilateral or multilateral treaty. However Iraq is only signatory to the Riyadh Convention on Judicial Cooperation of 1983 which is co-signed by other Arab states. In addition Iraq has concluded a number of bilateral treaties. Iraq has not joined the New York Convention of 1958 which includes 145 signatories.

Under current Iraqi laws, the enforceability of foreign judgments and international arbitral awards are governed by Law 30 of 1928, The Law of Enforcement of Foreign Judicial Awards. Conditions for enforceability under Law 30 allows Iraqi courts plenty of room to annul a foreign judgment or arbitral award on grounds that are subjective and vague on such grounds as the principles of equity and justice and public order.

Addressing this concern to the satisfaction of international investors requires the Iraqi government to join the New York Convention to expand the enforceability of foreign and Iraqi judgment and arbitral awards alike. In addition, a new arbitration law needs to be enacted, a law that closely aligns with such international best practices as UNCITRAL Model Law and which limits the amount of exemptions on grounds of public order.

The Jordan case study offers an example on regional experiences in infrastructure transactions which can assist the Iraqi government in building a road map for developing industrial zones. The first section presents the regulatory model and ownership structuring adopted in Jordan. The next section presents regional examples of successful infrastructure transactions conducted under PPP models, should the Iraqi government opt to go this route. It should be noted these transactions were structured under given legal and regulatory regimes which may not be applicable under current Iraqi laws.

Currently there are 15 industrial cities established in Jordan at various stages in development, out of which 9 are governmental and semi governmental and 6 are private.

1. The Jordan Regulatory Model

1.1. *Regulator*: Development and Free Zones Commission (DFZC)

1.2. Authorities within development zone[27]. DFZC assumes authorities and responsibilities of other government entities within development zone including but not limited to:

- i. Municipal affairs from Ministry of Municipalities. (*Article 7-d)*
- ii. Environment protection from Ministry of Environment. (*Article 7-f)*
- iii. Labor regulations from Ministry of Labor. (*Article 7-h)*
- iv. Income and sales tax from Income and sales Tax Department and Ministry of Finance. (*Article 22-b & 23-i).*

1.3. Land

- i. Ownership of Treasury land is transferred to DFZC (*Article 5).*
- ii. DFZC may sell or lease land to Developer *(Article 21)*
- iii. Developer may sell or lease land to Registered Investors (*Article 21-b)*
- iv. Registered Investors may sell or lease land to other Registered Investors (*Article 26-d and 26-e)* .
- v. Repossession of land possible in case of violation or non-fulfillment of contract by either the developer or registered investor.

1.4. Ownership of registered investor:

- i. Registered investors are duly licensed entities in accordance with Companies Law 22 of 1997.
- ii. No particular conditions or restrictions related to foreign ownership.

[27] Law 2 of 2008 "*Development and Free Zones Law".*
http://www.lob.gov.jo/ui/laws/search_no.jsp?year=2008&no=2

1.5. *Developers: (all established as Jordanian private shareholding or limited liability companies)*

i. Jordan Industrial Estates Corporation PSC. (JIEC)
ii. Jordan Developmental Zones Establishment PSC.
iii. Maan Development Corp PSC.
iv. Northern Developmental Corp LLC.
v. Mafraq Developmental Corp LLC.

1.6. *Ownership of Developers:* Predominantly governmental and semi-governmental.

1.7. *Private Sector Participation:* Aqaba International Industrial Estate (AIIE). Estate is developed by JIEC and operated under 30-year concession agreement by PBI Aqaba Industrial Estate LLP.

i. One-stop-shop model with all authorities consolidated with DFZC.
ii. Flexible rules regarding foreign ownership and transfer of land.
iii. Incentives to registered investors apply.
iv. Despite Jordan having successfully adopted PPP structures, industrial zones were developed largely through public structures as JIEC that are directly owned by the government or through such other agencies within the government domain as SSC and government-backed funds. That could be a legacy of public sector policies prevailing in 1985 when JIEC was established but today the role of private sector is limited to operation only at AIIE and limited equity stake in JIEC.
v. Financing the construction of industrial zones is likely to be undertaken through government resources except for phase 1 of AIIE which was funded through a USAID grant.

2. Funding under PPP Models

2.1. *Queen Alia International Airport (QAIA)*

i. *Transaction:* Rehabilitation, expansion and operation of QAIA.
ii. *Structure:* 25 year BOT agreement.
iii. *Cost*: USD 680m.
iv. *Concession Fees*
   a) Upfront: USD 1 million
   b) Ongoing 54.64% of gross revenues.
v. *Financing:*
   a) MDB concessionary loans USD 370m
   b) Private sector equity USD 160m
   c) Operating cash flow USD 150m
vi. *Developer Incentives:*
   a) Income tax exemption for 10 years starting from date of operation

b) Sales tax, customs, import duties exemption.

vii. *Government Support / Undertakings:*

a) Revenue shortfall
b) Currency exchange
c) Inflation
d) Exclusivity
e) Protection in case of termination, including assumption of debt by government and minimum guaranteed return on equity.

viii. *Risk Allocation:*

a) Private Sector: Design, construction, performance, O&M and commercial risks over minimum guaranteed revenue.
b) Public sector: Currency exchange, inflation, political, legal and regulatory.

2.2. ***Disi Water Conveyance Project***

i. *Transaction:* Development, construction and operation of water conveyance system from Disi (south of Jordan) to Amman through a 325 km pipes network.

ii. *Structure:* 25 year take-or-pay agreement. Transfer to GoJ at end of concession.

iii. *Cost*: USD 989m

iv. *Financing:*

a)	MDB concessionary loans	USD 550m
b)	Private sector equity	USD 200m
c)	GoJ Grants	USD 300m

v. *Developer Incentives:*

a) Exemption of income tax, capital gains and sales tax throughout project duration.
b) Exemption of withholding taxes on ordinary income or capital gains that may be realized during project duration.
c) Exemption of interest income realized by foreign funding agencies from any withholding taxes.
d) Exemption of incomes of non-Jordanian natural and legal persons employed by the project of income taxes.
e) Exemption of customs, import duties, sales taxes throughout project duration.
f) Protection against adverse changes in laws throughout project duration.

vi. *Government Support / Undertakings:*

a) Participation in funding of USD 300m plus additional USD 200m in soft loans from EIB and Proparco.
b) Protection against significant legal risks

vii. *Other Guarantees:*

a) General Electric Energy Financial Services (significant interest in project developer Disi Water Company) sought protection against expropriation through OPIC political risk insurance up to 90% of loan maximum USD 150m for period 20 years.

viii. *Risk Allocation*

a) Private Sector: Design, construction, performance and O&M except electricity price increase.

b) Public sector: Electricity price increase, legal and regulatory.

3. Key lessons

Below are a number of key lessons learned from examples above:

i. Given the high risks (sovereign and operational) involved with infrastructure projects, government support is crucial to ensuring successful implementation of project. Support can be financial, as in the case of GoJ subsidy for Disi project in the amount of USD 500m, or through undertakings against non-sovereign risks such as undertakings offered to QAIA project against risks of inflation and currency convertibility among others.

ii. Sovereign risks can be effectively hedged against through third party providers as OPIC guarantee to Disi project against risk of expropriation.

iii. Through a PPP structure, risks can be allocated to the most suitable risk manager, leading to an overall more efficient cost structure. In the case of Disi project, the risk of electricity cost for water pumping was particularly high and thus it was allocated to the public sector.

iv. PPP transactions can be complex and require skillful legal due diligence and thus it would be advisable to proceed gradually in implementing PPP structures. Building complex structures as QAIA and Disi projects can serve as a long term objective that Iraqi government can aim to achieve through a number of small steps starting first with a simple model as an outsourcing agreement as outlined in part 5.

v. International multilateral banks as IFC with QAIA or EIB, OPIC and Proparco with Disi, play a significant role in assisting governments in implementing infrastructure projects either in advisory capacity or funding role.

Chapter 3: Management of Industrial Zones

1. Introduction

The success of an industrial zone primarily depends on clear planning, appropriate financing and adequate management[28]. The zone operation and management is as critical as the initial phases of a zone development that are addressed in the previous sections of the present document. Best practices indeed point to the need for effective management throughout the zone development cycle.

Historically, zones were planned, developed and operated by one public body. Over the past 15 years, one of the most significant trends is the emergence of privately-developed and owned zones based on the assumption that these would be more effective and efficient. In this regard, the percentage of privately-managed zones in developing and transition countries reportedly reached 62% in 2008 according to a World Bank report[29]. In parallel, recent experience in zone management has been characterized by a more systematic demarcation of roles between the different stakeholders involved in zone management.

The present chapter reviews various layers and models of zone management. It deals with three main aspects:

- Institutional support infrastructure at the central level;
- Managing the development of a zone;
- The administration and operation of zones locally.

2. Iraqi Legislation and Existing Practices

The Working Group on legal and management issues reviewed the three pertinent Iraqi laws governing the establishment of Industrial Zones. That review found that the laws were weak as regards the provisions for the management of the zones:

- The Industrial Investment Law of 1998 does not cover the issue of zone management;
- The Investment Law 2006 provides for the creation of zones without specifying any management rules; the so-called investment zone regulation which is expected to address this issue in more detail has not been adopted yet;
- The Free Zone Law handles very few aspects of zone operations. The Law primarily focuses on the creation of the Free Zone Commission, placed under the supervision of the Ministry of Finance, but does not state specific rules for the management of individual free zones, neither does it provide for the possibility of private sector participation in zone management;

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[28] Farole, Thomas, "*Second best? Investment Climate and Performance in Africa's Special Economic Zones*", October 2010, World Bank Group

[29] FIAS, "*Special Economic Zones: Performance, Lessons Learned and Implications for Zone Development*", April 2008, World Bank Group

- It appears that there is no unified legal and operational framework which would provide clear guidance as to zone management.

A draft Industrial Zone Law for Iraq has been elaborated by the Government of Iraq in 2014 with a view to redressing the above-mentioned legal gaps. The draft carefully addresses the zone management topic and, in particular:

- Advocates the creation of an Industrial Zone Commission and specifies its mandate, structure and resources;
- Describes the rights and obligations of the zone developer, manager and user;
- Introduces the concept of zone licensing arrangements.

In practical terms, free zones are the only type of formalized zones that exist in Iraq. Three of them still operate but, due to the above-mentioned gaps, are characterized by light management arrangements and weak support to zone tenants. The informal and unorganized clustering of enterprises, especially within municipal limits, are a result of basic urban planning and environmental mitigation measures. These informal or municipal zones are characterized by an absence of management arrangements and provision of services. The concept of zone management as a support service to tenant/client firms is new to Iraq.

3. Institutional Support Infrastructure at the Central Level

The establishment of a zone is usually part of a country-wide industrial zone programme. The latter itself results from a national policy decision and it is translated into a range of policy, legal, institutional and administrative actions. One of them is the designation of an institutional umbrella charged with the oversight of zones for one specific region or for the country as a whole. Research on industrial zone programmes as well as on the performance of individual zones identifies weak or inappropriate governance and regulation as a factor causing the failure of the programme or that of an individual zone. It is, therefore of critical importance that a solid organization be created and be allocated an adequate set of capacities and competencies. The ensuing paragraphs look at the different roles that should be assumed by such entity and analyzed the various forms that it could take.

<u>Mandates</u>

An industrial zone authority shall first and foremost act as **zone regulator**. This includes:

- The oversight and promotion of the zone programme as a part of an overall national development strategy;
- Coordination of various stakeholders, including representatives of the private sector in order to design the zone programme on the basis of the investors' needs and challenges;
- Development of a national strategy based on a sound analysis of the country's economic endowments, opportunities and weaknesses;

- Establish an investment framework in line with international conventions and best practices (e.g. arbitration). In many countries, such framework is usually established by a parliamentary legislation or a cabinet decree;
- The adoption of a specific legal framework, that may be required in order to compensate for the weaknesses of existing legislation or to provide for specific types of benefits and incentives that would not be made available to the rest of the economy;
- Awarding zone licenses, i.e. transferring rights to a designated entity to develop and/or manage an industrial zone;
- From an institutional point of view, the zone authority should enjoy a certain degree of autonomy and flexibility and would need appropriate staffing and financial resources.

A zone authority is also responsible for the overall **zone planning**. This encompasses aspects such as recommendations as to the allocation and use of land and mobilization of government funds. This is a critical function as weak planning automatically leads to zone failure. The systematic development of zone projects is a reasoned endeavor that has to build on clear policy orientations and a solid analysis of the country's needs and challenges.

Finally, the implementation of an industrial zone programme requires careful **monitoring and evaluation of zone performance**, as follows:

- The industrial zone programme is to be monitored and evaluated with a view to determining whether it is able to attain the expected results and is the adequate instrument to implement the country's development strategy;
- The zone authority also has to specify how zone success will be defined and measured and how to monitor and evaluate the performance of zones against primary policy objectives;
- The monitoring and evaluation should be used as a tool for necessary adjustments and development of the national industrial zone strategy. Therefore the strategy adjustment should be a clearly specified role and responsibility for the zone authority.

<u>Different approaches</u>

The zone authority should take the form of a parastatal organization benefitting from a significant a degree of autonomy. Several approaches have been taken internationally, all with a high degree of efficiency. We have listed and analyzed three models that could be relevant to the Iraqi context.

Examples of zone administrative models			
Government Authorities	**Ministries**	**Zone-Specific Investment**	**Promotion Agencies**

		or Corporations Management Boards	
Jordan	Cape Verde	India	Sri Lanka
Bangladesh	Taiwan	Turkey	Uganda
Korea	Senegal	Ukraine	Ireland
Zambia	Slovak Republic	Poland	
Kenya	El Salvador	Vietnam	

Source: World Bank Group, 2008

The first option is the creation of an **autonomous government authority**. Its key features include:

- Historically, a clear and unique mandate;
- Relatively high level of autonomy granted through a specific law or a government decision; It though may be tied to a Ministry or to another institution (e.g. Prime Minister's Office, as in Bangladesh);
- Clearly established budget and specifically allocated human resources;
- Management flexibility; such an entity may not be bound by standard civil service regulations (e.g. salary scales for staff[30]);
- More demand-oriented than a traditional governmental organization;
- Supervision by a board of directors that involve all stakeholders, including representatives of the private sector.
- Specific mandate to coordinate all stakeholders.

The second option consists of designating a **Ministry or a ministerial department** as focal point for overseeing the zone programme. This mandate is usually awarded to the Ministry of Industry or Trade. On the one hand, it may be considered as positive to rely on an existing organization and possibly on experienced human resources. On the other hand, the concerned institution may not be able to cope with its new functions and responsibilities, especially if there is no extra budgetary allocation and enhancement of staff capacities. Similarly, it may not enjoy the required degree of autonomy, as it would formally be part of a line ministry.

The third, and final, possibility is to set up an **inter-ministerial body**. This is a more flexible and practical solution as it requires minor institutional developments. This is considered particularly relevant in countries where legal and administrative procedures for creating new institutions are complex. In addition, it offers the possibility of a satisfactory level of coordination between all stakeholders as it operates as a policy-level forum. However, it may be subject to political interference to the detriment of its effectiveness. It should also be noted that the body's operation capabilities and overall effectiveness depend on the actual commitment of its members and their willingness to cooperate with each other. The risk that has to be guarded against is that the authority of the body may get diluted, its decision making

[30] A demand-oriented organization would need to benefit from various types of expertise and should be able to offer competitive wages to qualified people.

process may be cumbersome or its decisions and recommendations may not be implemented.

4. Managing the Development of a Zone

In addition to the overall national strategy and oversight, the development phases of zones require clear and consistent technical decisions. The actual planning phase of an individual zone is a critical step of its development. The absence of appropriate planning leads to zone failure. A recent analysis of Chinese zones mentioned the failure of the Yongle Zone which suffered from a lack of a “clear and systematic planning”, characterized by the absence of sectors targeting, a lack of development strategy and no solid analysis of the region’s endowments and comparative advantages. The development plan only gave very general guidelines and was eventually not applied. Therefore there is a need for distinct technical analysis and institutional arrangements to guide the zone development phases.

Functions and steps

Three functions/steps are required in the zone programme implementation:

- **Zone planning**, including:
    - Selection of the site – a clear land allocation system is needed, as stated in the land section of this document;
    - Definition of the zone objectives and focus:
    - Elaboration of the zone design, including off-site infrastructure;

- **Zone financing**, namely:
    - Determining the value of the investments to be realized;
    - Defining the right modalities/institutional vehicles to finance the zones.

- **Marketing the zone, covering the following aspects**:
    - The zone promotion is a continuous effort that starts at its planning phase, and continues throughout the project life;
    - Promote the zone project to potential developers in case the development is to be outsourced;
    - Raise awareness of the zone to potential client firms;
    - Identify and solicit zone developers that have the adequate experience and investors that conform to the zone policy objectives and that have the capacity to attract further companies to the zone.

Different approaches

The management and regulation of an industrial zone programme differs significantly from the development of an individual zone. The former is a policy level function whereas the latter requires the capacity to manage a large investment. This is why it is advisable to dissociate the functions of regulator and developer, although there might be overlapping, especially at the project inception phase. Three institutional options may fit the Iraqi context:

- The creation of a **zone-specific public corporation** has been used in a variety of contexts. It allows the Government to retain control on the project through the establishment of a specific organization that should enjoy a certain degree of independence. It appears as a valid approach in resources-rich countries where 1) the Government could deploy budgetary resources and 2) the corporation could ease potentially complex administrative procedures for allocating funds.

- The zone development could also be performed through a **development contract**. In this case, the governmental project promoter – possibly the zone regulator – would elaborate terms of reference, launch a bidding process and select a specialized private firm to implement a development contract. It should be noted that this option is not incompatible with the other two as activities such zone design and infrastructure building are, in any case, often outsourced to competent private firms.

- Finally, the zone development could be realized through a **PPP agreement**[31].

5. The Administration and Operation of Zones Locally

The day-to-day management of a zone is exercised at the local level. This is the third and final layer of the zone management spectrum. It is of critical importance as it implies direct and continuous interactions with the zone tenants.

<u>Roles and responsibilities</u>

The administration and operation of a zone involves the zone management entity and the zone users.

- **The zone manager**:
  - Is in charge of the zone operation (including its maintenance);
  - Is responsible for the zone promotion, attraction of new companies and investors relations;
  - May provide business support services or partner with services providers;
  - Should contribute to the zone overall monitoring and evaluation efforts; it should monitor and evaluate its own performance in order to make adjustments as required;

[31] Zone financing approaches and scenarios are addressed in the relevant section of this document.

- Last but not least, the zone manager should act as a business facilitator, in particular through the operation of a one-stop-shop (OSS)[32]:
    - One of the main roles of the manager is indeed to provide efficient and standard administrative services (e.g. business registration, investment licensing, building permits) and act as focal point between the investors and relevant ministries with a view to streamlining and shortening approval procedures;
    - From an institutional point of view, the OSS results from a delegation of powers from ministries and local authorities to the zone manager and requires close coordination between the latter and the central regulator.

- **Zone users**:
  - The zone user is a resident firm operating from the zone;
  - It is the ultimate beneficiary of the zone creation;
  - Is provided with services and overall support.

<u>Different approaches</u>

There are three main types of zone management arrangements that are pertinent to the present context:

- **Public corporation or a public-private corporation** which usually has the following features:
  - It is a way for the public sector to retain control over the zone management and operation;
  - It is managed as a commercial entity as 1) it should be allowed collecting revenues from land sale/lease and provision of services in order to ensure its own sustainability, and 2) since it is likely to be more user-responsive if run as a corporation[33];
  - Such organization would remain under public sector control but would not prevent the private sector from being involved and/or consulted as the latter could participate in the corporation's board of directors and eventually become a shareholder of the company[34];
  - The Chengdu Wuhou Industrial Park Investment and Development Company illustrates this type of management arrangements. It was established by the Wuhou local government with a view to developing and managing the industrial park. The company was allocated funds to

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[32] Business registration and investment facilitation services are addressed in a comprehensive manner in the ensuing chapter of the road map.
[33] See previous references to civil service limitations.
[34] Reference could be made to the Plock Industrial Zone in Poland where the largest resident firm has partnered with the Municipality to administer the zone.

complete the zone. These funds have enabled the company to build infrastructure, manage facilities and provide specialized services to client firms, including incubation and financial services. To speed-up governmental approval, a one-stop-shop bringing together all the relevant individual departments was set up. It has helped expedite administrative procedures, notably in terms of business registration and investment licensing.

- **Private company or association**
  - This could take the form of a private developer making a significant equity investment in the zone and assuming management responsibilities for it; in this case, the zone developer/manager collects fees from the sale/rental of land and the provision of services;
  - Alternatively, in several cases the management authority has been transferred to (private) associations of zone users, for instance at the Jebel Ali Zone in Dubai and at the Sidi Bernoussi Zone in Morocco[35]. This option offers the benefit of fully integrating the client companies' needs and views but may not be able to sustain the same level of cooperation with relevant governmental authorities for the provision of OSS services.

- **Management or concession contract**
  - A public entity awards a contract to a specialized private company which will operate the zone on its behalf and will be paid accordingly;
  - It is a valid option in contexts where the zone promoter – possibly the regulator - has limited human and/or financial resources. However, there is a risk that the manager's objectives differ from those of the regulator. The contract performance therefore requires careful monitoring and supervision by the regulator;
  - This type of management arrangements is not incompatible with the first model as the newly-established corporation may consider separating management from daily operations that could be outsourced to a private sector agent.

6. Conclusions and Recommendations

Conclusions

The following conclusions may be drawn from the preceding discussion:

- Importance of private sector involvement in zone management:

[35] OECD, "*Special Economic Zones: Helping Resource Rich Countries Diversify*". 2014.

  - International experience reveals that a significant number of publicly-managed zones have been less effective than private ones;
  - It is essential, in the Iraqi context, to identify in principle and for each project, the realistic level of involvement of the private sector;
  - The private sector should be involved on a progressive basis, with its role expanding as investor confidence increases and the risk associated with investment in the zone decreases;

- Devolution: the involvement of and the consultations with local authorities are instrumental to appropriate planning, development, management and operation of zones;

- Demarcation of roles: although this is a fluid concept, it is recommended to clarify the roles of each stakeholder:
  - Regulator, developer and manager functions;
  - There should be one unique interlocutor for, on the one hand, those who want to develop/manage a zone and, on the other hand, those who would like to invest/relocate into the zone;

- The zone manager should be awarded a certain number of powers and authorities (OSS) to:
  - Properly manage the zone and make sure that the benefits associated with investment in the zone are actually provided to the zone users;
  - Support the attainment of the zone policy objectives;

- There are several workable management models:
  - Management arrangements vary from one zone to another, according to the zone location and specificities;
  - The management model will be influenced by factors such as land ownership regulations and possibilities and the zone financing structure;

- Zone management, similarly to zone development/financing, is a process:
  - Zone management arrangements can evolve over time: in some instances, zone management could be transferred to the private sector.

<u>Recommendations</u>

In the Iraqi context, the immediate approach would be for the creation of an autonomous zone authority, following the model described in Iraq's draft Industrial Zone Law. This organization would be charged with the zone programme oversight and would be in a position to stimulate the development of zone projects across the country. The *Industrial Zone Commission* would provide Iraq with a relevant institutional framework for a national body guiding the development of industrial zones. This should also be followed by the allocation of appropriate financial and human resources and be complemented by capacity development activities in order to train the staff of the newly-established institution. It would facilitate consultations with all types of stakeholders, including local authorities that should be encouraged to initiate zone projects. Both the local authorities and the private sector should be consulted with regard to financing and management arrangements for individual zones.

It is also proposed that a zone-specific corporation be created for each pilot project. The company's capital would be provided by the Government. This company would be formally charged with the zone development. Zone management responsibilities could at first be outsourced to private sector entities. The zone ownership/management could then evolve towards a higher level of private sector involvement, based on existing legal provisions and as private investments in the zones become less risky and more profitable.

Chapter 4: Stimulating Private Investment and Enterprise Development in Industrial Zones

1. Introduction

The ultimate objective of the creation of Industrial Zones (IZs) in Iraq is to attract investment and catalyse the development of enterprises in the Iraqi economy. Thus IZs should be part of an overall strategy to enhance investment and competitiveness and attain economic diversification. This chapter looks at the current issues confronting investment in industry and proposes efforts that could deepen the contribution of IZs towards achieving national development objectives in Iraq. It deals with four topics:

- Iraq's current weaknesses in generating domestic investment and attracting DFI.
- The potential for IZs in addressing these weaknesses.
- Possibilities for IZs offering non-financial support to private sector development through such instruments as business development centers, value chain development, the formation of innovation systems involving universities and technical support institutions etc.
- The policy instruments and action points that need to be considered by Iraqi decision makers on IZs in Iraq.

The discussion is, of necessity, brief. The intention is to identify the key issues and draw conclusions on the strategy and policies that could guide the creation and management of IZs in order to meet Iraqi goals for the development and diversification of the private sector.

2. Iraq's Weaknesses in Generating Domestic Investment and Attracting DFI

Iraq has yet to break out from the shackles of a heavily oil dependent economy, domestic investment is weak, there is a flight of private capital from the country and Foreign Investment (other than in the oil/gas and two or three other sectors) remains far below the potential opportunities that Iraq offers.

The reasons for weak investment performance and business development can be summarised under three headings: market conditions, legal and administrative weaknesses and political instability.

As regards the **market**, the current industrial structure in Iraq is dominated by relatively few large-scale state owned enterprises that are characterised by obsolete technologies and business management systems. About 98% of registered industrial units in Iraq are owned by the private sector while only 1.5% is State Owned Enterprises (SOEs) and 0.2% are mixed ownership units. However, SOEs account for about 90% of domestic industrial output. A significant number of them are not operating or operating far below rated capacity, due to their degraded productive facilities and inability to compete on the Iraqi market.

The capacity for industrial innovation and business dynamism is very limited. The SOE sector is run as government departments with investment and business operations financed by the government budget with rigid investment patterns and consequently limited possibilities for business diversification. Since there is virtually no lending by commercial banks to the private sector, private business has a limited financial capability and market space to invest in business expansion, innovation and diversification.

Overall the Iraqi business and industrial sector suffers a "missing middle"—most private businesses are micro and small enterprises and there is a virtual absence of medium scale enterprises to bridge the gap between these and the large-scale state enterprises.

The growth of industrial employment is stagnant or non-existent, given the precarious condition of SOEs and the job creation potential of the private sector being constrained by the small size of businesses. What applies to the stagnation of employment also holds true for investments. The State owned enterprises are in not in a strong competitive position or technical state and their business models do not allow them to generate significant profits and investment. The private sector is too small, weak and insecure to be a significant basis for generating the investment resources required for Iraq to diversify and develop its industrial economy.

A stagnant industrial sector, therefore, has difficulty in competing on domestic markets, leave alone penetrating export markets. The result is that Iraqi industry faces stiff competition from imports that have grown significantly since 2003, as the Iraqi market opens up and public revenues improve and private incomes recover.

The issue of **legal and administrative weaknesses** has been addressed (with limited success) by governmental and international development efforts. Some progress has been made on the improvement of the legal regime governing DFI, as witnessed by the passage of Investment Law 13 of 2006, and in the creation of the National Investment Commission (along with its branches at the Governorate level). However, as pointed out in UNIDO's review of Iraq's legislative framework (2013), legal provisions pertaining to foreign investor protection/expropriation and on arbitration need to be brought up to international standards as these aspects of the Iraqi investment code are not in tune with current trends in international economic relations, having been inherited from a highly protectionist and centralized economic regime.

In addition to the improvement of the legal system governing DFI and domestic investment, much remains to be done by way of reform, rationalization and improved efficiency of the administration of investment related procedures.

The process of business registration and licensing in Iraq is amongst the most cumbersome in the world. A large number of international surveys/studies and development advisory services in Iraq have pointed to this problem that frustrates the development of private business. For example, the number of procedures involved in establishing a business in Iraq is 25% more than the MENA average and twice as many as those of OECD countries. The amount of time (not counting administrative inefficiency and unforeseen delays) is almost two times that of the MENA and three times that in the OECD. Consequently, the relative cost indicator of starting business in Iraq is significantly higher than the comparators—some 40% higher than MENA and over 10 times that of the OECD[36].

The authorities and responsibilities for business permissions and licenses are spread. Business registration is typically the role of the local chamber of commerce. Business licensing is the responsibility of the relevant line Ministry. In the case of foreign investment, the Investment Commission issues the relevant investment license. The concerned municipality issues land allocation and building permits. Each of these authorities has its respective requirements and applications have to be separately moved by the prospective/business or investor.

The **political and security** situation in Iraq remains of paramount concern. In addition to posing a threat to life and limb, it inhibits the prospects for long-term private investment in productive enterprise.

The prolonged periods of conflict and political instability have caused the flight of private capital and emigration has resulted in the loss of qualified human resources from the country. This has deprived the country of much needed domestic private investment and, more importantly, technical, entrepreneurial and managerial capabilities to foster a healthy private sector.

The degraded infrastructure inherited from the successive periods of conflict makes it difficult for existing businesses to function and grow. The Iraqi context presents a situation where the infrastructure is a dominant issue facing enterprises, particularly small-scale businesses. All the surveys of businesses conducted by UNIDO in Iraq resulted in businesses identifying infrastructure unreliability as the most important issue they faced, and consequently the most important reason they would consider locating in an industrial zone.

It should be borne in mind that heavy security costs, unreliable supplies of energy and water or inefficient transport impose an avoidable cost burden on industry that inhibits its capacity to compete in open markets.

3. The potential for IZs in addressing these weaknesses.

The policy guiding the development of Industrial Zones in Iraq should address the factors just enumerated. IZs can function as policy instruments that can address the most immediate issues of investment facilitation, the improvement of the administration of investment licensing and business registration and the provision of efficient and cost effective infrastructure. The longer term goals of IZs would be in terms of diversification of the industrial sector, support to the creation of a healthy private sector and the deepening and enhanced competitiveness of the Iraqi business sector. The ensuing subsection looks at the immediate issues whereas the next subsection will review issues relating to the longer terms goals.

4.3.1 Immediate benefits

For the immediate considerations, IZs in Iraq should offer:

[36] See Annex 1, Table 2, drawn from the World Bank's "Doing Business 2014".

- Physical facilities for private investment and growth of private enterprise;
- Investor friendly administrative procedures that could attract domestic enterprises as well as investment from the Iraqi diaspora and from foreign sources;
- Stable and good quality infrastructure and services to client enterprises;
- Security of business operations and physical capital assets to firms operating within the limits of the zone.

The stimulation and attraction of private investment should be the overarching consideration in the design, development, management and promotion of IZs, the guiding factor in the business strategy for each zone. As repeatedly stated in the Roadmap, , the initial target enterprises should be Iraqi businesses, whether located in Iraq or in the Iraqi diaspora. This for two reasons—first, the Zones should act as vehicles that fortify and develop the domestic private sector, and, second, the restoration of business confidence starts with the domestic business community. Foreign investors would want to see the resurgence of Iraqi private capital being invested domestically before they would assume the risks associated with starting operations in Iraq.

As regards the improvement **of rules and procedures governing investment in the zone**, it has been argued elsewhere in the Roadmap that effective management of IZs would require the devolution of authority to the IZ manager. An IZ management that can award the business licenses and permits, effectively promote the zone and is responsible for provision of services would go a long way in the successful formation of businesses and their location in the IZ.

The argument for a “One Stop Shop” (OSS) has been frequently advanced in the Iraqi context, and GOI efforts have been made to create such a facility to support investors, including through the creation of the Iraqi National Investment Commission in 2006. However the reality on the ground has been that the agencies acting as the OSS are in reality coordinating the process of obtaining relevant approvals from various government departments, rather than acting as an effective executive authority to commit all concerned parts of the GOI. Thus the process of licensing is not shortened but made only marginally easier (if at all) for the investor.

While institutional interests and legal impediments may constrain the possibilities for quick and fundamental reform in Iraqi investment laws and regulations, there are possibilities within the existing legal and administrative framework to create a zone-specific arrangement whereby the process of investment approval and licensing could be made considerably easier.

The example of Jordan is one of many instructive instances where IZs have been able to shorten legal hurdles and facilitate investment. In most Jordanian zones, the zone manager, an autonomous public sector entity, is awarded municipal[37] and licensing authority to award the requisite business licenses and permits and also commit the government in its obligations to investors in the zones.

[37] As holder of the municipal authority, the zone manager has the authority to grant building permits within the zone.

Iraq, through a set of appropriate decisions/regulations or by way of project-specific agreements, could benefit from emulating such practices as those of Jordan and improving the efficiency of the Government's relations with private investors.

Thus the priority in the promotion of investments in the IZ would be to *award the authority to the zone manager to improve and shorten the process of awarding investment approvals, the granting of permits and licenses to client investors.*

The **promotion if DFI** in Iraq, as in other countries, should be an effort crossing all concerned government departments and be translated into a variety of actions and instruments to achieve success. A robust diversification of sources and sectors of DFI is needed to upgrade national business practise technology and productivity.

In addition to fiscal incentives, most economies that have a successful experience in attracting DFI offer access to adequate land and good business infrastructure, streamlined procedures for business registration and start up, qualified labour forces and in many instance natural resources or other location-specific assets that attract foreign business to establish operations in the host country.

IZs in Iraq can be an important part of the National Investment Promotion Strategy for Iraq, and they could form an instrument for dealing with the current impediments to securing foreign investor interest in the country.

Thus, all of the factors mentioned on general administration for investments are relevant to the DFI aspect of a strategy for the development of Industrial Zones. Efficient procedures for business registration, land allocation and licensing, good infrastructure, provision of logistical services and security etc. are as critical for the foreign investor as they are for domestic businesses.

However in the case of DFI there is an additional factor that needs specific attention. The weaknesses in the Iraqi foreign investment code pose additional impediments to a successful Investment promotion strategy. Unless these set of impediments are addressed comprehensively, IZs (as, for that matter, Iraq as a whole) will stay as risky and unattractive host locations for most sectors of DFI. Pending the revision of the investment code or the ratification of international conventions[38], a degree of investor confidence could be gained if potential investors be allowed to appeal issues of investment guarantees in third country arbitration framework, and an assurance provided that the results of third country arbitration could not be overturned by the Iraqi courts under existing Iraqi law.

The provision of **efficient and reliable on site infrastructure**—roads, energy supplies, information and communication technology, water and waste disposal and management—is one of the motivating arguments for the creation of industrial zones.

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[38] Reference is made to the UNIDO assessment of the Iraqi laws governing the development and management of industrial zones, completed in 2013.

The provision of infrastructure is a matter of the physical design and planning of the zone, but it also has a policy component. Zones that are of a wide, general, scope (for example zones only created for the purposes of urban planning) may need mere basic onsite infrastructure, those oriented towards small scale industry may need to provide appropriately sized factory shells in order to reduce the investment cost in physical facilities by the client enterprises. Technology based or sectorally specialized zones would need to tailor the infrastructure to the needs and requirements of the targeted sector, and so on. The Government, as zone promoter, needs to share its policy objective with the zone developer and specify the onsite infrastructure accordingly, in order to ensure the conformity of physical facilities with the policy objective.

The zone initiator/promoter and the zone developer *should design and offer infrastructure that is in tune with the policy objectives guiding the creation of the zone and with requirements of targeted types of business.*

The issue of support logistics is closely related to the provision of infrastructure. The "marketability" of the zone to private sector clients will depend to a significant degree by the support logistics offered. For example, companies dependent on commodity production and trade would greatly benefit from warehousing and storage facilities, in addition to the availability of transport facilities to destination markets. In green field areas such as the zone proposed for al Faw, it would be important to provide for both physical and social infrastructure, including workforce housing, recreation and transport, given the remote and undeveloped nature of the site.

Turning to the **capital assets and business operations**, it may be recalled that the chapter on land issues in the Roadmap concludes that there is sufficient flexibility in land law to allow for long-term stability of land use rights (among other things, through long term lease arrangements) for client investors in the IZ. The problem with land allocation lies primarily in the administration of the system, requiring separate approval for land allocation in addition to cumbersome procedures for business licensing.

A balanced, transparent and efficient land allocation system would enable client enterprises to enjoy ownership or usage rights over land and also to use land titles as collateral for bank borrowing in order to expand business operations.

Similar to investment licensing, *the zone manger should have the authority to allocate land and commit the government to the client investor as to the stability of land title and tenure.* In order to discourage speculation, the clauses of land award contracts should commit the client investor to commencing project start up within a specific time frame as well as limit his ability to transfer land title for a specified period[39].

The question of security is not least of the impediments to the survival and development of business investment in Iraq. The provision of effective security services for the clients of the zone is not only a necessity, but it would offer a major incentive for client investors to operate from the zone. The costs of security to the

[39] See the land chapter of the Roadmap for further details.

individual enterprise are usually high, but a collective security arrangement whose costs are distributed amongst zone tenants could make the security system more robust as well as more affordable to the individual client enterprise.

The thrust of the discussion in this subsection has pointed to the tangible assets and benefits that the zones should offer to targeted client investors. These assets would form the foundation of incentives and benefits promoted through outreach and communication strategies that would be formulated to attract target enterprises as investors operating in the zone.

4.3.2 Improving business conditions and diversification:
In addition to physical factors just enumerated, the zone would attract private investors by offering conditions <u>that help improve business conditions for its clients.</u> In this context, the most crucial support factor for small and medium scale business in Iraq is the availability of commercial finance for private investment and business operations. It was recognized at the beginning of this chapter that commercial bank financing and lending to the private sector in Iraq is virtually nonexistent. *The zone management could partner with financial institutions to undertake commercial lending to its clients who possess business assets that are secure and well defined, and offer standard banking services within the zone.* Were the financial institutions to undertake commercial lending to the zone clients, one of the major impediments to business expansion and operation would be overcome. Through such initiatives, the zone could spearhead the introduction of modern business practices in the Iraqi context. It should however be pointed out that the in-situ provision of financial services will be eased by a needed reform of the Iraqi banking sector and the adoption of modern commercial banking practices in accordance with international standards.

In addition to the provision of physical infrastructure and logistics, IZs offer possibilities for stimulating the development of enterprise, particularly in the Small and Medium scale sector.

By virtue of focusing on a specific business sector, **IZs offer the possibility of cluster or value chain development**. In the simplest initial concept, industrial clustering connoted the geographical concentration of several firms in the same business. Contemporary thinking has widened the concept--a cluster is considered to be a concentration of interlinked firms (suppliers along the value chain, support service firms and even competitive firms producing the same category of goods or services) that work in a geographical space to serve a particular market or provide a particular category of goods or services. In this wider scope of understanding, clustering allows for business to avail of economies of scale and scope, develop the value chain as well as enjoy a mutually reinforcing learning experience that facilitates business expansion and diversification. Often cited and studied examples of highly innovative and competitive clusters are found, for example, in Italy where small and medium scale enterprises are clustered in a variety of sectors such as textiles, leather products and even in hi-tech knowledge-intensive industrial sectors.

Internationally, most clusters have emerged spontaneously through the dynamism of private enterprise. However contemporary industrial development thinking suggests that public-private partnerships can be useful in facilitating the creation and accelerated growth of clusters. The theory and practise of cluster development policy goes beyond the granting of fiscal incentives and attracting of investment in a given sector. Instead it calls for public or private support (or a combination of the two) in such aspects as the provision of physical infrastructure, the development of human resources for the cluster's development, facilitating the organization of business associations to resolve common problems confronting the growth of the cluster, establishing cooperative arrangements between different actors in the value chain (eg. supporting R&D on common issues) etc. Internationally the experience of support to cluster development is rich, with successes and failures that are instructive as models for what could be replicated and what needs to be avoided. The development of clusters would, in all probability, not be spontaneous, due to the weakness of the private sector in Iraq but could be adopted as a corner stone of industrial policy with IZs being a key element supporting that industrial policy or strategy.

> *If the development of IZ's in Iraq are targeted efforts towards the development of particular clusters, external assistance could help in respect of (i) focussing on the choice of clusters; (ii) defining the strategy for cluster development; (iii) developing action plans in respect of realizing the strategy; (iv) helping organize private business members of the cluster to identify common issues and resolve them for the collective benefit of members of the cluster; and (v) designing the IZs in an optimal fashion so as to best serve the cluster's business requirements.*

In most general terms, a well-functioning and efficient industrial zone would endow a corporate brand image to client companies as credible businesses that operate on a regular basis in conformity with Iraqi business law. This is a possible externality that could be availed by client members as partners and suppliers to other businesses.

A service closely related to cluster development **is the fostering of subcontracting partnerships between smaller and larger enterprises**. Support services to subcontracting partnerships can be offered to enterprise clients of an industrial zone either on sectoral or multi sectoral bases.

At a basic level the support could be in the form of a subcontracting partnership exchange/information clearinghouse[40] that would provide structured and tailored information to client enterprises in the zone and their prospective market partners as to what productive capabilities exist within the zone and what business opportunities exist in the external market and the larger business system, in Iraq and elsewhere. The establishment of an information database, while conceptually simple, is a labour intensive endeavour that requires a considerable investment in time and money to be relevant in changing business circumstances. The management of an

[40] UNIDO has provided business support services of this kind in Iraq through its Subcontracting and Partnership Exchange Programme.

industrial zone could establish and maintain such a system for the benefits of its clients, on a cost recoverable basis for users of the facility.

At another level, the zone management could organize regular business exchanges between client enterprises and prospective larger business partners and clients to facilitate the conclusion of business deals, here again the effort would be on a cost recoverable basis from participating/beneficiary enterprises.

These are but two examples of many possibilities that could be created to facilitate business opportunities between the zone's SME members and larger client enterprises. The main issue that is raised here is that *the zone manager's role need not be limited to attracting investment and facilitating the establishment of the zone. The zone manager could continuously act as a business facilitator, providing or facilitating business development services (provided on commercial bases) that would help the client enterprises of the zone to grow and improve their businesses*.

As a development tool, the IZ could **offer programmes for entrepreneurship development** through business development centres**, in cooperation with external partners.** These programmes could be directed to existing enterprises seeking to improve their business operations as well as to prospective clients of the zone.

A catalytic development role that could be played by the zone would be in the provision of business incubation services to prospective entrepreneurs seeking to develop promising business ideas, especially in sectors already represented in the zone. This incubation could be in numerous forms, ranging from providing young entrepreneurs office and communication facilities at nominal cost to more formal mentoring services, which could involve zone client companies and could help shape and realize business ideas.
If a zone is cluster or sector based, it could **facilitate the training and development of human resources** at management and skilled worker levels. Courses, tailor made to the needs of client enterprises, could be offered in partnership with specialized external partners as a continuous service to fortifying the human capabilities of client enterprises.

This subsection identifies some of the development roles and services that could be continuously offered to clients of the IZ. Recent evolutions in IZs point to these sorts of activities being increasingly becoming part of the operations of modern zones. Cases have been reported of privately operated zones that derive about 50% of their incomes from such support services to client businesses[41]. The incorporation of features as those outlined would not only enable IZs to be more robust development tools in Iraq's industrial context, but also furnish the zone with more opportunities

41 "Special economic Zones--performance, lessons learned, and implications for Zone development" FIAS, World Bank Group April 2008,P. 21

for extending its revenue stream beyond the development, lease/sale and management of the real estate assigned to the zone.

As a strategic approach, the combination of infrastructure and the provision of business development services would serve to fortify the domestic business sector in Iraq and thereby, possibly, improving the business climate for foreign investors by increasing the network of their potential Iraqi business partners.

Specific to the Iraqi context is the possibility of creation of domestic value chains and subcontracting arrangements in the context of SOE restructuring/rehabilitation. The necessity of rehabilitating State Owned Enterprises is widely recognised in Iraq. However, there is equal recognition to proceed with care given socio economic sensitivities arising from the extent of employment offered by this sector as well as a host of governance issues arising from the fragile administrative and political environment.

One of the important considerations, in the restructuring/privatization/revamping of public sector entities in Iraq or in any other country, is that of the social safety net offered to redundant employees. IZs could play a role in partially answering that concern. The restructuring process of SOE's could proceed on the basis of hiving off non-core functions to smaller subcontractors, some of whom could be the released employees and management of the SOE in question. If SOEs could partner with IZs, a support facility could be created for these employees to initiate their own small-scale business ventures, either as suppliers to the SOE or to third parties and markets within their erstwhile sphere of business. The example of the Plock Industrial and Technological Park visited in Poland by a study tour organized under this project was particularly illustrative of the possibilities. A Polish state owned company in the petroleum sector (PKN Orlen) was restructured. Being the largest employer in the municipality of Plock in which it was established, it partnered with the municipality to create and jointly manage an industrial zone that offered business development services to former employees and locally-established firms. Thus, rather than being a neutral entity, the Polish SOE was able to play an active role in local economic recovery and restructuring.

In this connection, industrial zones could be established as extensions of actual SOE factories or facilities. This approach could come within the scope of Iraqi SOEs' rehabilitation efforts and help create the aforementioned synergies and subcontracting/value chains dynamics.

Finally the Industrial Zone could act as a nucleus for **the creation of Innovation Systems,** particularly in support of Small and Medium Enterprises. The concept of an innovation system is not new, and found in a range of instances, it could be a creation of the spontaneous activity of private enterprises, or the interaction between private enterprises and public institutions such as universities, or contract research initiated by the private sector to other private research institutions or in the domain of publicly funded research and development. While the term suggests high technology applications, innovation systems encompass both the hardware and the software of productive enterprise, and as such could have relevance to any scale of enterprise or any scale of business development. For example, an innovation system could:

- Bring together entrepreneurs and universities and research or technical institutions to improve simple business management practices
- Debottleneck production processes
- Improve overall productivity at the level of a firm.

Iraq possesses numerous institutions of higher education with considerable engineering or business management skill sets in their faculties and advanced study departments. These skill sets could be harnessed by a corporate effort by the zone and its tenants to engage technical resources of these institutions for the collective productive benefit of a whole cluster.

4. Conclusion

A successful strategy for attraction of client investments into Iraqi IZs has several aspects:

- The provision of business registration, licensing, infrastructure and security services offer the promise of success in attracting client investors to the zone, provided that the management of the zone is empowered within its jurisdiction and is efficient. These factors are crucial to any investment promotion effort for the zone;
- At the initial stage the concentration should be on attracting domestic entrepreneurs and those from the Iraqi diaspora. Successful efforts in this respect would help restore domestic business confidence, and set the stage for efforts to draw foreign investors;
- In parallel to the sort of facilities provided to domestic entrepreneurs, there are crucial changes required to the laws governing foreign investment. These changes will set the stage for enabling wider foreign participation in the IZ. Pending the legal reforms, industrial zones could offer a special policy package offering special incentives to foreign investors with clear and irrevocable provisions for third country arbitration;
- The IZ should not be seen as a static facility, but as an agent for development and change. Through imaginative programmes and partnerships, it could offer its clients a number of tailored business development services, making it a more effective partner for the development and diversification of the Iraqi private sector.
- Consequently, the evaluation of the success of the zone should not only be based on the extent of occupancy by tenants and the number of investments attracted into the zone, but also against indicators (such as those enumerated and discussed in this Annex) that demonstrate the improvement of business operating conditions compared to those currently operating in Iraq as well as comparators in the MENA. A proven track record of improved

operating conditions would be the most powerful source of attraction for potential client investors for the zones.

As a recent World Bank Study notes[42]:

> "*Zones cannot and should not compete on the basis of fiscal incentives, but rather differentiate themselves in terms of facilities, services, and most importantly, streamlined procedures, and purpose-built technology. International manufacturers have realized that there is much greater scope to reduce logistics costs than production costs. This can be accelerated within a zone setting by reducing transaction processing times and paperwork requirements. Many zones, especially those that are privately run, are rapidly reconfiguring themselves into efficient distribution, production, and trade facilitation hubs to reduce logistics costs in order to meet this demand from international operations*".

Points for Action by the High Level Steering Committee:
This review of the challenges confronting Iraq, current trends in IZ development and the use of IZs as overall policy instruments suggests that the High Level Steering Committee undertake to establish an Iraqi Strategy for IZ development. That strategy would link IZs as tools for overall national development goals, indicate the minimum services that should be offered by the IZs in order to be effective development goals, while indicating the wider possibilities for IZs to act as catalysts for Private Sector Development in Iraq.

The Strategy would help the High Level Committee to lead the process of IZ development throughout Iraq while also forming a basis for the development/modification/streamlining of rules and regulations in support of the strategy.

If so desired by the GOI, external assistance could be made available in order to help define that strategy.

Annex 1: The need for improved Infrastructure Services and Business Facilitation

It is instructive to look at Iraq's comparative global position in the ease of doing business. The World Banks's annual report, "Doing Business 2014" ranks Iraq at 151 (out of 189 economies) in the ease with which business can operate. Furthermore the report ranks countries under several sub topics. The rankings of Iraq are presented in the table below:

Table 1: Iraq's global position in various topics affecting business startup[43]

42 Special economic Zones--performance, lessons learned, and implications for Zone development" FIAS, World Bank Group, April 2008.

43 Source: World Bank "Doing Business 2014" http://doingbusiness.org/data/exploreeconomies/iraq/

Topics	DB 2014 Rank	DB 2013 Rank	Change in Rank
Starting a Business	169	168	⬇ -1
Dealing with Construction Permits	20	28	⬆ 8
Getting Electricity	39	49	⬆ 10
Registering Property	108	99	⬇ -9
Getting Credit	180	177	⬇ -3
Protecting Investors	128	127	⬇ -1
Paying Taxes	63	65	⬆ 2
Trading Across Borders	179	182	⬆ 3
Enforcing Contracts	142	143	⬆ 1
Resolving Insolvency	189	189	No change

Iraq fares comparatively well with regard to obtaining construction permits and electricity, as well as with the administrative procedures involved in paying taxes. However Iraq ranks well into the lower half of the 189 economies in all other areas of business regulation.

The indicators point to a clear set of priorities that need to be addressed by policy reform as well as Industrial Zones as instruments for the facilitation of private investment. There is a pressing need for regulations and management that would help improve conditions governing business startup, the registration of property, investor protection and trade facilitation. In addition, the Industrial Zones' management could help client investors in obtaining credit, the enforcement of contracts and the resolution of insolvency. All the areas just enumerated are critical deficiencies in the prevailing regulatory and business climate in Iraq.

Table 2 presents comparisons between Iraq, the rest of the MENA region and the OECD countries with regard to the procedures, time and costs involved in starting a business.

Table 2: Comparison of indicators on business start up[44]

Indicator	Iraq	Middle East & North Africa	OECD
Procedures (number)	10	8	5
Time (days)	29.0	19.8	11.1
Cost (% of income per capita)	39.3	28.9	3.6
Paid-in Min. Capital (% of income per capita)	13.1	45.4	10.4

Indicators such as these can be used to define priorities for the management of the zone and for the improvement of specific aspects of the business climate in Iraq.

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[44] ibid.

Annex 2: IZs, Business Support and Development Services

This annex discusses examples of how Industrial and Economic Zones have successfully been used as part of industrial policy in some developing countries.

Zones as policy instruments

Industrial zones, special economic zones, technology parks etc. have been targeted at numerous policy objectives of varying complexity. To enumerate just some of the objectives, such facilities have been used for purposes of municipal planning, attraction of DFI, development of export oriented industry that can integrate a country into global value chains, deepening of technological capacities, regional development within a country in order to increase local productivity and employment, development of industrial clusters, support to the development of SMEs, etc.

Provision of infrastructure and services and IZ revenue models

Private sector participation and the necessity for commercially profitable zone operation are increasingly changing the business models of zones. As zones compete to attract investments, both within and between countries, they are tending to rely less on mere rental or sale of competitively priced (and sometimes publicly subsidized) land and facilities. Instead modern zones are seeking to differentiate themselves from competitors by offering integrated facilities that offer land and infrastructure for industry in combination with supporting logistical, commercial, recreational and tourist facilities that can create fully articulated locations designed to attract labour and capital. As a recent World Bank study notes, this integrated approach allows for the diversification of revenues from zone operations, and at the same time ensures the financial viability of zones by augmenting low profitability from sales or rental incomes of industrial land and facilities with the profits from higher value business components of the zone.

In the context of business development, zone managers are increasingly offering a variety of business support and development services to client investors or the sectors targeted in the zones. Thus the integration of services and facilities offered by IZs is an appealing strategy in both operational and financial perspectives.

Zone performance in order to achieve development goals is not simply a matter of the design or the formulation of policy. The translation of intent to policy requires continuous strategic interventions by either the state or the zone manager to realize these goals, during the actual operations of the zone. There is a rich experience in the successes and failures of interventions in support of development goals intended for the zones. The East Asian economies as well as China offer some instructive examples of successful design and policy implementation issues as well as providing non-financial investment support and business development services.

Industrial zones and technology promotion

With regard to the *development of technology based zones* that would help the diversification and deepening of technology, SEZs have been established in Malaysia, Taiwan (China), Singapore, and elsewhere, targeting enterprises in a certain technological sphere or sector. The Laem Chabang industrial estate in the Thai Eastern Seaboard is configured for petroleum and chemical industries. SEZs catering to the software and informatics services industries have been developed in India, Jamaica, the Dominican Republic, Mauritius, and elsewhere. All these zones have purpose built infrastructure. Fiscal incentives are not so important in attracting client investors as the Government's/zone developer's offer of appropriate tailored infrastructure, human resources and a set of operating conditions that enable the client businesses to establish themselves. Usually such zones are established at or near facilities such as universities that offer facilities for applied research and development as well as skilled labour required by client industries. In addition, in some instances Governments support university and on-the job skills development programmes that can generate the necessary local skills base for the targeted sector. Also, in a few instances (especially in the IT/Information technology field) common spaces and facilities are designed in the zone with the intent of allowing interactions among zone tenants, where ideas can be exchanged, support businesses incubated and common issues and problems dealt with. Thus technology or science parks offer the most complete example of how zones are used as instruments for industrial and technological development policy.

Cluster development

In recent years and in the context of developing countries, the stimulation of industrial clusters has become an explicit subject of industrial policy. Perhaps some of the most successful examples in cluster development through industrial zones can be found on the Pacific coastal region in Southern China[45]. Industrial clusters in this region span across a number of provinces, and the industrial sectors are diverse, ranging from synthetic yarn, weaving, garmenting, footwear, garmenting ancillaries to metalworking and automotive industries. Despite the diversity, certain common factors are readily identifiable in the use of IZs as platforms for cluster development. These factors are:

- The sectoral focus of the IZ/Special Economic Zone was usually determined by local/provincial governments based on an appreciation of local resources, skills and traditional industries
- The government allocated land and on site infrastructure for the IZ development, and also invested in offsite infrastructure and logistics for improving the trading efficiency of the targeted region, for serving domestic or export markets
- Government actively solicited (including the provision of fiscal incentives) dynamic anchor investors, who could grow and become growth nodes for the development of the cluster
- Business start-up and registration procedures were simplified and managed by the Zone authority in order to facilitate the establishment of operations by large or small scale client firms
- Smaller enterprises were provided favourable conditions for the start-up of business in the Zones, through favourable land acquisition prices, and other means such as subsidized credit or even the creation of new

45 Tales from the Development Frontier: How China and Other Countries Harness Light Manufacturing to Create Jobs and Prosperity. Washington, DC: World Bank. © World Bank 2013.

micro credit and equipment leasing schemes that would enable the start-up of micro and small enterprise

- Once the zone was established and populated by thriving businesses, government, as zone manager, supported the cluster as a whole by such measures as furnishing management and human resource development programmes, providing facilities for trade and market development exhibitions, creating research and development linkages and quality control and certification programmes
- A continuous effort was undertaken to recognize and stimulate market innovation. Inter firm competitions or other types of forums were established to recognize and reward brand and product development or technological innovations by firms
- Partnership were established and investments were made with local, regional, national and international institutions to expose client firms to latest technological innovations and provide them R&D support for the development of their businesses
- An apparently clear demarcation of where government should act and where the private sector should take over. Generally stated the government created conditions for common support to enterprise once the cluster was established and leading nodes of the cluster were established.

The successes of industrial clusters based in IZs in the Southern Chinese region were due to a high degree of local ownership in the zone, a continuous partnership between government and private business, spanning the creation of the zone and its cluster as well as its continued development and growth. These are lessons that could well be adapted to the Iraqi context. The creation of *subcontracting partnerships* could equally benefit from the type of measures just summarized.

<u>Entrepreneurship development</u>

Entrepreneurship development is a topic that encompasses the economy as a whole and is rightfully the subject of national development and competitiveness systems. Its scope is far wider than the IZs. However IZs can be a tool in overall national efforts at fortifying entrepreneurship capabilities and opportunities. In particular, IZs, whether sectoral or cross sectoral, can play a role by designing the provision of *business incubation services* in their physical and operational structures. In particular the technology parks/economic zones in China and South East Asia not only provide physical facilities as business incubators but also through their facilitation of financial and non-financial support to business startups, help in promising business startups. The clustering of industry in a zone acts as a strong working environment within which such business startups can succeed.

<u>Human capital development</u>

Finally, IZs can act as promoters and stimulants of the demand and supply of improved human resources in the local economy. As concentrated centers of industry, economic zones can be designed to help overcome some of the challenges of local employment that exist throughout the economy. These include: challenges in finding suitable talent (a problem of matching), challenges in finding suitably qualified talent (a problem of training), and challenges of providing evolving talent to match the requirements of industry (a problem of alignment). Government and human resource development institutions (comprising the educational or vocational training systems) can help address these challenges by offering better training options and more relevant training. Such “demand-oriented” training programs are facilitated by the physical infrastructure. However the infrastructure, while necessary, is not sufficient to ensure the relevance and effectiveness of training. It needs to be backed up by a consultative process involving the stakeholders—industry, training institutions and the Government—in keeping abreast of changing needs and requirements for human resources. Zone developers can play a role in bringing this group of stakeholders together to address common workforce challenges. Consortia of co-located employers in similar industries can jointly offer their guidance and point of view on recruitment and selection of trainees, core curriculum requirements, appropriate assessment tools and effective job placement mechanisms. Trainers and educators can then work with this input to provide a service that will graduate useful and productive employees who will find work in the industry or industries housed in a particular zone. Thus while the supply of human resources is an economy wide issue, industrial zones can play their part in ensuring the continued relevance and effectiveness of human resource development systems.