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# **BUSINESS FREEDOM IN THE KURDISTAN REGION OF IRAQ: ENVIRONMENT AND CHALLENGES**

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# Imprint

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# Index

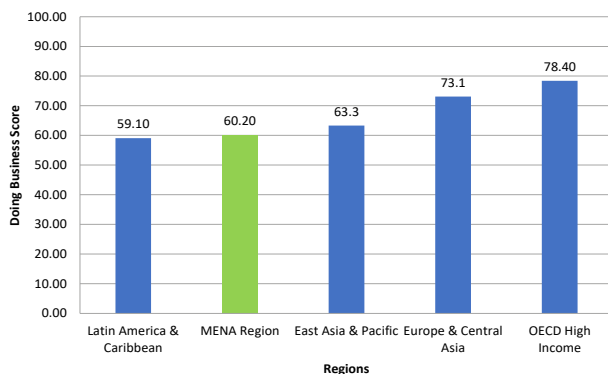
<b>1. INTRODUCTION .....</b>	<b>4</b>
<b>2. THE BUSINESS SECTOR IN IRAQ: PAST AND PRESENT .....</b>	<b>5</b>
<b>3. BUSINESS ENVIRONMENT IN THE KRI .....</b>	<b>8</b>
<b>4. BUSINESS ENVIRONMENT UNDER THE NINTH CABINET OF THE KRG.....</b>	<b>9</b>
<b>5. THE CHALLENGES OF BUSINESS ENVIRONMENT IN THE KRI .....</b>	<b>11</b>
5.1. The Weakness of The Institutional Structure.....	11
5.2. Imbalances in The Economic Structure.....	11
<b>CONCLUSION .....</b>	<b>12</b>
<b>REFERENCES.....</b>	<b>13</b>

# 1. Introduction

Business freedom constitutes an essential driver of economic growth and economic development (Beck, Thorsten; et al., 2003). The ability of individuals to establish and manage their own businesses without undue interference from the government gives a great incentive to expand investments and increase economic growth rates. Cumbersome and costly regulations are the most common barrier to business freedom, e.i., entrepreneurship. They increase production costs and waste a long time, which makes it difficult for investors and entrepreneurs to achieve success in the market (Miller, Terry,; et al., 2021, pp.15-16).

Although the Middle East and North Africa (MENA) region, including Iraq, has enormous economic and human potential, the level of its business environment is considered vulnerable compared to other regions (Doing Business Report, 2020). Figure (1) shows that the average score for doing business in the MENA region is 60.20 out of 100, which turns out that the business sector, suffers from an unfriendly environment for doing business.

Figure 1: Average Doing Business Score in the MENA Region, 2020.



Source: Adopted by the author from World Bank, Doing Business Report, 2021.

Moreover, academic studies and reports attributed the poor performance of the business sector in the MENA region to a set of multiple and complex constraints including political and security instability, lack of legal protection of property rights and contracts, social, religious, and bureaucratic constraints, as well as colonial heritage. As business sector has been used as a tool to enable political elites and governments to control economic and social affairs. Consequently, business sector has emerged as a sector dependent on the government and political elites enabling rent-seeking and protectionism (McMahon, Fred, 2014, pp.2-4).

Regarding the Kurdistan Region of Iraq (KRI), despite various political, economic, and bureaucratic obstacles, the performance of the business sector during the period 2007-2013 was relatively more effective than the current period. At the moment, the business sector is experiencing significant slowdown and confusion. The unemployment and poverty rates are more than 9 percent and 5.45 percent respectively (KRSO, 2020)<sup>2</sup> with a huge accumulation of public debt.

Accordingly, this paper endeavors to study the extent to which the economic, political and social environment in the Kurdistan Region Iraq (KRI) is compatible with the requirements of business freedom, by examining the business environment and the challenges it faces. For this purpose, Doing Business indicators<sup>3</sup> are used to analyze the business environment in the KRI. These indicators may assist in comprehending the state of business freedom. In the same vein, the study of business freedom in the KRI provides policymakers with insights into the extent to which the efficiency of the business sector in achieving economic growth and provides a clear roadmap for business environment reform including laws, regulations, and policies that govern the business sector.

The rest of the study is organized as follows. Section 2 explains the business sector in Iraq: past and present. Section 3 examines the business environment in the KRI. Section 4 analyzes the business environment under the ninth cabinet of the Kurdistan Region Government (KRG). Section 5 presents the challenges of business environment in the KRI and final section reviews the conclusions of the study.

<sup>2</sup> The lack and unreliability of economic data are the main challenges facing scholars in the KRI. For more than three decades since the establishment of the Kurdistan Regional Government (KRG), there is still a shortage and lack of transparency of data and information. Although the Kurdistan Region Statistics Office (KRSO) exists as the only official body authorized to collect and publish data, it suffers from significant structural and financial flaws.

<sup>3</sup> Although the World Bank Group decided in September 2021 to discontinue the Doing Business report. In this case, however, it is scientifically appropriate and legitimate to rely on Doing Business Indicators to interpret the state of business freedom in a manner commensurate with the purpose of the study in question.

## 2. The Business Sector in Iraq: Past & Present

The historical evidence indicates that Mesopotamia was the cradle of free business, banking transactions, free occupations, and private profit-seeking merchants. Many historians assume that ancient Mesopotamia's civilizations, i.e., Akkad, Sumer, Babylonia, Assyria, and others achieved a prosperous renaissance due to relying on the market mechanisms as a means of operating their economies (Sanandaji, N., 2018). Also, in Islamic times, the Islamic religion, since its inception in the seventh century AD, emphasized the necessity of free market, including freedom of ownership, freedom of work, and freedom of exchange under the Koran and Islamic Law (Al Sharia) (Sakina, Boyle, 2014-2015, pp.32-33). Moreover, in his writings, Ibn Khaldun<sup>4</sup> stressed free market, including freedom of ownership, business and trade, as an engine for the renaissance of nations. Ibn Khaldun advocated for the need to protect the property of individuals from government exploitation and abuse of others and to rely on freedom of competition, freedom of entry and exit from the market, and the price mechanism to direct the market to a fair price (Sakina, Boyle, 2014-2015, pp.107; Butler, Eamonn, 2019, pp. 12-13). Such ideas had an essential role in activating free trade and free business in the era of the Islamic State, especially during the Abbasid era.

More recently, however, in the era of the modern Iraqi state<sup>5</sup>, the evidence paints a bleak picture of the business freedom environment. As a state tried to control most economic sectors and excluded several social groups from the market under political, security, or ethnic pretexts. The successive Iraqi governments used the power to control the capabilities and property of individuals and redistributed economic resources under the pretext of reform and social justice. As a result, the business environment is distorted and crony capitalism has been emerged through the control of a particular group loyal to the government or the ruling party over the private sector (Abdul Jabbar, Faleh, 2006, p.20).

The economic recession that rocked Iraq during the 1930s and up to the 1950s prompted the Iraqi government to interfere in economic affairs. The business and occupations sector, dominated mostly by Jews and Christians, was strong enough to resist the authorities by hoarding money or withholding its products from the market. However, during the 1940s and 1950s, the government used force to weaken these businesses by excluding their owners from the market or even from the country. Also, business sector suffered from a major setback due to the policy of nationalization of the oil and gas, and the adoption of a socialist and centralized economic model by Iraqi governments during the 1960s, 1970s, and 1980s; as a result, the government enabled to control major economic activities and tightened its grip on most of the country's resources (Chaudhry, Kiren Aziz, 1994, pp. 16-19). Then, the business sector was marginalized and controlled by cronyism. Its role was limited to narrow economic activities that had little impact on Iraq's economic performance. During the 1990s, most of the economic sectors in Iraq collapsed due to the second Gulf War and the international economic sanctions. As the fundamental sources of financial and human resources fled Iraq. It became one of the poorest countries in the world (Al-Nasrawi, Abbas, 1992, 3345-346). Since the Anglo-American invasion of Iraq in 2003, the Coalition Provisional Authority (CPA) has attempted to implement drastic economic reforms and foster an environment conducive to business freedom, including passing legal decisions to privatize about 200 state-owned companies, and downsizing the corporate tax rate from around 45 percent to a maximum of around 15 percent, and supporting foreign direct investment in the infrastructure and energy sectors. However, the CPA attempts were not implemented due to security and political instability, and opposition from trade unions (Weisman, Steven R., 2004). Likewise, the reform programs and policies adopted by successive Iraqi governments since 2004 remained dead letters.<sup>6</sup>

<sup>4</sup> Historical facts indicate that Ibn Khaldun was one of the most significant philosophers who interpreted the free market economy. In his writings, he explained the idea of a free economy and the importance of protecting economic rights and freedom of individuals, freedom of competition, and non-interference of the government in the markets. He also called for specialization and division of labor. Ibn Khaldun added how governments exploit the economic rights of individuals. As he described the exploitation of private property by governments or other people as a major obstacle to the flourishing of markets. Further, the attack on the private property will lead to the removal of incentives to acquire property and wealth. Namely, attacks on individuals' property will prompt them to flee from the markets. When the incentive to buy, work, trade, and own property disappears, individuals do not make efforts to acquire and develop their enterprises. Specifically, infringement of property rights reduces individuals' incentives and limits their economic freedom (Sakina, Boyle, 2014-2015, pp.107). Thus, this insight can be explained that Ibn Khaldun was prominent in developing the thought of the free economic system through broad economic, political, and social dimensions.

<sup>5</sup> Political scientists and economists distinguish between two perspectives to explain the origins of the state: The first perspective is the contractual state (the state based on the social contract), i.e., the state that employs its authority according to the rule of law to protect the rights and freedoms of individuals. Accordingly, the role of the state lies in providing public services and goods that private sector cannot provide them. The power of the state is checked by legal and constitutional constraints, which encourage the development of inclusive institutions and the flourishing of political, economic, and civil liberties. The second perspective is the predatory state (the state based on coercion and control), i.e., the state that employs its power by coercion according to narrow concepts, including the pretext of security and political stability, the national majority, or the religious or sectarian majority...etc. Accordingly, the fundamental function of the state is to control the capabilities and property of individuals, redistribute resources, and intervene in the mechanism of markets away from the rule of law. Consequently, this view will encourage the emergence of extractive institutions that restrict political, economic, and civil liberties (Acemoglu, Daron; Robinson, James A., 2012, pp.73-76; Vahabi, Mehrdad, 2019). Unfortunately, the Iraqi state falls within the second perspective. Since the British established the Iraqi state in 1921, the state has used its power through coercion and violence to control Iraqi citizens, and their capabilities and properties (Ahram, Ariel I., 2015).

<sup>6</sup> It should be noted, since 2005, in every electoral round, politicians and ruling parties in Iraq presented comprehensive programs for economic and social reform. However, these programs remained dead letters once the elections ended. Therefore, economic and social dilemmas accumulated in Iraq, which led to demonstrations and mass social and political unrest. Then, the Iraqi government and Iran-backed militias used force to quell civil demonstrations that led to the deaths of more than 700 civilians.

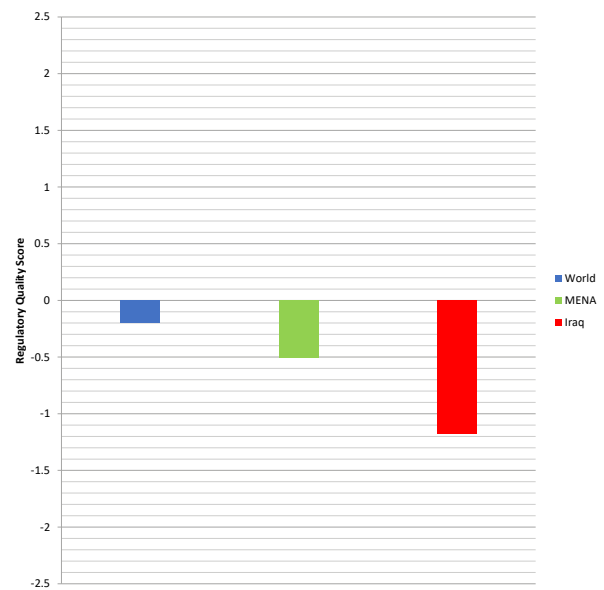
Obviously, the Iraqi constitution is clear in supporting a free market economy by encouraging and protecting property rights and the private sector, especially in Art. 1/ 23, and Art.25 (Iraqi Constitution, 2005). However, the business sector remained restricted by the legacy and policies of previous governments. In other words, the excessive regulations and policies of Iraqi governments prior to 2003, political, economic, and security instability, and corruption of the ruling elites, constituted the most challenge for the development of the business sector in Iraq. The Iraqi economy also continued to be dominated by the oil and gas sector, the expansion of the informal private sector, and the reliance on a cash economy that impeded the development of free business. Therefore, the foundations of the rentier state grew stronger in Iraq. As the oil and gas sector accounts for about 60 percent of GDP, 99 percent of exports, and more than 90 percent of federal government revenue. Further, Iraq has remained outside the WTO, due to the lack of rule of law, high level of corruption, and hegemony of militias over trade and business (UNDP-Iraq, 2020, p.6, IQIraq Media, 2021).

Moreover, the difficulties of the business sector in Iraq have been exacerbated, especially after the fall in oil prices, the occupation of large areas by ISIS in 2014<sup>7</sup>, and the outbreak of the Covid-19 pandemic in 2020. The average production of small and medium-sized enterprises fell to more than 52 percent. The employment rate for small and medium-sized firms has also fallen to more than 76 percent, in particular, among construction and manufacturing firms. The non-oil sectors such as services, trade, banking, transportation, and religious tourism incurred significant losses due to lockdown and restricted measures to prevent the spread of the Covid-19 (UNDP-Iraq, 2020, pp.9-11). Moreover, the intervention of the Central Bank of Iraq (CBI) in the value of the Iraqi dinar by devaluing it against the US dollar negatively affected the markets. Therefore, the official reports estimate the poverty rates rise to more than 31.7 percent and the inflation rate also rise to more than 5.6 percent (Iraq- Ministry of Planning, 2020-2021).

Compared to other countries in the MENA region and the world, business environment indexes indicate that Iraq is at a lower level in terms of indexes of Regulatory Quality, Cost of Starting a Business, Control of Corruption, political stability, and security. This can be clarified through the data issued by the World Bank as follows:

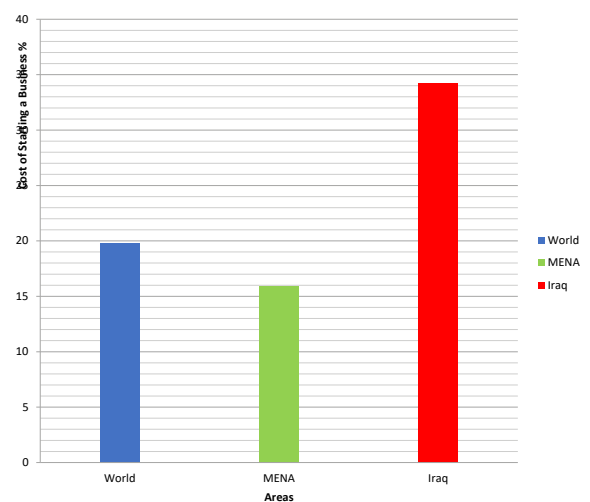
1. Index of Regulatory Quality: As mentioned, the business sector regulations in Iraq are outdated and ineffective. Such conditions negatively affect the Regulatory Quality Index in Iraq which is -1.18 out of 2.50, while the MENA region average and the world average are -0.5 and -0.2 respectively Figure (2).

Figure 2: Regulatory Quality Index in Iraq, 2020.



2. Cost of starting a Business Index: Iraq considers one of the countries with high costs to start a business compared to the countries of the MENA region, as getting a license to start a business takes a lot of money and time. It's evidenced by the average cost of starting a business in Iraq which is 34.2 percent of per capita income. At the same time, the average cost of starting a business in the MENA region and the world are estimated at 15.19 percent and 19.98 percent respectively Figure (3).

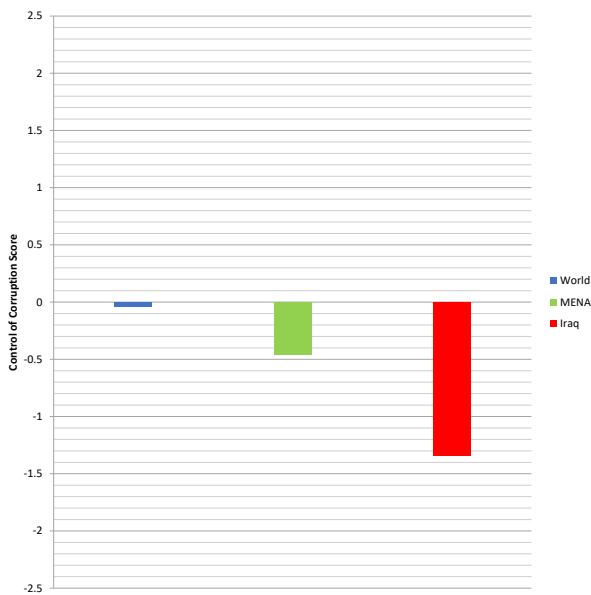
Figure 3: Cost of Starting a Business in Iraq, 2020



<sup>7</sup> Military conflicts cost Iraq heavy human and financial losses. Studies estimate that the cost of ISIS's occupation of Iraq alone about \$ 46 to \$ 88 billion.

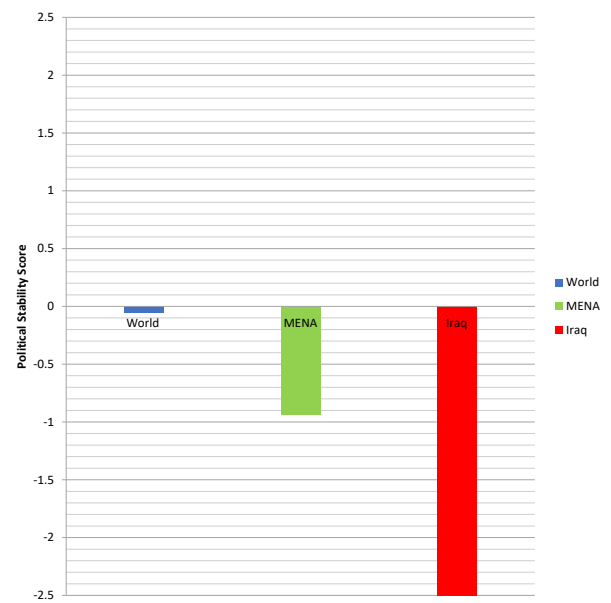
- Control of Corruption: Corruption constitutes the main factor hindering the development of the business sector in Iraq. It has become an essential part of the Iraqi political and economic system. So far, successive Iraqi governments have failed to reduce corruption. Therefore, it can be noticed through the Corruption Control Index in Iraq, which is -1.34, which is lower than the MENA region corruption control rate and the world corruption control rate of -0.46 and -0.04, respectively Figure (4).

Figure 4: Cost of Starting a Business in Iraq, 2020



- Political Stability Index: Political and security instability is endemic factors in Iraq. It is one of the biggest challenges facing the Iraqi economy, especially after the emergence of ISIS and the militias backed by Iran. Security threats to businesses increased, as these militias began to use force to obtain fees and royalties from business owners. Thus, Iraq scored the lowest rank on the political stability index, which is -2.56. It is also lower than the average of political stability in the MENA region and the world, which are -0.94 and -0.06, respectively Figure (5).

Figure 5: Political Stability Index in Iraq, 2020



Source: Adopted by the author from World Bank, 2021.

Summing up, the business sector in Iraq suffers from various obstacles and shortcomings. It is the victim of a complex set of interlocking constraints of historical, political, and economic dimensions that have prevented its development.

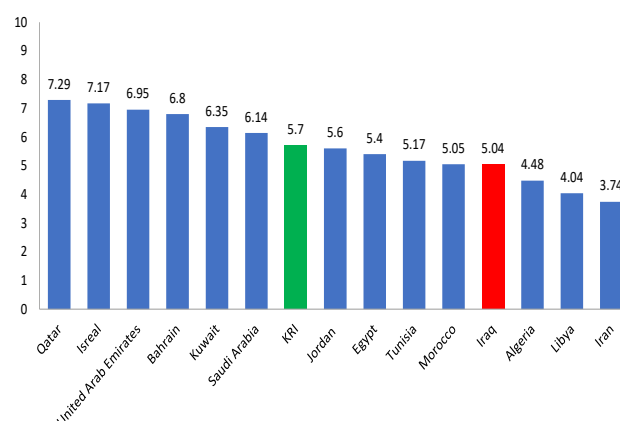
## 3. Business Environment in The KRI

The concepts of freedom, independence, peace, diversity, self-reliance, and good governance occupy a great place in the cultural heritage and the political and social literature of Kurdistan. Political parties and civil movements attempted to translate these concepts into action after the 1991 uprising that led to free elections in 1992. However, it seems that these trends were just an empty mottoes. As they were hampered by the predatory war between the two main Kurdish political parties, the Kurdistan Democratic Party (KDP) and the Patriotic Union of Kurdistan (PUK) during 1994-1998, which dismantled the cultural, social, political, and economic foundations of the KRI (Ahmed, Mohammed M. A., 2012, pp. 9-10).

At the same time, the initial trends towards the free-market economy appeared in the KRI. Namely, the beginnings of development in the free business sector in Kurdistan go back to 1991 when the Iraqi government institutions withdrew from the KRI. Despite various administrative and organizational shortcomings and the internal bloody war between the KDP and PUK, a friendly environment arose for the expansion of the business sector. The trade sector formed a nucleus for the development of the business sector in Kurdistan region. Accordingly, the KRI has become a significant commercial center and gateway for the export of oil derivatives and the import of tobacco, foodstuffs, and constructions materials from Turkey and Iran. It was a meeting place for Iraqi, Turkish, and Iranian merchants. The free trade movement contributed to the accumulation of capital and the employment of the local workforce. Further, it led to enrich the experiences of local merchants in making commercial decisions, concluding and implementing commercial deals, and dealing with foreign commercial banks, especially Turkish banks (Saadoun, Azad Ahmed, 2000, pp 243-244).

Moreover, the period 2003-2013 represents the most significant period in which the business sector in the KRI achieved remarkable growth. During this period, the KRI has been recognized as a federal region within the Iraqi state under the Art. 1/117 of the 2005 Iraqi constitution, and the institutions of the Kurdistan Regional Government (KRG) have unified. As a result, the KRI enjoyed a better and safer business environment than the rest of Iraq. According to the EIU assessment, the KRI score on the Business Environment Index<sup>8</sup> is 5.70 out of 10, which equates to a rank of 57 out of 83 countries. It tops the MENA region average of 5.66. By contrast, Iraq ranked 72nd with a score of 5.04 out of 10 see figure (6) (EIU, 2014, pp. 31-33).

Figure 6: Business Environment Index of the KRI and MENA Region Countries, 2014.



Source: The Economist Intelligence Unit (EIU), 2014, Benchmarking the Kurdistan Region, p.33.

The laws and policies adopted by the KRI authorities have had the advantage of creating an environment conducive to doing business and attracting investments. Specifically, the KRI Investment Law No. 4 of 2006 is one of the main laws that encourage private businesses and attract investments to the KRI. It is considered one of the most liberal investment laws in the Middle East (Nikolova, Lili, 2013, p.19). Accordingly, foreign investors are treated as domestic investors in terms of rights and duties. Investment projects are exempted from paying taxes and fees for 10 years. The investment law limits financial barriers to the entry and exit of capital for investors. During the period 2006-2019, the number of licensed investment projects reached 890, and the invested capital amounted to more than US \$52 billion. More than 16,000 acres have been allocated for investment projects. These investments are distributed between 81 percent local investment, 12 percent foreign investment, and 7 percent joint investment (KRG-Board of Investment, 2020, p. 4).

However, since 2014, the business environment has been subjected to complex challenges, including the occupation of areas adjacent to the KRI by the Islamic State in Iraq and Syria (ISIS), a drop in oil prices, the KRI's bad governance, and political conflict between the KRG and the Iraqi Federal Government. All together has led to the deterioration of most economic activities and social conditions in the KRI. In other words, these challenges led to the flight of foreign investments from various economic sectors, the closure of free businesses, the bankruptcy of many companies, and the failure of the KRG to fulfill its obligations, as well as the influx of about 1,800,000 displaced people and refugees from other regions of Iraq and Syria (World Bank, 2016; MERI, 2016).

local merchants in making commercial decisions, concluding and implementing commercial deals, and dealing with foreign commercial banks, especially Turkish banks (Saadoun, Azad Ahmed, 2000, pp 243-244).

<sup>8</sup> The business environment index has been found and published by the Economist Intelligence Unit (EIU) since 1996. The 2014 reports covered 82 countries. It includes 89 indicators that are distributed between ten categories including political environment, the macroeconomic environment, market opportunities, private enterprise and competition policy, foreign investment policy, foreign trade and exchange regime, taxes, financing, the labor market, and infrastructure. To measure the business environment index, the EIU experts used quantitative and qualitative methods. And, the index scored from 0 to 10, as 0 represents the lowest score, and 10 represents the highest score of the business environment (EIU, 2014, p. 31).



## 4. Business Environment Under The Ninth Cabinet of The KRG

In July 2019, the Kurdistan Parliament approved the formation of the ninth cabinet of the KRG. The new cabinet has formed from three major political parties including the KDP, the PUK, and the Gorran Movement. Its agenda mainly focuses on economic and political reform. Specifically, it has focused on reforming the public sector and tax system, promoting the private sector and private investments, establishing a fund for oil and gas revenues, protecting the rights and freedoms of individuals, establishing e-government to reduce bureaucratic restrictions, and adopting transparency and fairness in government institutions (KRG Media, 2019). Further, the KRG has put in place a program to develop a public-private partnership (PPP) framework, particularly in the areas of healthcare, roads, electricity, and water (KRG Media, 2020).

However, none of these reforms have yet been translated into actions. The public sector continues to suffer from corruption and stagnation, the e-government and the oil and gas revenues fund have not been established, and there is a decline in business and private investment due to high rates of taxes and fees and excessive bureaucratic restrictions. Furthermore, despite the government raising tax rates and customs duties by an average of 30 percent-35 percent, and deducting 21 percent of the salary of each government employee per month, the public debt has increased from about \$28,500 billion to \$31,637 billion.<sup>9</sup> Consequently, the government actions have hurt doing business environment, which is already suffering from poor funding and excessive restrictions. Thus, the current environment of the business sector in the KRI can be briefly explained through the following indicators:

1. **Starting a Business:** This indicator is based on the calculation of the number of administrative procedures, the time, the cost of per capita income, and the minimum capital to per capita income required to start a business. The fewer administrative procedures, time, cost, and minimum capital, the more motivating investors and entrepreneurs to do their business in an easy and smooth manner (Doing Business Report, 2020). In the KRI, the administrative system is still outdated, so starting a business requires complicated bureaucratic procedures, a long time, and high costs. Starting a business requires about 12-17 procedures, 60 days, and costs more than 45 percent (per capita) and about 35 percent - 45 percent (per capita) as a minimum capital (KRG-Companies Registration Department, 2020).
2. **Property registration:** This indicator measures the administrative and technical level of land and property administration, as well as the number of procedures, time and cost required to register property (Doing Business Report, 2020). The General Directorate of Real Estate Registration in the KRI concerns with registering lands and properties and all changes and procedures that take place on the land including buying and selling, changing the type and design of the land, drawing maps, estimating the value of the land, determining disputes over ownership, and implementing orders issued by civil courts about the land, following the amended Real Estate Registration Law No. 43 of 1971 and Iraqi Civil Law No. 40 of 1951. All administrative procedures are done by handwriting and papers, and technical procedures such as land surveying and designing are done by traditional methods. Therefore, property registration requires more than 10 procedures that must be performed between several institutions, including the Land Registry Department, the Real Estate Tax Directorate, and the Real Estate Bank. And then, the registering property process takes about 60 days for the KRI citizens, and for foreigners, it may takes 365 days, and it costs 3 percent of the property value (KRG-General Directorate of Income Tax and Real Estate Tax, 2020).
3. **Enforcing Contracts:** This indicator measures the costs and time required to resolve commercial disputes between different parties in the market through the courts (Doing Business Report, 2020). Accordingly, although there are several laws and regulations for resolving commercial disputes in the KRI, they are not fully and transparently implemented. The judicial system in the KRI suffers from administrative and technical shortcomings and political party interference. There are also no commercial courts to adjudicate commercial cases. As the commercial disputes are resolved by the civil courts. Therefore, the role of the courts remains poor in resolving commercial disputes. In many cases, clan elders intervene to resolve trade disputes between the conflicting parties. Whereas the commercial disputes with foreign companies transfer outside the KRI and Iraq due to the inability of the courts. Thus, resolving a commercial dispute in the KRI requires 183 days and costs 24 percent of the lawsuit value.<sup>10</sup>

<sup>9</sup> Practically, the ruling parties in the KRI do not believe in good governance and transparency of information and data. They controlled all official institutions. Consequently, it is difficult to obtain information and data on most economic activities, including oil revenues, oil and gas contracts, tax revenues, etc. Thus, the information published by some MPs and media considers only an official source for information.

<sup>10</sup> This information was collected through extensive interviews conducted by the author with employees of the Real Estate Department of the KRI and a group of lawyers and businessmen, Duhok, 2020.

4. **Getting Electricity:** This indicator measures all the procedures, time and costs required to obtain electricity for a commercial project. Reducing the number of procedures, time, and costs required will speed up the creation of business ventures (Doing Business Report, 2020). In the KRI, the lack of electricity supply is one of the main obstacles to doing business. The project owner shall bear all costs of obtaining electricity, including electrical materials and tools, electricity transfer costs, and administrative fees. Thus, getting electricity requires 28 procedures, 30 days, and more than 80 percent of the per capita income. Regarding the price of electricity, since February 2021 the KRG has raised the price per kilowatt/hour by 20%, with the price of one kilowatt for commercial projects reaching more than \$0.081 (Sirwan, Dilan, 2021). Further, the electricity sector in the KRI suffers from technical problems and corruption, which constitutes a major obstacle to increasing the electricity supply.
  
5. **Trading across Borders:** This indicator measures the number of administrative procedures, time, and cost required to export and import goods and services. The fewer bureaucratic constraints, time, and cost required, the higher the volume of trade (Doing Business Report, 2020). The infrastructure of the trade sector in Iraqi Kurdistan is still outdated, as it relies on traditional methods of organizing administrative and logistical processes for the exchange of goods and services. Therefore, the process of importing goods requires 16 procedures and 38 days. While the process of exporting goods takes 10 procedures and 28 days (KRG-General Directorate of Customs, 2020). Regarding the costs required, the data published by the Kurdistan Parliament members indicate that the border crossings in Iraqi Kurdistan take about 13 types of fees from traders, which led to an increase in the costs of trade through the border crossings of the KRI (Saleh, Ali Hama, 2021). This prompted traders to relocate their trading operations to border crossings under the control of the Iraqi federal government.

Summing up, despite the KRG promises and slogans to reform and support the business sector, the experiences indicate that the business sector continues to suffer from complex and costly regulations and restrictions. All operations related to doing business are carried out according to traditional methods, starting from the registration of the commercial project and obtaining licenses, land, and electricity until closing the project. Such restrictions constitute an obstacle to the expansion of the business sector in the KRI. Therefore, the KRG must translate laws and decisions into action transparently and fairly to enhance the business environment in the KRI.

## 5. The challenges of Business Environment in the KRI

There are severe and overlapping challenges facing the business sector in the KRI. These challenges are mainly related to the weakness of the institutional structure including the fragility of the political, security and social environment, and imbalances in the economic structure. The following subsections endeavor to analyze the main challenges impeding the progress of the business sector in the KRI.

### 5.1. The Weakness of The Institutional Structure

The KRI is a constitutionally recognized semi-autonomous region in northern Iraq. Its government, the KRG is located in Erbil. The KRG enjoys a parliamentary democracy with a regional council of 111 seats. In other words, the Iraqi constitution of 2005 recognized the institutions of the KRI, including the executive, legislative and judicial institutions, as well as laws and contracts. Further, according to Art. 120 of the Iraqi constitution, the regions have the right to create their own constitution (Iraq Constitution, 2005). However, the KRI still does not have its own constitution, as the ruling parties elude and evade writing the constitution, believing that the constitution will impede their control of the power and economic resources of the KRI. Consequently, institutions in KRI face significant challenges, which are the blatant neglect of the rule of law and good governance, lack of transparency, and the fragility of the political, economic, and security environment (LSE-the Middle East Centre, 2018, p. 6-9). The ruling parties organized public and private institutions according to their partisan interests, and practiced centralization, politicization, and favoritism (Jameel, Hemn Namiq, 2017). Thus, extractive (predatory) institutions and strong patronage network appeared aimed at extending the control of the ruling parties over the economy and society (LSE-the Middle East Centre, 2018, p.9). Major projects and private companies have been distributed among the ruling parties and influential elites away from the market mechanism and transparency, which led to a certain group of society monopolizing most of the economic projects, and it became difficult for entrepreneurs and investors to establish the business without the consent of the ruling parties.

In the absence of the rule of law, the role of informal institutions has expanded, including the increasing role of clan leaders and former military and security leaders in society and public services have deteriorated. All these factors have led to a decline in individuals' trust in the political, economic, and security system, and an increase in social unrest and immigration rates from the KRI (Global Partners Governance, 2020, p.41). Ultimately, business and investment in several economic sectors have declined. This situation can be explained by the fact that the dominance of puritanical (uncivil) traditional values and standards may conflict with the values and norms of free economy and good governance <sup>11</sup>(Noori, Nyaz Najmalddin, 2016).

Furthermore, the KRI has recently witnessed a fragile security environment due to the threats posed by the Islamic State in Iraq and Syria (ISIS) and the Iraqi militias backed by Iran and the Kurdistan Workers Party (PKK). Namely, ISIS attacks in the "disputed territories"<sup>12</sup> have recently escalated, and there is a fragile peace between the KRI and the Iraqi militias backed by Iran and the Kurdistan Workers Party (PKK) (the Arab Weekly, 2021; Baban, Salah Hassan, 2021). Undoubtedly, the escalation of security turmoil harms the business and investment environment.

### 5.2. Imbalances in the Economic Structure

The characteristics of the rentier economy are dominant the economic structure of the KRI. As the KRI's economy is highly dependent on the oil sector, either directly or indirectly. Oil revenues make up more than 54% of the KRG's public revenues (World Bank Group, 2016: p. 21; KRG Media, 2021, pp. 19-20). Heavy dependence on oil revenues increases the uncertainty in the business environment. In other words, economic prosperity prevails and structural distortions disappear when oil prices rise and government revenues increase, while economic decline prevails, and structural distortions come to the surface when oil revenues decline. Thus, a business cycle of boom-bust and an uncertain business environment arises.

<sup>11</sup> A free economic system relies on powerful systems of values and norms, including mutual trust, dignity, and rationality. Such values and norms may help individuals to carry out business transactions efficiently and smoothly. The absence of such values and norms among competitors in the market makes a free economic system incomplete or distorted (Sen, Amartya, pp.262-265).

<sup>12</sup> The disputed territories of Iraq are regions defined by article 140 of the Iraqi Constitution 2005 as being Arabised during the Ba'ath Party rule in Iraq. These territories include a diverse mixture of nationalities and religions, Kurds, Assyrians, Yazidis, Turkmens, Shabak, and Arabs.

An increase in oil revenues led to an expansion in the size of the public sector. The public sector is a key driver of employment in the KRI. It employs between 65 percent and 68 percent of the workforce (Hawrami, Ashti, 2016). Therefore, public expenditures are the primary driver of economic growth. About 97% of public expenditures are allocated to salaries, pensions, social assistance, and subsidies to public servants (KRG Media, 2021, p. 21). Consequently, the size of the local private sector in the KRI remains small and undeveloped due to significant crowding out by the public sector.

Also, shortcomings in the labor market in the KRI constitute an obstacle to the business sector. The labor market suffers from stagnation, outdated laws and labor regulations, weak technical and language skills of the workforce, and limited management expertise (Heshmati, Almas, 2007, pp.6-7; World Bank Group, 2016: p. 24). The dominance of the public sector in the labor market is a major obstacle in stimulating and developing the skills and capabilities of the workforce in the Kurdistan Region. Most individuals prefer to work in the public sector because it provides them with retirement, paid vacations, regular working hours and it does not require high skills and abilities. These benefits are few or not available in the private sector in the Kurdistan Region (Hansen, Michael L.; Shatz, Howard J.; et al, 2014, p. 58).

Moreover, the outputs of the education sector are still not commensurate with the market requirements. The education sector in the KRI still follows old educational programs as it does not provide technical and vocational skills and necessary training (Heshmati, Almas, 2007, pp.6-7). In fact, developing the education sector is not a priority for the KRG, according to the previous financial and economic committee of the Kurdistan Parliament; the government allocated 4.38% to the education sector compared to 31.4% to the Ministry of Interior in the past few years.

At the same time, the underdevelopment of the banking and financial sector in the KRI is another challenge that is delaying the growth of the business sector and entrepreneurship. It suffers from a lack of liquidity, bureaucratic constraints, and outdated systems, which reduce its ability to finance Small and Medium Enterprises (SMEs) (World Bank Group, 2016: p. 25). The number of banking and financial institutions in the KRI is 90: three government-owned banks whose tasks are entirely focused on distributing the salaries and wages of public servants; 87 privately owned banks and finance companies (Kurdistan 24 Media, 2021). The banking sector in the Kurdistan Region is under the control of the KRG and not the supervision of the CBI. Banking and financial services between government-owned and private sector banks are rare. Bank and financial transfers within the Kurdistan Region and between the Kurdistan Region and the rest of Iraq are few and difficult. KRG regulations do not allow private banks to participate in the financing of public sector economic activities, nor do they allow them to pay the salaries and wages of public servants. However, some private banks and financial companies finance SMEs. The size of the credits offered

by these institutions ranges from \$2,000 to \$10,000 with an interest rate of 7-12 percent (Al-thiqa, 2020; Kurdistan Bank, 2021). Thus, the contribution of the banking and financial sector in providing loans to the private sector does not exceed 2% as a share of GDP (World Bank Group, 2016: p. 25). Moreover, the banking and financial sector has lost the confidence of individuals as a result of repeated financial turmoil and economic instability in the Kurdistan Region, which has reduced its ability to attract deposits and investments. Therefore, this is considered a major challenge for SMEs in obtaining credit opportunities. Furthermore, the stagnation of the tax system, the lack of information and data about the market, and the expansion of the cash economy constitute an obstacle to the progress of the business sector in the KRI.

## Conclusions

Business freedom in the KRI has a relatively better environment than the rest of Iraq. It has been relatively affected by several factors including the laws and regulations issued by the KRG and the relative stability of the political and security situations, as well as, the social fabric in Kurdistan is more open than in the rest of Iraq. However, the business sector in the Kurdistan Region still faces many institutional, economic, social, and security challenges, which makes Kurdistan's environment to be an unfriendly environment for doing business. It has been affected by the Iraqi institutional, political and economic situation. On the one hand, freedom of business in the KRI is restricted due to complicated and costly bureaucratic regulations and procedures. On the other, the weakness of the institutional structure has reduced the rule of law-security of property rights and contract enforcement, spread corruption, favoritism, politicization, and the ruling parties' monopoly on major business projects, which negatively affected the freedom and competitiveness of markets. Additionally, the over-reliance of the Kurdistan economy on oil revenues and the weakness of the labor and education sectors distorted the economic structure and led to the stifling of the private sector and crowding it out by the public sector. Therefore, the KRG must translate laws, reform programs, and decisions into real actions transparently and fairly to enhance the business environment and achieve long-run economic growth.

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