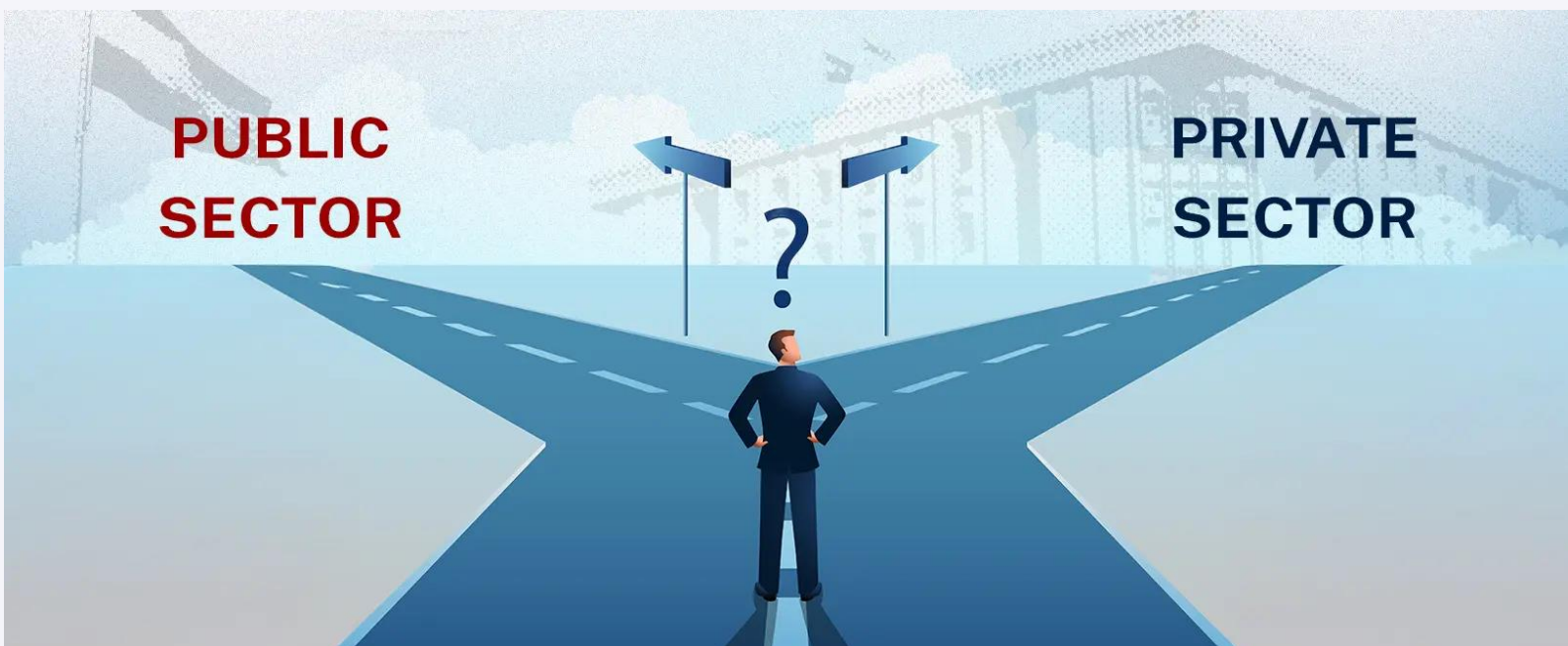


DOWNSIZING THE PUBLIC SECTOR IN KRI: CHALLENGES AND OPPORTUNITIES

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Executive Summary

Public sector payrolls have placed a chronic burden on the budget of the Kurdistan Regional Government (KRG). Despite persistent challenges such as the Region's economic structure and vulnerable institutions, the government has recognized the issue's damaging effect and initiated several reforms. Nevertheless, none of these reforms fully achieved their intended results. However, evolving local and regional circumstances have created new opportunities to facilitate public sector downsizing and enhance private sector development. The Region's growing labor force, potential for sector diversification, and an emerging cultural shift in employment preferences are all present viable enablers for reform. In this context, strengthening institutions, reforming the education system, and establishing a comprehensive regulatory framework are essential prerequisites for downsizing the public sector through private sector growth.

Background and Context

The expansive and overstaffed public sector has been a challenge that many oil-dependent states have faced, and the Kurdistan Regional Government is by no means an exception. Considering the constitutional status of the KRI as a semi-autonomous region within Iraq, with its own governing institutions and economy, the KRI is evaluated as a state, albeit within the state of Iraq. Vast public employment, mostly driven by nepotism and political patronage, has been a tool for rentier states to build political legitimacy and public satisfaction. Governments used oil-generated wealth to place an excessive number of employees in the public sector with symbolic roles and minimum output. In Kurdistan, this practice has led to the emergence of a substantial body of ineffective public sector employees. Over time, the large public payroll has become a burden on the government budget, without any significant economic productivity. The issue has

worsened due to volatile oil prices and its unstable revenue income, which often results in public sectors consuming a sizable portion of the budget. In the long term, the deficit resulted in irregular spending on infrastructure and productivity, which led to economic unsustainability and stagnation. The issue became further compounded as more workers eagerly looked to enter the public sector, incentivized by fewer working hours and the promise of job security.

The growing preference for public employment, along with the decline in economic productivity, further exacerbated the government's fiscal dilemma. Eventually, this issue triggered serious concern for the governments of many oil-dependent countries, which, in response, were compelled to prioritize strategies that help the government escape this self-reinforcing cycle. The KRG has also witnessed this pattern. The situation reached a critical point by 2014, when budget allocation disagreements arose between the central government of Iraq and the Kurdistan Regional Government. Disagreements over budget allocations, the oil market crash, and the significant ISIS war expenditure exacerbated the situation immensely. These events created an imbalance between revenue and expenditure for KRG, resulting in a delay in payment of KRG's public employees' salaries for almost a decade. This chronic delay makes economic structure reform in KRI an economic as well as a political necessity.

Comparative Overview of Oil-Dependent States

A comparative examination across oil-dependent states will enhance clarity and highlight strategies used to address this issue in various contexts. Public sector dependency and social preference for state-dominated employment are the common characteristics most rentier states share. Among cases in the Middle East, both the United Arab Emirates (UAE) and the Kingdom of Saudi Arabia (KSA) designed initiatives to downsize public sector payroll and assist private sector development via administrative frameworks and practical agendas; their future development vision has emphasized schemes to enhance financial sustainability and economic productivity.

KSA has introduced a strategy known as the Golden Handshake to downsize their public employment payroll. In this strategy, the government pays a financial reward to encourage people to relocate into the private sector and disengage from the public sector willingly. The Golden Handshake program grants employees a financial profit when they relocate to private firms as compensation for the disadvantages they face during the period of unemployment and new job hunting. The initiative aims to downsize public sector spending in KSA, which has been estimated to be almost 40% of the general budget.¹ Despite the program's enormous financial cost, the initiative is expected to yield significant economic benefits in the long term. Furthermore, to build a more sustainable and diversified economy, KSA has prioritized investment in the entertainment and non-oil sectors in its 2030 vision.²

While KSA emphasized financial rewards for relocating its public employees, the UAE has approached this issue with a longer-term strategy. The UAE has focused on structural reform of its economy, as referenced in the United Arab Emirates 2030 vision. The UAE aims to transform its economy from an oil-based economy to a knowledge-based economy.³ In a knowledge-based economy, instead of natural resources, sectors that utilize knowledge to generate wealth are prioritized. This strategy was designed to diversify the UAE's economy, strengthen its infrastructure, and motivate people into more productive and skillful jobs in private firms. In addition, both cases attempted to create a welcoming environment for foreign direct investment as a reflection of a greater diversification effort.

Kurdistan Region of Iraq: Downsizing Public Sector and Developing Private Sector

Opportunities for Downsizing and Private Sector Growth

Despite the challenges that restrict the KRG from reducing its public sector expenditure, several opportunities exist in the region that could be leveraged through targeted interventions. In KRI, these opportunities can

be categorized into three interrelated essential areas. First, there has been a significant change in cultural and social expectations toward the job market. Second, the Region's growing young labor force is present in the KRI, with an educational background and untapped talent to be developed. Lastly, the KRG boasts several key sectors that, if strategically supported, could bring significant economic benefits and strengthen economic diversification. These potentials offer unique opportunities for significant economic growth with inevitably emerging job opportunities. For many countries in the Middle East and previously for the KRI, people's social expectations and cultural understanding significantly influenced their preferences towards employment sectors. For many residents in rentier states, government-involved employment is considered a social prestige marked by political patronage, fewer working hours, and greater job security. Consequently, many citizens are incentivized to seek employment in a secure job environment with the least effort and skill required.⁴

Across comparative cases in the Middle East, social expectations and cultural boundaries hampered the process of public sector downsizing despite the financial rewards and compensation offered. Before 2014, these factors could have been considered restraining factors for KRG. However, from 2014 onward, a decade of disappointment surrounding government salary payments discouraged many from seeking public sector employment. The employment freeze in the mentioned time period added another layer of pressure for youth and fresh graduates to seek jobs outside of traditional public positions. After a decade of hiring freezes, many job seekers disregard the public sector as a secure source of employment. Years of these issues surrounding the public sector have changed people's expectations of the public sector.

Youth Perception Survey

According to a survey conducted in 2023 among KRI young residents, when questioned about their preferences for employment, 76% of young people preferred the private sector, which was recognized for offering more beneficial

opportunities.⁵ This change of perception among young people indicates that public employment is no longer perceived as a source of open opportunities, job security, and guaranteed monthly payment. Over the last ten years, a large number of graduates with no hope of being employed by the government have gradually sought alternative career options. This gradual shift presents the private sector with an opportunity to become an alternative to the public sector. The less-crowded private sector job market has slowly seen a growing demand among job seekers who are unable to find employment in the public sector offices. This transition could become a fruitful possibility for downsizing the public sector in the KRI if navigated properly. While in other societies a major financial cost is spent on changing people's preferences for their preferred job sector, this shift happened naturally in KRI as a self-regulatory process resulting from the generation experiencing the trauma of vast unemployment despite their potentials. The direction of people in the job market has already shifted, caused by diminished expectations from the public sector. Once the private sector provides a protected environment and proper regulation, it becomes a feasible alternative where youth can confidently thrive.

Demographic and Labor Force Potential

The change in sectoral preferences is complemented by another significant potential for the KRG, which is a sharp growth rate with a flourishing potential young labor force. This social capital could be effectively integrated into job markets and assist in the establishment of a new economic paradigm. The population growth and demographic conditions grant the job market a promising labor force within the working-age window. In 2021, the KRG's Ministry of Planning conducted a survey on labor force conditions and reported the potential labor force as 314,800 residents who are aspiring and capable of working but either unemployed or unsatisfied with their current career position.⁶

Moreover, since 2014, the annual entrance of new graduates into job markets is estimated to be 24,000 graduates.⁷ A strong labor force, combined with an

evolving employment expectation, highlights a significant opportunity for the private sector to absorb productive and qualified candidates. Younger generations are equipped with strong competencies and sufficient enthusiasm to pursue opportunities beyond symbolic job positions. Proper facilitation for potential workers would help place the best candidates into growing private sector opportunities, which will ultimately reduce the pressure on the bloated public sector to hire new employees unnecessarily. These changes would turn the labor force into a lucrative social capital with productive and innovative outputs. Such an approach benefits both firms that seek excellent and productive workers and credentialed individuals to fit their best working position and assists public sector downsizing eventually. Comprehensive training course packages accompanied by a merit-based portal to access job opportunities would facilitate the proper pairing of suitable positions with potential candidates. In the long term, the reform results in a balanced, productive private sector and a decongested, sustainable public sector.

Sector Diversification Opportunities

Building on a significant labor force and evolving people's expectations from the employment sector, sector diversification opportunities complete the KRG strategic reform's bigger picture. KRI owns several essential sectors that can be invested in and leveraged into economic diversification. A proper environment for agriculture, prospects to expand the banking sector, and an attractive destination for tourism are all opportunities that can be harnessed and capitalized on as beneficial economic sources.

KRI is naturally endowed with utilities highly capable of attaining further economic diversification. Multi-sector independence and cross-sectional collaboration would result in a wide range of job creation. Private sector investment in underutilized sectors would result in associated job growth and an increasing demand for workers to fill the newly emerged job positions. Therefore, further fiscal and regulatory support to attract local and international investors

into underdeveloped fields will lead to evolving opportunities for developing the private sector directly and diminish public sector employment demands. Before 2014, there were genuine intentions to achieve economic diversification. The KRG officially asked the World Bank for a recommended package of technical and data-driven economic strategies intended to be fulfilled by 2020.⁸ However, several emerging challenges in the region had a significant negative impact on the KRG's economy and hindered the achievement of economic diversification. After almost five years of unsuccessful efforts, potential still exists with further lessons learned from past experiences.

Restraints and Potential Challenges that Could Hinder Reform

First: Institutional Weakness

Despite potential strengths discussed earlier, a comprehensive analysis of the existing constraints is essential to ensure a result-oriented reformation of the KRI economy. Previous studies identified several obstacles impeding the economic and financial sustainability of the KRG, including security threats from ISIS, refugee influx from the Syrian conflict, and escalating disputes with the federal government. However, several previously existing constraints have disappeared, and the evolved regional and local contexts have raised new challenges that require careful consideration. Currently, institutional capacity and the economic structure of the KRI are the key existing limitations. First, strong institutions, which are essential for government responsiveness and effectiveness, remained underdeveloped in the KRI. Fragile institutions, in the case of the KRG, not only contributed to the emergence of an unproductive, politicized public sector body but further perpetuated the dilemma by hampering successful implementation of reforms. Why is this the case? Strong institutions can recognize evolving public issues and act efficiently in response.⁹ Years of unresponsive and inefficient

institutions cause mismanagement and prevent merit-based public sector expansion.

Additionally, weak institutions limit reform processes. During periods of transformation, strong institutions are crucial for enhancing adaptability, as they enable the government to recognize necessary modifications, function effectively under evolving circumstances, and implement requisite alterations. Nevertheless, the KRG's bureaucratic and administrative capacities were insufficient to implement large-scale reforms, caused by decades of nepotism and political patronage, feeding further stagnation within the KRG. It is crucial to consider institutional vulnerability as a central factor in the emergence and endurance of public sector inefficiencies. At a broader level institutional quality influences economic development, since strong and impartial institutions improve the KRG trustworthiness and enhance its capacity to attract foreign investments.¹⁰

Therefore, beyond addressing the surface issue, it's important to recognize that reform is required not only in the economic sector but also further transition in the institutional model and political structure. This makes institutional reform a critical area of transformation, particularly to address realistic public sector reformation. Weak institutions have often contributed to the emergence and resilience of overstaffing and inefficiency in the public sector; without proper regulation and strong institution building, similar issues such as opportunity manipulation, nepotism, and inefficiency could also emerge in the private sector.

Second: Sector Diversification Opportunities

The structure and resilience of the KRI's economy are another major challenge for reform. Years of oil dependency have shaped the KRI economy into a resource-dependent model, fostering characteristics of the resource curse and a consumerist economic paradigm. KRG should recognize that both local and foreign investors prioritize financial returns, which makes already profitable sectors, such as oil, more attractive. Without proper guidance and regulation from the government, these dynamics could reinforce existing inequalities between

strong and weak sectors. Technical assistance and sector-specific tax reduction will incentivize further investment in primitive sectors and lead to a more diversified and balanced economy. It is critical to keep in mind that deregulated investment without well-designed interventions could result in further imbalance in various sectors. To prevent this self-reinforced inequality, it's crucial to prioritize production, technology, and innovation as the main pillars of the economy.

Despite the urgent necessity of diversification, cross-case studies indicate that many resource-dependent economies have struggled to accomplish a result-oriented diversification process. Sector diversification is a long-term process that requires persistent efforts and adaptive strategies. However, in many oil-dependent economies, the consistency of the diversification process is frequently disrupted by volatile oil prices and changes in resource-generated revenue.¹¹ Budgetary constraints and drops in oil prices often prioritize diversification programs. Nevertheless, when oil prices rise, surplus resource wealth is directed toward further unproductive expenditure instead of being invested in long-term economic transformation. This pattern reinforces a cyclical imbalance during an inconsistent period of the diversification process. This eventually limits the achievement of the intended result. The necessity of economic diversification and structural reform is well recognized, yet practical implementation requires long-term ambition and enduring commitment.

Policy Recommendations and Areas for Further Improvement

Policymakers should prioritize meticulously designed policies to transform the economic structure without provoking political backlashes, given the evident risk of political destabilization and vulnerable legitimacy associated with the current economic structure. Moreover, understanding KRG's specific context, including its financial and administrative capabilities, is essential in ensuring the recommended policies are both feasible and effective. Effective policy recommendations require

a careful assessment of a policy's cost and outcomes to ensure that designated policies are both realistic and strategically beneficial.

Institutional Reform

Unlike wealthier states such as Saudi Arabia and the United Arab Emirates, the financial budget in the case of the KRG is limited due to recurring budget allocation problems over the past decade. The gradual decline of budget transfer from the central government of Iraq has negatively impacted the fiscal capability of the KRG. Therefore, financially compensated strategies are not feasible and applicable policy options to downsize the public sector within the KRG's current fiscal framework. Strategies like KSA's Golden Handshake will impose heavy financial costs that can outweigh their expected economic outcomes. However, the region's existing potentials indicate a significant possibility for economic prosperity and progress.¹² With comprehensive planning, these potentials can be strategically harnessed to maximize the preferred economic outcome. Within this context, three main areas should be prioritized for policy focus and investment. First, the focus should be on building stronger institutions and enhancing the rules of law. Second, education reform and human capital development. And third, the focus should be on regulatory oversight and private sector transparency.

As discussed earlier, weak institutions have led to fragile regulation and undermined transparency. Therefore, the KRG's policies must prioritize building stronger institutions to effectively design, enforce, and administer a new economic structure. This reform can be consolidated via the depoliticization and merit-based competence of institutions. Performance-based institutionalization would ensure predictability and fair management of the economic resources, establishing the foundation of a successful economic reform. Without strong institutions, the best-designed downsizing strategies can remain unimplemented or poorly administered. Without merit-based institutions, the downsizing process may be perceived as politicized and unfair, increasing the risk of public dissatisfaction and backlash. Furthermore, enhanced transparency and bureaucratic strength would

build local and foreign investors' trust and confidence. Therefore, institutional reform additionally contributes to creating an attractive environment for business expansion and financial investments in the Region.

Educational Reform

The second key policy direction involves developing social capital through comprehensive education reform. Integrating the growing number of graduates into the private sector and investment initiatives requires an education system that supplies the potential workforce with the qualifications required in the growing job market. To accomplish this alignment, a change in the economic model must be accompanied by a corresponding reform in education and curricula. Graduates and the potential workforce with vast options available to them from the private sector are less attracted to public sector employment. These changes will ensure that graduates' practical and linguistic capacities meet the skills demanded in the labor market. In this way, both employers and job seekers benefit from a harmonized set of skills and required proficiencies.

Regulatory Oversight

The third area of recommendation is to establish effective oversight regulations to ensure transparency and fairness in the private sector. While a less-regulated environment may seem appealing to investors, excessive deregulation without institutional monitoring can lead to exploitation of employees and manipulation of opportunity. Building a proper balance between economic freedom and regulatory oversight is essential to ensure the protection of all parties involved. After all, downsizing the public sector is not only about shifting employees from the public to the private sector but also about ensuring a trustworthy and sustainable working environment in the alternative workplaces. Introducing and enforcing clear labor laws is essential in minimizing the risk of worker exploitation. Moreover, promoting fair competition within the private market would prevent

market monopoly. Ultimately, both workers and employers in the private sector would gain confidence in a fair and protected environment for work and investment. Opportunities to work and invest outside of the public sector with proper regulation and protection will enhance the credibility of the private sector and encourage greater voluntary involvement.

Conclusion

Comprehensive economic reform does not only require financial compensation and revenue allocation, but also the pursuit of emerging opportunities, evaluating implemented strategies, and enhancing administrative capacity. While economic structure and weak institutions continuously limit the KRG's reformation capacity, the growing potential of strategically targeted intervention would build a foundation for a sustainable, outcome-based reformation. The KRI has experienced a growing shift in employment preferences, supported by a strong labor force and opportunities for sectoral diversification. Strategic investment in institutional resilience, building strong regulatory oversight, and reforming education to develop social capital would harness the demographic, social, and economic conditions of KRI into a downsized public sector and a sustainably developed private sector.

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