



IMPEDIMENTS TO STABILITY IN IRAQ: THE ILLUSIVE ECONOMIC DIMENSION

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Of the major contributors to stability in Iraq--military, political, and economic, the economic dimension has received the least attention from both the United States and the Iraqi authorities. In turn, the country's failed economy has undermined efforts in the other two key areas. While many mistakes have been made in trying to jump-start the economy, a number of lessons emerge from these efforts. Rather than piece-meal programs, economic recovery must be part of a comprehensive strategy oriented toward creating a virtuous circle whereby improved security leads to economic gains which in turn facilitate improvements in governance and market reforms.

In a significant policy statement released toward the end of 2005, the United States outlined its strategy for victory in Iraq.¹ It defines victory in terms of a sequential set of completed goals. In order to achieve victory, in the short term, Iraq must make steady progress in fighting terrorists, meet political milestones, establish democratic institutions, and build standup security forces; in the medium term, Iraq must defeat terrorists and provide its own security, have a fully constitutional government in place, and be on its way to achieving its economic potential; and in the longer term, Iraq must be peaceful, united, stable and secure, well integrated into the international community, and a full partner in the war on terrorism.

Along with developing democracy and providing security, then, reviving the economy is seen as one of the three most important issues for achieving victory in Iraq. In the economic area, U. S. and Coalition efforts focus on helping Iraq restore the country's neglected and damaged infrastructure, with the goal of restoring and expanding essential services. Other objectives include the creation of a market-based economy and greater transparency and accountability in the public sector.²

The logic of this strategy is straightforward.³ First, the rebuilding of Iraq's infrastructure and the provision of essential services would increase the confidence of Iraqis in their government and help convince them that the government is offering a brighter future. People would then be more likely to cooperate with the government and provide intelligence against the enemy, creating a less hospitable environment for terrorists and insurgents.

Second, the reconstruction efforts have significant implications in the security realm when they focus on rebuilding post-conflict cities and towns. Compensation for civilians hurt by counter-terrorist operations and the restoration of some economic vibrancy to areas formerly under terrorist control could help ease resentment and win over an otherwise suspicious population.

Third, economic growth and reform of Saddam-era laws and regulations would be critical to ensuring that Iraq could support and maintain the new security institutions that the country is developing, attract new investment to Iraq, and become a full and integrated member of the international community.

Finally, economic growth and market reform--the promotion of Iraq's private sector--are necessary to expand job opportunities for

the youthful Iraqi population and to decrease the unemployment that makes some Iraqis more vulnerable to terrorist or insurgent recruiting.

While this strategy has many merits, it is basically a continuation of the long-term approach taken by Ambassador L. Paul Bremer III and the Coalition Provisional Government (CPA) in 2003. Later, Ambassador Bremer expressed reservations over the course he set out for Iraq's economic recovery:

We also placed too much emphasis on large-scale reconstruction projects. While the urgent need for modern highways, electrical generating plants and the like was clear, we should have anticipated that building them would take a long time. Our earlier efforts should have been directed more tightly at meeting Iraqis' day-to-day needs.⁴

Iraqis themselves are increasingly skeptical of the viability of the postwar economic strategy. Certainly the ability to complete infrastructure projects on time and within budget has proven to be a nearly impossible task. As noted by the U.S. inspector general for Iraq reconstruction, infrastructure programs in that country have been plagued by "violence, corruption, and mismanagement."⁵ As a result, "the ambitious U.S. reconstruction effort in Iraq is likely to fall far short of its goals because soaring security costs and poor management have slashed the amount of American money available for rebuilding projects."⁶ Just as serious is the extremely long lead time before the average Iraqi sees any tangible benefits in terms of improved living standards.

Implicit in Ambassador Bremer's assessment is that the main flaw in the U.S. strategy has been its inability to deliver short-run economic gains to large segments of the Iraqi population.

While we still don't have a complete picture of the contemporary dynamics of the Iraqi economy, it is still safe to say that the country's economic health will be a key

determinant of the country's long-run stability.⁷ Clearly, factors such as the "brain drain" and lack of commercial credit,⁸ together with uncertainty due to the security situation, have largely brought investment in the formal segments of the economy to a halt.⁹ Yet from anecdotal accounts, there are indications that many areas of the shadow economy are prospering and--as during the period of sanctions--successfully adapting to the harsh environment.¹⁰

With these themes in mind, the purpose of the sections that follow is to examine the means by which the economy can contribute toward building a viable new Iraq. First, an assessment is made of key issues surrounding the economy, including an examination of the initial obstacles to the economy's reconstruction; the approach taken toward the economy in the post-war period; the major accomplishments and failures of postwar reconstruction; and the lessons learned thus far.

Second, based on this assessment, several key areas are highlighted as critical to the establishment of a broad-based inclusive economy capable of supporting a new, modern Iraqi state.

OBSTACLES TO RECONSTRUCTION

Even without the insurgency, Iraq's reconstruction would have been a monumental undertaking. Saddam Hussein's economic legacy will be present for some time. In particular, that regime's questionable economic policies and mismanagement of the economy together with political repression, internal conflicts, wars, and sanctions left a number of serious impediments to recovery and growth. Initial reconstruction efforts dealt largely with correcting and reversing the effects of debilitating forces that had built up over the years.¹¹ Such efforts included the restoration of government economic functions after looting and state collapse; the prevention of currency collapse, hyperinflation, and economic chaos; the rebuilding of infrastructure ravaged by war, sanctions, looting, and neglect; the rehabilitation of a

health care system cut off from medical advances for two decades; the dismantling of corrupt, dysfunctional state economic controls; and the stimulation of the growth of a private sector that had been stunted by government interference.

A number of major successes did occur, especially under the CPA. The CPA reestablished a nationwide food-ration system and rehabilitated several thousand schools, health clinics, and hospitals. Furthermore, it provided public services to populations deprived under Saddam, as well as funded small projects across Iraq to meet critical community needs. The CPA also was responsible for increasing electrical generation and output.

On an economic level, the provisional government introduced a new currency and stabilized the exchange rate; liberated most prices without igniting inflation; rebuilt the government's economic ministries; and promulgated market-oriented banking, taxation, foreign trade, investment, and business regulations.

Still, the Coalition's economic accomplishments were overshadowed by its unfulfilled promises. During the occupation, the CPA was unable to prevent rampant looting of infrastructure and production facilities. It failed to attract foreign investment, implement its newly enacted economic regulations, restructure state-owned industries, or fulfill promises of substantial job creation. Similarly, the CPA did not meet targets for electricity production—despite increases—restore oil production to prewar levels, eliminate costly distorting energy and food subsidies, or combat corruption in reconstruction projects. The Coalition was unable to spend more than a fraction of the \$18.4 billion the U.S. Congress allocated for Iraq's reconstruction.

In sum, the net result of postwar economic efforts has been disappointing, though some economic obstacles and distortions are lessening thanks to the reforms put in place by the CPA.¹²

Many problems were created or reinforced through postwar policy errors and

miscalculations.¹³ The net result is an economy wherein the oil sector dominates the economy, accounting for around 74 percent of GDP.¹⁴ Iraq now depends solely on oil exports for finance of investment and consumption expenditures, for government revenues—of which oil export proceeds exceed 93 percent—and for 98 percent of foreign currency earnings.

Another setback is that centralized decisionmaking and intrusion of the state into economic life have distorted the pricing structure in many sectors to the extent that prices often do not reflect the real value of the product or service. In turn, distorted prices have caused inefficiencies and waste. The public sector is overrepresented in the economy, leading to inefficiency and decreased growth. Many state enterprises are currently dormant. The weakness of the private sector has limited its role in economic development, increasing the lack of diversification.

Additional problems plague the public sector. Poor governance practices are common, including widespread nepotism in public appointments and corruption among public servants. The lack of accountability and transparency in managing state resources has abetted corruption and increased its corrosive effect on growth and efficiency. Iraq's decades-long isolation has resulted in the digital divide, as well as in outdated institutions, administrative systems, and know-how. Technological stagnation and the use of outmoded production methods have weakened the economy as a whole; and public sector institutions have witnessed serious looting, theft, and destruction.

Another legacy of the past was the total dependence on monetary expansion to finance the budget deficit, which led to an average inflation rate of 50 percent annually during the 1990s. While monetary policy is now on sounder footing, the inflation psychology and lack of a developed government bond market together with supply-side shocks have resulted in volatile movements in price and an inflation rate still in double digits.

Moreover, social inequalities are widespread in a broad range of fields covering health, education, public services, and social services to low-income groups, the disabled, internally displaced persons, refugees, single-parent households, and other vulnerable groups across geographic areas. Unemployment ranges to about 50 percent, and the absolute poverty level—in which the population depends on the government's rationed food basket—is more than 60 percent. Unemployment has led to an increase in demands for social assistance. Furthermore, with over 50 percent of the population under 24 years of age, rapid rates of population growth are likely for many years. Many in this large demographic group are alienated due to violence and limited access to education, training, and career prospects.

The traditional family unit and the community have remained the core of Iraqi society, ensuring solidarity and social cohesion against all odds. However, conflict and inequality have eroded the social fabric of communities and families throughout the past three decades. In Iraq, social capital establishes an important relation between incomes and human capability to withstand shocks. Iraqis have witnessed a depletion of social capital, which has led to social deprivation in most sectors of society. Civic participation and recognition of human rights were denied during the previous regime. They remain poorly understood and lack ancillary support structures.

Finally, a large informal economy coexists alongside the formal sector. This informal economy may account for as much as 65 percent of GDP.¹⁵ Even more worrisome is the large criminal element that controls large segments of the informal sector.¹⁶

A recent UNDP household survey documents the impact the above factors are having on the average Iraqi household.¹⁷ The survey suggests that the poorest 20 percent of the population earns 7 percent of the income, while the top 20 percent earns 44 percent of the income. The survey also found that Iraq's median household income has dropped to \$144, down from a postwar high of \$255 in

2003. One-third of the Iraqis canvassed by UNDP described themselves as being poor. One-sixth of interviewees did in fact meet all or most of the criteria suggesting that they lived beneath the poverty line.

MODELS OF SUCCESS AND FAILURE

Several patterns emerge.¹⁸ Most importantly, the Coalition's success stories share some essential elements. Its less successful ventures also have their own set of distinctive characteristics.

Specifically, successful initiatives appear to have imposed no major costs or sacrifices on the population at large. For instance, most Iraqis welcomed the rehabilitation of their schools and hospitals. Furthermore, successful initiatives did not suffer from security disruptions. This was either because the security situation was not a constraining factor—as with the creation of new banking regulations—or because effective steps were taken to provide security protection—as with the nationwide distribution of civil-service salaries.

High visibility was another condition for success. Projects prioritized by Washington or the Coalition leadership, such as the introduction of a new Iraqi currency, were given lavish support. Funding was also a key element. Projects that could be funded quickly, without going through cumbersome contracting channels, achieved rapid results. For instance, the military's highly successful (but under-funded) Commander's Emergency Response Program (CERP) funds were used to respond immediately to pressing community needs. Programs that built on existing Iraqi capacity were also more likely to succeed. The child vaccination program that took advantage of a strong Iraqi outreach capability is a case in point. Finally, successful policies tended to be finite in scope and limited in duration—involving, for example, the approval of a new law or the one-time distribution of textbooks to schools.

The Coalition's failures were marked by a very different set of conditions. Failure often coincided with high social cost. For instance,

the Coalition's inability to end fuel price subsidies reflected its fears of sparking mass unrest. Also, most failed initiatives were afflicted by security disruptions, such as looting and sabotage, which precluded sustained progress.

Low priorities attached to certain sectors by the CPA were another handicap typical of unsuccessful projects. For instance, plans for agricultural reconstruction languished as CPA energies were directed towards infrastructural activities such as electricity. Funding problems also characterized failed projects. Many projects ran into disabling delays when they encountered the complex U.S. government procurement process.

Another common element of policy failure was the lack of existing Iraqi capacity on which to build. Efforts to collect taxes, for example, failed because there was not a history of voluntary compliance, nor the organizational capacity to monitor incomes. Finally, unsuccessful policies tended to involve extensive structural changes. The Coalition's inability to combat endemic corruption illustrates the difficulties in altering long-standing practices and relationships.

Perhaps because reconstruction efforts did not effectively incorporate large segments of the Iraqi population into the decisionmaking process, there is a widespread perception among Iraqis that the Coalition efforts have been a failure.

One ABC survey of Iraqis interviewed in late 2005 found that:

Only 44 percent of Iraqis say they believe things are going well in their country; 52 percent said they felt the country was "doing badly." Support for the U.S.-led invasion has dropped: In February 2004, 39 percent of Iraqis told us they believed the invasion was wrong, but today that number stands at 50 percent. Even among optimistic Iraqis it appears the United States gets little credit for any improvements in their lives. Less than one in five Iraqis

believes that U.S. reconstruction efforts have been "effective." Most Iraqis now say they "disapprove strongly" of how the United States has operated in Iraq. Not surprisingly, the percentage of Iraqis today who oppose the U.S. presence has spiked—from 51 percent to 65 percent.¹⁹

Many Iraqis cannot understand why electricity and sewage were not more reliable, why more reconstruction projects did not reach their neighborhoods, why corruption remained so prevalent, and why local (usually democratically elected) officials did not change things for the better.

Another respected poll in January 2006 found a sharp split between Kurds, Shi'a, and Sunnis over U.S. aid efforts in Iraq. While 38 percent of the Kurds expressed approval, the numbers fell to 30.3 percent for Shi'a, and only 4.7 percent for Sunnis. The corresponding figures for disapproval were 11.3 percent, 14.8 percent, and 77.7 percent.

LESSONS LEARNED

The postwar Iraqi reconstruction experience points to some important lessons that can provide a useful set of guides for that country's ongoing attempts in restoring economic growth and stability.²⁰

Reconstruction entails painful trade-offs rather than easy choices. To get things done as quickly as possible in the early days of reconstruction, the CPA often bypassed Iraqi ministries and various local groups. More often than not, Iraqis and their viewpoints were not included in the process. This flaw continues to take a toll on the country's reconstruction efforts.

High hopes and lofty promises are no substitute for sound planning and prudent expectations. As we receive clearer accounts of the functioning of the CPA, it is shocking to find how little planning went into the effort.

Expectations should be controlled to realistic levels. The CPA had promised to quickly exceed rather than simply restore prewar production, therefore, its many

accomplishments were often seen by the Iraqis as failures instead.

Several contingency plans should be developed for each action. Proper contingency planning that had taken into account the possibility of infrastructure degradation, persistent violence, and revenue shortfalls would have resulted in more realistic reconstruction goals.

Economic reconstruction depends upon adequate security, yet security depends on successful reconstruction. While the CPA was quite aware of the needs for security, it did not appear to realize that its reconstruction efforts should be focused not on just constructing physical buildings such as schools, but primarily on creating an environment in which the average Iraqi would feel secure. Delays should have been avoided if at all possible. Instead, many of the CPA's self-inflicted delays in project implementation contributed to Iraqi feelings of resentment and despair, which, in turn, fueled insurgency and crime, thereby worsening the security climate.

Reconstruction requires coordination of short-term initiatives and long-term structural reforms. The Coalition's short-term successes in economic stabilization and small-scale reconstruction generated positive momentum for economic recovery. Yet the CPA's inability to carry through with longer-term programs such as restoring state-owned enterprises, creating sustainable jobs, and promoting private sector growth resulted in lost momentum and further Iraqi frustration.

It is important to avoid over-reliance on market forces in a conflict setting. In part, the loss in reconstruction momentum stemmed from the CPA's assumption that market forces and a surge in private investment would follow the initial reconstruction efforts. Ideological blinders and the lack of a contingency plan made it difficult to overcome these errors when confronted with the effects of increased violence and uncertainty.²¹

Ongoing reforms require empowered owners. It remains to be seen whether Iraq's government will be willing or able to continue economic reforms initiated under the CPA. Clearly, if Iraqis had been consulted and made

an integral part of the reform process they would be more inclined to continue to build on earlier efforts. The reform process is being largely controlled by the International Monetary Fund, with Iraqis again more in the position of resisting outside efforts for reform--largely for the removal of subsidies and price controls--rather than controlling and adapting the reform process to meet their own domestic priorities.²²

Broad-based participation is critical for maintaining reform momentum, but requires overcoming centralization tendencies. Creating Iraqi ownership of reconstruction also requires decentralization of government authority. Decentralization has been shown to strengthen accountability and stimulate economic recovery in other post-conflict and transitional settings. Unfortunately, the CPA was unsuccessful in overcoming ministries' opposition securing funding for local authorities and Iraqi citizens to participate directly in the reconstruction process.

Overcoming and controlling corruption is extremely difficult. Corruption thrives in the environment of post-conflict reconstruction. The combination of large public procurement projects, small funding infusions, and inadequate government regulatory mechanisms creates fertile ground for corrupt practices. In the Iraqi context, a long history of entrenched corruption in government economic management only compounded the problem.

CRITICAL FACTORS FOR THE FUTURE

As the previous section suggests, the chances of an improved economic future for Iraq will hinge in large part on the ability of that country's leaders to reorient policy away from its postwar, centralized top-down orientation toward one that is more decentralized and inclusive. In the financial area, two additional factors stand out: Iraq's relationship with the international financial institutions, especially the IMF, and developments in the oil sector, especially with

regard to oil production and the disbursement of revenues.

Iraqi Debt Relief and Economic Reform

The IMF's role in Iraq's postwar setting became clear on November 21, 2004. At that time, in a major development on the debt front, the 19 industrialized nations that comprise the so-called Paris Club agreed to write off a portion of Iraq's debt in three stages. The first 30 percent, amounting to \$411.6 billion, was to be written off unconditionally. A second 30 percent reduction would be delivered "as soon as a standard International Monetary Fund (IMF) program is approved." A final 20 percent reduction would be granted "upon completion of the last IMF board review of three years of implementation of standard IMF programs." In other words, 30 percent of Iraqi debt will be excused only if the IMF and Iraqi authorities agree on an economic "reform" package, and another 20 percent will be written off only if the IMF is satisfied that Iraq has implemented the terms of this package.²³

As Paris Club Members hold around \$40 billion in Iraqi debt, Iraq will still owe \$7.78 billion to the Paris Club, even if the IMF certifies its adherence to the specified conditionality requirements. If Iraq does not satisfy the IMF, it will owe \$27.16 billion to the society of 19 industrialized nations.

At the time of the Paris Club Accord in September 2004, the Iraqi authorities apparently concluded that the economy was at the point where it was capable of successfully undertaking an initial IMF program. Given the country's postwar state, together with the ongoing insurgency, the IMF's Emergency Post-Conflict Assistance (EPCA) program seemed the most appropriate choice. Furthermore, completion of this program would allow the government to move to a more ambitious economic program of reform that would address remaining structural impediments to long-term sustainable economic growth with external stability. The idea was that such a follow-up program would be supported with a standby arrangement from

the IMF, on the basis of a positive assessment that the government's capacity for planning and policy implementation was adequate.²⁴

In their request for EPCA, Iraqi authorities indicated that they planned to seek further financial support from the IMF in the form of an upper-credit tranche standby arrangement in 2005, on the assumption that sufficient progress had been made in strengthening administrative and institutional capacity under the program.²⁵

For its part, the Iraqi government pledged to develop a comprehensive economic and financial program. The IMF stressed that it was important for the authorities to adhere to their commitment to prioritize any windfall oil revenues in favor of additional reconstruction investment and/or help meet budgetary needs in 2006 and beyond. The IMF also stressed the need to increase the price of petroleum products and to make monetary policy more adaptable by widening the number of instruments for managing liquidity conditions. They also emphasized the undertaking of structural reforms with regard to tax administration, payments and settlements systems, state-owned enterprise restructuring, and governance and transparency in the oil sector.²⁶

Iraq is under pressure to make significant progress at reform in several key areas not just from the IMF, but from the World Bank and the Paris Club as well.²⁷

First, these institutions are pressuring Iraq to reorient the economy toward an allocation system based on competition and free markets. In practice, this involves reducing the role of the state in the economy through restructuring the private sector, privatizing state-owned firms, and developing small and medium enterprises. There are some 192 state firms in Iraq with around 500,000 employees. By some estimates, up to 33 percent of this workforce may be "surplus"--that is, workers who could be removed with no discernable fall-off in output. If many of these individuals lose their jobs, it is doubtful that they could be absorbed by the formal private sector. Many will be forced into a life of crime or to find odd jobs in the country's large informal economy.

Second, Iraq must also gradually abolish government subsidies for basic consumer goods such as fuel--petroleum derivatives--and food. Iraq's extensive subsidy system provides most citizens with access to basic consumer goods, fuel, and electricity at extremely low prices. Reforms in this area are considered necessary if the country is to achieve fiscal solvency together with the creation of an efficient industrial structure. As discussed in more detail below, the distortion in market prices made possible by the country's subsidy program has created an economic climate conducive to corruption. It has also generated income for the insurgency and encouraged crime (mainly smuggling)²⁸ and has weakened economic growth through diverting scarce public resources away from infrastructure and other directly productive investments. Last, it has stifled the development of the private sector.

Third, Iraq needs to develop a social security network and support families hurt by price and structural reforms. In the likely absence of dynamic productivity gains, the phasing-out of subsidies will lead to rising prices throughout the economy. Both consumption and investment will be affected by rising costs. Most likely, increases in the costs of basic industrial inputs--such as fuel and electricity--will create added unemployment in the short term. In the absence of a comprehensive social security network, this added unemployment is likely to translate into an increase in the rate of poverty. In turn, a greater incidence of poverty may lead to even more unrest brought on by increased political and social tension, especially if those hurt see the reforms as imposed by outside powers such as the IMF, rather than a democratically elected government.

This last point is important, because by the summer of 2005, the IMF was expressing concern that reform implementation was moving too slowly and that the country was not strictly adhering to the terms of the EPCA. Specifically, Iraqi officials were reluctant to increase domestic prices in key subsidized areas, particularly petroleum products. Under

the EPCA timeline, the authorities were supposed to have begun the adjustment of domestic prices by the end of 2004. This did not occur. By mid-2005, gasoline prices in the black market had risen to very high levels, with the authorities continuing to supply gasoline locally at heavily subsidized prices--less than two U.S. cents per liter (five cents per U.S. gallon), one of the lowest prices in the world, even though local refineries were unable to keep up with demand. Prices were several times higher in neighboring oil states such as Kuwait and Iran, while the price differential with Turkey may at times have been as much as ten times greater.

As might be imagined from elementary economic theory, the low price of gasoline produced both shortages and thriving black markets. To ease the shortages, Iraq, a country with the world's third largest crude oil reserves, spent \$3.2 billion in 2004 on imports of petroleum products--mostly gasoline.²⁹ Ironically, much of the imported petroleum products had originated in Iraq, only to be smuggled out of the country to take advantage of the Iraq/external price differential.

The cost of buying from neighboring countries is magnified by rampant export smuggling, with a steady stream of subsidized gasoline flowing back out of the same countries from which the government bought it. Black market fuel dealers, offering a faster alternative to queuing at the pumps, exploit the artificial price gap. The insurgency is also heavily involved in black market arbitrage.³⁰ The resulting revenue loss in the government budget was as much as \$8 billion, or 30 percent of GDP in 2004.³¹

While the economic solution to smuggling and black markets is rather straight-forward--simply let the price of gasoline be determined by market forces--there is considerable opposition to this in Iraq. Iraqis mired in poverty have become too dependent on cheap fuel, with many arguing that Saddam Hussein always produced enough gasoline to meet local demand, even during the 13-year period of UN-imposed sanctions.

For its part, the Iraqi government has tried to avoid price increases through various

initiatives designed to decrease local consumption. One plan ordered drivers to leave their cars at home on alternating days based on odd- or even-numbered license plates. However, as might be imagined, the rule was hard to enforce, with many drivers reportedly using two sets of plates and switching them daily to avoid the heavy non-compliance fine.³²

Finally, toward the end of 2005, under pressure from the IMF and facing mounting opposition to non-price solutions, the Iraqi cabinet agreed to raise the price of petroleum and petroleum derivatives by between 100 and 200 percent. This would bring the price per liter for regular gasoline to 50 dinars and for refined gasoline to 150 dinars, in addition to price increases for other derivatives of white petroleum and liquefied gas.³³ This was meant to be the first in a series of increases designed to raise the price of fuel to the average in Persian Gulf States--about 93 cents per gallon.³⁴

Clearly, the fuel price increases were undertaken largely to qualify for the next phase of IMF lending. However, a very good economic case can be made that the price reforms were clearly in the government and country's best interest. A World Bank analysis of the country's domestic fuel markets concluded that black market prices averaged ten to 40 times above the official ones.³⁵ The bank's econometric simulations suggested that a six-fold increase in fuel prices would lead to a 16 percent decline in fuel imports and a 30 percent decline in black market sales. Government savings would amount to about \$1.73 billion, allowing for additional investment and/or compensation to households.

However, the resistance met by the government's December 18, 2005 decision to increase fuel prices raises a question about Baghdad's ability to impose economic reforms in the face of popular and provincial opposition. That the government was not able to make a convincing case to the public on such an obviously beneficial policy raises serious doubts about the future of economic reform in Iraq.

Oil and Iraqi Development

The Iraqi constitution will play a significant role in structuring both production and revenue developments in the oil sector. For this reason, of all the articles in the constitution, those relating to oil have been the most contentious. The key provisions are outlined in Articles 109 and 110.³⁶

Article 109 states: "Oil and gas is the property of all the Iraqi people in all the regions and provinces."

Article 110 states:

1st The federal government will administer oil and gas extracted from current fields in cooperation with the governments of the producing regions and provinces on condition that the revenues will be distributed fairly in a manner compatible with the demographical distribution all over the country. A quota should be defined for a specified time for affected regions that were deprived in an unfair way by the former regime or later on, in a way to ensure balanced development in different parts of the country. This should be regulated by law.

2nd The federal government and the governments of the producing regions and provinces together will draw up the necessary strategic policies to develop oil and gas wealth to bring the greatest benefit for the Iraqi people, relying on the most modern techniques, market principles and encouraging investment.

Article 110 clarifies that revenue-sharing will be based on needs as well as demography, reflecting the region's "duties and obligations, and taking into consideration the [region's] resources and needs."

The wording of Article 110 hints that exploration and development strategy will be undertaken in partnership with the regions. The wording of Article 109 does not exclude

foreign ownership of upstream oil industry assets, though most senior oil officials are not in favor of this level of foreign investment. Presumably, the detail of hydrocarbon development policy will be left to national and regional legislatures.³⁷

The constitution's treatment of oil production and revenues presents a number of unattractive scenarios to the Sunnis, and it is easy to see why they have been quite opposed to the new charter. Specifically, they are concerned with the creation of a federal system in which they are at a major financial disadvantage in comparison to the Kurds and Shi'as. In this regard, the constitution defines a "region" as one or more provinces that choose by referendum to form a region. (A referendum can be called fairly easily, either by one-third of the members in the relevant provincial councils or by one-tenth of the voters in these provinces.) Moreover, two or more regions have the right to create a single larger region. As Fred Kaplan summarizes it: "Here is the Sunni nightmare in plain black and white: The Kurds are allowed to form a single supra-region in the oil-rich north, the Shiites to form theirs in the oil-rich south, while the Sunnis are left in the oil-dry center."³⁸ Clearly, the Sunnis fear that the Kurds and Shi'as will create their own super-regions, which will dominate Iraqi politics and economics.

As noted above, Article 110 addresses the resulting inequities by declaring that revenue from oil and gas extraction will be fairly distributed throughout the country according to need. However, this refers only to revenue from "current" oil and gas fields, not from the vast untapped wells. Sunnis fear they will see little revenue derived from new wells brought on-line in the future. As the constitution stands, the regions are delegated authority over all new fields and therefore have control over the negotiation of exploration contracts and the bulk of revenues derived from future production.

Article 110 suggests that the Sunni areas could be disadvantaged for some time on the grounds that the Shi'a south and Kurdish north suffered chronic underdevelopment during the

Saddam era. The exact formula for revenue-sharing will be fluid and shaped by Iraq's national parliament, where the Sunnis are likely to be a distinct minority.

Over the past few years, the Kurdish government concluded at least three production-sharing agreements with Turkish and Norwegian companies that cover several fields in the Kurdish areas. Those deals were done independent of the Iraqi oil ministry. At the same time, Baghdad did not recognize those agreements and warned companies against signing such agreements. With the new constitution, such agreements would now become legal.³⁹

While turning a de facto situation in Kurdistan into a legitimate one, the implications for the rest of Iraq are even more significant. Iraqi oil experts warn that while the role of the federal government in oil matters has been marginalized, the powers of the Shi'a oil-producing region in the south are more likely to grow. There are two producing governorates in the south--Basra and Maysan. However, other governorates such as Nasiriyya, which contains the Gharraf oil field, have non-exploited oil fields. According to the constitution, those governorates can set up regions and become semiautonomous, like the region of Kurdistan.⁴⁰

Related concerns have been expressed by a number of knowledgeable oil executives and industry analysts. The main concern is that the constitution as worded could lead to several autonomous zones under which a central government in Baghdad would not have complete control over oil resources.⁴¹

Optimists say that in the longer term, a decentralized government could lead to a faster development of Iraq's oil and gas fields. However, Sunni dissatisfaction with the constitution could agitate the insurgency further and keep foreign investments at bay. In that case, only the Kurdish region, which has been spared the security problems characteristic of the rest of Iraq, would be able to attract foreign companies to invest in developing its oil and gas fields.⁴²

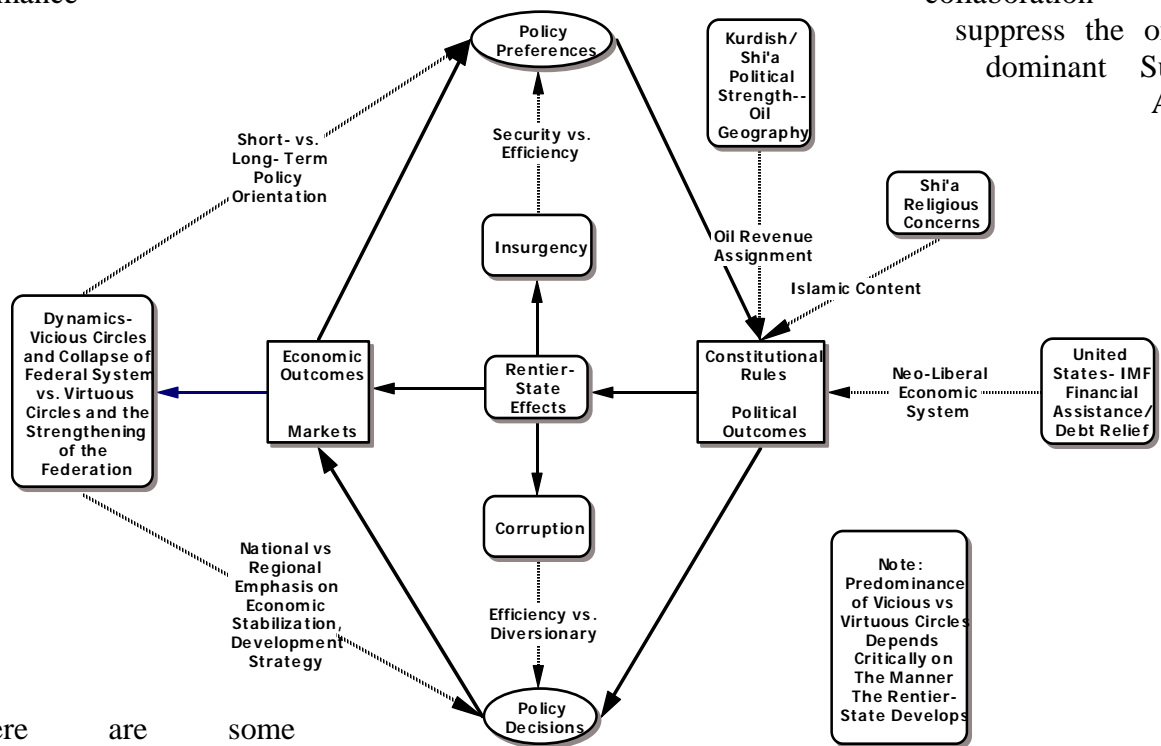
With oil revenue assignment shifting more toward the producing regions, the ability and

perhaps willingness of local governments to pursue independent policies will increase with time. The likelihood of adverse rentier effects may increase with oil revenues concentrated in the hands of the regional governments. In this environment it is easy to visualize a vicious circle setting (Figure 1) whereby the distributive formulas embedded in the constitution skew policy-making decisions towards an over-reliance on oil revenues, leading to poor economic outcomes, which in turn skew policy preferences more toward short-run distributive--rather than efficiency--outcomes.

If rentier-state effects are subsequently strengthened, corruption and a more active

insurgency are likely to reinforce the process of economic decline. On the other hand, if rentier-state effects can be controlled or weakened, then economic outcomes improve and with that, the possibility of establishing a virtuous circle strengthening the federation. With increased political stability, there will be further gains in economic activity. This longer-term virtuous circle can be further strengthened if stability results in a reorientation of economic policies from short- to longer-term focus with stabilization funds providing a supporting macroeconomic environment.

Figure 1
Iraq: Constitutional Rules and Economic Performance



There are some encouraging signs. In the southern provinces, interviews of voters suggest that the critical issue is to ensure that the proceeds of Iraq's oil exports are distributed more fairly than in the past--something that is explicitly catered to in the constitution. The impulse toward creating a virtual separate state is not as strong in the south as it is in the Kurdish north. Southern voters, for the most part, seemed to view the

constitution as a vital step towards peace and stability, rather than as a divisive, provocative formula for Shi'a-Kurdish collaboration to suppress the once-dominant Sunni Arab

minority.⁴³ Although the Sunnis opposed the decentralization structure of the new constitution, their opposition centers more on the potential loss of oil revenues to the Kurds and Shi'a and less on regaining control of the entire country.⁴⁴

What might the government consider in the way of modifying the economic sections of the existing constitution? One option that has

received surprisingly little attention is the simple one of distributing a relatively large share of oil revenues directly to the population. A clear advantage of this approach is that it would give the Sunnis a clear stake in the success of the economy. Acts of insurgency that jeopardize oil revenues would directly hurt large segments of the Sunni community. Formalization of this type of distributive system would allay Sunni fears that at some time in the future they would be completely cut off from the country's oil revenues.

A number of other benefits would also flow from the direct disbursement policy. With direct payments, massive subsidies and price controls would no longer be needed and could be phased out quickly, leaving prices to be determined by market forces. The broad-based demand that would be created from increased purchasing power no doubt would provide opportunities for more profitable small-scale private sector businesses. Many studies of small- and medium-sized businesses in developing countries have concluded that businesses of this type are the chief engines of job creation and innovative activity.

As the experience of the transitioning countries of Central and Eastern Europe has shown, in addition to job creation and innovation, growing business sectors often find it in their best interest to press governments for additional market reforms. Governments, in turn, find it is in their interest to nurture this new base of prosperity and respond accordingly. In this way, it is conceivable that a virtuous circle of growth, reform, and further growth could be put in place over time in Iraq. The country has the broad-based talent, skills, and ingenuity to prosper if only it can break the link between state and oil, with its corrupting and debilitating influence.

Unfortunately, to date, improvements in economic performance have been limited. An independent assessment, made in late 2007 by Stuart W. Bowen the Special Inspector General for Iraq Reconstruction (SIGIR), notes some bright spots,⁴⁵ including economic growth in the Kurdish north;⁴⁶ tribal

reconciliation in the western desert province of Anbar; and patchy progress in the development of local governments. Beyond that, some of the provinces are showing increasing ability to create plans, write contracts, and carry out construction projects to rebuild Iraq's physical infrastructure.⁴⁷ Skill shortages are, however, impeding progress in many local governments and ministries.⁴⁸

Clearly, many factors are still impeding progress in key areas across the country. For example:⁴⁹

- The failure of the Council of Representatives to pass a provincial powers law that defines local governments' rights and responsibilities has limited provincial councils' effectiveness in managing their governmental institutions.
- Weak and uncoordinated rule of law programs within the provinces and at the national level have been a continuing problem. In most provinces, there is little cooperation.
- Among the police, courts, and correctional facilities, judicial orders are routinely ignored.
- Efforts to increase local living standards and reduce unemployment have been undermined by the dangerous security situation, but micro-lending programs, agribusiness development, and small-business development programs are beginning to make headway.
- Provincial governments have limited capacity to manage and sustain infrastructure and to budget for operations and maintenance, but some improvements have been noted in Iraqi management of local reconstruction projects.
- Local political reconciliation efforts have been undermined in some areas by rival Shi'a groups, a sense of alienation among Sunnis, and growing frustration over the inability to obtain government services.

At the risk of over-generalizing, the greater picture is one of high investment and rapid increase of incomes in the Kurdish regions, promise of stability and improved prospects in the Sunni region of al-Anbar, and continued stagnation in Baghdad with limited pockets of progress in the Southern provinces. One danger of the development of distinct regional economies is the Balkanization of Iraq, which may in the longer term impede efforts to consolidate the country around a strong central government. There are already an increasing number of examples of provinces defying the central government through such actions as withdrawing their electricity generation from the national grid.⁵⁰

What accounts for this sad state of affairs? The failure to integrate economic programs more tightly with political and military dimensions is a major factor. Since the overthrow of Saddam Hussein, the economy has largely been an afterthought with the result that political and military gains are hard to sustain in an environment of grinding poverty and unemployment.

One of the main lessons learned from the British experience in Southern Iraq was that:⁵¹

In conditions of economic stagnation the security forces find that they are dealing with general public order issues caused by significant numbers of ordinary disgruntled Iraqis, rather than the pure terrorist threat. What is required is a balanced approach with equal focus on the redevelopment of the domestic economy as well as the rebuilding of the domestic security forces.

CONCLUSIONS

Iraq's economic future will be largely determined by events surrounding the oil sector together with the adoption of a number of the basic principles noted in the previous section. One can easily envision a bright future as well as one quite grim. There are, however, several simple guidelines that Iraq's leaders should keep in mind. Most

importantly, the true test of the expenditure of scarce resources in Iraq should be the total contribution to political and economic development. Expenditure patterns that contribute to the avoidance of rentier-state effects are likely to be the most productive for the country's eventual recovery and growth.

Fortunately, within Iraq there appears to be increasing acceptance of these principles. On July 27, 2006, the Iraqi government and the United Nations announced the creation of the International Compact with Iraq. Over a five-year period the Compact--jointly chaired by the government of Iraq and the United Nations with the support of the World Bank--is to aim to unite the international community and multilateral organizations to help in Iraq's recovery.

The Compact primarily focuses on building a framework for Iraq's economic transformation and on Iraq's integration into the regional and global economy. To achieve this goal the government of Iraq will focus on political inclusion and consensus-building, establishing professional security forces, tackling corruption, creating a transparent and efficient oil sector, developing a solid budgetary framework, and improving governance by building and consolidating effective national institutions.

Hopefully this is a blueprint for Iraq to achieve its national vision "[t]hat in five years Iraq shall be a united, federal and democratic country, at peace with its neighbors and itself, well on its way to sustainable economic self-sufficiency and prosperity."⁵²

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