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# Reconstruction and Peacebuilding Under Extreme Adversity: The Problem of Pervasive Corruption in Iraq

ROBERT E. LOONEY

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Indexes of corruption compiled by the World Bank and Transparency International suggest that Iraq is one of the world's most corrupt countries. While corruption thrived under Saddam Hussein, it has worsened further in the post-Saddam era. Controlling and eradicating Iraqi corruption has proved difficult owing to the fact that it is the product of an inter-related set of forces including: (a) the growth and dynamics of the shadow or informal economy; (b) the deterioration in social capital, and in particular the near absence of trust between the different regions, religious groups, tribes and even within local neighbourhoods; and (c) the evolving relationship between tribes, gangs and the insurgency. Any effort that attempts to control corruption without taking these factors into account will have little chance of success.

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*Uncontrolled levels of corruption in Iraq are fuelling the country's sectarian conflict and creating a political economy of violence. The political economy of this conflict is very much rooted in the alarming levels of corruption that we are dealing with. A lot of the money from many sectors of the economy is diverted to sustain the violence.*

Barham Salih, Iraqi Deputy Prime Minister<sup>1</sup>

There are two major obstacles to Iraq's economic recovery: the ongoing insurgency and growing sectarian strife. Combating these problems has been further complicated by the large numbers of unemployed, easily available weaponry, a quickly widening gap between the rich and poor and a largely impotent government. Pervasive violence and a deteriorating economy have created a vicious circle that has further undermined the government's ability to tackle the economy's four basic problems: the security of the oil supply, the high levels of unemployment, deficiencies in infrastructure and the government's failure to introduce much-needed economic reforms. In turn, these four problems have contributed to the development of a large underground economy reinforced by pervasive corruption at all levels of government.

In conflict countries, similar types of vicious circle are often set in motion through a process whereby negative developments are reinforced over time. These cycles will often continue in the same direction until an exogenous factor intervenes and stops or reverses the cycle. Research suggests that this is what is happening to the Iraqi economy in the post-Saddam period.<sup>2</sup> Any efforts to reconstruct and restore a functioning Iraqi economy will be constrained by the government's ability to set in motion a virtuous circle of economic expansion and

improved security. In turn, this means constructing a strategy that positively addresses a number of interrelated factors, including: (a) the growth and dynamics of the shadow or informal economy; (b) the deterioration in social capital, in particular the near absence of trust between the different regions, religious groups, tribes, and even within local neighbourhoods; and (c) the evolving relationship between tribes, gangs and the insurgency.

As Deputy Prime Minister Barham Salih suggests (in the above epigraph), corruption is the common element that ties these diverse forces together and drives the dynamic for the current vicious circle of violence and economic stagnation that Iraq has experienced. Unfortunately, international media attention on corruption in Iraq has tended to focus exclusively on high-profile cases of fraud, waste and abuse by US contracting authorities and private foreign firms,<sup>3</sup> or the fall-out from the oil-for-food programme of the 1990s. Without denying the importance of these forms of corruption, the analysis that follows is more focused on the future, in particular on the rampant and growing domestic Iraqi corruption that is draining the country's public finances, choking reconstruction efforts and undermining what little support remains for the new Iraqi state.<sup>4</sup>

As the following sections illustrate, the ongoing violence, lack of trust, and conflict, together with unique factors such as oil revenues and the presence of a serious criminal element, have combined to create an environment in which the extent and effects of corruption are even more pronounced than those observed by Mark Philp in 'normal' post-conflict settings:

In post-conflict societies its [corruption's] impact is potentially still more serious, because it can undercut the emergence of stable expectations and the processes by which they are legitimated, it can maintain or further exacerbate situations in which outcomes lack legitimacy, making it difficult for any serious form of authority to emerge, it can lead to the squandering of aid and external political will, and it can make the weak weaker, the poor poorer and the vulnerable still less secure.<sup>5</sup>

All of this has occurred in Iraq, perhaps even to an unprecedented degree – certainly to an extent not envisaged by even the most vocal critics of the invasion of Iraq and subsequent reconstruction efforts.

### Comparative Measures of Corruption

Unfortunately, there are no definitive measures of corruption.<sup>6</sup> Instead several indices of the relative ranking of countries are available (Tables 1 and 2). In each case, Iraq ranks as one of the world's most corrupt countries. Even worse, the already pervasive corruption that has gripped the country may be worsening.

The World Bank's Governance Indicators (Table 1) document Iraq's lack of effective governance not just in the area of corruption control, but in other key areas of governance: voice and accountability, political stability/no violence, government effectiveness and the rule of law. The country consistently ranks in the bottom 5–10 per cent in each category.

TABLE 1:  
IRAQ: MEASURES OF RELATIVE GOVERNANCE, 1996–2005

	2005	2004	2003	2002	2000	1998	1996
<b>Voice and Accountability</b>							
Percentile Rank (0–100)	9.2	4.3	7.2	0.5	0	0.5	1
<b>Political Stability/NoViolence</b>	2005	2004	2003	2002	2000	1998	1996
Percentile Rank (0–100)	0	0	0.9	5.2	1.9	0.5	0
<b>Government Effectiveness</b>	2005	2004	2003	2002	2000	1998	1996
Percentile Rank (0–100)	1.4	3.8	5.7	0.5	3.3	0	4.3
<b>Regulatory Quality</b>	2005	2004	2003	2002	2000	1998	1996
Percentile Rank (0–100)	5.9	4.4	5.9	0	0.5	0	2
<b>Rule of Law</b>	2005	2004	2003	2002	2000	1998	1996
Percentile Rank (0–100)	0.5	0.5	5.3	1.9	2.4	1.9	2.4
<b>Control of Corruption</b>	2005	2004	2003	2002	2000	1998	1996
Percentile Rank (0–100)	4.9	2	14.7	1	3.9	2	3.4

Source: World Bank, Worldwide Governance Indicators (World Bank: Washington, 2006). <http://info.worldbank.org/governance/kkz2005/tables.asp>

As the country's governance standards are so poor, making connections between corruption and the slow progress of reconstruction is difficult. Do reconstruction cost overruns stem from corruption or from government incompetence? Does the diversion of reconstruction funds stem from corruption or the absence of the rule of law? Do infrastructure projects fail to attract follow-on private investment because of corruption or the level of violence? Most probably, all these factors are interrelated, thus necessitating a comprehensive approach to combatting the country's growing levels of corruption.

Transparency International's Corruption Perceptions Index is a composite index that draws on multiple expert opinion surveys that poll perceptions of public sector corruption. It scores countries on a scale from zero to ten, with zero indicating high levels of perceived corruption and ten indicating low levels of perceived corruption. Again, Iraq (Table 2) has one of the lowest scores (1.9 for 2006), and the situation appears to have got worse over time. As of 2006, out of 163 countries examined, Iraq ranked ahead of only Haiti.

### The Pervasive Nature of Iraqi Corruption

Underlying the figures and indexes are numerous accounts of corruption cutting across all segments of Iraqi public and private life.<sup>7</sup> In many of the key public ministries that should be playing a lead role in the country's reconstruction, even

TABLE 2:  
IRAQ: CORRUPTION PERCEPTION INDEX 2003–2006

	2003	2004	2005	2006
Rank	113–117	1 29–1 32	1 37–1 43	160–162
Score	2.2	2.1	2.2	1.9
Total Number of Countries	133	145	158	163

Source: Compiled from Transparency International Corruption Perceptions Index [http://www.transparency.org/policy\\_research/surveys\\_indices/cpi](http://www.transparency.org/policy_research/surveys_indices/cpi)

rudimentary systems of accountability, internal controls and the rule of law are lacking. The Interior Ministry epitomizes this sad state of affairs. Rather than enforcing the law in an impartial manner, the ministry is driven by political factions. It houses a myriad of competing police and intelligence agencies that pursue various political or sectarian agendas. In the Oil Ministry, corruption at all levels has led to massive losses of revenue. At the border, travellers report that guards often regard bribes as a standard operating procedure. In the Health Ministry, the dire shortage of medicines and drugs in Iraqi hospitals is largely due to the organized theft that takes place at every point in the supply chain. In the Defence Ministry, senior officials are under investigation following allegations that over US\$1 billion worth of military equipment was paid for, but not delivered to army units.

In the justice system, the police and judges in many areas have reverted to a system where families can only secure the release of their detained relatives on payment of a bribe. It is now routine to hear reports of new officers who have just graduated from the police academy selling their handguns on the black market. Even worse, many in the police are linked to, or are members of, assorted militias and criminal gangs – thus the distinction between the police, the political militias and criminal groups is often marginal in the minds of Iraqis. In the southern provinces, where UK troops have regularly confronted ‘insurgent’ attacks, more often than not the insurgents are gangs of criminals or smugglers, loosely affiliated with a Shia militia, mainly concerned with preventing the closing down of lucrative smuggling routes by Iraqi and UK forces.<sup>8</sup> With oil products still being massively subsidized in Iraq, the smuggling trade is still booming.<sup>9</sup>

Additional examples of widespread corruption, shoddy work and poor management have been documented at length in a series of reports from the US Government’s Special Inspector General for Iraq Reconstruction (SIGIR), the Government Accountability Office (GAO), which is the investigative arm of Congress, and CorpWatch, a non-partisan, not-for-profit monitoring organization.

In his April 2007 report, Stuart Bowen, the head of SIGIR, noted that his agency sampled eight projects and found that seven of them had significant operational problems either because the expensive equipment that was purchased was never used or there were other problems such as plumbing and electrical failures, lack of proper maintenance, and looting.<sup>10</sup> What was particularly troubling was that this report was focused only on projects that the administration had touted as *successes*. In reality, these successes, should have been described as failures.

- At Baghdad International Airport, where \$11.8 million was spent on new electrical generators, \$8.6 million worth of the project is no longer functioning.
- In a maternity hospital in the northern city of Erbil, a newly built water purification system does not function; an expensive incinerator for medical waste is padlocked, and medical waste – including syringes, used bandages and empty drug vials – is clogging the sewage system and probably contaminating the water system.

- At the same hospital, a system for distributing oxygen has been ignored by the medical staff, who told inspectors they distrusted the sophisticated new equipment and had gone back to using tried-and-true oxygen tanks – which are stored unsafely throughout the building.
- Expensive generators are missing from the Iraqi Camp Ur military base, having been hauled off to another post. Also at Camp Ur, three modular buildings constructed at a cost of \$1.8 million were dismantled and removed with no explanation given.
- Barracks renovated for enlisted soldiers are already in disrepair, just a year after being handed over to the Iraqi Army.

As these problems presumably developed after the US turned the projects over to the Iraqi government, there is widespread concern over the ability of the various ministries to sustain the reconstruction effort. How much of the difficulty can be attributed exclusively to corruption, however, is difficult to assess.

In its report, SIGIR concluded that the Iraqi civil service is hampered by inadequately trained or unskilled staff. 'Iraqi government institutions are undeveloped and confront significant challenges in staffing a competent, non-partisan civil service; effectively fighting corruption; using modern technology; and managing resources effectively.'<sup>11</sup> Furthermore, political and sectarian loyalties have jeopardized the ministries' abilities to provide basic services and build credibility among Iraqi citizens. In short, government ministries are being staffed with party cronies and their budgets are being used as sources of power for political parties.

SIGIR in particular noted that patronage in the ministries has led to staff instability, as key personnel are replaced when the government changes or a new minister is named. Some Iraqi ministries, including the Ministries of Interior, Agriculture, Health, Transportation, and Tourism, are being led by ministers who are aligned with political parties that are hostile to the international presence. These ministers have used their positions to pursue partisan agendas that conflict with the goal of building a government that represents all ethnic groups.

In this environment SIGIR noted that, 'Corruption jeopardizes future flows of needed international assistance and reportedly undermines the government's ability to make effective use of current reconstruction assistance'. Other factors contribute to the corruption problem: an ineffective banking system that leaves the government dependent on cash transactions, opaque and obsolete ministry procurement systems, and inadequately resourced accountability institutions such as the ministries' inspectors general.

Aside from the lack of security, corruption is the biggest threat to progress in stabilizing Iraq. SIGIR reports that Iraq has been losing \$4 billion to corruption every year since the overthrow of Saddam Hussein. The country now has more than 1,400 criminal corruption cases open, involving about \$5 billion. Paying bribes for services is now standard practice. Corruption is particularly endemic in the oil sector, with the Ministry of Oil hit by smuggling rackets that have reduced state oil earnings. At least 10 per cent of refined fuels are sold on the black market and about 30 per cent of imported fuels are smuggled out of Iraq.<sup>12</sup>

On paper, Iraq has a strong set of institutions designed to address corruption issues:

- The Board of Supreme Audit dates back to the 1920s.
- The coalition installed inspectors general in all Iraqi ministries and also created a Commission on Public Integrity (CPI) to investigate the most serious cases of corruption.<sup>13</sup>
- Since April 2003, a large amount of international assistance has gone into providing these institutions (and the Iraqi courts and police) with training, equipment and technical advice.

Nonetheless, these anti-corruption institutions are very weak and easily influenced by political pressures, and it is common in today's Iraq to use charges of corruption to discredit officials who stand in the way of political objectives. This forces the coalition to remain the watchdog of last resort. However, in some ministries, such as Health and Interior, the US-appointed inspectors general have become political players rather than independent guarantors of probity.<sup>14</sup>

The breadth and depth of corruption has infuriated Iraqi citizens, who see politicians and officials growing rich while services decline. This has fed disillusionment with the United States, UK and Coalition presence, and may have contributed to support for militias and insurgents. Corruption also alienates international donors, who see much of their investment in Iraq going to waste.

In order to address this issue, Iraq's key international partners have suggested a range of schemes that include training investigators, protecting judges and witnesses, and reforming procurement and financial processes to remove opportunities for fraud. However, without the political will of those at the top of the incoming Iraqi government, such technical assistance will be of little use. The government's ability, let alone its determination to crack down on corruption, remains very much in doubt.

### Corruption as an Integral Part of the Economic Dynamics of Post-war Iraq

Although commendable, the attempts at combating corruption in Iraq are unlikely to be successful as long as many of the underlying factors remain unchanged. As noted above, this means addressing three interrelated factors: (a) the growth and dynamics of the shadow or informal economy; (b) the deterioration in social capital; and (c) the evolving relationship between tribes, gangs and the insurgency.

#### *The Shadow Economy*

The only part of the economy to have thrived under Saddam Hussein and in the post-2003 period of instability and insurgency is the country's informal economy. In fact, there is ample evidence that the country's informal economy has expanded considerably since Saddam's overthrow. In this regard, Iraq has followed a pattern seen in other parts of the world, where informal economies have tended

to grow during periods of political, economic and social crisis. Preliminary analysis also suggests that a clear pattern exists whereby the relative size of a country's informal economy (as a share of gross national product (GNP)) is related to its progress in opening up to the world economy.<sup>15</sup> Countries that are relatively closed tend to have large informal economies, whereas those countries open to the pressures of globalization have much smaller informal economies. Furthermore, the informal sector becomes significantly smaller as countries increase their control over corruption.<sup>16</sup>

As might have been expected, Iraq under Saddam was in a group of countries with the highest probability of possessing a large informal economy. With limited exposure to the world economy under the sanctions regime, Iraq's shadow or informal economy probably accounted for around 35 per cent of gross domestic product (GDP) in 2000,<sup>17</sup> with nearly 70 per cent of the labour force employed in informal activities. Since the fall of Saddam, Iraq's informal economy has been fuelled by the ongoing crisis. Clearly, conflict and the insurgency have taken a heavy toll on the formal economy. As private firms or public enterprises are down-sized or closed, newly unemployed workers often find that their only choice is to seek work in the informal sector. Also, in response to conflict-driven inflation or cutbacks in public services, households have often needed to supplement formal sector incomes with informal earnings. In some parts of the country such as al Anbar, the breakdown of law and order has led to an expansion of criminal activity, some of which links to the shadow economy. For example, street vendors are now selling stolen merchandise. In sum, corruption has been one of the key factors affecting the size of Iraq's informal or shadow economy.<sup>18</sup>

Given increased levels of corruption, the insurgency and the uncertainty surrounding political developments, we can expect large segments of the population to continue to rely on survival relationships that were characteristic of the 1990s sanctions period. This is confirmed daily with the news coming out of Iraq describing economic mismanagement,<sup>19</sup> vast black markets in gasoline,<sup>20</sup> increased crime and shortages of critical inputs.<sup>21</sup> These developments do not bode well and suggest that the current size of the informal economy is considerably larger than the 35 per cent of GDP during the late 1990s. A safe estimate, in light of the insurgency and its detrimental impact on investment, electricity and transport, would put the informal economy at around 65 per cent of GNP.<sup>22</sup> It is difficult to assess the impact of disbanding of the army and the anti-Baathist campaign following Saddam's overthrow – this estimate may err on the conservative side.

In addition to the factors noted above, the informal economy may be growing simply because of the constraints limiting the expansion of formal economic activity. Just as private capital formation is often critical to the development of a thriving modern economy, social capital creation may be just as essential in creating the shift to more formal activities. Iraq's informal or shadow economy presents a number of obstacles to peacebuilding. Most notably, it facilitates an opaque environment that accommodates official corruption. There are solutions, but in the Iraqi context they are difficult to implement. Specifically, recent research<sup>23</sup> suggests that improvements in institutional quality reduce the



shadow economy directly and corruption both directly and indirectly (through its effect on the shadow market). Unfortunately, in Iraq's case the political accommodation of crime-based activities and their associated financial gains significantly lessens the incentives for public officials to initiate the institutional reforms needed to create a modern transparent state.<sup>24</sup>

### *The Deterioration in Social Capital*

Perhaps the most detrimental effect of corruption on the peacebuilding process is its effect on the country's social capital. Social capital refers to networks of relationships that bind people together.<sup>25</sup> Analysts distinguish such relationships from physical capital and human capital.<sup>26</sup> In the context of Iraqi reconstruction and the establishment of a market economy, a key element of social capital centres on a particular component of social capital: the notion of trust. Corruption reduces trust at all levels thus making it nearly impossible for a formal economy to grow and displace the shadow economy.

Trust is such a critical factor in the development of modern economies because it enables contact with others and facilitates the exchange of goods and services. It fosters co-operation, and co-operation then breeds trust in a two-way interaction necessary for the creation of long-term generalized norms for co-operation. Social capital thus represents a set of resources rooted in networks of relationships possessing the power to facilitate economic progress. There are three types of relationships among parties to an economic transaction, giving rise to three different types of trust:<sup>27</sup>

1. *Ascribed trust.* This first type of relationship is found among kinship groups and family members. These relationships dominate economic transactions in subsistence economies and still characterize reproduction and the household economy (but also many small-scale crafts and trades).
2. *Process-based trust.* This type of relationship is between individuals who have known each other for a long time, but do not share loyalty to a specific group. Most business networks are characterized by this type of repeated relationship and the prevalence of what develops as a process-based trust.
3. *Extended trust.* This relationship is between individuals who enter into a transaction with only limited information about the counterpart's specific attributes. For economic exchange to take place between these types of individuals, generalized or extended trust is needed. The importance of this third type of relationship and the correspondent economic transactions between largely anonymous individuals is a key element of a modern economic system.

This typology suggests that the building of extended trust is a key challenge for Iraq's development into a modern economy. It is also important to bear in mind the relationships between the various forms of trust. In particular, extended trust could not exist without the experience of reciprocity that is created through repeated interactions among family and other members of a societal or business community. Where process-based trust is absent, extended trust is unlikely to develop.

Corruption's impact is to weaken trust at each stage, especially at the extended stage and, to a somewhat lesser extent, at the process stage. The net result is to retard the development of national and even regional markets, thus making the attainment of any sort of normal efficiency nearly impossible to attain. In Iraq's case it is unlikely that extended trust in economic exchanges could be sustained without third-party enforcement by the state. Clearly, trust in government institutions will be a necessary prerequisite before Iraq can expect any type of significant expansion of the formal economy. This is where the country's problems lie.

It is not just the current lack of incentive for policymakers to reform the country's institutions; the situation inherited from the past would have made reforms extremely difficult even under more favourable circumstances. The Ba'athist government had a profound effect on the nature of formal and informal institutions in Iraq. Not only did Ba'athism hamper the emergence of a market economy, but it also corrupted the judicial and legal institutions needed to create and nurture trust. The result was nearly to eliminate extended trust, weaken process-based trust, and force most transactions into networks that rely almost exclusively on ascribed trust. Furthermore, the manner in which Ba'athist Iraq dealt with UN sanctions was to abdicate authority over large swaths of public services to local groups and militias, which undermined many of the state institutions that normally help to create and maintain trust.<sup>28</sup>

In short, Iraqi values today are no longer those that were reported in earlier accounts of the pre-Ba'athist period, which stressed the country's vibrant entrepreneurial spirit. People's values have been affected by years of repression under authoritarian top-down decision-making. Several decades of political and economic insecurity have caused doubt and distrust to be deeply entrenched in the individual mind. They represent a major constraint against drawing entrepreneurs and individuals out of the safe, kinship-based informal economy.

One of the main criticisms of US policy in post-war Iraq has been a rejection of the very state-centred approaches that were critical to the successful reconstruction of post-war Japan and Germany. At the same time, fundamental social reforms were also ruled out.<sup>29</sup> As might be expected, combined with the demise of the state as a social safety net, the lack of trust in the buying and selling of goods and services has resulted in the contemporary Iraqi economy being divided into segments of mutually exclusive networks.

*Ascribed Trust Networks.* The individual and business networks built on ascribed trust are by far the largest in number in Iraq. These are usually confined to the local, informal economy. Most ascribed trust networks involve groups bound together by family, tribal, or ethnic ties, which facilitates business based on verbal contracts. Many of these networks have the potential to expand through selective interaction with outsiders. However, such expansion will take time in Iraq, especially under the current conditions of public corruption and great uncertainty over the enforceability of contracts.

In today's Iraq, many ascribed trust activities fall under what is commonly referred to as the coping economy – numerous economic interactions during

armed conflict that provide benefits to the civilian population, particularly the poorest and most vulnerable. These functions are even more important to civilian livelihoods where the formal economy and traditional livelihoods have been destroyed or rendered difficult to sustain. The coping economy includes a wide range of activities including subsistence agriculture, petty trade, and various household businesses such as catering and food processing.

Of the country's three main economic sectors – the public sector, the oil sector and the coping economy – it is reasonable to assume that a disproportionate share of the country's poor participate primarily in the coping economy. Recent data released by the Ministry of Labour and Social Affairs indicate that about five million Iraqis are living below the poverty line, compared with 143,000 in 1993.<sup>30</sup> Significantly, the Ministry noted that more than one million Iraqi women aged 25–40 were unmarried, while divorce cases were increasing, as was child labour. It is reasonable to assume that this group of women is firmly entrenched in the coping economy.

*Process-based Trust Networks.* Second, there are the process-based trust networks that rely on existing ties between the previous members of the Ba'ath government and criminal groups that thrived during the sanctions period of the 1990s. Today, these activities have largely shifted into the criminal area. The emergence of pervasive criminality was readily apparent soon after the overthrow of Saddam Hussein. If anything, these problems have become increasingly severe. According to a UN report: 'The emerging crime problem is subtler and scarier: theft, extortion, and drug- and arms-smuggling operations that have become more sophisticated, more clandestine, and more organized. In Baghdad, one team of thieves recently burned down a warehouse filled with the hot booty of another group. It was one mob sending a message to another'.<sup>31</sup>

As in the case of the ascribed trust groups, the activities of these networks have been affected by the insurgency. Process-based networks' activities have often contributed directly to prolonging the insurgency in five ways. First, they have contributed to the destruction or circumvention of the formal economy and the growth of informal and black markets, thereby effectively blurring the lines between the formal, informal and criminal sectors. Second, such networks have engaged in pillage, predation and extortion; they have used deliberate violence against civilians to extort ransoms and capture trade networks and diaspora remittances. Third, these networks have led to greater decentralization, both in the means of coercion and in the means of production and exchange, again blurring the lines between formal and informal activities. Fourth, such networks have contributed to the licit or illicit exploitation of lucrative natural resources. Finally, process-based trust networks often rely on cross-border trading networks, regional kin and ethnic groups, arms traffickers, and mercenaries, as well as legally operating commercial entities, each of which may have a vested interest in the continuation of conflict and instability. Scores of cross-border relationships cultivated by the various smuggler/criminal groups in the 1990s are still in place and operational at the present time. Jonathan Goodhand observed that in many conflicts the shadow economy was already widespread before the outbreak of

conflict and is a facilitating factor for conflict, as it often contributes to violent state collapse, or serves as a source of income to would-be rebels. Once conflict erupts, shadow economies are easily captured by combatants and thus often become the basis for the combat economy.<sup>32</sup> This has happened in Iraq, with kidnappings and smuggling providing significant financial assistance to the insurgency.<sup>33</sup>

Western intelligence agencies are becoming increasingly worried about this systematic strengthening of ties between terrorists and organized crime. Stefan Maier of the German Institute for International and Security Affairs confirmed that co-operation between the two camps was on the rise, despite their different political and economic motives.<sup>34</sup> As he observed: 'Common ground between terrorists and organized criminal groups can be found primarily in two areas. First, the two come together in money-laundering activities: terrorists often need to park their money temporarily with somebody else to cover up their tracks. Secondly, they need weapons, and they usually get them straight from organized crime'.<sup>35</sup>

'With the lack of security measures, disorganized crime became organized crime' said Hania Mufti, Baghdad director of Human Rights Watch, 'Then, at some point, there was a merging between organized crime and political crime'.<sup>36</sup> In today's Iraq, terrorist groups use many of the same channels for their activities that the Iraqi government and associated criminal groups used in the 1980s and 1990s. In this regard, Iraq is an ideal environment for this type of activity. Decades of socialist and statist experiments of the Ba'ath Party regime, together with subsequent wars and the consequences of UN sanctions have left the Iraqi economy heavily damaged, distorted, and exposed to administrative and political interference.<sup>37</sup> Within this context, terrorists, insurgents and organized crime elements have been able to thrive by exploiting various economic and institutional weaknesses.

*Extended Trust Networks.* Although extended trust networks may involve some reliance on kinship and family relationships, they are largely characterized by transactions between anonymous individuals. As noted, they are a key element in a modern economic system. As the focus of this analysis is on the informal economy, these networks will not be treated in detail other than to note that they are largely undeveloped outside the public sector and the national oil industry. Some banking arrangements are moving in this direction, albeit extremely slowly.<sup>38</sup>

Clearly, for Iraq, the key challenge facing the economy is developing the conditions conducive to the creation and growth of extended trust networks. Conversely, the lack of supporting institutions has constrained most economic agents to informal activities characterized by family- and kinship-based ascribed trust.

As the informal economy is largely the result of a convergence of powerful long-run demographic and economic forces, it will be a fixture for some time to come. At best, informal activities may evolve over the next several years with some progression from ascribed trust-based networks to process trust-based networks. If this transition is viewed as successful by Iraqi entrepreneurs and the government makes significant strides in the governance area, then the

progression to extended trust-based networks becomes a distinct possibility, particularly if the security situation stabilizes enough to support foreign direct investment. However, a good case can be made that under current conditions, the development and evolution of organized networks may perpetuate and even expand the shadow economy through corruption and intimidation. Many of the organized networks today have evolved out of Ba'th party efforts to limit traditional centres of tribal authority. In effect, the Ba'th party encouraged the growth and proliferation of informal associational links locally, as described below.

### The Evolution of Local Networks<sup>39</sup>

Local-level kinship affiliation was increasingly encouraged as the effects of the 1980s war with Iran and the sanctions of the 1990s drained the power of the central government. Particularly after the 1991 Gulf War, the central government was weakened to the point that it was unable to perform many of its traditional military, economic and security functions.<sup>40</sup>

The Ba'thist survival strategy during this period was for the party to serve as an umbrella for local tribal associations that would assist in providing state capacity. By 1996, officially sanctioned 'tribes' were not only responsible for the maintenance of local law and order, but also collected taxes on behalf of the government, were appointed judicial powers, and applied customary tribal law within their territory. They received arms and ammunition, vehicles, and logistical support as payment for services rendered to the party.

Local dominance of revived tribal networks was evident in 1998, following the eviction of the UN weapons inspectors, which resulted in US/UK air strikes against Iraq. At that time, heavily armed and equipped Sunni tribal units were positioned in and around Baghdad to control the restive urban population, a role formerly belonging to the Ba'th party militia. With time, the interests of the central government and local networks began to diverge. Clan-based groups controlled the highways around Baghdad. They increasingly turned to criminal activities, such as looting, smuggling and hijacking throughout most of al Anbar province. Conditions deteriorated to the extent that convoys were necessary even for basic travel in daylight to avoid raids by tribal guerrillas.

By 2000, policemen, judges and party officials were subject to violent tribal recriminations. Encounters between Iraqi soldiers and tribal irregulars, especially those based in al Anbar province, escalated in frequency and scale. In this ever more lawless environment, tribal elements began to take over many of the local, informal street markets. These markets comprised a substratum of the informal Iraqi economy that, as discussed earlier, began to grow from the early 1980s as a result of chronic resource scarcities brought on by war, and were aggravated by unrest and a decade of sanctions. In addition, Saddam Hussein's selective distribution of scarce resources created some of the underlying group rivalries that exist today. By directing funds, rations, government positions, electricity, clean water, fuel and industrial investment towards specific villages in the western Sunni regions in exchange for service to the regime, and

withholding resources to other villages as a punitive mechanism, a local-level competitive calculus developed that was perpetuated by Hussein as an instrument for rule. As the state-level formal economy was dramatically curtailed by sanctions, this competition for resources further encouraged the growth of informal activities and employment.

The tendency of corrupt party and state institutions to favour key supporters in the distribution of goods and services encouraged those operating in the informal (and formal) economy to rely on local-level mediation by tribal groups. As informal activity is based in large part on social capital – the trusted familial and kinship ties noted above – local tribal groups played a central role in the expansion of the informal economy. By assessing fees for the settlement of disputes and collecting taxes on local production, local tribal groups also began to establish financial support systems free of state control.

Tribal groups were also increasingly involved in criminal-type activities, especially in the western border regions. Illicit criminal networks were initially based on the cross-border smuggling of animals, tea, alcohol and electronics. Later, these activities began to encompass the drug trade. Tribal-based organized criminal activities increased towards the end of Ba'athist rule, with many party members becoming involved owing to declining opportunities to acquire official resources. By early 2002, the entire route along the Euphrates River in al Anbar had essentially developed into a sanctuary for illicit traffickers and criminal entrepreneurs.

Resource scarcity and the stature of sub-tribal groups were both greatly enhanced at the local level following the removal of Saddam Hussein. The process began with the Coalition Provisional Authority's early adoption of a neo-liberal economic programme, which had the unintended effect of impeding the growth of regulatory and legal institutions. This institutional vacuum forced businesses and those entering the labour market to rely on the trusted kinship or extended family networks of the informal economy. Shortages of critical inputs such as electricity and fuel, and the dangers of transportation further encouraged informal entrepreneurs to rely on tribal and extended family associations for protection and support.

Endemic corruption and uncertainty contributed further to a dramatic increase in the informal sector following the 2003 invasion. As a result, approximately 80 per cent of the labour force is now engaged informally, accounting for nearly two-thirds of Iraq's GDP. In this regard, growth of the informal economy is particularly evident in certain areas west of the capital, where the destruction of the Sunni-oriented military establishment and related industries has contributed to a substantial contraction of formal employment.

Reinforcing these trends has been a dramatic rise in criminal activity dominated by local-level tribal elements, including emerging economic sectors based on the distribution of scarce resources, kidnapping, trafficking in petrol, narcotics, looted weaponry and the targeting of coalition forces. Where the Iraqi government lacks control or where there is not a substantial Coalition presence, the shadow economy is rapidly displacing any legal or semi-legal structures that have managed to survive.

### Conclusion: A Possible Way out of the Vicious Circle

The integrated model sketched above suggests that any attempts to reduce corruption in Iraq need to view and place the problem in a broader historical, social and economic context. Rather than focusing on trust-building and institutional reform, the current reconstruction strategy has emphasized market reforms, infrastructure development and private foreign investment. It is not producing tangible economic gains and in fact has created an environment in which corruption flourishes.

As a result, the massive expenditures in infrastructure have not produced the significant follow-on investment that Hirschman's unbalanced growth strategy might have anticipated.<sup>41</sup> Instead, infrastructure projects have been an easy target for the insurgents and a financial drain for the United States and the Iraqi government. The top-down nature of the post-war strategy is another reason for its limited impact. Rather than focusing on grassroots community development and trust building, there has only been limited Iraqi input and participation. Consequently, many of the investments undertaken are not nearly as productive in the Iraqi context as they would have been if they had been indigenously designed to respond to a tangible domestic demand enhanced by growing domestic markets. On the other hand, bureaucratic fear of the anti-corruption measures that are in place has brought needed capital programmes to a halt.

The critical question is what can be done to break out of the current vicious circle pulling Iraq towards increased chaos and civil war? Thomas Palley, for instance, has argued that the country's current needs are so pressing that a significant share of oil revenues should be disbursed to the population immediately.<sup>42</sup> His tentative figure was that 25 per cent of revenues be distributed.

The logical argument against disbursing a large share of oil revenues directly to the public is whether the country can afford such a programme. The reconstruction costs in Iraq are enormous and with the United States severely limiting its expenditures in Iraq, there will be a large funding shortfall. It is important to note, however, that the so-called funding shortfall is a contrived number. It is based on the assumption that funds are being diverted from projects with maximum impact to activities of little economic importance. A substantial proportion of project expenses, however, is due to high security costs and foreign staffing; it is also likely that these projects have limited effectiveness. Consequently, much of this 'shortfall' is largely illusionary.

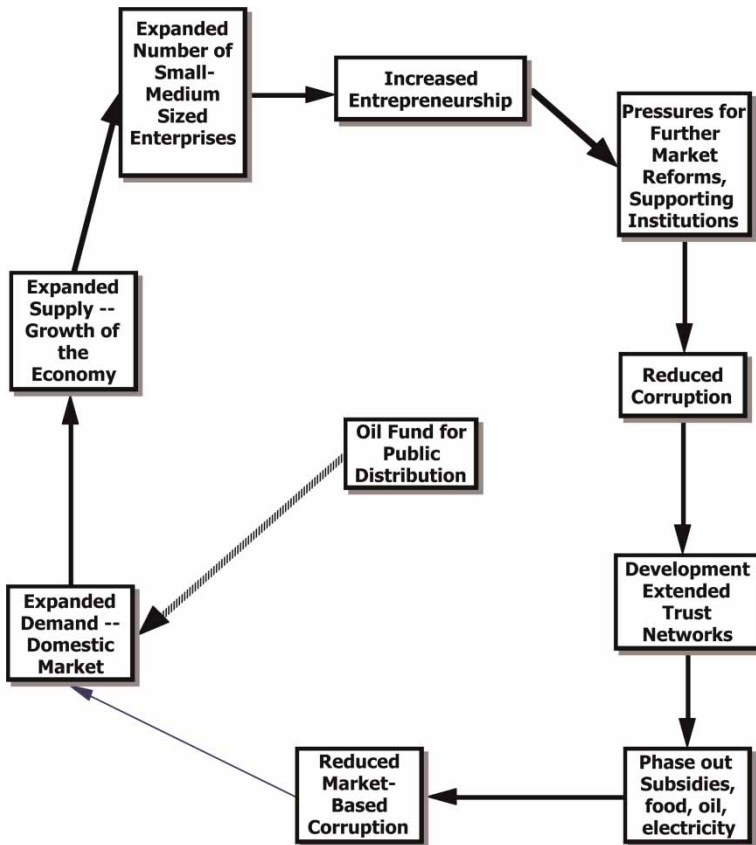
More importantly, as noted above, these projects have been a major source of corruption. Taking the money out of the hands of a corrupt political elite and giving it to the population is probably the most powerful anti-corruption policy available today – the policy of simply going after the 'bad guys' has clearly failed. By contrast, a distribution scheme would help undermine two key elements contributing to the country's massive corruption problem – the shadow economy and deficient social capital. With regard to the latter, currently one of the main stumbling blocks in uniting Iraq is the ongoing controversy over the distribution of oil revenues, with each region not trusting the others to agree to a 'fair' allocation. The direct distribution of oil revenues would assist in overcoming this

impediment while eliminating one of the major impediments to improved trust. The process is summarized in Figure 1.

Such a policy would provide an incentive to ordinary Iraqis to protect the country's oil facilities by providing intelligence on insurgent groups attempting to disrupt the production and flow of oil.<sup>43</sup> It might further help to quell the insurgency by allaying the fears of the Sunnis that they will suffer financially from the fact that most oil reserves are in Shiite and Kurdish territories. Without an equitable distribution of oil revenues, the competition among various groups for oil money could turn ugly and even erupt into violent conflict in Iraq. Rifts over oil revenues already run deep, as Iraqi Kurds, Arabs and Turkmen struggle for control of oil-rich Kirkuk.<sup>44</sup>

Distributing oil revenues directly to the public could also contribute to the formalization of a range of economic activities by creating an irrevocable personal identity under the law, and thus establishing the conditions for, *inter alia*, property rights and the registration for taxation; and could expand banking and

FIGURE 1  
IRAQ VIRTUOUS CIRCLE OF DEMAND-LED PRIVATE SECTOR ACTIVITY





credit access for small businesses. As it would increase the disposable income of families, it could also help to overcome public resistance to eliminating government subsidies for petrol – a key requirement in eliminating the incentives for oil smuggling. Although not a panacea, the impact of such a policy is likely to contribute to reducing the impact of corruption and stabilizing the economic environment in post-conflict Iraq.

## NOTES

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5. See Philp, this issue.
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