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Reform Initiatives for Iraq and the Middle East: The Search for What Works

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The Iraqi people are entrepreneurs. That's the good news. The bad news is that there is no economic system in the country. Everyone seems to have overlooked this.[1] -John Hulsman, Heritage Foundation

We inherited a corrupted and bad economy. It was a mafia economy rather than a market economy. We are trying to rebuild the new Iraq on a solid basis.[2] -Adel Abdul-Mahdi, Iraqi Finance Minister

Introduction

Leading up to the war and especially after the swift military defeat of Saddam Hussein's regime, optimism was running high among many Iraqis and American planners that the country would be quickly transformed into a free nation with a liberalized economy. Yet even after the June 28, 2004 transfer of sovereignty to an interim Iraqi government, the obstacles to these goals loom larger than ever. The insurrection is taking a huge toll of U.S. troops, Iraqi citizens, foreign aid workers and diplomats. The insurgent's aim is to sabotage economic reconstruction and the building of democratic institutions that could make Iraq a showcase for neighboring Arab countries that have drifted listlessly in

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[1]Quoted in David Lazarus, "Iraq Won't be Paying for Itself," *San Francisco Chronicle*, June 30, 2004, C1.

[2]Quoted in Paul Wiseman, "Iraq to Get New Start With Bond Market," *USA Today*, July 8, 2004, p. 8.

repressive backwardness.[3]

U.S. hopes to bring economic gains and democracy to the Middle East and North Africa region as a whole have also been thwarted. The original idea of revitalizing the region arose in response to September 11th and the growth of Islamic extremism. It was then that the Americans began to realize that due to the lack of democracy and freedom, economic stagnation and widespread unemployment were driving many young people in the Middle East and North Africa towards extremism and terrorism. The existence of pro-American, yet autocratic regimes was no longer a guarantee for lasting stability. But since the time a first draft of the reform plan for economic and political liberalization, dubbed the Greater Middle East Initiative (GMEI),[4] was leaked in February 2004, the Arab reaction has been less than enthusiastic.

Many of the generalities found in the popular press concerning the wisdom and viability of U.S. backed Middle East reforms are of little value in assessing the likelihood of a positive outcome – individual, detailed case studies are needed to provide a more realistic insight into the scope and magnitude of the tasks that confront both the United States and like-minded regional leaders.

In this regard, despite all of its difficulties, Iraq still remains a valid case for examining the strengths and weaknesses of U.S. initiated reforms. Needless to say, the post-Saddam economy is not off to a good start. At the end of June 2004 Iraq's unemployment was estimated at ranging anywhere from 30 to 70 percent,[5] and one out of six Iraqis still depended on the rationing system. Yearly per capita income dropped from around \$3,600 in the 80s to \$970 following the Gulf War in 1990, then to \$420 at the present time.

[3]John Hughes, "Whispers of Democracy Across the Middle East," *Christian Science Monitor*, October 22, 2003.

[4]For a description of this initiative as well as its successor the Broader Middle East Initiative (BMEI) see Robert Looney, "The Broader Middle East Initiative: Requirements for Success in the Gulf," *Strategic Insights*, August, 2004.

[5]Ahmed Janabi, "Iraqi Unemployment Rate Reaches 70 Percent," <www.Aljazeera.Net>, July 20, 2004.

How much of this sad state of affairs can be attributed to the reforms is an open question. In Iraq, the U.S. reforms decreed by the Coalition Provisional Authority (CPA) began appearing in the summer of 2003, (Independence of the Central Bank, June 2003) culminating in the winter of that year – rules for foreign investment. Clearly the reforms introduced by the CPA are intended to nudge and guide Iraq down a certain path.

Needless to say if the security situation does not improve considerably, efforts to rebuild the economy will be fruitless. Yet improvements in the economy are critical for dampening the insurgency.

> Last week a former senior security adviser in the occupation authority told the Senate Foreign Relations Committee that a key reason Iraqis haven't cooperated with the coalition against the insurgency has been resentment over the lack of progress in improving conditions and solving unemployment.[6]

On the assumption that the Interim Government makes significant progress in the security area, the following sections assess whether the current Interim Government and its successors will be able to draw on the country's reform efforts to date as a means of initiating economic prosperity and perhaps eventual democracy. As for further reforms, are there any good role models for the Iraqi's to follow in designing their development strategy? Based on the transition economies of Eastern and Central Europe's experience, several areas of reform effort are identified as critical if Iraq is to make significant progress towards becoming a modern, dynamic economy in a relatively democratic setting. Drawing on these results, a final section draws some lessons for the GMEI countries as a whole.

The CPA Reforms

On May 16, 2003 the Coalition Provisional Authority (CPA) issued Regulation 1, assigning itself "all executive legislative and judicial authority necessary to achieve its objectives." In this capacity it issued around 100 orders, memoranda and regulations that will serve as the main constraints on Iraqi policymakers until elections are held in December 2005. Some orders address liberal free market economic

[6]Quoted in Hannah K. Strange, "Iraqi Reconstruction Flawed, Say Experts," *United Press International*, July 27, 2004.

policies to be implemented, while others are mainly administrative. Their scope is broad in addressing such diverse areas as: banking, the media, de-Baathification, nongovernmental organizations, traffic, procurement, intellectual property, elections and the judiciary. To assure implementation of the orders, Ambassador Bremer appointed, with five year terms, key individuals in the country's relevant ministries.

Coalition Provisional Authority (CPA) Orders

The Orders are exercised pursuant to the Iraqi interim constitution, the Transitional Administration Law (TAL). The Annex to the TAL states that the Orders can only be overturned with the approval of the president, the two vice presidents and a majority of the ministers. More importantly the Annex limits the Interim Government from taking "any actions affecting Iraq's destiny" beyond the election of an Iraqi government. The identical sentence appears in UN Security Council Resolution 1546, which outlines Iraq's transition to full sovereignty.

Orders pertaining explicitly to the economy are extremely encompassing.

Order #39 – Foreign Investment: assists in transitioning Iraq "from a ... centrally planned economy to a market economy." The Order permits the following: (1) privatization of Iraq's 200 state-owned enterprises; (2) 100 percent foreign ownership of Iraqi businesses; (3) "national treatment" of foreign firms; (4) unrestricted, tax-free remittance of all profits and other funds; and (5) 40-year ownership licenses.

Order #40 – The Banking Sector: transforms the banking sector from a state-run to a market-driven system. It allows foreign banks to enter the Iraqi market and to purchase up to 50 percent of Iraqi banks.

Order #49 – Taxes: reduces the tax rate on corporations from a high of 40 percent to a flat rate of 15 percent. The income tax rate is also capped at 15 percent.

Order #12 – Trade: suspends "all tariffs, customs duties, import taxes, licensing fees and similar surcharges for goods entering or leaving Iraq, and all other trade restrictions that may apply to such goods."

Order #17 – Foreign Contractors: grants foreign contractors, including private security firms, full immunity from Iraq's laws.

Order #77 – Auditing: establishes the Board of Supreme Audit and named its president and his two deputies. The Board oversees inspectors in every ministry with wide-ranging authority to review government contracts, audit classified programs and prescribe regulations and procedures.

Order #57 – Inspectors: creates and appoints an inspector within every Iraqi ministry to five-year terms. These inspectors have the authority to perform audits, write policies and have full access to all offices, materials and employees of the ministries.

In late June 2004 as he was about to leave his post Ambassador Bremer noted that "Iraq has been fundamentally changed for the better." He noted that "among his biggest accomplishments...were the lowering of Iraq's tax rate, the liberalization of foreign investment laws and the reduction of import duties."[7]

Clearly, the Bremer Orders fundamentally altered Iraq's economic system. It has transformed it from a closed Baathist statist model[8] to one of the more open, neo-liberal economies in the developing world.[9] Unfortunately, what seemed to be the application of sound economic principles to Americans often came across as a radical intrusion by many Iraqis. As one observer has noted:

> Even textbook-perfect economic reforms will not lead to sustained economic growth or an open Iraqi economy unless Iraqis own the process – especially if sovereignty is to have any real meaning.[10]

The same applies to the power assigned to independent regulators that will drastically reduce the power of Iraqi government ministries. For instance one report suggested that these regulators were likely to prevent the Communications Ministry from canceling licenses the coalition awarded to foreign-managed consortia to operate three mobile networks and the national broadcaster. Apparently interference of this sort is a major source of Iraqi ill will.[11]

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[7]Quoted in John B. Judis, "Talking Points Memo" Iraq's Economy," *Occupation Watch*, June 23, 2004.

[8]Cf. Robert Looney, "A return to Baathist Economics? Escaping vicious Circles in Iraq," *Strategic Insights* (July 2004), <http://www.ccc.nps.navy.mil/si/2004/jul/looneyJul04.asp>.

[9]Robert Looney, "Iraq's Economic Transition: The Neoliberal Model and its Role," *The Middle East Journal*, 57:4, (Autumn 2003), pp. 568-587.

[10]Bathsheba Crocker, "The Economy: With Money Comes Power," *Washington Post*, June 20, 2004, b1.

[11]Naomi Klein, "Bremer Has Destroyed my Country," *The Guardian*, April 3, 2004.

There is some controversy over how much power the Interim Government has to overturn or modify these orders. No doubt the provisional government will be able to exercise some control over the details of implementation. Most concede, however, that changing the fundamental laws or the essential character of the neo-liberal economic policies they facilitate is quite another matter. Ambassador Bremer characterized the orders: "You set up these things and they begin to develop a certain life and momentum on their own – and it's harder to reverse course."[12]

A long uphill struggle lies ahead for the Iraqi interim government. A number of pressing policy choices need to be made which include creating job opportunities for the unemployed, stimulating the private sector, establishing a social safety net, rehabilitating the agricultural sector and integrating it within the reconstruction priorities, guaranteeing stable food supplies and finding the adequate funding for all these tasks.[13]

The critical question is whether within the context of the Orders an economic strategy can be developed in keeping with the country's priorities and interests. If the Orders are overly constraining and Iraqi needs not met, the legality[14] of the Orders may come into question and valuable time will be lost in the restoration of the economy.

Fiscal Operations

As noted above, the Orders place several constraints on the fiscal operations of the authorities:

Taxes. As noted above, Order #49 limits the highest tax bracket at 15 percent, a rate lowered considerably from the official prewar rate. As a result, during 2004 Iraqi officials expect to collect only $5 million worth of personal income taxes and nothing in corporate taxes.

Bonds. Other constraints on the Interim Government's finances involve treatment of past government domestic debt and constraints on the official borrowing from the Iraqi Central Bank. On June 4, 2004 U.S. administrator Paul Bremer signed the public debt law. This new statute stipulates that the Iraqi government will be required to honor all

[12]Quoted in Rajiv Chandrasekaran and Walter Pincus, "U.S. Edicts Curb Power of Iraq's Leadership," *Washington Post*, June 27, 2004, p. 1.
[13]Henry Azzam, "Security is the Major Constraint Hindering Business Activity and Economic Rebound in Iraq," *Jordan Times*, July 25, 2004.
[14]Some jurists contend that the Orders violate the Hague regulations of 1907.

of its previous domestic debts to Iraq's commercial banks – debts largely contracted by Saddam Hussein. This "Saddam Paper" is estimated to be around 1,300 billion dinars. The public debt law can therefore be seen as a way to bring funds back into Iraq's banking sector, much of which would otherwise face bankruptcy due to insolvency. The Iraqi Central Bank also holds about $2.5 billion in Iraqi government debt. Under the Bond Market Plan put together by Paul Bremer that debt must be paid as it matures.[15]

The Coalition Provisional Authority (CPA) also passed a law in January 2004 that created the Central Bank of Iraq (CBI) as an independent bank, meaning the government cannot force the bank to buy its paper as was done under Saddam.

Given these domestic debt servicing obligations as well as a cash shortage, the Interim Government is attempting to develop a domestic bond market as an additional source of finance. Iraq's Finance Minister Adel Mahdi noted that "It's a way to recover the economy. We are issuing new treasury bills not only to finance the repayment of treasury bills outstanding from the former regime, but to regulate the market and determine interest rates." On July 18, 2004 the Central Bank of Iraq raised about 150 billion dinars ($103m) for the government, selling three month bonds.

The bonds offered a market determined interest rate of between 5 and 8 percent, not enough to entice foreign banks, given the political risks involve. Instead, the vast majority of the buyers were local banks and the auction was a first step in laying the groundwork for further borrowing. Three-month bonds were chosen for their short maturity, allowing the government to prove that it is credit-worthy. It plans to issue six month and one-year bonds later in 2004, hopefully raising as much as $1.2 billion by the end of the year. It is expected that the development of a government debt market will introduce another constraint on the government – if it overspends the way Saddam did, investors will demand higher interest rates.

Privatization. Even though the energy sector is exempt, privatization of Iraqi industry is probably the most controversial of the U.S. proposed reforms (Order #39). U.S. officials saw privatization as part of

[15]Paul Wiseman, "Iraq to Get New Start with Bond Market," *USA Today*, July 9, 2004, p. 2B.

the broader conservative economic agenda that Reagan had endorsed in the 1980s.[16] The supply-side tax cuts – increasing profitability, and the elimination of import duties – lowering costs were to complement the privatization of Iraqi state-owned enterprises (SOEs).

The state still controls almost all large businesses in Iraq. The 61 major industries under the Ministry of Industry and Minerals account for 90 percent of Iraq's industrial production, including oil, leather goods and textiles. At the time the Interim Government assumed power most SOEs were in dire straits, with just the oil and cement industries profitable.[17] State-run enterprises brought in $73 million in revenue in the first five months of 2004, but paid out $85 million in salaries alone, much of it to employees not working -- about two-thirds of the workforce is redundant. More than half the state-owned companies are not operating and the remainder is functioning at a fraction of its capacity.

Clearly something needs to be done. On the surface, privatization would appear to offer an ideal solution to these problems. The central rationale for privatization is that, left to its devices, a privately owned enterprise is by definition more efficient that its publicly owned counterpart. This general proposition has been borne out by numerous empirical studies of privatization programs around the world.[18] In Iraq's case the government would receive needed revenues from the sale, and divest itself of the on-going drain of subsidies. The firms would receive needed technology and capital.

A closer look, however, suggests the difficulties that would face any new owner are likely to dampen interest for some time. The State Company for Woolen Industries[19] provides a useful illustration. The company has power generators that can keep equipment running even when Baghdad's electricity supply shuts down. Two of the factories were

[16]Cf. Robert Looney, "Reaganomics," in *Routledge Encyclopedia of International Political Economy*, ed. R.J. Barry Jones (London: Routledge, 2001), Volume 3, pp. 1310-1313.
[17]Doug Struck, "Engines of Industry Sputtering in Iraq," *Washington Post*, July 10, 2004.
[18]Summarized in William Megginson and Jeffrey Netter, "From State to Market: A Survey of Empirical Studies on Privatization," *Journal of Economic Literature*, XXXIX:2, (June 2001), pp. 321-389.
[19]This section draws heavily on Doug Struck, "Engines of Industry Sputtering in Iraq," *Washington Post*, July 10, 2004.

looted or bombed, but the five functioning plants are running only one shift out of three per day. Schedules are juggled to try to keep the 3,700 employees working at least a few shifts a week; all are being paid full salaries.

A major source of the firm's difficulties stems from the fact that the U.S.-led Coalition Provisional Authority arbitrarily doubled worker salaries to reduce unrest when it took over in April 2003. That huge increase in operating costs makes the company's wool blankets, tents and clothing much more expensive than imports which are now entering the country essentially duty free as a result of Order #12. As one factory manager lamented:

> We can't sell out products on the local market. Our prices are too high – It's good to have better salaries for our workers. People need to feed their families, but it's a disaster for the company – the output is just piling up unsold in warehouses.[20]

Other state owned companies have no capital to get equipment or income to buy parts. Materials suppliers reuse to overhaul Iraq's bandit-ridden roads. In addition many Iraqi workers have little motivation to go back to work if their salaries are still being paid.[21]

Given the current situation in Iraq, privatization at this time would appear to be an ineffective tool to address the country's pressing problems. The security situation makes it impossible to arrive at fair value bids, and the high unemployment rate negates wholesale restructuring for efficiency gains.

The Post-CPA Period

Before turning over power to the Interim Government the CPA shelved its privatization plans. Even as early as December 2003 the initiatives touted by the CPA to fashion Iraq into a secular, pluralistic, market-driven nation was put on hold. "The Americans are coming to understand that they cannot change everything that they want to change in Iraq," noted Adel Abdel-Mehdi, the current Interim Government finance minister, "They need to let the Iraqi people decide the big issues."[22]

[20]Quoted in Doug Struck, "Engines of Industry Sputtering in Iraq," *Washington Post*, July 10, 2004.
[21]Doug Struck, "Engines of Industry Sputtering in Iraq," *Washington Post*, July 10, 2004.
[22]Rajiv Chandrasekaran, "Attacks Force Retreat from Wide-Ranging Plans for Iraq," *Washington Post*, December 28, 2003.

Critics of the CPA's reforms feel that in the face of continued insurgency, the absence of electrical power and of elementary safety on the city streets, that the focus should not have been placed on economic liberalization. If not the liberalization program laid out in the various orders, then what for the Interim Government? A return to Baathist economics, abandoning the market economy?[23] An East-Asia export oriented model stressing domestic demand management for full employment?[24]

Undertaking a full scale shift in development strategy makes little sense until an elected Iraqi government is in place. Perhaps for this reason, the Interim Government has shown little inclination to deviate markedly from the path laid out by the CPA. As a possible prelude to future privatization programs under an elected Iraqi government, the interim government hopes to start leasing-out some of the struggling state-owned firms as a means of attracting much needed investment.[25]

The assumption behind leasing is that potential investors are more likely to invest in factories that are already operational and don't require major improvements. However, because of the high unemployment rate, investors would be required to avoid laying off large numbers. One plan is to offer leases to foreign and local companies through temporary contracts that could last as long as 15 years. Leasing would allow investors to run individual factories as joint ventures and share profits.[26]

The Interim Government has also implemented a CPA initiated program – the revamping of the old Baghdad Stock Exchange. The new Iraq Stock Exchange opened on June 24, 2004. It was the product of more than a year's work on a regulatory framework undertaken by 12 brokerage firms and banks who share joint ownership. The Iraq Stock Exchange has 27 companies with about 100 to go public before the fall

[23]Robert Looney, "A Return to Baathist Economics?" *Strategic Insights*, July 2004.

[24]As described in Robert Looney, "Thaksinomics: A New Asian Paradigm?" *The Journal of Social, Political and Economic Studies*, 29:1 (Spring 2004), pp.65-86.

[25]Edmund Blair, "Iraq to Lease State Plants to Foreigners," *Reuters*, July 12, 2004.

[26]Todd Pitman, "With Plan to Lease State-Run Factories, Iraqi Minister Says Insecurity Hindering Efforts to Attract Foreign Investment," *Associated Press*, July 24, 2004.

with a total of 180 to 200 expected by the end of the year.[27] In just five sessions, trading volume has nearly quadrupled and the value of some stocks has surged more than 600 percent.[28]

The old stock exchange comprised only Iraqi companies and traders, while the new bourse will eventually be accessible to foreigners. The key to the exchange's success is a strong regulatory framework, transparency and accountability. A shift to an electronic trading system will be introduced in the near future.

Hopefully the stock market will begin to lure money back from Iraqis citizens living overseas. What better way to build national pride or a symbol of capitalism working in the new Iraq than creating a stock exchange?[29]

Failure of CPA Reforms?

As noted above the U.S. sponsored reforms have come under intense criticism both in and outside of Iraq. Much of this criticism has been directed at the deplorable state of unemployment. While the CPA reforms may account for some of this job loss, other factors appear to account for the bulk of the country's joblessness. As in the above Woolen Industry example, looking at job loss in a plant that can't compete because of free trade imports gives you one picture – a microeconomic explanation. Looking at the larger picture that reflects job joss due to insufficient demand – the macro explanation, gives you an entirely different perspective.

After the fall of Saddam's government, Ambassador Bremer and the Governing Council decreed the top three levels of the Baath party membership could not be on the government payroll. Estimates vary, but a safe guess is that more than 120,000 people lost their jobs. Some were diehard Saddam loyalists, but many others were doctors, nurses, university professors and other professionals who argued that they had joined the Baath Party simply to obtain their jobs or to receive promotions or advance their careers, not out of ideology or loyalty to

[27]Deborah Haynes, "Iraq Stock Exchange Poised to Rally in 'Japan' of the Middle East," *Agence France Presse*, July 16, 2004.

[28]Tarek Wl-Tablawy, "With Pen and Sweat, Brokers Push Iraq Stock Exchange to New Highs," *Boston Globe*, July 18, 2004.

[29]Cheryl Glaser, "Reviving Baghdad Stock Exchange Will Help Democracy," *Minnesota Public Radio*, Marketplace, June 29, 2004.

Saddam.[30] Not only were their productive services lost, but their reduced or lost incomes resulted in slack demand for consumer goods, throwing many workers in those sectors out of work. Belatedly, in April of 2004 after much of the damage was one, Ambassador Bremer reversed the much criticized de-Baathification policy and noted that many laid-off Baathist teachers would be eligible to regain their jobs through a newly streamlined appeals process.[31]

Employment also fell after the war as a result of the CPA's controversial decision in Late May to disband the army. When the war ended, the army consisted of about 500,000 or about 7 percent of the labor force. The coalition would later pay stipends to former soldiers, but the decision to put them back on the streets without jobs has been blamed for the increase in insurgency.[32]

Delays in reconstruction have also taken a toll in jobs. Seven months after Congress approved the largest foreign aid package in history to rebuild Iraq, less than 5 percent of the $18.4 billion had been spent.[33] By late May 2004 the pace of expenditure appeared to be picking up, under Congressional pressure.[34] However, by then, the damage to Iraqi good will caused by the unaddressed unemployment situation was more than apparent.

Reconstruction contracting is also responsible for the small amount of job creation in Iraq. In principle Iraqi companies were to be secondary beneficiaries of the $18.4 billion in aid allocated for reconstruction by the U.S – they were to be given priority in the sub-contracting bidding, although firms from a list of sixty-nine coalition countries could also bid. As it turned out, Iraqi companies were at a distinct disadvantage in competing with foreign firms because they did not have the capital, nor

[30]Eric Schmitt, "U.S. Generals Criticize Ban on Employing Es-Baathists," *International Herald Tribune*, April 21, 2004.
[31]Nicholas Riccardi, "Iraqi Teachers Learn Hard Political Lesson: Hussein's Victims and Baath Party Members Compete for Lucrative and Limited Positions," *Los Angeles Times*, May 14, 2004, A10.
[32]Christopher Foote, William Block, Keith Crane, and Simon Gray, "Economic Policy as Prospects in Iraq," Federal Reserve Bank of Boston, Public Policy Discussion Paper No. 04-1, May 4, 2004, p.11.
[33]Jonathan Weisman and Ariana Cha, "Rebuilding Aid Unspent, Tapped to Pay Expenses," *Washington Post*, April 30, 2004, A1.
[34]Robert O'Harrow, "U.S. Finally Spending Iraq Construction Funds," *Washington Post*, May 25, 2004, A11.

could they obtain the necessary financing from the country's primitive banking system.[35]

As a result, reconstruction projects are simply not getting enough money into the hands of entrepreneurial Iraqis and large segments of the Iraqi workforce. By May 2004 fewer than 25,000 Iraqis were working on projects funded by the U.S. "tempering expectations that more than $18 billion in American spending would jump-start Iraq's economy and trigger a surge in goodwill towards the United States."[36]

As noted above, most Iraqi companies are not able to take advantage of reconstruction jobs because of lack of credit. Whether these midsize businesses succeed or fail with their job creating expansions is critical for stability. Again, delays in restoring the country's banking and financial system are severely limiting the economy's recovery.

Belatedly, to address the private sector's dire credit needs the CPA has begun (May 2004) accepting applications for a new program designed to provide loans of $500,000 to $5 million for midsize companies. However as of early June 2004 the program was still not formally approved.[37] Under other programs the coalition has distributed about $7.5 million in "microfinance" credits, typically loans averaging $2,500 for small businesses such as bakeries and grocery stores. An additional $17.5 million is in the pipeline for that effort.[38] Again, these amounts are dwarfed by the country's needs. An expansion of this program might be the most productive and least cost way of making a significant dent in the country's massive unemployment.

In sum, the causes of Iraq's current economic malaise have their origins in a series of CPA miscalculations. Too many decisions were made without examining or at least acknowledging the economic dimension. While the reforms are an easy target for assigning blame, they are only a small source of the problem.

[35]Ali B. Al-Shouk, "CPA Prepares Iraqi Firms for Reconstruction Subcontracts," *Iraq Today*, December 29, 2003.
[36]Matt Kelly, "Fewer than 25, 000 Iraqis Working on Reconstruction Funded by U.S.," *Associated Press*, Mary 19, 2004.
[37]David Lynch, "Cash Crunch Curbs Rebuilding in Iraq," *USA Today*, June 1, 2004.
[38]Ibid.

Assessment

> There's no financial policy, because there's been no government. And as yet we have no idea what will happen now [with a sovereign Iraqi government].[39] - Abdul Jaber Al-Rubaie, Managing Director, Industrial Union Investment Bank

This quote pretty much sums up the sentiment of the Iraqi business community in the period soon after the formation of the interim government. The previous sections suggest that the Interim Government without much fanfare is essentially staying the course, perhaps hoping that with a number of new construction projects coming on line unemployment will come under control and with that a lessening of the insurgency. With an improvement in security, increases in aid flows should follow thus facilitating more reconstruction expenditures and job creation.

> What is happening here is just a phase and the bad news is being exaggerated. But the biggest problem is security...Once the security situation is improved, as we hope it will under the new government, the economy will take off.[40] – Ismael Al Bahrani, Managing Director, Bahrani Group

Clearly this is wishful thinking, grounded in little or no economic theory or empirical support. Economic miracles do happen, however, with reforms in post-war West Germany, together with the Marshall Plan,[41] often cited as a model for Iraq. No doubt, the German experience provided the inspiration for many of the CPA's reforms noted above:

> After World War II, the first economic miracle was brought about by Ludwig Erhard's reforms in West Germany, which began in 1948. Tariffs were greatly reduced, price controls were abolished, and the exchange rate of the new deutschemark was fixed to the dollar, which in turn was tied to gold. Income tax rates were slashed from 95 percent on incomes above $15,000 at the time of the Allied occupation to a maximum of 53 percent on income of $250,000 in the early 1950s. Inflation stopped immediately, shortages vanished, trade flourished and for more than a decade, the West German economy grew much faster than that of the United States.[42]

In fact, the Bush Administration has drawn a number of historical analogies between Germany and Iraq[43] and in so doing appears to be sending several messages: First, that the Iraq war was a noble cause, as noble as fighting the Nazis. Second, that the rebuilding will be lengthy, costly and complicated. And third, that despite the difficulties, the United States can be successful in Iraq, just as it was ultimately successful in Germany.[44]

As noted, the West German reforms bear some resemblance to those undertaken by the CPA. The massive U.S. led reconstruction and aid effort also brings back memories of the Marshall Plan for post-war reconstruction in Europe. However Germany recovered as fully as it did, in large part, because the country had substantial experience with capitalism and, though more briefly, democracy. It was a Western nation long before Hitler; it required only a restoration, not a transformation to establish a modern self-sustaining economy. The same cannot be said of Iraq before Saddam.[45]

To its credit, the Bush Administration through its greater Middle East Initiative appears to recognize that Iraq is only one part of a larger problem. As Condoleezza Rice has noted: "U.S. troops will not need to be in Iraq as long as they have been in Germany, now almost 60 years, but the United States will need to engage broadly throughout the region economically, diplomatically and culturally. We must have the patience and perseverance to see it through."[46]

The enormity of the task can be easily seen from the statistics. Over the past 20 years, the average per capita growth rate in the Arab world

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[39]Quoted in Gareth Smyth, "Lack of Direction in Iraq Stunts Business Growth," *Financial Times*, July 9, 2004.
[40]Quoted in Gareth Smyth, "Lack of Direction in Iraq Stunts Business Growth," *Financial Times*, July 9, 2004.
[41]Jonathan Kallmer, "Marshall Plan Principles Model for Rebuilding Iraq," *Daily Yamiuri*, September 8, 2003.
[42]Alan Reynolds, "National Prosperity is no Mystery," *Orbis* 40:2 (Spring 1996), p. 200.
[43]Robin Wright, "Rice Likens Iraq to Postwar Germany," *Los Angeles Times*, August 8, 2003, A10.
[44]Faye Bowers, "What Lessons Postwar Germany Holds for Iraq: Bush Aides See Parallels, urging Patience, but Others Note a Difference – More Fighting," *The Christian Science Monitor*, September 3, 2002, p. 2.
[45]Fred Kaplan, "Iraq's Not Germany: What a 60-Year-Old Allen Dulles Speech can Teach us About Postwar Reconstruction," *Slate*, October 17, 2003.
[46]Quoted in Robin Wright, "Rice Likens Iraq to Postwar Germany," *Los Angeles Times*, August 8, 2003, A10.

has been less than 1 percent, lower than that of sub-Saharan Africa. Official unemployment rates are in double digits, and likely underestimate the problem. Labor productivity in the 1990s was the same as it was in the 1970s. In ranking of everything from exports to technological development and access to foreign literature and ideas, the Middle East is the world's weakest region, and falling further behind. In the 1950s, per capita income in Egypt was similar to that of South Korea, but it is now 80 percent lower. In the past 20 years, Egyptians, with a population of 70 million, filed 77 patents in the United States. The 50 million South Koreans filed 16,328. Today, non-oil exports of Hungary exceed those of all Arab countries combined.[47]

Future Areas of Reform

The reforms often suggested for the Middle East by U.S. officials, fall into two broad categories: (a) those intended to develop efficient market-based economies, with increased economic freedom, and (b) those related to democracy and improved governance.

Economic Freedom

Both the Heritage Foundation/Wall Street Journal's Index of Economic Freedom[48] and the Fraser Institute's Economic Freedom of the World[49] provide good measures of the relative progress made by countries in moving to a deregulated, limited government, free-market environment. Because the Heritage Foundation data set included more of the Middle Eastern countries it was used for the analysis that follows. The Heritage Index reflects the absence of government constraint or coercion on the production, distribution or consumption of goods and services. Stripped to its essentials, economic freedom is concerned with property rights and choice. To measure economic freedom the Heritage

[47]Jeffrey Garten, "Chinese Lessons: The Best Way to Deliver on Bush's Call for Freedom in the Middle East May be Found in the China Model," *Newsweek*, November 24, 2003, p. 54.
[48]See for example Marc Miles, Edwin Feulner and Mary Anastasia O'Grady and Ana Eiras, *2004 Index of Economic Freedom* (Washington: Heritage Foundation, 2004).
[49]Available from Global Economic Software, Ltd., <www.globaleconomicsoftware.com>. See Cf. Robert Looney, "Iraq's Economic Transition: The Neoliberal Model and its Role," *The Middle East Journal*, 57:4 (Autumn 2003), pp. 568-587 for an application of this data set to the Middle East.

Foundation/Wall Street Journal Index takes ten different factors into account:

1. Trade Policy
2. Fiscal Burden of Government
3. Government Intervention in the Economy
4. Monetary Policy
5. Banking and Finance
6. Capital Flows and Foreign Investment
7. Wages and Prices
8. Property Rights
9. Regulation
10. Informal Market

Implied in these measures is the notion that economic freedom also requires governments to refrain from many activities. They must refrain from actions that interfere with personal choice, voluntary exchange, and the freedom to enter and compete in labor and product markets. Economic freedom is reduced when taxes, government expenditures, and regulations are substituted for personal choice, voluntary exchange and market coordination. Restrictions that limit entry into occupations and business activities also retard economic freedom.

The index provides a framework for understanding most of the objectives of U.S. reform efforts in the region: how open countries are to competition; the degree of state intervention in the economy whether through taxation, spending or overregulation, and the strength and independence of a country's judiciary to enforce rules and protects private property. Some countries may have freedom in all factors; others may have freedom in just a few. One of the most important findings of research carried out using the index is that economic freedom is required in all aspects of economic life. That is countries must score well in all ten of the factors in order to improve their economic efficiency and consequently the living standards of their people.[50]

Governance

The other main area of U.S. reform efforts, democracy and governance are increasingly seen as essential for long run economic growth

[50]Ana Isabel Eiras, *Ethics, Corruption and Economic Freedom* (Heritage Foundation, December 9, 2003).

and prosperity. In fact some dimensions of governance now sit at the center of academic and policy discussions of economic development.[51]

While the ranking of countries on the basis of their relative progress in attaining improved governance is inherently subjective, a recent World Bank study[52] provides a set of rankings incorporating the full extent of our knowledge about this phenomenon. More precisely, the World Bank data set presents a set of estimates of six dimensions of governance covering 199 countries and territories for 1996, 1998, 2000 and 2002.

Voice and Accountability. This variable measures various aspects of the political process, civil liberties and political rights. These indicators measure the extent to which the citizens of a country are able to participate in the selection of governments. Also included in this variable are indicators measuring the independence of the media.

Political Stability and Absence of Violence. This governance cluster combines several indicators which measure perceptions of the likelihood that the government in power will be destabilized or overthrown.

Government Effectiveness. This variable combines aspects of the quality of public service provision, the quality of the bureaucracy, the competence of civil servants, the independence of the civil service from political pressures, and the credibility of the government's commitment to policies.

Regulatory Quality. This aspect of governance is more focused on the policies themselves. It includes measures of the incidence of market-unfriendly policies such as price controls or inadequate bank supervision as well as perceptions of the burdens imposed by excessive regulation in areas such as foreign trade and business development.

Rule of Law. Included in this dimension of governance are several indicators which measure the extent to which the citizens of a country have confidence in and abide by the rules of society. These include perceptions of the incidence of crime, the effectiveness and predictability of the judiciary and the enforceability of contracts.

Control of Corruption. This dimension of governance measures perceptions of corruption. By this measure corruption is defined as the

[51]Herbert Kitschelt, "A Review of the Political Economy of Governance," World Bank Policy Research Working Paper 3315, May 2004, p. 1.

[52]Daniel Kaufman, Aart Kraay and Massimo Mastruzzi, *Governance Matters III: Governance Indicators for 1996-2002* (Washington: World Bank, June 30, 2003).

exercise of public power for private gain. It is often a manifestation of a lack of respect of both the corrupter and the corrupted for the rules which govern their interactions, and hence represents a failure of governance.

As a whole, the Greater Middle East Initiative countries have lagged considerably behind other major groupings of countries (Table 1). The high growth (so-called "catching-up") developing countries[53] – Malaysia, Thailand, Mexico etc. have made considerably more progress in nearly all of the major areas of reform. In turn there is a comparable but generally smaller gap between the various reform measures of the catching-up and advanced countries.

The reform gap between the Greater Middle East Initiative (GMEI) countries and those catching up to the advanced economies are particularly evident in the main dimensions of governance (lower values in Table 1 represent a worsening of governance). While the gaps between the GMEI countries and the catching up countries are not as great in the economic freedom area, they are still fairly consistent (higher values in Table 1 for these variables signifies a worsening of economic freedom) across all ten dimensions with the exception of monetary policy.

Finally, the standard deviations of nearly all reform dimensions are relatively high across the board for the Greater Middle East Initiative countries. This suggests considerably more diversity of reform experiences within this group of countries relative to those found in the catching up and advanced economies.

A Conceptual Framework

The various dimensions of economic freedom and governance provide a good gauge of the progress made by Iraq and the GMEI countries in reforming their economies and political systems. However, to fully appreciate the contribution made by these reforms, one needs to see them in a broader context. Which combinations and levels of reforms appear to be associated with movements to higher levels of development and modernization? Which reform strategies appear most

[53]As defined in Jeffrey Sachs, "Globalization and Patterns of Economic Development," *Weltwirtschaftliches Archiv* 136:4 (2000), p. 581. Sachs considers these countries to be narrowing the income gap with the higher technology and richer countries through a process of technological diffusion and capital flows from the leader to follower.

efficient in placing a country on the path to sustainable levels of prosperity?

In the case of Iraq, although post-war Germany appears to offer few policy insights,[54] several models are available to provide guidance for reform strategies. Each has its limitations however:

1. The economic development literature is replete with "success stories" Iraq might consider emulating.[55] However, while applicable to a wide variety of situations confronting Iraq most of these development models, the East Asia Model for example, seem inappropriate because Iraq faces far greater challenges than those countries at the start of their transformations: Iraq not only needs to emerge from decades of poverty, but also needs to rebuild after decades of violent conflict.
2. The literature on failed states[56] and post-conflict reconstruction is therefore also relevant to the Iraqi case,[57] but here Iraq differs from most post conflict countries in that it has, at least potentially, its own independent and abundant source of funding in the form of oil revenues.
3. Oil economies however have their own set of problems. The oil economy or "rentier state" literature addresses many of the issues specific to Iraq's situation,[58] but one would be hard pressed to find a "success story" that might be emulated by the Iraqis. The only success story of note is Norway, a country of few similarities to Iraq. In fact rentier economies like Iraq have tended to be some of the worst performers in the world economy, falling further and further behind their less well endowed neighbors.
4. A final area of potentially useful literature is that of the transition countries of Central and Eastern Europe as well as the republics of the former Soviet Union. While Iraq was not a Communist country, this literature[59] does provide insights into the problems encountered by Iraq in moving from a centrally planned economy to that of a market-driven country. Several of the transition countries also experienced periods of conflict, while others do have abundant oil revenues.[60]

[54]Cf. Douglas Porch and George Cornewall Lewis, "Occuptational Hazzards: Myths of 1945 and U.S. Iraq Policy," *The National Interest*, Issue 72 (Summer 2003).

[55]Much of which is summarized in Dani Rodrik, "Understanding Economic Policy Reform," *Journal of Economic Literature*, XXIV (March 1996), pp. 9-41.

[56]Ralph Peters, "Spotting the Losers: Seven Signs of Non-Competititve States," *Parameters* (Spring 1998), pp. 36-47.

[57]John Lampe, "The Lessons of Bosnia and Kosovo for Iraq," *Current History* (March 2004), pp. 113-118.

[58]Robert Looney, "Iraq's Future: Will Oil be a Blessing or Curse?" *The Middle East Business and Economic Review*, 16:1 (June 2004), pp. 15-29.

Most importantly, the transition economies appear to be split into two groups – one that has achieved a large measure of success in critical areas of the economy, and another that has not been able to make major strides in this regard. Certainly these countries are far more relevant to Iraq than postwar Germany and Japan–countries that were rich, industrialized and war torn, not backward and war torn.[61] This fact was not lost on the CPA who in September of 2003 invited Yegor Gaidar (along with other transition state experts), architect of many of the Russian reforms in the early 1990s, to Baghdad for discussions over possible reform strategies in Iraq.[62]

For his part, Gaidar noted a number of similarities – the fundamental problem in the Soviet Union, Russia in 1991, and in Iraq in 2003 was a "total collapse of the political institutions of the totalitarian regime. In both places, for all the gravity of economic problems, they were derivatives of the fact that there was a certain rigid structure: the CPSU in the Soviet Union and the Baath party in Iraq that permeated all the elements of the state machinery."[63]

[59]Cf, Pradeep Mitra and Marcelo Selowsky, "Lessons from a Decade of Transition in Eastern Europe and the Former Soviet Union," *Finance & Development*, 39:2 (June 2002) and Stanley Fischer, "The Transition Economies After Ten Years," National Bureau of Economic Research Working Paper 7664 (April 2000).

[60]Oleh Havrylyshyn, "Recovery and Growth in Transition: A Decade of Evidence," *International Monetary Fund Staff Papers*, 48: Special Issue (2001), pp. 53-87.

[61]Jeffrey Garten, "Chinese Lessons: The Best Way to Deliver on Bush's Call for Freedom in the Middle East May be Found in the China Model," *Newsweek*, November 24, 2003, p. 54.

[62]Yegor Gaidar, Director of the Institute for the Economies in Transition, interview broadcast on the *Official Kremlin International News Broadcast*, September 9, 2003.

[63]Yegor Gaidar, Director of the Institute for the Economies in Transition, interview broadcast on the *Official Kremlin International News Broadcast*, September 9, 2003.

The Empirical Dimension

In short, Gaidar elevated reforms in governance to just as an important level as those reforms directly affecting the workings of the economy. The issue then became one of identifying those governance and economic reforms that appear to be critical in the transformation process.

The first step in this regard was to identify the successful and unsuccessful transition countries. By most accounts,[64] the former communist countries of Central and Eastern Europe, together with the Baltic States and several Balkan countries have experienced successful transitions, while most of the former Soviet Union countries have not. Tentatively, fourteen countries were grouped in the unsuccessful (Low Transition Group, Table 2) while 11 were assigned to the successful (High Transition Group, Table 2). Using the same set of reform variables as the previous comparison (Table 1), a number of sharp differences appear between the two sets of transition countries across the whole spectrum of governance and economic reforms.

These differences in reform attainment appear to be associated with a number of economic performance variables (bottom, Table 2). In particular the successful transition countries have average per capita incomes roughly four times that of the unsuccessful group of countries. The successful countries have been able to contain private consumption, diverting these resources to government programs. They have higher investment rates and have attracted considerably more private capital flows. Trade also accounts for a much higher percentage of Gross Domestic Product (GDP) in the successful transition countries – they are more open to international market forces and have been able to establish competitive industries in the international environment.

A statistical technique, discriminant analysis[65] was then performed[66] to determine if the transition countries were "correctly" grouped. That is, is it possible for the six governance and ten economic freedom variables described above to define two sets (corresponding to the successful and unsuccessful transition economies) of unique reform environments? If this is the case, countries possessing a particular set of reform attainments would be classified with a high degree of probability in one of these groups. As part of its analysis, the discriminate procedure also generate a numerical function, the discriminant function, indicating for each country the extent to which critical areas of reform would have to be improved if the country were to advance (or regress) to the other group. The main results of this analysis are summarized in Figure 1.

The discriminate analysis confirmed[67] that our initial pre-assignment of the transition countries was correct – all of the countries in the sample were placed in identical groups by the program. The probability of correct placement was also extremely high.

Finally out of the sixteen reform/governance variables the discriminant program found three – (1) Rule of Law, (2) Fiscal Burden and (3) Property Rights to be critically important in defining the two groups of reform environments. Fiscal burden was no doubt significant simply because it was the one area of reforms in which the low transition group actually scored higher than the high transition countries.

The picture does not change fundamentally when a group of 14 poor performing Greater Middle East Initiative countries were added to the low transition group (Table 3). Again, with the exception of the fiscal burden, the low GMEI/Transition group lags considerably in their relative reform efforts. While average per capita income gap between this expanded low group is a little less than little less than that between the two groups of transition countries, the other economic structure differences are roughly comparable with the high group investing more, having an expanded public sector, attracting considerably more foreign private investment and much more engaged in international trade.

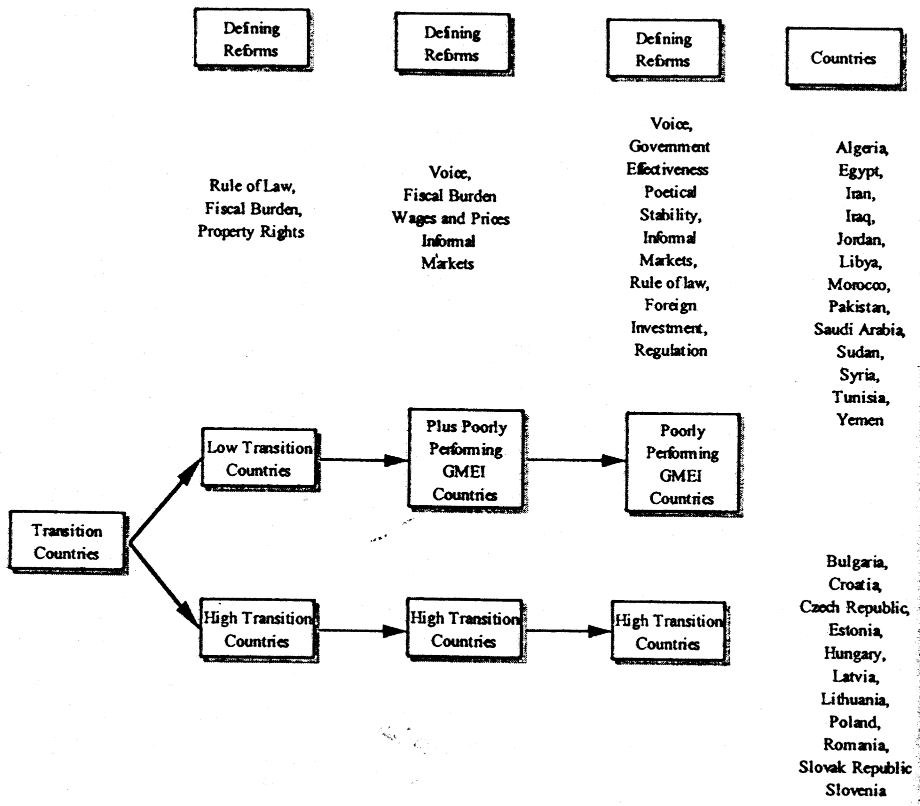
[64]See for example, Erik Berglof and Patrick Bolton, "The Great Divide and Beyond: Financial Architecture in Transition," *Journal of Economic Perspectives*, 16:1 (Winter 2002), pp. 77-100, and Oleh Havrylyshyn and Thomas Wolf, "Determinants of Growth in Transition Countries," *Finance & Development*, 36:2 (June 1999).

[65]A discussion of this technique together with several examples is given in: "Discriminant Analysis," in *SPSS Base 10.0 User's Guide*, (Chicago: SPSS Inc., 1999), pp. 315-322.

[66]Based on the data sets, the period of analysis was 1995-2002.

[67]The results are available from the author upon request at relooney@nps.edu.

Figure 1
Reform Defined Country Groupings



The assumption that our sample of GMEI countries, including Iraq before the March 2003 conflict, was roughly similar in reform progress to the low transition group was confirmed by the discriminant analysis.[68] As in the previous discriminate exercise, all of the group pre-assignments were confirmed. However, reflecting the democracy deficit in the Middle East, voice was now the most important reform variable separating the two groupings of countries. In descending order of significance statically fiscal burden, wages and prices and informal markets

[68]Available from the author upon request at relooney@nps.edu.

completed defining the group environments.

Comparing just the sample of GMEI countries with those of the high transition group produced a similar pattern of relative reform attainment (Table 4). While the Middle East countries scored higher on monetary policy and were comparable on the fiscal burden, they lagged considerably behind the successful transition countries in all other areas of reform. In addition they lagged even further behind the other low groupings in the critical areas of private capital flows and trade. For these two groups of countries a series of variables were significant[69] in their differentiation. In declining order of importance those variables were voice, government effectiveness, political stability, informal markets, rule of law, foreign investment and regulation. Given the fact that all of the GMEI countries were classified with a 100 percent probability of being in the low group significant progress would have to be made in all of these areas for the GMEI countries to reach the level of development attained by the successful transformation countries.

In sum, our sample of GMEI countries (UAE, Kuwait, Qatar and Oman appear further along the reform path and were thus omitted from the analysis) show many similarities to the low transition group of countries. Progress across a wide range of key reform areas has lagged considerably behind other parts of the world. What progress might have been made in some individual areas was apparently not sufficient propel similar attempts at broader based reforms. For the GMEI countries, the lack of voice is no doubt responsible for much of the sad state of reforms with the democracy deficit setting this group of countries a bit apart from the low transition countries.

A Reform Strategy

While the discriminant analysis above identified several key areas upon which Iraq and the GMEI countries will have to focus if they are ever to attain the economic status of the high transition group of countries, its main limitation is that it was static – focusing on one point in time (averages over the 1996-2002 period). As such, this exercise does not shed much light on the critical issues of the sequencing of reforms – should governance precede economic reforms? If so which ones?

[69]This, along with all of the other empirical results noted in the paper is available from the author upon request at relooney@nps.edu.

However, the literature is beginning to form a consensus in this area.[70] The shock therapy approach tried initially in Iraq[71] and in many of the transition countries has fallen into great disfavor.[72] In its place most experts advocate some sort of gradual approach whereby one set of reforms creates pressures/incentives for another set of reforms and so on.[73]

Based on the results above and with the CPA reforms as the starting point for further market based and governance reforms, it's possible to visualize a virtuous circle of growth and reform gaining traction in a manner similar to many of the successful transitions in Eastern Europe.[74]

None of this will just occur automatically. Progress will require the Iraqi government to shift from an expenditures/reconstruction mindset to a reform/development/growth orientation. Clearly some reforms will be more effective than others in lifting to a path of high sustained growth. The analysis above suggests that voice, government effectiveness, political stability, informal markets, rule of law, foreign investment and regulation will be critical. Interestingly, the three most important are in the area of governance, with economic variables assuming a lesser, but still important role in advancing Iraq and the GMEI countries along the reform path to a higher level of transition.[75]

Of course sustaining reforms is easier said than done. Many transition countries have experienced stalled reforms after several years of productive liberalization and institution building. As with the transition economies, the reform process in Iraq can take the country in one of two directions. Through their past reform efforts, some Eastern European/Baltic countries are close to being predominantly market economies. They have experienced a healthy sustained economic revival and have met or are close to meeting the conditions for membership in the European Union (EU). In contrast many other transition economies, who started their reform process at the same time, have implemented reforms to the extent they no longer have socialist economies, but are still struggling to develop their private sector, complete the liberation of prices, establish market institutions, rationalize government activity and impose an effective rule of law.[76]

Why has one group of countries succeeded while the other failed? The recent literature on reforms in transition countries stresses the problem of rent seeking and vested interests. These are groups who benefit financially from the exiting state of affairs and have a financial incentive to block further reform. One can already see these groups beginning in Iraq, especially workers in the state enterprises, paid excessively high salaries, with no real incentive to work. Many of those receiving subsidized energy, food etc. are making good profits by selling these products in the black markets of neighboring countries. No doubt there are many other instances of individuals or groups benefiting from the current incompleteness of Iraqi reform efforts. The more numerous and entrenched these groups and individuals become, the greater the obstacles to advancing reforms in Iraq.

To offset these groups, Iraqi reformers will have to begin creating their own groups of winners – individuals and groups that can see the success of their efforts as well as the link between the reforms and their success. In the Eastern European countries these groups have often been workers and entrepreneurs associated with new small and medium-sized businesses. This is where most of the new jobs will have to be created in Iraq. It is also the reason why a top economic priority should be the health and vitality of the country's financial system. The CPA reforms have laid the foundation for the system, but much work remains.

Although the CPA reforms do no appear to be an impediment to the economy's recovery, sooner or later the Iraqis will have to implement a development strategy focused on diversifying the economy away from

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[70] See for example David Ellerman, "Lessons of the Post-Socialist Transition for the Iraqi Economic Transformation," Testimony before the Joint Economic Committee, June 11, 2003.

[71] Cf. Robert Looney, "The Neoliberal Model's Planned Role in Iraq's Economic Transition," *Middle East Journal*, 57:4 (Autumn 2003), pp.568-586, and Robert Looney, "The Viability of Economic Shock Therapy in Iraq," forthcoming, *Challenge* (September/October 2004).

[72] George Stiglitz, "Whether Reform: Ten Years of Transformation," Keynote Address World Bank Annual Conference on Development Economics (April 28-30, 1999).

[73] Juhani Laurila and Rupinder Singh, "Sequential Reform Strategy," *Russian and East European Finance and Trade*, 37:3 (May-June 2001), pp. 25-76.

[74] Cf. Oleh Havrylyshyn and Thomas Wolf, "Determinants of Growth in Transition Countries," *Finance & Development*, 36:2 (June 1999), pp.12-15.

[75] Cf. Robert Looney, "The Broader Middle East Initiative: Requirements for Success in the Gulf," *Strategic Insight*, (August 2004).

[76] Olen Havrylyshyn and John Odling-Smee, "Political Economy of Stalled Reforms," *Finance & Development*, 37:3 (September 2000).

the oil sector. At that time, many of the reforms in place today will have to be modified so that they are consistent with the encouragement of a broad based industrial structure and provide for a diversified source of revenues for the government. While the current no tariff policy is useful in allowing a clearer identification of the country's comparative advantage outside of the energy sector, temporary tariffs will have to be enacted to facilitate infant industry development. Also the tax system will have to be revamped to enable the authorities to better shift resources in desired directions and offset oil price fluctuations.

Final Observations

Understandably, there is a strong resistance in the Arab world in general and Iraq in particular against reform being imposed from an external power. There is also great skepticism in many Arab quarters concerning the efficacy of markets in allocating resources in the national interest. The Iraqi experience to date with reforms suggests a number of lessons the United States and other like minded countries will have to absorb before significant meaningful reforms can take place in the region:

1. Although textbook economics provide a number of guidelines for reform, the actual reforms should be homegrown and should take into consideration internal conditions, national objectives and limitations of the individual countries.
2. Care should be taken so that reform efforts are not undermined by poor macroeconomic policymaking. Governmental actions should consciously take economic ramifications into account.
3. While adequate financing reforms are essential in many cases, it is more important to change attitudes – people need to see how they are benefiting from the reforms.
4. In turn the beneficiaries of reform will place pressure on the authorities for further reform. In this regard, the sequencing of reforms will be critical in assuring that the reform process will not become stalled.
5. Economic reforms will be unsuccessful in permanently improving standards of living in the region unless there is a fundamental change in attitudes towards markets and competition.

Perhaps Henry Azzam best sums up this last point:

> Allowing markets to prevail requires having a set of cultural values that emphasize the virtue of competition, the ability to create and gain in a socially acceptable way, the legitimacy of profits and the importance of freedom of transaction. Spreading a market culture in the region is therefore not only an exercise in economic restructuring but also an acceptance of the basic values and standards that make the system work.[77]

[77]Henry T. Azzam, "Changing the Legacy of Failure in the *Arab World,*" Arab News, May 17, 2004.

Table: 1
Greater Middle East Initiative Countries Governance-Economic Freedom Group Comparisons
(1996-2002 Averages)

	Voice	Political Stability	Government Effectiveness	Regulatory Quality	Rule Law	Control of Corruption
Greater Middle East Initiative Countries (20 Countries)						
Mean	-0.91802	-0.37126	-0.17018	-0.41027	-0.01853	-0.17146
Std. Deviation	0.470583	0.989188	0.720173	1.096394	0.859818	0.673571
Catching-Up Economies (37 Countries)						
Mean	0.48504	0.35871	0.28211	0.46249	0.26696	0.15342
Std. Deviation	0.581143	0.622755	0.511180	0.415176	0.521825	0.544002
Advanced Economies (25 Countries)						
Mean	1.27878	1.15325	1.70471	1.34893	1.74568	1.84731
Std. Deviation	0.396079	0.446343	0.373612	0.288472	0.331339	0.443233

	Trade Policy	Fiscal Burden	Government Intervention	Monetary Policy	Foreign Investment
Greater Middle East Initiative Countries (20 Countries)					
Mean	3.87135	3.55462	3.47632	2.46959	3.22105
Std. Deviation	1.131846	0.886989	0.765516	1.435857	0.987222
Catching-Up Economies (37 Countries)					
Mean	3.16592	3.39094	2.49234	3.10698	2.51254
Std. Deviation	0.953574	0.648153	0.598365	0.955559	0.498750
Advanced Economies (25 Countries)					
Mean	1.94089	4.01658	2.45400	1.27189	1.90178
Std. Deviation	0.289542	0.797321	0.588025	0.364115	0.531872

	Banking & Finance	Wages & Prices	Property Rights	Regulation	Informal Market
Greater Middle East Initiative Countries (20 Countries)					
Mean	3.35380	3.12339	3.06491	3.27302	3.37690
Std. Deviation	1.053723	0.830339	1.186112	0.834108	1.367260
Catching-Up Economies (37 Countries)					
Mean	2.76156	2.59512	2.66494	3.12830	3.27387
Std. Deviation	0.585669	0.570191	0.805735	0.714370	0.783671
Advanced Economies (25 Countries)					
Mean	2.00000	2.07278	1.24044	2.42633	1.37444
Std. Deviation	0.745632	0.329991	0.409115	0.609504	0.585709

Notes: Governance data, Average Values 1996-2002, Economic Freedom data, Average Values 1995-2004. Source: Compiled from: Daniel Kaufmann, Aart Kraay and Massimo Mastruzzi, Governance Matters III: Governance Indicators for 1996-2002, (Washington: World Bank, June 30, 2003), and Index of Economic Freedom Rankings, (Washington: Heritage Foundation, various issues).

Table: 2
Transition Economies: Governance, Economic Freedom Group Comparisons
(1996-2002 averages)

	Voice	Political Stability	Government Effectiveness	Regulatory Quality	Rule Law	Control of Corruption
Low Transition Group (14 Countries)						
Mean	-0.69891	-0.42884	-0.77023	-0.87185	-0.79721	-0.83539
Std. Deviation	0.513940	0.555638	0.307984	0.657388	0.281156	0.211557
High Transition Group (11 Countries)						
Mean	0.72428	0.69484	0.30359	0.56790	0.34155	0.20858
Std. Deviation	0.355024	0.249563	0.432893	0.374831	0.370138	0.421502

	Trade Policy	Fiscal Burden	Government Intervention	Monetary Policy	Foreign Investment
Low Transition Group (14 Countries)					
Mean	3.75816	3.29596	3.16706	4.36315	3.38322
Std. Deviation	0.847439	0.584254	0.441332	0.740221	0.650677
High Transition Group (11 Countries)					
Mean	2.65202	3.96588	2.50404	3.73965	2.26338
Std. Deviation	0.775195	0.357896	0.437791	0.740233	0.461220

	Banking & Finance	Wages & Prices	Property Rights	Regulation	Informal Market
Low Transition Group (14 Countries)					
Mean	3.60692	3.42562	3.74921	3.97222	4.49433
Std. Deviation	0.860035	0.636028	0.373320	0.387452	0.393646
High Transition Group (11 Countries)					
Mean	2.42525	2.56338	2.81035	3.04672	3.26515
Std. Deviation	.615481	0.535783	0.695351	0.692023	0.404024

Economic Structure Variables

	Per Capita Income ($)	Private Consumpt (%GDP)	Public Consumpt (%GDP)	Investment (%GDP)	Private Capital Flows (%GDP)	Trade (%GDP)
Low Transition Group (14 Countries)						
Mean	1013.97	72.31199	15.40061	22.39315	13.35154	72.52454
Std. Deviation	788.88	14.811718	4.511183	5.697611	5.624283	28.815698
High Transition Group (11 Countries)						
Mean	4099.96	62.01956	18.68349	24.79063	18.59334	88.67385
Std. Deviation	2632.51	7.124784	5.228647	4.449303	6.818769	27.136595

Notes: Data Sources, See Table 1.

Table: 3
Middle East Economies Grouped with Low Transition Economies: Governance, Economic Freedom Group Comparisons With High Transition Group
(1996-2002 averages)

	Voice	Political Stability	Government Effectiveness	Regulatory Quality	Rule Law	Control of Corruption
Low Transition/ME Group (28 Countries)						
Mean	-0.88220	-0.57813	-0.62803	-0.82372	-0.60846	-.64217
Std. Deviation	0.528185	0.757456	0.531081	0.796795	0.552928	.412935
High Transition Group (11 Countries)						
Mean	0.72428	0.69484	0.30359	0.56790	0.34155	.20858
Std. Deviation	0.355024	0.249563	0.432893	0.374831	0.370138	.421502

	Trade Policy	Fiscal Burden	Government Intervention	Monetary Policy	Foreign Investment
Low Transition/ME Group (28 Countries)					
Mean	4.17681	3.63688	3.38101	3.66151	3.40391
Std. Deviation	0.785600	0.668271	0.653831	1.298274	0.871453
High Transition Group (11 Countries)					
Mean	2.65202	3.96588	2.50404	3.73965	2.26338
Std. Deviation	0.775195	0.357896	0.437791	0.740233	0.461220

	Banking & Finance	Wages & Prices	Property Rights	Regulation	Informal Market
Low Transition/ME Group (28 Countries)					
Mean	3.67494	3.40743	3.74325	3.82375	4.25510
Std. Deviation	0.906342	0.766259	0.734270	0.629045	0.779337
High Transition Group (11 Countries)					
Mean	2.42525	2.56338	2.81035	3.04672	3.26515
Std. Deviation	0.615481	0.535783	0.695351	0.692023	0.404024

Economic Structure Variables

	Per Capita Income ($)	Private Consumpt (%GDP)	Public Consumpt (%GDP)	Investment (%GDP)	Private Capital Flows (%GDP)	Trade (%GDP)
Low Transition/ME Group (28 Countries)						
Mean	1341.33	68.73104	15.53526	22.05540	10.98818	62.66866
Std. Deviation	1487.05	13.922040	5.173162	4.999747	6.523658	26.476192
High Transition Group (11 Countries)						
Mean	4099.96	62.01956	18.68349	24.79063	18.59334	88.67385
Std. Deviation	2632.51	7.124784	5.228647	4.449303	6.818769	27.136595

Notes: Data Sources, See Table 1. Sample of Middle East countries pre-grouped with low transition countries.

Table: 4
Middle East Economies Compared with High Transition Countries: Governance, Economic Freedom
(1996-2002 averages)

	Voice	Political Stability	Government Effectiveness	Regulatory Quality	Rule Law	Control of Corruption
Middle East Group (13 Countries)						
Mean	- 1.09236	-0.74890	-0.46440	-0.74238	-0.39551	-.44610
Std. Deviation	0.502216	0.947339	0.691158	0.968601	0.714316	.497937
High Transition Group (11 Countries)						
Mean	0.72428	0.69484	0.30359	0.56790	0.34155	.20858
Std. Deviation	0.355024	0.249563	0.432893	0.374831	0.370138	.421502

	Trade Policy	Fiscal Burden	Government Intervention	Monetary Policy	Foreign Investment
Middle East Group (13 Countries)					
Mean	4.66325	3.97060	3.53632	2.98974	3.38034
Std. Deviation	0.363295	0.602528	0.769365	1.427086	1.104239
High Transition Group (11 Countries)					
Mean	2.65202	3.96588	2.50404	3.73965	2.26338
Std. Deviation	0.775195	0.357896	0.437791	0.740233	0.461220

	Banking & Finance	Wages & Prices	Property Rights	Regulation	Informal Market
Middle East Group (13 Countries)					
Mean	3.73419	3.37521	3.64017	3.57338	3.94017
Std. Deviation	1.017354	0.937602	0.958614	0.720257	0.989064
High Transition Group (11 Countries)					
Mean	2.42525	2.56338	2.81035	3.04672	3.26515
Std. Deviation	0.615481	0.535783	0.695351	0.692023	0.404024

Economic Structure Variables

	Per Capita Income ($)	Private Consumpt (%GDP)	Public Consumpt (%GDP)	Investment (%GDP)	Private Capital Flows (%GDP)	Trade (%GDP)
Middle East Group (13 Countries)						
Mean	1757.93	64.55328	15.69235	21.21573	7.05360	49.65372
Std. Deviation	2092.455350	12.077702	6.059780	4.148001	4.911575	18.358790
High Transition Group (11 Countries)						
Mean	4099.96	62.01956	18.68349	24.79063	18.59334	88.67385
Std. Deviation	2632.515505	7.124784	5.228647	4.449303	6.818769	27.136595

Notes: Data Sources, See Table 1.