The Economic Challenge: Building a Viable New Iraq

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Introduction
In a significant policy statement\(^1\) released toward the end of 2005 the United States outlined its strategy for victory in Iraq. Victory is defined in terms of a sequential set of completed goals: (1) Short term, Iraq is making steady progress in fighting terrorists, meeting political milestones, building democratic institutions, and standup security forces; (2) Medium term, Iraq is in the lead defeating terrorists and providing its own security, with a fully constitutional government in place and on its way to achieving its economic potential; and (3) Longer term, Iraq is peaceful, united, stable and secure, well integrated into the international community and a full partner in the war on terrorism.

The US strategy is essentially three pronged: developing democracy, providing security and reviving the economy. In the economic area U.S. and coalition efforts to date have focused on helping Iraq restore the country’s neglected and damaged infrastructure with the goal of restoring and expanding essential services. Other objectives include: the creation of a market based economy, and greater transparency and accountability in the public sector.\(^2\)

The logic of this strategy is straight-forward: \(^3\)

1. The rebuilding of Iraq’s infrastructure and the provision of essential services will increase the confidence of Iraqis in their government and help convince them that the government is offering a brighter future. People will then be more likely to cooperage with the government and provide intelligence against the enemy, creating a less hospitable environment for the terrorists and insurgents.

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\(^2\) Ibid., p. 22.
\(^3\) Ibid.
2. Efforts in the reconstruction realm have significant implications in the security realm when they focus on rebuilding post-conflict cities and towns. Compensations for civilians hurt by counterterrorism operations and the restoration of some economic vibrancy to areas formerly under terrorist control can help ease resentment and win over an otherwise suspicious population.

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

4. Economic growth and market reform – the promotion of Iraq’s private sector – are necessary to expand job opportunities for the youthful Iraqi population and decrease unemployment that makes some Iraqis more vulnerable to terrorist or insurgent recruiting.

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

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

Iraqis themselves are increasingly skeptical of the viability of the post-war economic strategy. Certainly the ability to complete infrastructure projects on time and within budget has proven to be a nearly impossible task. As noted by the U.S. Inspector General for Iraq Reconstruction infrastructure programs in that country have been plagued by “violence, corruption and mismanagement.”5 As a result “the ambitious US reconstruction effort in Iraq is likely to fall far short of its goals because soaring security costs and poor management have slashed the amount of American money available for rebuilding projects.”6 Just as serious is the all too apparent long lead time

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6 Ibid.
before any tangible benefits in terms of improved living standards are seen by the average Iraqi.

Implicit in Ambassador Bremer’s assessment is that the main flaw in the US strategy has been its inability to deliver short-run economic gains to large segments of the Iraqi population. Unfortunately the NDS does little to address this issue, and appears content simply continuing the existing strategy.

On a more fundamental level, other than noting that oil revenues will assist in financing infrastructure and much of the country’s capital expenditures, the NDS does not explicitly address the role of oil in Iraq’s future. Yet there is a vast literature suggesting that the oil sector and the allocation of its revenues is the critical variable in shaping both the economic structure and political systems of countries like Iraq. For the most part this literature focuses on the so called “oil curse” or the “paradox of plenty.” These colorful phrases capture the gist of oil’s potentially destructive powers -- unless properly managed oil revenues more often than not undermine the economic, political and social fabric of countries irrespective of how well intended their long run goals and objectives. The result is often the creation of a rentier state mired in corruption, economic mismanagement, and authoritarianism.

While we still don’t have a complete picture of the contemporary dynamics of the Iraqi economy, it’s still safe to say that the country’s economic health will be a key determinant of the country’s long-run stability. Clearly factors such as the “brain drain,” the lack of commercial credit together with uncertainty due to the security situation have largely brought investment in the formal segments of the economy to a halt. Yet, from antidotal accounts there are indications that many areas of the shadow economy are prospering and, as during the period of sanctions, successfully adapting to the harsh environment.

With these themes in mind, the purpose of the sections that follow is to examine the means by which the economy can contribute toward building a viable new Iraq. First, an assessment is made of key issues surrounding the

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10 “Unemployment Caused by Insecurity and Vice-Versa,” IRINnews.org (November 29, 2004).
economy: (a) what were the initial obstacles to the economy’s reconstruction? (b) The approach taken towards the economy in the post-war period? (c) The major accomplishments and failures? (d) The lessons learned? Second, based on this assessment, several key areas are highlighted as critical to the establishment of a broad based inclusive economy capable of supporting a new, modern Iraqi state.

Obstacles to Reconstruction

Even without the insurgency, Iraq’s reconstruction would have been a monumental undertaking. As the NDS notes, Saddam Hussein’s economic legacy will be present for some time. In particular, that regime’s questionable economic policies, its mismanagement of the economy together with political repression, internal conflicts, wars and sanctions left a number of serious impediments to recovery and growth. Initial reconstruction efforts dealt largely with correcting and reversing the effects of these debilitating forces that had built up over the years:

- Restoring government economic functions after looting and state collapse;
- Preventing currency collapse, hyperinflation and economic chaos;
- Rebuilding infrastructure ravaged by war, sanctions, looting and neglect;
- Rehabilitating a health care system cut off from medical advances for two decades;
- Dismantling corrupt, dysfunctional state economic controls; and
- Stimulating the growth of a private sector that had been stunted by government interference.

A number of major successes did occur, especially under the Coalition Provisional Authority (CPA). Major successes under the CPA included:

- Re-established nationwide food-ration system;
- Introduced a new currency and stabilized the exchange rate;
- Liberated most prices without igniting inflation;
- Rebuilt the government’s economic ministries;
- Promulgated market-oriented banking, taxation, foreign trade, investment, and business regulations;
- Rehabilitated several thousand schools, health clinics, and hospitals;
- Provided public services to populations that had been deprived under Saddam;
- Increased electrical generation and output;

• Funded small projects across Iraq to meet critical community needs.

Still the Coalition’s economic accomplishments were overshadowed by its unfulfilled promises. During the occupation the CPA failed or was unable to:

• Prevent rampant looting or infrastructure and production facilities;
• Attract foreign investment;
• Implement its newly enacted economic regulations;
• Restructure state-owned industries.
• Fulfill promises of substantial job creation;
• Meet targets for electricity production (despite increases)
• Restore oil output to prewar levels;
• Eliminate costly distorting energy and food subsidies;
• Combat corruption in reconstruction projects;
• Spend more than a fraction of the $18.4 billion the U.S. Congress allocated for Iraq’s reconstruction.

In sum, the net result of post-war economic efforts has been disappointing while some economic obstacles and distortions are lessening thanks to the reforms13 put in place by the Coalition Provisional Authority (CPA), others were created or reinforced through post-war policy errors and miscalculations.14 The net result is an economy whereby15:

1. The oil sector dominates the economy, accounting for around 74% of GDP. Iraq now depends solely on oil exports for finance of investment and consumption expenditures, for government revenues – of which oil export proceeds exceed 93%, and for 98 percent of foreign currency earnings.

2. Centralized decision making and intrusion of the state into economic life have distorted the pricing structure in many sectors to the extent that prices often do not reflect the real value of the product or service. In turn distorted prices have caused inefficiencies and waste.

3. The public sector is over represented in the economy, leading to inefficiency and decreased growth. Many state enterprises (SOEs) are currently dormant. The weakness of the private sector has limited its role in economic development, increasing the lack of diversification.

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4. Social inequalities are widespread in a broad range of fields covering health, education, public services, social services to low-income groups, the disabled, internally displaced persons, refugees, single-parent households, and other vulnerable groups, across geographic areas.

5. With over 50% of the population under 24 years of age rapid rates of population growth are likely for many years. Many in this large demographic group are alienated due to violence and limited access to education, training and career prospects.

6. Widespread unemployment, ranging to about 50% and absolute poverty where more than 60% of the population depends on the government’s rationed food basket. Unemployment has led to an increase in demands for social assistance.

7. Poor governance practices are common including widespread nepotism in public appointments and corruption among public servants. The lack of accountability and transparency in managing state resources has abetted corruption and increased its corrosive effect on growth and efficiency.

8. Iraq’s decades long isolation has resulted in the digital divide, outdated institutions, administrative systems and know-how. Technological stagnation and the use of outmoded production methods have weakened the economy as a whole.

9. Public sector institutions have witnessed serious looting, theft and destruction.

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

11. The traditional family unit and the community have remained the core of Iraqi society, ensuring solidarity and social cohesion against all odds. However, conflict and inequality have eroded the social fabric of communities and families throughout the past three decades.
12. In Iraq, social capital establishes an important relation between incomes and human capability to withstand shocks. Iraqis have witnessed a depletion of social capital which led to social deprivation in most sectors of society.

13. Civic participation and recognition of human rights were denied during the previous regime. They remain poorly understood and lack ancillary support structures.

14. A large informal economy coexists with the formal sector. This informal economy may account for as much as 65% of Gross Domestic Product.\(^{16}\) Even more worrisome is the large criminal element that controls large segments of the informal sector.\(^{17}\)

A recent UNDP\(^ {18}\) household survey documents the impact these factors are having on the average Iraqi household:

1. The UNDP survey suggests the poorest 20% of the population earns 7% of the income, while the top 20% earns 44%.

2. Iraq’s median household income of 144 dollars has dropped from a post-war high of 255 dollars in 2003.

3. One-third of Iraqis canvassed by UNDP described themselves as being among the poor.

4. One-sixth of interviewees met all or most of the criteria suggesting that they lived beneath the poverty line.

Models of Success and Failure

Following Henderson\(^ {19}\), several patterns emerge. Most importantly, the Coalition’s success stores shared some essential elements. Its less successful ventures had their own set of distinctive characteristics. Specifically, successful initiatives appear to have imposed no major costs or sacrifices on the population at large. For instance, most Iraqis welcomed the rehabilitation of their schools and hospitals. Also, successful initiatives did not suffer from


\(^{19}\) Op. cit., pp. 4-5.
security disruptions. This was either because the security situation was not a constraining factor—as with creation of new banking regulations—or because effective steps were taken to provide security protection—as with the nationwide distribution of civil-service salaries.

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

The Coalition’s failures were marked by a very different set of conditions. Failure often coincided with high social cost. For instance, the coalition’s inability to end fuel price subsidies reflected its fears of sparking mass unrest. Also most failed initiatives were afflicted by security disruptions, such as looting and sabotage that precluded sustained progress. Lack of powerful patrons was another handicap typical of unsuccessful projects. For instance plans for agricultural reconstruction languished with a committed CPA sponsor. Funding problems also characterized failed projects. Many projects ran into disabling delays when they encountered the complex U.S. government procurement process.

Another common element of policy failure was lack of existing Iraqi capacity on which to build. Efforts to collect taxes for example failed because did not have a history of voluntary compliance or the organizational capacity to monitor incomes. Finally, unsuccessful policies tended to involve extensive structural changes. The Coalition’s inability to combat endemic corruption illustrates the difficulties in altering long-standing practices and relationships.

Perhaps because reconstruction efforts did not effectively incorporate large segments of the Iraqi population into the decision making process there is a wide spread perception among Iraqis that the coalition efforts have been a failure. One ABC survey of Iraqis interviewed in late 2005 found that: 20

Only 44 percent of Iraqis say they believe things are going well in their country; 52 percent said they felt the country was "doing badly." Support

for the U.S.-led invasion has dropped: In February 2004, 39 percent of Iraqis told us they believed the invasion was wrong, but today that number stands at 50 percent. Even among optimistic Iraqis it appears the U.S. gets little credit for any improvements in their lives. Fewer than one in five Iraqis believes that U.S. reconstruction efforts have been "effective." Most Iraqis now say they "disapprove strongly" of how the U.S. has operated in Iraq. Not surprisingly, the percentage of Iraqis today who oppose the U.S. presence has spiked -- from 51 percent to 65 percent.

Virtually all signs of optimism vanish when one is interviewing Iraq's Sunni Muslims. There's more on this in the Local Government section of the report; suffice for now to cite a pair of poll results. While 54 percent of Shia Muslims believe the country is in better shape than it was before the war, only 7 percent of Sunnis believe the same. Optimism about security -- 80 percent of Shias and 94 percent of Kurds say they feel safer -- is absent among Sunnis. Only 11 percent of Iraq's Sunni Muslims say they feel safer than they did under Saddam.

Many Iraqis cannot understand why -- two-and-a-half years after the Americans arrived -- electricity and sewage are not more reliable, why more reconstruction projects have not reached their neighborhoods, why corruption remains so prevalent and why their local (and in many cases democratically elected) officials have not changed things for the better.

These survey results were not unique. Another respected poll undertaken in the first week of January 2006 found a sharp split between Kurds, Shi’ites and Sunnis over the U.S. aid efforts in Iraq. Over the various categories of U.S efforts, 38% of the Kurds expressed approval, falling to 30.3% for Shi’ites and 4.7% for Sunnis. The corresponding figures for disapproval were 11.3%, 14.8% and 77.7%

**Lessons Learned**

The post war Iraqi reconstruction experience points to some important lessons. These can provide a useful set of guides for that country’s on-going attempts in restoring economic growth and stability.21

Reconstruction entails painful trade-offs rather than easy choices. Perhaps the major made in the early days of reconstruction was a tendency to try to get things done as quickly as possible. To do this the CPA often bypassed Iraqi Ministries and various local groups. More often than not, Iraqis and their

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viewpoints were not included in the process. This flaw continues to take a toll on the country’s reconstruction efforts.

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

**Control expectations to realistic levels.** Because the CPA had promised to quickly exceed rather than simply restore prewar production its many accomplishments were often seen by the Iraqis as failures instead.

**For any actions develop several contingency plans.** Proper contingency planning taking into account the possibility of infrastructure degradation, persistent violence and revenue shortfalls would have resulted in more realistic reconstruction goals.

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

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

**Don’t Over-Rely on Market Forces in a Conflict Setting.** In part, the loss in reconstruction momentum stemmed from the CPA’s assumption that market forces and a surge in private investment would follow the initial reconstruction efforts. Ideological blinders and the lack of a contingency plan made it difficult to overcome these errors when confronted with the effects of increased violence and uncertainty.

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Ongoing reforms require empowered owners. It remains to be seen whether Iraq’s new government will be willing or able to continue economic reforms initiated under the CPA. Clearly if Iraqis had been consulted and made an integral part of the reform process they would be more inclined to continue and build on earlier efforts. As of early 2006, the reform process is being largely controlled by the International Monetary Fund, with Iraqis again more in the position of resisting outside efforts at reform, largely removal of subsidies and price controls, rather than controlling and adapting the reform process to meet their own domestic priorities.23

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

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

Critical Factors for the Future

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

Iraqi Debt Relief and Economic Reform

The IMF’s role in Iraq’s post-war setting became clear on November 21, 2004. At that time, in a major development on the debt front, the 19 industrialized nations that comprise the so-called Paris Club agreed to write off a portion of Iraq’s debt in three stages. The first 30 percent amounting to 411.6 billion is to be written off unconditionally. A second 30 percent reduction will be delivered “as soon as a standard International Monetary Fund

(IMF) program is approved.” A final 20 percent reduction will be granted “upon completion of the last IMF board review of three years of implementation of standard IMF programs.” In other words, 30 percent of Iraqi debt will be excused only if the IMF and Iraqi authorities agree on an economic “reform” package, and another 20 percent will be written off only if the Fund is satisfied that Iraq has implemented the terms of this package. 24

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

At the time of the Paris Club accord (September 2004) the Iraqi authorities apparently concluded that the economy was at the point were it was capable of successfully undertaking an initial IMF program. Given the country’s post-war state, together with the on-going insurgency, the Fund’s Emergency Assistance Program (EPCA) seemed the most appropriate choice. Furthermore, completion of this program would allow the government to move to a more ambitious economic program of reform that would address remaining structural impediments to long term sustainable economic growth with external stability. The idea was that such a follow-on program would be supported with a stand-by arrangement from the Fund, on the basis of a positive assessment that the government’s capacity for planning and policy implementation was adequate. 25

EPCA type programs have an interesting history. In 1962 the IMF began providing emergency assistance to member countries afflicted by natural disasters – such as floods, earthquakes, hurricanes or droughts. This assistance is aimed at meeting immediate foreign exchange financing needs arising from e.g., shortfalls in export earnings and/or increased imports. A prime consideration underlying this type of loan is the avoidance of a serious depletion of external reserves. 26

In their request for EPCA, Iraqi authorities indicated that they planned to seek further financial support from the Fund in the form of an upper credit tranche stand-by arrangement in 2005, on the assumption that sufficient

progress had been made in strengthening administrative and institutional capacity under the program.\footnote{27}

For its part, the Iraqi government pledged to develop a comprehensive economic and financial program. The Fund stressed that it was important for the authorities to adhere to their commitment to prioritize any windfall oil revenues in favor of additional reconstruction investment and or help meet budgetary needs in 2006 and beyond. The Fund also stressed the need to: \footnote{28}

1. Increase the price of petroleum products;
2. Make monetary policy more adaptable by widening the number of instruments for managing liquidity conditions;
3. Undertake structural reforms with regard to: (a) tax administration, (b) payments and settlements systems, (c) state owned enterprise restructuring, and (d) governance and transparency in the oil sector.

Iraq is under pressure not just from the IMF, but the World Bank and the Paris Club as well, to make significant progress at reform in several key areas: \footnote{29}

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

Gradually abolish government subsidies for basic consumer goods such as fuel (petroleum derivatives), and food. Iraq’s extensive subsidy system provides most citizens with access to basic consumer goods, fuel and electricity at extremely low prices. Reforms in this area are considered a necessary if the country is to achieve fiscal solvency together with the creation of an efficient industrial structure. As discussed in more detail below, the distortion in market prices made possible by the country’s subsidy program has: (1) created an economic climate conducive to corruption, (2) generated income for the

\footnote{27} Iraq: 2005 Article IV Consultation – Staff Report (Washington: International Monetary Fund, August 2005), p.5
\footnote{28} Ibid.
\footnote{29} Mehdi Hafez, “Economic Challenges in Iraq Under the Paris Club Agreement,” Al Hayatt, June 22, 2005
insurgency and encouraged crime – mainly smuggling\textsuperscript{30}, (3) weakened economic growth through diverting scarce public resources away from infrastructure and other directly productive investments, and (4) stifled the development of the private sector.

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

This last point is important because by the summer of 2005 the Fund was expressing concern over the slow pace of reform implementation and that the country was not strictly adhering to the terms the EPCA. Specifically Iraqi officials were reluctant to increase domestic prices in key subsidized areas, particularly petroleum products. Under the EPCA timeline the authorities were suppose to have begun the adjustment of domestic prices by the end of 2004. This did not occur and by mid-2005, gasoline prices in the black market had risen to very high levels with the authorities continuing to supply gasoline locally at heavily subsidized prices – less than two US cents per liter (US$0.05 per U.S. gallon), one of the lowest prices in the world, even though local refineries were unable to keep up with demand. Prices were several times higher in neighboring oil states such as Kuwait and Iran, while the price differential with Turkey may at times been as much as ten times greater.

As might be imagined from elementary economic theory, the low price of gasoline produced both shortages and thriving black markets. To ease the shortages, Iraq a country with the world’s third largest crude oil reserves, spent US$3.2 billion in 2004 on imports of petroleum products, mostly gasoline.\textsuperscript{31} Ironically much of the imported petroleum products had originated in Iraq only to be smuggled out of the country to take advantage of the Iraq/external price differential.

The cost of buying from neighboring countries is magnified by rampant export smuggling, with a steady stream of subsidized gasoline flowing back out of the same countries were the government bought it. Black-market fuel

\textsuperscript{31} “Iraq Economy: Subsidies Drain,” EIU Viewswire, October 6, 2005.
dealers, offering a faster alternative to queuing at the pumps, exploit the artificial price gap. The insurgency is also heavily involved in black market arbitrage.\textsuperscript{32} The resulting revenue loss in the government budget was as much as US$8 billion or 30% of GDP in 2004.\textsuperscript{33}

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

For its part the Iraqi government has tried to avoid price increases through various initiatives designed to decrease local consumption. One plan ordered drivers to leave their cars at home on alternating days based on odd- or even numbered license plates. But as might be imagined the rule was hard to enforce, with many drivers reportedly using two sets of plates and switching them daily to avoid the heavy non-compliance fine.\textsuperscript{34}

Finally toward the end of 2005, under pressure from the IMF and facing mounting opposition to non-price solutions, the Iraqi cabinet agreed to raise the prices of petroleum and petroleum derivatives by between 100% and 200%. This would bring the price per liter for regular gasoline to 50 dinars and for refined gasoline to 150 dinars, in addition to price increases for other derivatives of white petroleum and liquefied gas.\textsuperscript{35} This was meant to be the first in a series of increases over the next year (2006) designed to raise the price of fuel to the average in Persian Gulf States – about 93 cents per gallon.\textsuperscript{36}

Clearly the fuel price increases were undertaken largely to qualify for the next phase of IMF lending. However, a very good economic case can be made that the price reforms were clearly in the government and country’s best interest. A recent World Bank analysis\textsuperscript{37} of the country’s domestic fuel markets concluded that black market prices average 10-40 times above the official ones. The Bank’s econometric simulations suggested that a six-fold increase in fuel prices would lead to a 16 percent decline in fuel imports and a 30 percent

\textsuperscript{33} Ibid.
\textsuperscript{34} “Iraq Economy: Subsidies Drain,” EIU Viewswire, October 6, 2005.
\textsuperscript{35} Adil Abd-al-Zahrah Shabib, “About the Decision to Raise the Prices of Petroleum Derivatives,” Tariq al-Sha‘b (Baghdad), November 5, 2005 (FBIS Translation from the Arabic).
decline in black market sales. Government savings would amount to about $1.73 billion, allowing for additional investment and/or compensation to households.

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

Oil and Iraqi Development

Unless it is amended, the Iraqi Constitution will most likely play a significant role in structuring both production and revenue developments in the oil sector. For this reason, of all the articles in the Constitution those relating to oil have been the most contentious. The key provisions are outlined in Articles 109 and 110.38

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

**Article 110**
1st The federal government will administer oil and gas extracted from current fields in cooperation with the governments of the producing regions and provinces on condition that the revenues will be distributed fairly in a manner compatible with the demographical distribution all over the country. A quota should be defined for a specified time for affected regions that were deprived in an unfair way by the former regime or later on, in a way to ensure balanced development in different parts of the country. This should be regulated by law.

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

Article 110 clarifies that revenue-sharing will be based on needs as well ad demography, reflecting the region’s “duties and obligations, and taking into consideration the (region’s) resources and needs.

38 The following Articles from the Iraqi Draft Constitution are taken from the translation provided by the Associated Press http://news.bbc.co.uk/1/shared/bsp/hi/pdfs/24_08_05_constit.pdf
The wording of Article 110 hints that exploration and development strategy will be undertaken in partnership with the regions. The wording of Article 109 does not exclude foreign ownership of upstream oil industry assets, though most senior oil officials are not in favor of this level of foreign investment. Presumably, the detail of hydrocarbon development policy will be left to national and regional legislatures. 39

The Constitution’s treatment of oil production and revenues present a number of unattractive scenarios to the Sunnis and it is easy to see why they have been quite opposed to the new charter. Specifically they are concerned with the creation of a federal system where they are at a major financial disadvantage vis a vie the Kurds and Shiites. In this regard, the Constitution defines a “region” as one or more provinces that choose by referendum to form a region. (A referendum can be called fairly easily: either by one third of the members in the relevant provincial councils or by one-tenth of the voters in these provinces. Moreover, two or more regions have the right to create a single larger region. “Here the Sunni nightmare in plain black and white: The Kurds are allowed to form a single supra-region in the oil-rich north, the Shiites to form theirs in the oil-rich south, while the Sunnis are left in the oil-dry center.”40 Clearly the Sunnis fear that the Kurds and Shiites will create their own super-regions which will dominate Iraqi politics and economics.

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

Article 110 suggests that the Sunni areas could be disadvantaged for some time on the ground that the Shia south and Kurdish north suffered chronic underdevelopment during the Saddam era. The exact formula for revenue-sharing will be fluid and shaped by Iraq’s national parliament where the Sunnis are likely to be a distinct minority.

The Kurdish government concluded at least three production-sharing agreements with Turkish and Norwegian companies in the last few years that

cover several fields in the Kurdish areas. Those deals were done independent of the Iraqi oil ministry. At the same time, Baghdad did not recognize those agreements and warned companies against signing such agreements. With the new Constitution, such agreements would now become legal.  

While turning a de facto situation in Kurdistan into a legitimate state, the implications for the rest of Iraq are more significant. Iraqi oil experts warn that while the role of the federal government in oil matters has been marginalized, the powers of the Shiite oil producing region in the south are more likely to grow. At the moment there are two producing governorates in the south, Basrah and Missan. However, other governorates have non-exploited oil fields such as Nasiriyah, which contains the Gharraf oil field. According to the Constitution those governorates can set up regions and become semiautonomous like the region of Kurdistan.

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

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

Summing up, the constitution’s sections on oil appear to satisfy Kurdish and Shiite concerns and needs, but not those of the Sunnis. Furthermore the Constitution leaves open the possibility of abuse of economic power by the Kurds and Shiites. The Constitution’s lack of clarity on many oil issues such as production and distribution are also conducive to an atmosphere of corruption and underinvestment.

With oil revenue assignment shifting more toward the producing regions, the ability and perhaps willingness of local governments to pursue independent policies will increase with time – the likelihood of adverse rentier effects may increase with oil revenues concentrated in the hands of the

42 Ruba Husari, op. cit.
regional governments. In this environment it is easy to visualize a vicious circle setting in (Figure 1) whereby the distributive formulas embedded in the constitution skew policy making decisions towards an over-reliance on oil revenues, leading to poor economic outcomes which in turn skew policy preferences more toward short run distributive rather than efficiency outcomes.

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

There are some encouraging signs. For the southern provinces interviews of voters suggest that the critical issue is to ensure that the proceeds of Iraq’s oil exports are distributed more fairly than in the past—something that is explicitly catered for in the constitution. The impulse towards creating a virtual separate state is not so strong in the south as it is in the Kurdish north. Southern voters, for the most part, seemed to view the constitution as a vital step towards peace and stability, rather than as a divisive, provocative formula for Shia-Kurdish collaboration to suppress the once-dominant Sunni Arab minority. Although the Sunnis opposed the decentralization structure of the new constitution, their opposition centers more on the potential loss of oil revenues to the Kurds and Shi’a and less on regaining control of the entire country.

What might the new government with increased Sunni participation want to consider in the way of modifying the economic sections of the existing constitution? One option that has received surprisingly little attention is the simple one of distributing a relatively large share of oil revenues directly to the population. A clear advantage of this approach is that it would give the Sunnis a clear stake in the success of the economy. Acts of insurgency that would jeopardize oil revenues would directly hurt large segments of the Sunni community. Formalization of this type of distributive system would allay Sunni fears that in some time in the future they would be completely cut off from the country’s oil revenues

46 Ivan Eland, “The Iraq Constitution: And They Call This Victory?” The Independent Institute, October 17, 2005.
A number of other benefits would also flow from the direct disbursement policy. With direct payments, massive subsidies and price controls would no longer be needed and could be quickly phased out, leaving prices to be determined by market forces. The broad-based demand that would be created from increased purchasing power no doubt would provide the opportunity for more profitable small-scale private sector businesses. Many studies of small- and medium-sized (SMEs) businesses in developing countries have concluded that businesses of this type are the chief engines of job creation and innovative activity.
As the experience of the transition countries of Central and Eastern Europe has shown, in addition to job creation and innovation, growing business sectors often find it in their best interest to press governments for additional market reforms. Governments, in turn, find it in their interest to nurture this new base of prosperity and respond accordingly. In this way, it is conceivable that a virtuous circle of growth, reform, and further growth could be put in place over time in Iraq. The country has the broad-based talent, skills, and ingenuity to prosper if only it can break the link between state and oil, with its corrupting and debilitating influence.

Conclusions

Iraq’s economic future will be largely determined by events surrounding the oil sector. One can easily envision a bright future as well as one quite dark. There are, however, several simple guidelines that Iraq’s leaders should try to keep in mind. Most importantly, the true test of the expenditure of scarce resources in Iraq should be the total contribution to political and economic development. Expenditure patterns that contribute to the avoidance of rentier state effects are likely to be the most productive for the country’s eventual recovery and growth.

Fortunately within Iraq there appears to be increasing acceptance of these principles. On July 27, 2006 the Iraqi government and the United Nations announced the creation of the International Compact with Iraq. During the next five years the Compact – which is jointly chaired by the Government of Iraq and the United Nations with the support of the World Bank will aim to unite the international community and multilateral organizations to help in Iraq’s recovery.

The compact primarily focuses on building a framework for Iraq’s economic transformation and on Iraq’s integration into the regional and global economy. To achieve this goal the government of Iraq will focus on:

- Political inclusion and consensus-building;
- Establishing professional security forces;
- Tackling corruption;
- Creating a transparent and efficient oil sector;
- Developing a solid budgetary framework; and
- Improving governance by building and consolidating effective national institutions

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