

Bassam Yousif
Indiana State University
byousif@isugw.indstate.edu
Telephone: 812-237-8628
Fax: 812-237-4349
December 26th 2005

What Went Wrong? Coalition Policies and Current Economic Conditions in Iraq¹

**NOTE: PLEASE DO NOT QUOTE OR CIRCULATE WITHOUT THE
AUTHOR'S PERMISSION**

Summary

Prospects for Iraq's economy are bleak: unemployment remains high and the rebuilding effort slow, weighed down by chronic instability. Although rising oil prices will undoubtedly increase GDP in 2005, an oil-induced rise in GDP will not necessarily bring about a general rise in incomes, because the oil sector, even though it accounts for most of GDP, employs only *1 percent* of the labor force.² The real challenge will be to convert oil income to increased employment and output in sectors with high social rates of return, thus raising general living standards. This will not be easy given the current technical and security constraints—greatly aggravated by ill-conceived Coalition policies.

¹ The data presented in this paper rely heavily on work that I have published elsewhere. See Bassam Yousif, 'Coalition Economic Policies in Iraq: motivations and outcomes,' *Third World Quarterly*, Vol. 27, No. 3, pp. 491-505, April 2006.

² Christopher Foote, William Block, Keith Crane and Simon Gray, 'Economic Policy and Prospects in Iraq,' *Journal of Economic Perspectives*, Vol. 18, No. 3, Summer 2004, pp. 47-70, p. 50.

Inappropriate Policies: Coalition policies centered on the sweeping liberalization of markets, the goal being to improve the efficiency in the allocation of resources and to thus expand output and incomes.

In the labor market, over half a million state employees (about 8% of the labor force) were fired, mostly as a result of the dissolution of the Iraqi Army.³ Workers retained in the public sector nevertheless received substantial salary increases, six-fold on average.⁴ These measures were accompanied with reforms in currency, foreign trade, taxation and capital markets: the new Dinar was successfully introduced; import tariffs were slashed;⁵ corporate tax rates were reduced as foreign companies were allowed to acquire Iraqi assets and to repatriate profits—all to encourage investment. And, despite UN and World Bank advice to the contrary, agricultural subsidies were ended.⁶

The Coalition also planned to privatize public sector firms but was unable to do so because of the 1949 Geneva Convention, which prevents occupying powers from selling assets they do not own. Unable to privatize, the Coalition froze the bank accounts and subsidies of public enterprises and inserted a clause in Iraq's interim constitution, mandating that Coalition orders, including those relating to privatization, could only be changed by an elected government.

³ Christopher Foote, et al., 'Economic Policy and Prospects in Iraq,' p. 55.

⁴ International Crisis Group (ICG), 'Reconstructing Iraq,' ICG Middle East Report No. 30, 2 September 2004, Amman/Baghdad/Brussels, p. 1, <http://www.icg.org/library/documents/middle_east___north_africa/iraq_iran_gulf/30_reconstructing_iraq.pdf>, accessed, 6-27-05.

⁵ Christopher Foote et al., 'Economic Policy and Prospects in Iraq,' p. 64.

⁶ ICG, 'Reconstructing Iraq,' p. 5.

Low Capacity to Absorb Investments: While some of the reforms (especially the currency reforms and debt relief) are praiseworthy, the central objective of these measures—to induce capital and labor to flow to high return activities—remains unfulfilled. It is in the promotion of employment and in capital formation where the policies ran aground.

The Iraqi economy's capacity to absorb investment was already low at the onset of the US/UK occupation. Wars and sanctions destroyed and prevented the reconstruction of the country's physical and industrial infrastructure. Chronic insecurity and the emigration of large numbers of skilled and technical personnel since the occupation have magnified the investment absorption problem.

The army's demobilization and the termination of agricultural subsidies (which made Iraqi farm goods uncompetitive and so induced the migration of farmhands to the cities) raised unemployment and have undoubtedly contributed to insecurity. Iraq's Central Statistical Organization surveys reveal that unemployment climbed sharply to 28.1% in late 2003⁷ and declined only marginally to 26.8% in the first half of 2004.⁸ Despite the slight decline in early 2004, independent estimates of the unemployment rate are higher and average from 25 to 40% for the period of January to November 2005.⁹ The demobilization raised joblessness, especially for young urban males—that is among those

⁷ John Howley, 'The Iraq Jobs Crisis,' Education for Peace in Iraq Center, Issue Brief No. 1, June 2004, p. 3, <<http://www.transafricaforum.org/documents/EPIClaborreport.pdf>> accessed 12-20-05.

⁸ United Press International (UPI), 'Iraq Unemployment Drops Despite Violence,' December 4 2004, <<http://washingtontimes.com/upi-breaking/20041204-061822-5610r.htm>> accessed 12-20-05.

⁹ Brookings Institution, 'Iraq Index: Tracking Variables of Reconstruction & Security in Post-Saddam Iraq,' <<http://www.brookings.edu/fp/saban/iraq/index.pdf>> accessed 10-20-05.

who are most likely to riot or join militias—thus fuelling insecurity. The lack of security has, in turn, restrained investment.

Foreign investors have been understandably reluctant to do business at these high levels of risk, and investments made by Iraqi entrepreneurs and US-funded contractors have proceeded slowly. The binding constraint on investment in Iraq has not been availability of funds, but rather the economy's low ability to absorb investments, exacerbated by the spiraling violence. This stands in contrast to the experience of other countries, notably in Eastern Europe and the former Soviet Union, where the radical liberalization of markets and prices resulted in substantial macroeconomic instability and consequently in greatly reduced investment levels. Jeffrey Sachs, a proponent of shock therapy, blamed the prolonged difficulties faced by these countries on the unwillingness of Western countries to provide the financial assistance required for macroeconomic and price stability.¹⁰

In Iraq, by contrast, it is the lack of security rather than funds that has hampered capital formation. Violence and insecurity have both delayed implementation and increased the costs of rebuilding. US-financed rebuilding proceeded very slowly in the first 18 months of occupation, so that, by September 15th 2004, only \$1.1 billion out of the \$18.4 billion (later increased to \$20.9 billion) allocated by the US congress for reconstruction had been spent. Similarly, only \$16 million of the \$4.2 billion earmarked for water and sanitation projects had been utilized; and only a mere \$2 million of the \$786 million for health care had been spent.¹¹ It is no wonder that the majority of Iraqis polled in May 2004 stated

¹⁰ See Jeffrey Sachs, 'Consolidating Capitalism,' *Foreign Policy*, Vol. 98, spring 1995, pp. 50-64.

¹¹ Jonathan Weisman, 'US Plans to Divert Iraq Money,' *Washington Post*, September 15, 2004,

that rebuilding had yet to begin.¹² Reconstruction has accelerated in 2005: a total of \$8.6 billion has been spent as of September 28th 2005, including \$390 million on water and sanitation projects and \$242 million on health.¹³

Even so, the figure for total expenditure falls substantially short of the allocated funds and gives a distorted picture of the actual reconstruction. Much of the US-financed spending on rebuilding has been unrelated to civilian reconstruction: as of September 28th 2005, spending on security and law enforcement—as evinced in the hurried training and equipping of local security personnel, often to secure vulnerable civilian infrastructure projects—was the largest expenditure item, representing \$3.6 billion, more than two-fifths of the \$8.6 billion total.¹⁴ That is, US spending on all other items, including electricity, oil, civil society, roads and bridges, education, health, transport and sanitation, has amounted to only about \$5 billion.¹⁵ But even this modest sum overstates the extent of US-funded capital formation, as the real value of spending is almost surely lower than these statistics indicate. According to a Center for Strategic and International Studies report, fraud and mismanagement are responsible for soaking up an estimated 15% of reconstruction expenditures.¹⁶ Furthermore, as a large portion—two-thirds, in term of value, in 2003¹⁷—of the rebuilding contracts were awarded to US companies on a non-

<<http://www.washingtonpost.com/wp-dyn/articles/A21489-2004Sep14.html>>, accessed 12-20-05.

¹² ICG, 'Reconstructing Iraq', p. 2.

¹³ US Department of State, 'Iraq Weekly Status Report', September 28 2005, p. 23,

<<http://www.state.gov/documents/organization/54230.pdf>>, accessed 12-20-05.

¹⁴ US Department of State, 'Iraq Weekly Status Report', September 28th 2005.

¹⁵ Calculated from US Department of State, 'Iraq Weekly Status Report', September 28th 2005.

¹⁶ See Center for Strategic and International Studies (CSIS), 'Progress or Peril? Measuring Iraq's Reconstruction,' December 2004, p. 3, <http://www.csis.org/isp/pcr/iraq_funds.pdf>, assessed 10-23-05.

For an exploration of the role of corruption in Iraq's reconstruction see Philippe Le Billon, 'Corruption, Reconstruction and Oil Governance in Iraq,' *Third World Quarterly*, Vol. 26, No. 4/5, 2005, pp. 685-703.

¹⁷ Philippe Le Billon, 'Corruption, Reconstruction and Oil Governance', p. 696.

competitive basis, the costs of reconstruction have swelled. The real value of capital formation is consequently lower than even the small total for US-funded reconstruction suggests. Meanwhile, the Interim Governing Council spent \$1.87 billion on reconstruction in 2003¹⁸, \$3.5 billion in 2004¹⁹ and planned to spend more in 2005. Still, this is a fraction of the \$17.5 billion that the World Bank and UN estimate is required to restore infrastructure and public services to pre-invasion levels.²⁰

Present and Prospective Outcomes: Coalition policies thus simultaneously increased unemployment and hampered investment, precisely the opposite of what they intended to achieve. Along with the joblessness and insecurity there has been a perceptible decline in human development outcomes. Investment difficulties have delayed the restoration of basic services. For example, March 2003 levels of electricity generation were reached in August 2004, but have since declined. As a case in point, electricity output in Baghdad, from January to April 2005, was two-fifths of its pre-occupation level.²¹ In a close repeat of post-sanctions conditions in the 1990s, the lack of electricity has, in turn, lead to a reduced availability of safe water and to a rise in water-borne disease and child malnutrition, which has almost doubled according to a UN study.²² Mortality rates increased during the invasion period of March/April 2003 and have remained high. Most

¹⁸ ICG, 'Reconstructing Iraq', p. 2.

¹⁹ Calculated from IMF, *Iraq: Statistical Appendix*, Report No. 05/295, Washington DC, August 2005, p. 8 & 11, <<http://www.imf.org/external/pubs/ft/scr/2005/cr05295.pdf>>, accessed 10-05-05.

²⁰ ICG, 'Reconstructing Iraq', p. 2.

²¹ Brookings Institution, 'Iraq Index.'

²² Karl Vick, 'Children Pay Cost of Iraq's Chaos,' *Washington Post*, November 21 2004, <<http://www.washingtonpost.com/wp-dyn/articles/A809-2004Nov20.html?sub=AR>>, accessed 10-08-05.

deaths have been the result of violence, frequently from coalition military action but also from crime.²³

Parallel to this deterioration in living standards, there has been a rise in inequality, as retained public workers, many of whom were idle at state enterprises that were denied working capital by the Coalition, have experienced large salary increases. There is a limit to how much inequality a society is willing to accept and this depends in part on the history and the degree of social cohesion in the country. Whatever their merits, reforms are likely to meet stiff opposition from losing sections of the public. In Iraq, the brusque Coalition measures in the labor market accentuated the sense of gain and loss in society and have undermined support for future reform among broad sections of the public.

Indeed, to the extent that Coalition policy avowedly aimed to nurture pro-market sentiments on the part of Iraqis and so reduce reliance on the state,²⁴ they promoted the reverse—a solidification of the view of the market as largely arbitrary and unfair.

Coalition officials expressed disappointment that 49% of Iraqis reported that they wanted a political platform that called for more government employment as opposed to private sector jobs.²⁵ Yet, support for state intervention in the economy is well-established. It predates the Ba'th regime and developed in the context of historically devastating market

²³ Les Roberts, Riyadh Lafta, Richard Garfield, Jamal Khudairi, and Gilbert Burnham, 'Mortality before and after the 2003 invasion of Iraq: cluster sample survey,' *The Lancet*, Vol. 364, November 20 2004, pp. 1857-1864, suggest that the war resulted in 100,000 civilian deaths.

²⁴ Christopher Foote et al., 'Economic Policy and Prospects in Iraq.'

²⁵ *Ibid.* p. 68.

failures and intense economic insecurity.²⁶ The desire to correct these failures impelled successive Iraqi governments, including pro-market administrations under the monarchy, to intervene in the national economy. Oligopoly control of markets by foreign (namely British) companies and local merchants resulted in domestic shortages and runaway inflation during and after the Second World War, when sharp price increases prompted high profits for merchants and landowners but severe declines in real wages and salaries.²⁷ Activist and interventionist measures by successive governments, including the nationalization of the oil sector in the early 1970s, were thus greeted with general acclaim as these were seen to promote economic stability. As most Iraqis recognize, had market price mechanisms been relied upon to allocate food during sanctions, a famine would have almost surely resulted. In contrast, coalition policies have worked to reinforce, rather than alleviate, the suspicions that Iraqis harbor about markets.

Nor have Coalition reforms helped fortify the historically precarious nature of property rights in Iraq, where frequent and arbitrary changes stand as the norm rather than the exception. In order to secure the administration of rural areas and, later, to check the power of the more nationalist urban centers, the British favored tribal Sheiks during their occupation of Iraq beginning in 1917. In time, “a society of generally free tribesmen became transformed into one of groups of near-serfs . . .” as new Sheikh-landlords gained power.²⁸ With the overthrow of the monarchy in 1958, this landed group lost political

²⁶ See Kiren Aziz Chaudhry, ‘Consuming Interests: Market Failure and the Social Foundations of Iraqi Etatism,’ in Kamil A. Mahdi (ed.) *Iraq’s Economic Predicament*, Ithaca Press, Reading UK, 2002, pp. 233-265.

²⁷ Ibid. p. 236-241. For estimates of inflation and declining real earnings in this period, see Hanna Batatu, *The Old Social Classes and Revolutionary Movements of Iraq*, Princeton University Press, Princeton NJ, 1978, pp. 471 & 474.

²⁸ Peter Sluglett, *Britain in Iraq 1914-1932*, Ithaca Press, London, 1976, p. 231.

power, through the abolition of parliament that they dominated, and economic power, via land reform. Subsequent nationalizations, in 1964, of large banking, commercial and industrial establishments and later measures under the Ba’th eroded the rights of the domestic industrial and commercial bourgeoisie. Later, under sanctions, while the savings of the lower and middle classes were wiped out, a hated class of “nouveaux riches,”²⁹ with close ties to the former regime, emerged as a social force. Yet none of this instability surrounding assets has been assuaged by Coalition policies. If anything, the chronic lawlessness that has resulted from these policies has aggravated the issue. Thus, not only did the economic policies pursued by the Coalition harm the immediate prospects for employment and rebuilding, they hampered the transition to an open economy and polity.

Alternative Policies: None of this has helped the new Iraqi government establish control and legitimacy in the country: Coalition measures, with whom the new Iraqi leaders are associated, have generated joblessness and insecurity, while making future reform more difficult. What is urgently needed in Iraq is a change in focus, away from radical liberalization and towards an agenda that emphasizes human development—that is, policies that perceptibly and fairly rapidly raise the living standards of the population, especially the poor, and improve the economy’s aptitude to absorb investments for rebuilding. This is preferable to the hurried liberalization whose promised benefits accrue in the long term, but in the meantime leave large numbers of people jobless, unhealthy and insecure. Such an agenda might include the following policies:

²⁹ Phoebe Marr, Comment on Isam al-Khafaji, ‘The Myth of Iraqi Exceptionalism,’ *Middle East Policy*, Vol. 7, No. 4, October 2000, pp. 87-91, p. 90.

1. *A program of guaranteed public employment* in labor-intensive work projects, at relatively low wages (in order to minimize labor market distortions).³⁰ Labor-intensive activities, ranging from rubbish collection to irrigation network repairs to basic construction activities, could be targeted with such a program.

This is not a novel proposal.³¹ In fact, some US military commanders implemented such schemes but were forced to abandon them when the allocated funds were exhausted.³² Such an employment plan should not be viewed as a public assistance program but as a public investment venture. Projects could be carefully selected and only those with a relatively high social rate of return should be undertaken.

2. *Incentives for US contractors to hire more Iraqi labor.* Construction activities are typically characterized by substantial opportunities to substitute labor for capital.³³ But abundant Iraqi labor has been underutilized in reconstruction, since US firms, largely responsible for the reconstruction effort, do not face Iraqi relative factor prices. The cost of hiring Iraqis is greater than appears, as they are considered to be a security risk.³⁴ It therefore makes little sense for US contractors to hire local labor.

³⁰ Keith Griffin and Terry McKinley, *Implementing a Human Development Strategy*, St. Martin's Press, New York, 1994.

³¹ Public employment schemes have been used successfully in India and Bangladesh. See Keith Griffin and Terry McKinley, *Implementing a Human Development Strategy*, Chapter 5.

³² ICG, 'Reconstructing Iraq,' p. 18.

³³ Ian Little, Tibor Scitovsky and Maurice Scott, *Industry and Trade in some Developing Countries: A Comparative Study*, Oxford, Oxford University Press, 1970.

³⁴ As one Coalition procurement officer put it: "from a force protection standpoint, Iraqis are more vulnerable to bad guy influence." Quoted in ICG, 'Reconstructing Iraq,' p. 17.

Yet what is rational for individual contractors is not necessarily beneficial to the rebuilding effort as a whole, as unemployment and the resultant insecurity have seriously hampered reconstruction efforts. Unwillingness to hire Iraqi labor transfers, but does not solve, the security problem.

3. *A reorientation of reconstruction expenditures* away from large infrastructure projects, whose benefits have a longer maturation period, to smaller projects, whose positive effects are more immediate. Of course, some expenditure on such large projects, such as electricity generation, is desirable.³⁵ Where possible, however, preference should be shown to smaller projects, such as minor repair of buildings, roads and sewage systems. Not only are these activities typically labor-intensive, they are also often associated with a high social rate of return.

4. *Avoidance of hasty privatization of state assets.* Many state-owned enterprises will need to be privatized eventually, but insistence that this be done immediately would further swell joblessness and insecurity, and promote resistance to future reform.

These initiatives would greatly improve the lives of all Iraqis: they would improve the employment and security picture, and alleviate investment bottlenecks, thereby aiding reconstruction. In addition, the involvement of large numbers of Iraqis in their nation's rehabilitation—in contrast to present efforts from which many Iraqis feel excluded³⁶—

³⁵ This is especially the case as more than 90 percent of household receive electricity through electrical networks. See UN, Iraq Living Conditions Survey 2004, Vol. 2: Analytical Report, Baghdad, Iraq, 2005, p. 16 <<http://www.iq.undp.org/ILCS/PDF/Analytical%20Report%20-%20English.pdf>>, accessed 6-27-05.

³⁶ ICG, 'Reconstructing Iraq,' pp. 11-13.

would be hugely beneficial in terms of political legitimacy and help to lay the foundation for an open economy and society.

Such measures may also prove essential politically. No government can survive repeat failure in providing the most basic public good of all: peace. The inability of a global superpower to do exactly that: establish security in Iraq, thus provides the new Iraqi government with an opportunity to enhance its legitimacy by sponsoring people-centered policies that promote not only economic development but *security*.

The obstacles to the implementation of such a program are nevertheless considerable. The program would likely meet stiff opposition from international lenders such as the World Bank, and may thus need to be mostly domestically financed. But despite the rise in oil revenues, the Iraqi government is running a large fiscal deficit,³⁷ and as most of the US funds devoted to reconstruction have been contracted (even though only a fraction has been spent),³⁸ there is little in terms of excess funds available. As a result, substantial changes in the composition of existing expenditures as well as increased taxation—never easy even at the best of times—may be required to successfully carry out a human development program. Regardless of the obstacles, economic policies that promote rather than hamper security are the only solution for Iraq's future. Otherwise, the prospects for Iraq's economy and its long-suffering people will remain bleak.

³⁷ For estimates of the deficit see IMF, *Iraq Staff Report for the Article IV Consultation*, pp. 31-2.

³⁸ See US Department of State, 'Iraq Weekly Status Report', September 28 2005.

References:

- Batatu, Hanna, *The Old Social Classes and Revolutionary Movements of Iraq*, Princeton University Press, Princeton NJ, 1978.
- Brookings Institution, 'Iraq Index: Tracking Variables of Reconstruction & Security in Post-Saddam Iraq,' <<http://www.brookings.edu/fp/saban/iraq/index.pdf>> accessed 10-20-05.
- Center for Strategic and International Studies (CSIS), 'Progress or Peril? Measuring Iraq's Reconstruction,' December 2004, <http://www.csis.org/isp/pcr/iraq_funds.pdf>, assessed 10-23-05.
- Chaudhry, Kiren Aziz, 'Consuming Interests: Market Failure and the Social Foundations of Iraqi Etatism,' in Kamil A. Mahdi (ed.) *Iraq's Economic Predicament*, Ithaca Press, Reading UK, 2002, pp. 233-265.
- Foote, Christopher, Block, William, Crane, Keith and Gray, Simon, 'Economic Policy and Prospects in Iraq,' *Journal of Economic Perspectives*, Vol. 18, No. 3, Summer 2004, pp. 47-70.
- Griffin, Keith and McKinley, Terry, *Implementing a Human Development Strategy*, St. Martin's Press, New York, 1994.
- Howley, John, 'The Iraq Jobs Crisis,' Education for Peace in Iraq Center, Issue Brief No. 1, June 2004, <<http://www.transafricaforum.org/documents/EPIClaborreport.pdf>> accessed 12-20-05.
- International Crisis Group (ICG), 'Reconstructing Iraq,' ICG Middle East Report No. 30, 2 September 2004, Amman/Baghdad/Brussels, <http://www.icg.org/library/documents/middle_east__north_africa/iraq_iran_gulf/30_reconstructing_iraq.pdf>, accessed, 6-27-05.
- IMF, *Iraq: Statistical Appendix*, Report No. 05/295, Washington DC, August 2005, <<http://www.imf.org/external/pubs/ft/scr/2005/cr05295.pdf>>, accessed 10-05-05.
- Le Billon, Philippe, 'Corruption, Reconstruction and Oil Governance in Iraq,' *Third World Quarterly*, Vol. 26, No. 4/5, 2005, pp. 685-703.
- Little, Ian, Scitovsky, Tibor and Scott, Maurice, *Industry and Trade in some Developing Countries: A Comparative Study*, Oxford, Oxford University Press, 1970.
- Marr, Phoebe, Comment on Isam al-Khafaji, 'The Myth of Iraqi Exceptionalism,' *Middle East Policy*, Vol. 7, No. 4, October 2000, pp. 87-91.

Roberts, Les, Lafta, Riyadh, Garfield, Richard, Khudairi, Jamal and Burnham, Gilbert, 'Mortality before and after the 2003 invasion of Iraq: cluster sample survey,' *The Lancet*, Vol. 364, November 20 2004, pp. 1857-1864.

Sachs, Jeffrey, 'Consolidating Capitalism,' *Foreign Policy*, Vol. 98, spring 1995, pp. 50-64.

Sluglett, Peter, *Britain in Iraq 1914-1932*, Ithaca Press, London, 1976.

United Press International (UPI), 'Iraq Unemployment Drops Despite Violence,' December 4 2004, <<http://washingtontimes.com/upi-breaking/20041204-061822-5610r.htm>> accessed 12-20-05.

UN, Iraq Living Conditions Survey 2004, Vol. 2: Analytical Report, Baghdad, Iraq, 2005, <<http://www.iq.undp.org/ILCS/PDF/Analytical%20Report%20-%20English.pdf>>, accessed 6-27-05.

US Department of State, 'Iraq Weekly Status Report', September 28 2005, <<http://www.state.gov/documents/organization/54230.pdf>>, accessed 12-20-05.

Vick, Karl, 'Children Pay Cost of Iraq's Chaos,' *Washington Post*, November 21 2004, <<http://www.washingtonpost.com/wp-dyn/articles/A809-2004Nov20.html?sub=AR>>, accessed 10-08-05.

Weisman, Jonathan 'US Plans to Divert Iraq Money,' *Washington Post*, September 15, 2004, <<http://www.washingtonpost.com/wp-dyn/articles/A21489-2004Sep14.html>>, accessed 12-20-05.