

III. ASSISTING IRAQ'S ECONOMIC DEVELOPMENT

It is difficult to make many detailed recommendations regarding the economic aspects of reconstruction because Iraq's economy remains largely held hostage to developments in the security and political arenas. The greatest economic problems in Iraq today derive from the persistent insecurity, widespread corruption, and unsettled political situation that define its landscape. It is hard to envision meaningful progress in reviving or improving Iraq's economy without commensurate—and in many cases, preceding—improvements in Iraq's security and political fortunes. To some extent, any progress in the political and security arenas will have an immediate positive impact on the economy, as has been the case with the semblance of improvement in security resulting from the consolidation of militia control over central and southern Iraq coupled with the successful referendum and elections in Iraq in the fall and winter of 2005. Moreover, it is almost certainly the case that there are deep, structural problems in the Iraqi economy (many of them extant long before the American liberation of the country in 2003 and even before the Iraqi invasion of Kuwait in 1990) that should be addressed as part of the broad program of reconstruction, but cannot really be treated until the security and political

situations improve enough to allow the economic gears to really begin to turn.

Iraq's problems with security, both in terms of insurgent attacks, militia violence and crime, are the first problem for economic reconstruction. Some Iraqis are afraid to leave home, which is especially true for women and girls, making it hard for them to find work or shop for their families. Traveling long distances is always dangerous for Iraqis, and those who must, do so sparingly and often with heavy security. Goods often do not reach their destinations because they are waylaid by militias, insurgents, or thieves. The need for security, both in the form of physical barriers and armed guards adds somewhere between 20–50 percent to all economic costs in Iraq.¹ Anything not properly guarded at all times can vanish in the blink of an eye. Electricity is not always available, to a considerable extent because of sabotage to the power grid, leaving businesses from small shops to enormous factories at the mercy of the fates. According to a report by the Congressional Research Service, in 2004 saboteurs cut over 100 electrical lines and knocked down 1,200 electrical towers.² External investment in Iraq is negligible because few foreign entrepreneurs are willing to run

1 See for instance Joseph Farinella, "Iraq: Perceptions, Realities and Cost to Complete," Testimony to the Committee On Government Reform, Subcommittee on National Security, Emerging Threats, and International Relations, U.S. House of Representatives, October 18, 2005, p. 8; Renae Merle and Griff Witte, "Security Costs Slow Iraq Reconstruction," *The Washington Post*, July 29, 2005, p. A1; Curt Tarnoff, "Iraq: Recent Developments in Reconstruction Assistance," Congressional Research Service, CRS Report for Congress RL31833, May 12, 2005, p. 11.

2 Tarnoff, *ibid.*, p. 11.

the enormous risks that putting money into Iraq entails. In fact, anecdotal evidence strongly suggests that even wealthy Iraqis (many of them newly-enriched from graft and organized crime) are not investing their earnings back into the country, but are transferring huge amounts of it out for safekeeping to Jordan, the Arab Gulf States, and Europe. Non-Government Organizations (NGOs), which have repeatedly proven themselves critical to the rebuilding of a nation's economy, have mostly fled Iraq because insurgents have deliberately targeted their personnel and the Coalition has been unable to provide for their safety.

For the most part, security problems have caused greater harm to Iraq's larger industries than to its small businesses. Factories need to have workers, managers, power, and materials all present at the same time for any products to be manufactured, and in current circumstances, it is simply too infrequent that such harmonic convergences occur for most factory owners to make the investment in opening their plants. State-Owned Enterprises continue to "operate," but mostly in the sense that the government pays the salaries of the workers, not that anything actually gets produced. Small businesses can usually make do in the face of such shortfalls, and their owners also frequently need to keep them open to earn money in the way that owners of factories generally do not. For instance, small businesses often can buy electricity from neighbors with private generators—or even buy small generators themselves; far fewer owners of large businesses are willing to buy the big generators they would need to meet their power requirements given the ease with which they can be destroyed or otherwise sabotaged. Moreover, larger businesses also tend to be more heavily reliant on foreign investment than smaller concerns, and so they also suffer from the dearth of external investment capital flowing into the country.

Iraq's political problems also hobble its economy. First, there is the indirect impact that politics has on

the economy by contributing to Iraq's prevailing insecurity. This is worth noting because it again underscores the intricate interrelationship among military, political, and economic developments in Iraq. Beyond this, however, there are other problems as well. Corruption is the most obvious of these; as noted in Chapter 2, graft is endemic throughout the Iraqi government and, like security, imposes heavy costs on all business transactions. The incapacity of Iraqi ministries means that vast sums of money are simply wasted, as does the infighting among the different ethnic, sectarian and even tribal groups within the government, which paralyzes budgeting, regulations, and other aspects of economic policy. Many major Iraqi enterprises were state-owned, leaving them prey to all of the problems of the central government. These state industries employ roughly 500,000 people, making them a critical employment sector, but they produce little and their workforce is generally overstaffed by 30–40 percent, making them even less efficient as economic engines.³ Beyond this, Iraq still has numerous other manifestations of a command economy—which inserts an unhelpful and undermanned central bureaucracy into far too many economic activities—not least of which is a mindset among too many Iraqis that they can and should do nothing for themselves but must wait for Baghdad to do it for them.

Consequently, the most useful things that the United States and the new Iraqi government could do to help Iraq's economy would be to embrace the many recommendations regarding security and politics described above.

Of course, there are also a range of pre-existing problems besetting the Iraqi economy from Saddam's mismanagement of the Iraqi economy, the twelve years of UN-imposed sanctions, Iraq's various wars, and the fall of Saddam. Iraq's banking sector remains moribund, in large measure because so much cash appears to be flowing out of the country from graft. This lack

³ Ken Dilanian, "Iraqi Business Begins to Boom," *Knight-Ridder Newspapers*, March 16, 2004; The Economist Intelligence Unit (EIU), "Country Report: Iraq," September 2005, p. 24.

of liquidity, manifested in relatively high interest rates, has hindered the service economy and made construction and infrastructure repair efforts heavily dependent on foreign aid rather than internal or external investment.⁴ Similarly, the distorting subsidies on fuel and the government-provided rations are also important problems introducing inefficiency into the economy that date to earlier eras in Iraqi history. Iraqi worker productivity remains low thanks to poor education and the mindset among many fostered under Saddam's totalitarianism that receiving a paycheck is not necessarily tied to a person's skill or output.

Another example of this phenomenon is that health care in Iraq remains poor (even by regional standards) as a result of the impact of sanctions, Iraq's wars, and the distortions of Saddam's totalitarian state. Diarrhea, measles, respiratory infections, malaria, and even tuberculosis and cholera, plague the population, especially Iraq's children. These diseases, coupled with malnutrition affecting nearly one-third of Iraqi children under the age of five, have pushed Iraqi infant and child mortality rates well above regional averages and comparable Iraqi figures from before the 1991 Persian Gulf War. Likewise, inadequate healthcare for pregnant women has contributed to high maternal mortality rates.⁵ Even here, corruption, crime, violence, and political paralysis also play a role. For instance, pharmaceuticals take long periods of time to reach Iraqi doctors and come with high price tags attached, while many hospitals and clinics lack the resources to care for all seeking their aid. Typically, they charge unofficial "user fees" which make them largely unaffordable for the average Iraqi.⁶ Meanwhile, few health NGOs maintain sizable operations in Iraq because of the security threat to foreign personnel.

SIGNS OF LIFE

While the Iraqi economy is not doing well, it is also important to keep in mind that it is not listless either. In fact, there are important signs of life, although the manifestations of progress are important in their own right because of what they say about the fragility and, in some cases, the superficiality of Iraq's economic activity. To some extent, credit for the relative progress of the Iraqi economy is due to the CPA and their successors at the U.S. Embassy, who have done much better dealing with Iraq's economic problems than they have on security and political matters. The transitional Iraqi government also proved far more astute at handling some of its economic problems than it did its political and security problems, thanks to some able ministers in key places, particularly Minister of Finance 'Ali Allawi.

Foreign aid continues to flow into Iraq. The United States alone has appropriated some \$25 billion in non-military assistance and a considerable portion of that money has been allocated and even disbursed.⁷ Likewise, by August 2005, Iraq had also received about \$2.7 billion in bilateral assistance from other countries and recently secured loans of nearly another \$1 billion from the IMF and World Bank.⁸ Moreover, Iraq and the US have been able to get Iraqi oil exports up to a respectable level, although they are still not at prewar rates. Because Iraq's economy remains almost entirely dependent on oil revenues, increased oil production coupled with very high oil prices in 2004 boosted growth (in GDP per capita) to an astronomical 50 percent. By the same token, the downturn in oil prices coupled with falling exports (thanks mainly to theft and sabotage) meant an equally dramatic slowdown to a growth rate of less than 5 percent in 2005.⁹ Although

4 International Monetary Fund, IMF Country Report No. 05/295, Iraq: Statistical Appendix, August 2005, p. 9.

5 USAID, "Assistance for Iraq: Health," available at <<http://www.usaid.gov/iraq/accomplishments/health.html>>.

6 Medact, "Iraq Health Update – Summer 2005," available at <<http://www.medact.org/content/communique/iraqupdate.PDF#search='Iraq%20health%20statistics'>>.

7 Steven Kosiak, "The Cost of US Military Operations in Iraq and Afghanistan Through Fiscal Year 2006 and Beyond," Center for Strategic and Budgetary Assessments, January 4, 2006, p. 1.

8 Joseph A. Christoff, "Rebuilding Iraq: Enhancing Security, Measuring Program Results, and Maintaining Infrastructure are Necessary to Make Significant and Sustainable Progress," Testimony before the Committee on Government Reform, Sub-Committee on National Security, House of Representatives, October 18, 2005, p. 6.

9 The Economist Intelligence Unit, "Country Risk Service: Iraq," October 2005, p. 8.

far too much of Iraq's oil money is siphoned out of the country in the form of graft, much still remains—even if that too is often in the form of corruption. Thus, legal or illegal, a fair amount of cash still flows into the country. The problem is that it is a bit like a patient with a terrible wound who is being provided with constant blood transfusions: the transfusions are able to keep the patient alive, but he is still likely to die unless the wound is closed because it is impossible to keep maintaining the transfusion rate. In other words, at some point, foreign aid to Iraq is likely to dry up, and when that happens, if Iraq's economy is not on a more sustainable basis, it could experience major dislocations.

The constant flow of money into the country, coupled with the U.S. decision to temporarily lift all import duties after the fall of Baghdad brought in a flood of foreign consumer goods. Tariffs have been reimposed, but the new Iraqi government has generally kept them very low (5 percent) maintaining the attractiveness of Iraq as a destination for foreign goods. Consequently, there is quite a lot of food, household necessities, electronics, and appliances in Iraqi markets and stores. Unfortunately, the same could have been said (with the exception of major appliances) about Iraqi markets at the end of Saddam's reign. There were never real shortages, just an inability on the part of Iraqis to afford to purchase anything. Although inflation has slowed considerably since the fall of Baghdad, it is still high at roughly 20–30 percent, according to the IMF and the Economist Intelligence Unit, respectively.¹⁰ Indeed, the continuing distortion caused by price controls and subsidies has also allowed Iraq's black market to persist and even to thrive. Thus, goods are often available, but they tend to be expensive—too expensive for most Iraqis.

The influx of foreign aid, especially since so much of it was initially earmarked for infrastructure repair, caused Iraq's construction industry to boom. As

expected, this has taken some of the edge off of unemployment and has helped push money down into the hands of Iraq's working classes—all of which was beneficial and also helped the recovery of Iraq's consumer economy. However, too much of what was built did not materially affect the Iraqi economy: far more schools were built than were really needed; too many huge “white elephant” projects were built that cannot be sustained by Iraq's limited labor and management force; other projects turned out to be useless because of faulty planning, like the famous electrical generators that were never connected to the national power grid; and too many of these projects have become targets for the insurgents (or local militias) and so are either destroyed or demand scarce resources to pay for security. Moreover, the United States and other aid providers, recognizing these problems, are shifting aid away from construction. While this is probably necessary, to some extent, based on the need to get a better return on the investment, it could undermine Iraq's construction industry, possibly boosting unemployment once again, and leaving a legacy of huge expenditures with little impact on Iraq's long-term economic viability.

Wherever American and other foreign aid has been able to intervene directly in Iraq's healthcare system it has typically done quite a bit of good, but mostly in alleviating immediate problems rather than building a sustainable healthcare system. For instance, USAID-supported programs have resulted in a huge improvement in child immunization rates all across the country. Similarly, infant mortality has been cut in half since the fall of Baghdad through direct intervention in Iraqi pre-, neo-, and ante-natal care; still, only Yemen has a worse infant mortality rate in the Middle East. In contrast to these (relative) success stories, Iraq still averages over 50 infant deaths per 1,000 live births, while Egypt averages less than 33, Syria under 30, and Jordan and the Gulf states are all below 20.¹¹

10 The Economist Intelligence Unit, “Country Report: Iraq,” September 2005, p. 12; International Monetary Fund, “Country Report No. 05/295, Iraq: Statistical Appendix,” August 2005, p. 18.

11 CIA, *The World Factbook*, 2005.

GRAPHIC 3. BASIC SOCIO-ECONOMIC INDICATORS IN IRAQ, 1989–2005

Socio-Economic Indicator	1989	2002	2003	2005
GDP, in billions of constant 2003 dollars	39	26	20	30*
GDP per capita, in current dollars	1,940	802	518	1,051
GDP per capita, in constant 2003 dollars	2,878	815	518	1,000
Inflation (Consumer Price Index)	30-40	19	34-40**	20-30**
Unemployment	3-5	NA	50-60	25-40
Life Expectancy in years	61	63	59	69
Infant Mortality, per 1,000 live births	40	102	102	50
Maternal Mortality, per 1,000 births	117	310	NA	193 (2004)

* Projected for 2005

** In both cases, the first number is from the IMF, the second from the EIU.

Sources: CIA, *World Factbook*, 1991 and 2005; Economist Intelligence Unit, "Country Report: Iraq," September 2005, p. 12; International Monetary Fund, "Country Report No. 05/294: Iraq: 2005 Article IV Consultation—Staff Report," August 2005, p. 9, 18; Measuring Stability and Security in Iraq October 2005, Report to Congress In Accordance with Conference Report 109-72, Emergency Supplemental Appropriations Act, 2005, page 11; UNDP, *Iraq Living Conditions Survey, Volume II: Analytical Report*, 2004, p. 51; UNFPA, "Iraq: Reproductive Health Assessment," November 2003, pp. 4–5; World Bank, *World Development Indicators Database*, 8/29/05.

Likewise, in late 2004 one-third to half of Iraqi women were giving birth at home, often with only traditional midwives in attendance, because Iraq's hospitals and health clinics were too few, too understaffed, too short on pharmaceuticals, and too expensive for most.¹² Thus, here as well, there has been a short-term improvement thanks to direct provision of foreign aid, but this has not yet been transformed into overall improvements in Iraq's healthcare system that would allow the system to sustain these improvements (let alone address problems in other areas) in the absence of that foreign aid. All of this suggests that Iraq's current economic activity is superficial and highly dependent on large-scale foreign assistance.

MANAGING EXPECTATIONS

American misunderstanding of Iraqi unhappiness derives at least in part from the different measures that each group employs. Graphic 3 above sets out some basic socio-economic indicators for Iraq, starting in 1989 at the end of the Iran-Iraq War, running through 2002 (i.e. just before the liberation of Iraq), then to 2003 (immediately after the liberation), and finally to the latest estimates for 2005. Americans typically like

to compare the last column (current economic indicators) with either the second column (the end of Saddam's reign) or the third column (the immediate postwar situation). These comparisons show progress, both over how well Iraq was doing at the end of Saddam's reign and, particularly, since the nadir of Iraqi fortunes in the chaos immediately following Saddam's fall. To Washington, this suggests both significant progress in both a relative and an absolute sense. In American eyes, these numbers tell the story that Iraqis are better off than they were under Saddam and there is steady upward progress.

Iraqis, however, are often more concerned with the comparison between the first column, when Iraq was doing reasonably well before Saddam's invasion of Kuwait, and the last column. By this standard, Iraq has not improved much at all and in many ways is still very badly off. Moreover, few Iraqis believe 1989 was the golden age of Iraq, an honor that is reserved for the late 1970s, before Saddam's invasion of Iran. Indeed, for Iraqis, 1989 was much like the current moment because it was a time of rebuilding after the hardships of the miserable eight-year war with Iran. Thus, Iraqis see the United States as having done little

¹² UNDP, *Iraq Living Conditions Survey, Volume II: Analytical Report*, 2004, p. 69.

to improve their lives economically and much to worsen them.

What makes it all the more damaging still is that many Iraqis believed that one of the benefits of the U.S. invasion—to be balanced against its many costs—would be real economic development that would put them in the same league as many of the East Asian countries, or at least the South American states. While most Iraqis always had exaggerated expectations of what the U.S. invasion might accomplish in this area, what they have gained to date has fallen so far short of their expectations that many of them question whether the Americans really know what they are doing or, worse still, whether the Americans are purposely denying Iraq the economic prosperity that they believe the Bush Administration promised. In particular, when adjusted for inflation, Iraqi wealth measured by constant GDP per capita remains less than half of what it had been 15 years ago and unemployment is 8–12 times higher than what it once was. As is well understood at this point, unemployment may be the worst of the economic problems besetting the Iraqi people. Moreover, unemployment may actually be worse than the numbers above convey because these indices do not capture widespread *underemployment*. Thus, for the Iraqis, not only is their economy not the dream they had imagined, but it does not even compare well to previous moments in their recent history.

This “expectations gap” is an important element of the problem. But there are two critical “buts” to that statement. The first is that the expectations gap is only part of the problem. There are real structural problems in the Iraqi economy that are regularly exacerbated by the unstable security and political conditions. *The second is that referring to an “expectations gap” inevitably trivializes an extremely dangerous phenomenon.* A dramatic divergence between expectations and reality inevitably breeds anger and frustration. Indeed, this is exactly what has fueled the growth of Salafi Jihadist terrorist groups like al-Qa’ida throughout the Islamic world, where many are deeply unhappy over their lot given where they believe it

ought to be. What’s more, in Iraq, many popular expectations were actually quite reasonable. For instance, it was entirely reasonable for the Iraqis to assume that if the United States were going to invade their country, that Washington would employ adequate forces to secure the country after we toppled their government. The fact that we did not do so, and still have not properly filled the security vacuum we consequently created, is causing a great deal of anger and frustration, and is part of the expectations gap. In part, *it is this expectations gap that could drive Iraq to civil war if reconstruction is seen as continuing to fail.*

SHORT TERM VS. LONG TERM ECONOMIC REFORMS

The United States and the new government of Iraq really have two economic challenges ahead of them. The first is the pressing need to begin to provide tangible benefits to the Iraqi people quickly—within the next 6–12 months as the Iraqis assess whether this new government will be any different from its predecessors. As noted repeatedly above, the great danger is that the Iraqi people will see no change from the past and conclude that this government will be no different from its predecessors, and that they therefore need to make other arrangements to get what they need for themselves and their families. The problem is that this will likely mean casting their lot with Sunni insurgents, Shi’i militias, and other extremist groups. The only way to combat this threat is to begin to show the Iraqi people that their lives are getting better. If the new Iraqi government can do so (and this will inevitably require considerable help from Iraq’s American benefactors), there is every reason to believe that most Iraqis will continue to support reconstruction if only because the vast majority are so desirous of a better future and so afraid of civil war.

The second, however, is the at-times contradictory need to help Iraq begin to deal with the various structural problems with its economy. At some point, the Iraqi economy will have to move solely under its own power and provide for the Iraqi people without prodigious

external assistance, and this will require major changes—physical, organizational, and psychological. The last vestiges of Saddam’s command economy need to be dismantled. Iraq’s oil wealth needs to be harnessed as an engine to help increase the productivity of the Iraqi worker and diversify the economy so that it is not so wholly reliant on oil revenues. Market forces need to be allowed to operate, and the Iraqi work force is going to have to become integrated into the global economy, which is likely to be a rude awakening for them. In addition to the far-reaching changes this will require, such efforts often run at cross purposes with the need to produce results quickly. For example, the need to create jobs immediately inevitably works against efforts to eliminate distortions and inefficiency in both the labor and investment markets. However, Iraq’s economy cannot run on the adrenaline of massive foreign aid contributions forever, and in the coming year the United States must continue to help Iraq reform its economy so that it can survive when the foreign aid runs out.

Unfortunately, there is no easy or obvious way to square this circle. It would be a mistake to simply argue that every effort and every resource needs to be devoted to one course or another. *Iraq must have both immediate economic relief and long-term economic reform.* If it emphasizes the short-term over the long, at best it will require constant infusions of foreign assistance to sustain even its current level of economic growth, and at worst, could mean just postponing an economic crash. However, if it emphasizes long-term reforms without doing enough in the short-term, either the economy or popular support for reconstruction might crash—which would preclude getting to the long-term. This is part of the conundrum facing Iraq in the economic realm: it must simultaneously begin to show immediate progress to people who have been miserable for too long while simultaneously laying the foundation for a more vibrant (and stable) economy to emerge a few years into the future.

Given these conflicting requirements, it is critical that the United States and the new government of Iraq set

clear priorities for economic policy for the next year. We need to identify the sectors of the Iraqi economy that are most important to the short-term well-being of average Iraqis and make focused efforts to produce immediate progress in those sectors. In all other areas of the Iraqi economy, the emphasis should be on long-term structural reform. In this way, the United States and Iraq ought to be able to strike an adequate balance between providing enough immediate relief to the Iraqi people to keep them committed to reconstruction, while also building a stable, competitive Iraqi economy.

SHORT-TERM EFFORTS

Those sectors of the Iraqi economy that U.S. and Iraqi (and preferably international) officials should target for short-term improvement must be those that the Iraqis have identified as being of greatest concern to them, as well as several other sectors which are indirectly just as vital because they underpin those sectors the Iraqi people are most concerned about. After all, the goal of this effort is to address Iraqi unhappiness to keep Iraqi public opinion from collapsing and causing a mass desertion to the militias and insurgents. *Specifically, the areas in which the U.S. and Iraq should make a determined effort to produce more tangible results are unemployment, electricity, oil production and export, corruption, agriculture, decentralization, banking and investment, and foreign aid.*

While critically important, this overarching recommendation is hardly novel. Although they have not necessarily articulated this approach explicitly, this is effectively what U.S. and international officials have been promoting all along. What’s more, they have had some degree of success. Unfortunately, they have not had enough success. Thus this section should be seen principally as a series of recommendations regarding how to improve on efforts that the U.S. government already recognizes as important and has committed a fair degree of resources toward, albeit with varying degrees of impact.

Unemployment. Unemployment is consistently one of the greatest complaints of Iraqis. It is clear that far too

many Iraqis are not gainfully employed, although the exact dimensions of the problem are elusive. Various estimates put the range of unemployment as low as about 10 percent to as high as about 70 percent. The Iraqi Ministry of Planning believes that the true unemployment rate is about 28 percent, and most experts concur that somewhere between 25 and 40 percent is probably about right.¹³ While this is bad enough, it does not include problems either with underemployment or Iraqis being forced to supplement their incomes with multiple jobs. Thus, there are Iraqis who have jobs, but jobs that do not pay them enough to survive. Either they starve or become homeless, or they take on additional jobs to try to make ends meet. Thus, employment problems extend beyond the large number of people who simply do not have jobs. Moreover, it is important to note that one of the worst problems with unemployment is its concentration among young men—37 percent of educated youth are unemployed, and for uneducated young people, the rates are even higher.¹⁴ This is problematic because young, unemployed men are the principal recruits of the insurgents and militia groups.

The U.S. government is well aware of the problem of unemployment and has made a number of efforts to fight it. In part because of these efforts, and in part because of the resurgence of Iraq's consumer economy, unemployment is not as pervasive as it was even 12 months ago. However, a great deal remains to be done and many of these early efforts must be preserved just to prevent a resurgence of even worse employment problems. This is one of the principal areas in which short and long-term needs run at cross purposes. Economists and reconstruction experts point out that nearly three years into the reconstruction effort, Iraq should be moving away from Works Progress Administration-style aid programs that fund what are often nothing more than make-work projects concentrated in construction and infrastructure repair to take unemployed men off the streets. They correctly argue

that Iraq needs to be shifting its emphasis to more economically viable and productive methods of employing its work force. They also note that these kinds of aid programs—particularly those focused on construction—are notorious magnets for corruption, the eradication of which is another short-term priority for Iraq.

However, because progress in Iraq's economy has largely been limited to just a few sectors, it is not yet ready for a radical shift. The jobs do not yet exist in the economy to absorb large numbers of Iraqis if these make-work programs are ended. What's more Iraq's infrastructure is still far from being repaired, let alone modernized, thus construction remains an important demand and it would be deleterious to end these programs too abruptly.

- *Maintain adequate levels of funding for current Iraqi construction projects and other programs that generate large numbers of jobs.* Iraqis and foreign experts complain about the inefficiency of these programs, and they are correct. As a result, USAID and other foreign donors have announced plans to move away from these kinds of grants and instead to focus on longer-term economic development. While the latter is equally necessary, it would be a mistake to do so in the name of ending these projects. Because those working on these projects have not been properly retrained, and because the Iraqi economy does not have other jobs available, the effect could be to quickly swell the ranks of the unemployed (which likely would mean swelling the ranks of the insurgents and militias just as quickly). What's more, while inefficient and susceptible to corruption, these programs have been an important element in the revival of Iraq's consumer economy. There are construction sites all over Iraq and these employ lots of people, pumping lots of U.S. dollars and Iraqi dinars into local economies. Thus a rapid cut in these projects could have severe repercussions for the Iraqi economy in general.

13 The Economist Intelligence Unit, "Country Report: Iraq," September 2005, p. 24.

14 Ibid.

- *Emphasize high-employment projects that will contribute to Iraq's long-term economic health.* A frequent criticism of some of the early American-sponsored construction projects designed to employ large numbers of Iraqis is that they produced “white elephants”—massive facilities that were expensive and difficult to operate in the violent and unpredictable circumstances of Iraq, and that contributed little to Iraq's economy when they were finished. While these programs need to be sustained to some extent to prevent a collapse of the labor market in the short term, it would be useful to learn this lesson. This cuts in two directions. *First, the United States should be willing to provide greater funding to smaller, local projects which are more likely to be sustainable and to have an immediate impact, even if that impact is localized.* USAID does have such programs, but they would need to be greatly expanded. *Second, future U.S. funding for any large projects needs to be based on Iraq's needs and have a reasonable expectation that they can be protected.* To some extent, this builds on the “oil stain” approach to security described in Chapter 1: large infrastructure projects should only be undertaken in those areas secured by Coalition forces. *One possibility would be to build a national light rail system.* Iraq's rail infrastructure is ridiculously inadequate to its needs. A modern, light-rail system that began in the secured areas of the “oil stain” and then slowly expanded outwards as new areas of Iraq were brought into the secured areas. Nothing would do more to make clear the inexorable march of Coalition forces, while simultaneously helping to bind the country together physically and economically.
- *Encourage the creation of job training and retraining programs.* This has been a considerable failing on the part of the United States. Since the fall of Baghdad, too little effort has been put into establishing programs that can teach Iraqis skills that would make them desirable employees, including by multina-

tional firms. As a result, Iraqi worker productivity is low and many firms have preferred to hire foreign workers (even paying to bring them to Iraq) rather than employing Iraqis. Indeed, the mistake that the United States made in disbanding the Iraqi Army and security services was not the decision to disband them *per se*, but the failure to provide for their employment afterwards. Moreover, at this point, after a decade-and-a-half of war and sanctions, many Iraqis lack even basic education: in 2001, the UN Human Development Report observed that 55 percent of Iraqis age 15–24 were illiterate.¹⁵ *The United States should provide grants to Iraqis and to international NGOs to establish vocational schools and job training programs, while the government of Iraq should provide financial incentives for the same.* In particular, the oil redistribution program discussed in Chapter 2 and below specifically would distribute money to individual Iraqis that could be used to pay for various educational programs, including vocational education. *Education and vocational training programs are important not only to ensure that Iraqis have the skills to be productive members of society in future years, but are excellent ways to get large numbers of people off the streets in the short-term.*

- *Increase both aid and other inducements to agriculture, which generates jobs very quickly.* Rebuilding Iraq's agricultural sector is vital for a wide variety of reasons. However, with regard to employment it is important because agricultural work is labor intensive and much of the labor does not need to be skilled. On the specifics of this effort, see “Rebuilding Iraq's Agricultural Sector,” below.

Corruption This report has referenced the problems of corruption in Iraq many times, and so a full account is certainly not warranted here. It is worth pointing out that corruption does impose an enormous burden on the Iraqi economy, and so there are economic

15 Cited in Christopher Foote, William Block, Keith Crane, and Simon Gry, “Economic Policy and Prospects in Iraq,” Public Policy Discussion Papers No. 04-1, Federal Reserve Bank of Boston, p. 7.

incentives to fight it, in addition to the political and other motivations. For instance, a December 2005 Senate Foreign Relations Committee staff report found that Iraqis estimated that corruption generally added about 40 percent to the cost of all business transactions.¹⁶ (To which should also be added the 20–50 percent surcharge imposed by security needs on Iraqi economic transactions to understand why prices in Iraq are often prohibitively high). In addition to the many recommendations for addressing corruption proposed in Chapter 2, above, there is one additional recommendation specifically related to economic matters that can be offered:

- *Remove Ahmed Chalabi as the head of the Contracts Review Committee.* The Contracts Review Committee was established as a corruption-control mechanism. All contracts in excess of \$3 million granted by the government of Iraq must be approved by this Committee. Charges of corruption have dogged Chalabi for decades (including a 1992 conviction for embezzlement and fraud *in absentia* in Jordan), and there is a widespread belief in Iraq that he is using his control of the Contracts Review Committee to skim funds, take contracts away from his rivals, and make sure that they go to his friends. Obviously, the government of Iraq should investigate these claims thoroughly. However, under any circumstances, Chalabi should be removed. His reputation for corruption, deserved or not, is seen by many Iraqis as proof that their government is failing them. Like Caesar's wife, the head of the Contracts Review Committee must be above suspicion for Iraqis to have confidence in it.

The oil sector. The Iraqi economy is addicted to oil production, with all of the negative connotations that metaphor implies. However, it would be a mistake to

force Iraq to quickly “kick” this habit, and there is the potential for Iraq's oil wealth to be a far more positive factor in Iraq's economic and political health than it has otherwise been, either before or since Saddam's fall. At this point, 95 percent of Iraqi government revenue is coming from oil sales.¹⁷ In the words of the Economist Intelligence Unit, “When the oil doesn't flow, unemployment and poverty increase, creating new recruits for the insurgency.”¹⁸

Unfortunately, too little of Iraq's oil revenues are actually going to meet its vital economic needs. Oil production, distribution, and export are the most lucrative venues for theft and graft, and so are at the heart of Iraq's problems with both crime and corruption. Moreover, the insurgents are well aware of the government's dependence on oil and various groups have mounted a vicious campaign against Iraqi oil production and export capabilities. Consequently, the Iraqi oil ministry claimed that it had lost \$11.35 billion worth of oil production to sabotage of pipelines and facilities between April 2003 and July 2005.¹⁹ How much of what the ministry officials claim was lost to sabotage was actually lost to graft, we may never know. But the bottom line remains the same: thanks to crime, sabotage and corruption, far too much of Iraq's oil wealth is not going to fund reconstruction. The problems with corruption, crime, and sabotage are limiting private investment in the Iraqi oil sector, with repercussions for both short- and long-term production.

To make matters worse, sabotage coupled with extensive damage to Iraq's oil fields and production infrastructure over the past 30 years have also combined to keep oil production lower than was hoped (so far) and this, along with increased demand from liberated Iraqis has kept exports down. Exports of oil averaged 1.39 million barrels per day (m b/d) in 2005, down

16 “Iraq: Assessment of Progress in Economic Reconstruction Governmental Capacity,” Staff Trip Report to the Committee on Foreign Relations, United States Senate, December 2005, p. 9.

17 Ibid, p. 5.

18 The Economist Intelligence Unit, “Iraq Economy: Iraq's Weak Heart,” January 4, 2006.

19 The Economist Intelligence Unit, “Country Report: Iraq,” September 2005, p. 28.

from 1.5m b/d in 2004, and about 2.5m b/d in 2002, at the end of Saddam's reign.²⁰ Finally, Iraq has a major problem with refinery capacity, to the extent that its refineries are able to supply only 55 percent of domestic demand, which forces the country to import gasoline and other refined petroleum products at market rate—which they then sell to the public at the subsidized rate.²¹ The results have been disastrous: Iraq is pumping less oil, exporting less of what it is pumping, losing huge amounts of the revenue from what it does export, and then having to use too much of the revenues from what it does export to pay for refined oil products on which it then loses money by reselling these refined products to its own citizens at far less than what it bought them for.

Nor are there easy answers to any of these problems. Recognizing the importance of oil to Iraq's economic future, the United States has invested \$2.4 billion to try to get Iraqi oil production up to 3m b/d by 2006, but found that much of that money is instead going to simply maintain the existing infrastructure and repair damage from attacks—which again speaks to the need for greater security efforts on behalf of Iraqi infrastructure.²² The Iraqis have begun to diminish the extent of the fuel subsidy, raising the price of premium gasoline at the end of 2005 five times from \$0.13 per gallon to \$0.64 per gallon, but will have to continue to move slowly on this because of the fear of causing widespread political unhappiness and throwing the economy into recession.²³ Privatization of Iraq's downstream oil sector, which is desperately needed to improve efficiency and fight corruption, will also have to proceed slowly to avoid simply turning over Iraq's crown jewels to organized crime as has happened elsewhere in the world.

Neither is decentralization of the management of the Iraqi oil system (in the sense of allowing Iraqi local governments to manage whatever piece of the oil industry lay in their jurisdiction) a good solution. Iraq's oil production system is part of a seamless whole. In addition, in oil production, economies of scale are vitally important to keeping costs down and revenues up. Thus, attempting to divide up the Iraqi oil system among the country's 18 provinces would greatly reduce its efficiency and profitability. As oil analyst Fareed Mohamedi notes, "Without a national [oil] system, fragmentation and increased inequality will impair long term growth and prevent recovery in the short term."²⁴

Instead, the longer-term process of structural reform of the Iraqi economy should seek to "unbundle" such enterprises. Iraq does not need vertically integrated, state-owned companies—which have typically proven to be highly inefficient themselves. By unbundling, Iraq would expose the structural weaknesses in these enterprises and give managers a greater sense of responsibility for their part of the firm, rather than allowing them to hide in the enormity of the enterprise. This would then make it possible to privatize discrete pieces of the organization that the state does not need to control. However, eventually unbundling and privatizing Iraq's oil industry is not the same thing as decentralizing it.

All of this means that improving Iraq's oil production and export is vitally important, but fixing it will not be easy. Nevertheless, a number of things can be done:

- *Establish the centralized oil-revenue distribution system described in Chapter 2.* As noted in the previous chapter, such a system is desperately needed for both political and economic reasons.

20 The Economist Intelligence Unit, "Iraq Economy: Iraq's Weak Heart," January 4, 2006.

21 "Iraq: Assessment of Progress in Economic Reconstruction Governmental Capacity," Staff Trip Report to the Committee on Foreign Relations, United States Senate, December 2005, p. 5.

22 Ibid.

23 The price of regular gasoline also went up five times, from \$0.014 per gallon (\$0.034 per gallon in Baghdad) to \$0.07 per gallon. However, the price of regular gasoline sold by black marketers to those wishing to avoid lines at state-owned gas stations is \$1 per gallon, see Richard A. Opper Jr., "In Iraq, Rich in Oil, Higher Gasoline Prices Anger Many", *The New York Times*, December 31, 2005 and International Monetary Fund, *Iraq: Letter of Intent, Memorandum of Economic and Financial Policies and Technical Memorandum of Understanding*, December 6, 2005, p. 1. Available at <<http://www.imf.org/external/np/loi/2005/irq/120605.pdf>>.

24 Fareed Mohamedi, "Accelerating Economic Progress in Iraq," Testimony before the Committee on Foreign Relations, U.S. Senate, July 19, 2005.

- *Keep cutting the fuel subsidies.* The U.S. and Iraqi governments so far recognize the importance of this, but need to stick to this course to eliminate the market distortions that are breeding corruption and draining public coffers. Doing it gradually is fine, as long as the process keeps moving.
- *Press the Iraqi government to invest in natural gas, both for domestic consumption and potentially for export.* Iraq is currently flaring 1,000 million cubic feet per day of natural gas, which could cover 100 percent of Iraqi domestic power requirements.²⁵ Unfortunately, the Iraqis have always relied on oil for their energy and inertia, the cost of replacing Iraq's oil-based energy infrastructure, plus security and political problems, are preventing them from changing over. This ought to be a priority, and an area where foreign aid might be able to make a considerable difference especially because it can defray many of the costs involved in changing over from oil to natural gas.
- As the Staff Report of the Senate Foreign Relations Committee recommended, *a greater emphasis must be placed on developing a capability for more rapid pipeline repair (along with enhanced security for the pipelines), coupled with the construction of properly guarded storage facilities at Iraq's ports and border crossings to minimize export disruption coming from attacks on the pipelines or production facilities.* This will increase Iraq's revenue streams by making its deliveries more predictable. Iraq also requires more refining capacity, which would mean some very helpful construction projects that would not only mitigate unemployment but also help the economy over the long term—precisely the kind of project recommended above.
- *Make cleaning up the Iraqi Oil Ministry the first priority for the various anti-corruption measures.* A part of this problem is that Ahmed Chalabi is also

the chairman of the new Energy Council, which oversees the production, distribution, and export of oil, electricity, and all other sources of energy in Iraq. Again, there are widespread accusations of corruption against him in his handling of this position. Regardless of whether the charges are valid (and they should be investigated thoroughly as part of this effort), he should be removed from this job simply because of the impression that keeping him there, given his long-standing reputation, creates among the employees of the ministry from top to bottom.

Rebuilding Iraq's agricultural sector. As already noted, the revival of Iraq's agricultural sector is critical for a variety of short- and long-term reasons. Iraq has some of the most fertile land in the Middle East and at times in its past was a net exporter of agricultural products. Enhanced agricultural production could be the start of real diversification in Iraq's economy—in terms of labor, production, and exports—away from its current dependence on oil. Moreover, agriculture is far more labor-intensive than oil, making it an excellent way of curbing unemployment.

Unfortunately, Iraq's agricultural sector has not been properly handled, either by the United States or the Iraqis. There are three basic problems that must be solved. First, not enough money, either in the form of grants or loans, has gone to Iraqi agricultural projects. USAID has provided roughly \$100 million, which has been enormously beneficial, but has certainly not been adequate to meet Iraq's needs. Second, the Iraqi government continues to purchase food for its food rations (the government-provided "food basket" that is the foundation of most Iraqis' diets) almost entirely from abroad. This is stunningly foolish. It sends Iraq's badly-needed dollars out of the country, does not stimulate Iraq's agricultural sector, and actually undermines it by destroying the ability of farmers to allow the market to set prices and so provide them with

²⁵ "Iraq: Assessment of Progress in Economic Reconstruction Governmental Capacity," Staff Trip Report to the Committee on Foreign Relations, United States Senate, December 2005, p. 5.

reasonable incomes. Third, both U.S. officials and Iraqi government bureaucrats have badly hampered the revival of Iraqi agriculture by micromanaging and insisting on procedures and timeframes divorced from the realities of agricultural production. The weather waits for no man, no matter how imposing his office in the Republican Palace or the Ministry of Agriculture. However, too many American and Iraqi officials have insisted on doing things “by the book” and without regard for the timing issues that lie at the heart of all agricultural production. The result has been catastrophic for many farmers unable to take the necessary action, buy needed supplies or equipment, or build necessary facilities in time to meet the needs of their crops and livestock.

To address these three problems, the United States and the government of Iraq should:

- *Increase aid to Iraq’s agricultural sector.* Ideally, this should include programs which enable local government (and not the ministry in Baghdad) to provide micro-loans directly to Iraqi farmers. However, the continuation of the original USAID agriculture-assistance programs—which helped establish veterinary clinics, dredged irrigation canals, and provided grants for other communal projects valuable to agriculture across communities—should also be extended and expanded. Andrew Apostolou has suggested that the creation of an agricultural or cooperative bank to take the place of the former state-owned Agricultural Bank would allow farmers to purchase land, machinery, and other needs, that would greatly speed the pace of agricultural expansion. Moreover, making it possible for farmers to hold title over what they till creates collateral, allowing them to borrow against it for further improvements and expansion.
- *Demand that the Iraqi government cease purchasing food for the ration basket internationally.* As described below, it would be best to end the rationing system altogether and instead provide either cash payments or a type of food stamps.

However, recognizing that this will be politically unpopular and therefore slow to unfold, the Iraqi government should be required to purchase as much food as possible domestically before making any purchases abroad until such time as the food basket is entirely phased out.

- *Insist that both Iraqi and U.S. personnel working on agricultural issues have a strong background in agricultural management and have incentives to make the process work for the farmers.* This is part of a broader need to make bureaucratic handling of Iraq issues performance-based; to the extent possible, U.S. and Iraqi officials should benefit when the process works well and should suffer—in their careers and possibly even in their paychecks—when it does poorly.
- *Decentralize control over contracting and administration of agricultural programs to local government to the greatest extent possible.* Many of the problems with the administration of agriculture stem from Baghdad’s being overly involved, both because the central government bureaucracy is stultifying and because it is difficult even for well-meaning bureaucrats to properly address problems that frequently vary widely from one locale to another. Consequently, it is far more efficient and effective if the governmental administration of agriculture projects is done at the most local level possible. *The Ministry of Agriculture in Baghdad needs to give up contracting and implementation authority, and should instead concentrate on standards and practices, regulations, and overall governmental policy.*

Electricity. A constant complaint of Iraqis is the ubiquitous, unpredictable blackouts that undermine economic activity and aggravate daily life. To a certain extent, the problem stemmed from the absence of a plan on the part of the United States to quickly increase Iraqi electricity generation capacity and rebuild and improve Iraq’s generation and distribution networks immediately after the fall of Baghdad. We have been playing catch-up ever since. However,

a problem of equal magnitude is the skyrocketing Iraqi demand for electricity. Immediately after Saddam's fall, Iraqis ran out to buy every type of household appliance imaginable, including refrigerators, televisions, microwaves, and—especially—air conditioners. As a result, demand for electricity to run these items soared from about 4,500–5,000 megawatts per day to nearly 9,000 megawatts per day. Meanwhile, Iraqi and Coalition efforts to repair the Iraqi electrical grid have resulted in current peak capacity of about 4,750 megawatts per day. The United States and the new government of Iraq are presently working to increase Iraq's capacity to import electricity from Iran, Turkey, and Syria, while increasing Iraq's own domestic production to about 6,000 megawatts per day.²⁶ The Staff Report of the Senate Foreign Relations Committee authored by Patrick Garvey proposed two key recommendations for dealing with Iraq's electricity problems that this report strongly endorses:²⁷

- *Limit the demand for Iraqi electricity usage.* This is a three-part process. First, meters need to be installed throughout the country. Second, limits need to be placed on the kilowattage that any home or business can use. Third, the subsidy on electricity which makes it virtually costless to the consumer needs to be slowly eliminated. It should be obvious that this is a process that is easily said, but very hard and painful to do. However, neither is it hopeless. The installation of meters would be an excellent project for foreign aid—a donor nation could purchase the meters and the hardware and software to monitor them, hire local Iraqi contractors to install them, provide advisors to train the government personnel to staff the system, and then hand it over to the Iraqi government. Limits on usage and the gradual elimination of the subsidy will be politically painful, but especially if coupled with ongoing efforts to improve capacity and a new effort to increase the security of the grid, it ought to be a trade-off that Iraqis will recognize as

beneficial by increasing both the number of hours of electricity they enjoy per day and their ability to control when they have power.

- *Demand that Iraqis stop running their electrical grid underfrequency.* For decades, the Iraqis have steadfastly insisted that running the grid underfrequency somehow saved power—like the Middle Eastern habit of not running the headlights in a car (even at night) in the belief that having the headlights on drained the battery (even when the motor was running). This practice does not save power, it simply damages the grid, thereby reducing its efficiency and making it more susceptible to other problems. Given that Iraq needs every kilowatt that it can get, this is a ridiculous and costly practice. Indeed, the United States should make its provision of further aid to the power grid conditional on the Iraqis ceasing it.

Decentralization. Chapter 2 dealt with the need for political decentralization at some length, but it is equally the case that Iraq requires greater economic decentralization in a variety of sectors—other than oil. As noted above, the central government in Baghdad remains a sinkhole of corruption, a bureaucratic bottleneck, and whether through understaffing, inability, or malign intent its overall efficiency has improved little over the days of Saddam. The net effect is that many resources go into Baghdad, and far fewer come out—and when they do, they are often inadequate and late.

Many American bureaucratic and contracting procedures reinforce these problems. Because U.S. personnel tend to congregate in the Green Zone in Baghdad, they also tend to do their business through their Iraqi counterparts nearby—meaning the ministries in central Baghdad. Likewise, U.S. contract regulations often make it hard for small Iraqi contractors: they lack the English-language, accounting, auditing, legal, other skills to successfully apply for, let alone be awarded,

²⁶ Ibid, p. 6.

²⁷ Ibid, pp. 6–7.

U.S. government contracts given the tight constraints of U.S. anti-corruption measures. Iraq's is a cash society, and too often the U.S. bureaucracy insists on credit (and electronic banking) capacities that Iraq generally lacks. The U.S. government has done far too little to cut through this red tape in the name of getting more money into the hands of local contractors.

Consequently, one of the challenges of reconstruction will be to push resources directly to the Iraqi people, bypassing Baghdad, and cutting out much of the U.S. bureaucracy. At present, far too much U.S. aid and Iraqi wealth is blocked by this set of reinforcing bottlenecks.

A related matter has been Washington's over-reliance on massive American firms to handle much of the contracting in Iraq. This makes sense from a bureaucratic perspective, but has been bad for reconstruction. Again, it means that resources are not going directly to Iraqis. Indeed, far too much of the funds in each contract stay here in the United States or are directed to subsidiaries of the multinationals in other countries than actually get into Iraq. Whatever graft there might be in Halliburton's dealings in Iraq would actually be secondary compared to the damage done because so little of the money awarded to Halliburton for a contract actually gets spent in Iraq.

In addition to the steps noted in Chapter 2 regarding decentralization, which would apply equally well to both Iraq's political and economic sectors, two further recommendations are worth making:

- *U.S. and other foreign aid programs must be re-focused to provide grants directly to local councils, for infrastructure development and micro-loans to small businesses.* At present, U.S. aid programs have focused too heavily on the development of national-level capacity.
- *Foreign donors and the Iraqi government itself need to focus more on micro-loans.* So far, micro-loans have

had an enormous positive impact in Iraq, but far too little has been disbursed in that form. Micro-loans to small businesses foster less graft, provide more money directly to the people who need it most, stimulate market forces, and are much easier (and more appropriate) for local government leaders to disburse. Moreover, hiring by small business is a far more efficient and practical solution to Iraq's unemployment problems than the creation of massive new economic enterprises.

More donor funding. As noted above, the resurgence of Iraq's economy, such as it is, depends heavily on grant money. Since a key consideration of American-Iraqi policy must be to boost Iraqi popular support for reconstruction over the next 6–12 months by demonstrating tangible signs of progress and the Iraqi economy is not structurally sound enough to do so on its own—now is *not* the time to try to wean Iraq off of its dependence on foreign aid. Moreover, U.S. assistance may have been prodigious so far, but its impact on the Iraqi economy has been less than the raw numbers would suggest. For instance, of \$2.2 billion in aid earmarked for civilian reconstruction in 2004, only two-thirds of that was spent on rebuilding the domestic economy and of that money, half was devoted to security, which meant that in practice only about one-third reached the domestic economy.²⁸ Meanwhile, many countries that pledged money to Iraq have not yet made good on their promises. According to the Government Accounting Office, foreign governments have pledged \$13.6 billion to Iraq in the form of various grants and loans. However, only \$2.7 billion has actually been provided. In some cases, this is because Iraq has not accessed the loans that it has been offered; however, in other cases it is because grants have not been forthcoming. *Iraq needs to continue to receive large amounts of external funding at least for the next 12–36 months, and the United States must both provide it and encourage others to do so.*

On a related matter, at this point in time 5 percent of

28 The Economist Intelligence Unit, "Country Report: Iraq," September 2005, p. 20.

all Iraqi oil revenues still go to the United Nations Compensation Commission to pay for damages incurred by other countries as a result of Iraq's 1990 invasion of Kuwait and the ensuing Persian Gulf War. Most of this money—about two-thirds of the monies being paid at this point—goes to Kuwait, which is wealthier than its northern neighbor to the tune of a GDP per capita almost twenty times that of Iraq. Kuwait did suffer terribly during the invasion and six months of Iraqi occupation. However, at this point, Iraq has paid over \$20 billion to the foreign victims of Saddam's invasion, and Kuwait has received a large percentage of that figure, although exact numbers appear unavailable. There is an argument to be made that the Iraqi people were also victims of Saddam and they are being forced to bear yet another burden by paying for the damages he inflicted on others as well as those he inflicted on them. Indeed, given the risks to Kuwait if Iraq were to fall into civil war, *it would be best for Kuwait if it were willing to defer or assume payment for many of the private claims still uncompensated from the 1990–91 war. At the very least, the United States should press Kuwait to declare a compensation holiday for 1–3 years while the Iraqi economy recovers.*

ECONOMIC DEVELOPMENT: OVER THE LONGER TERM

Unfortunately, providing immediate relief from pressing economic problems is only part of the challenge. The United States also will have to ensure that Iraqi economic growth is sustainable over the long-term. This is an enormously complicated matter, deserving of a paper of its own. Consequently, this report can only highlight several issues that should be part of such an effort.

Debt relief. If Iraq's short-term need is for continued foreign aid and a halt (even if temporary) in payments

to the UN Compensation Commission, its long-term need is for debt relief. On this issue, the Bush Administration has made considerable progress. They took this issue very seriously and, thanks to the labors of special envoy James Baker, have already succeeded in getting huge amounts of Iraq's outstanding foreign debt forgiven. They have, and must continue, to make this a high priority.

In November 2004, the Paris Club of creditor nations struck a deal with Iraq to write off 30 percent of Iraq's international debt immediately, another 30 percent after a restructuring deal with the IMF was agreed to (which it has been) and another 20 percent to be written off when the IMF agreement was completed. While this means that 80 percent of Iraq's non-commercial debt has effectively been forgiven this still leaves Iraq owing foreign nations over \$15 billion, according to IMF projections.²⁹ *This is still a huge amount of money given Iraq's revenue problems and it would be desirable to have more of it forgiven.* In addition, the entire forgiveness package is contingent upon Iraq's deal with the IMF. So far, the IMF has been moderate in its demands upon Iraq, but in the past it has insisted on the kind of rapid privatization of industry that would probably cripple the Iraqi economy for the long-term by delivering up most of Iraq's state-owned enterprises to organized crime and militia leaders of various stripes. The United States must help ensure that the IMF does not begin down this same road with Iraq.

Eliminating subsidies. Iraq's economy remains hobbled by costly subsidies dating to Saddam's era and before. The principal subsidies on food, gasoline and electricity constitute 21 percent of the Iraqi government's budget—over \$7 billion of a \$33 billion budget for 2006.³⁰ Imports of gasoline and other refined petroleum products—which are then sold at subsidized prices—cost the government another \$3 billion.³¹ As numerous economists have pointed out, these subsidies

29 Ibid, p. 3. The issue of the disputed debt to Kuwait and Saudi Arabia has yet to be resolved.

30 "Iraq: Assessment of Progress in Economic Reconstruction Governmental Capacity," Staff Trip Report to the Committee on Foreign Relations, United States Senate, December 2005, pp. 7–8.

31 The Economist Intelligence Unit, "Country Report: Iraq," September 2005, p. 21.

are horrifyingly costly to the Iraqi economy, not just in terms of public spending, but in the negation and distortion of market forces, which skews every other aspect of the Iraqi economy. Of course, all are political “sacred cows” and so quickly eliminating them is probably impossible. *All of these subsidies need to be phased out over the next several years.* Washington has already been pushing Baghdad to do so, and has had some success, with the first increases to gasoline prices coming at the end of 2005.

- As argued above, *electricity subsidies should be gradually phased out along with the introduction of meters and the limiting of kilowatt consumption across the country.*
- *Start removing items from the “food basket” and replacing them with food stamps.* It will be impossible to do away with the food basket overnight and there are concerns about the monetization of the food basket because of the problems with corruption and violent crime. Consequently, it might benefit Iraq to employ a system of food stamps that would be redeemable by underprivileged Iraqis for food only. This too could happen gradually. For instance, in late 2005 Iraqi newspapers carried stories reporting that some of the wheat being distributed in the food basket was contaminated, so most Iraqis refused to eat it. That would have provided the perfect opportunity to eliminate wheat from the food basket altogether and instead replace it with food stamps.
- *Make provision of the food basket need-based.* This is another simple remedy. Right now, rations are available to all, including those with plenty of money to buy food. This makes no sense given Iraq’s other priorities.
- *Insist that the Iraqi government buy food locally to the greatest extent possible.* As noted above, it is absurd

to have a situation where the government is undermining the country’s agricultural sector.

Education. There is nothing more important to Iraq’s long-term economic prosperity than improving the state of its educational system. Here as well, the United States and the international community recognized the need early on and have already provided considerable assistance, largely in terms of building schools, raising the pay of teachers, providing revised textbooks, furnishing school supplies, and eliminating Saddam’s worst flunkies from university positions. While these were all positive steps, there is still a great deal more to be done. To a certain extent, assistance to the Iraqi educational program will help alleviate the nation’s most pressing problems in terms of the decline in literacy and other basic education among Iraq’s younger generations, largely as a result of the 12 years of sanctions and Saddam’s response to them.

However, in many ways, this is merely the tip of the iceberg. Iraq suffers from all of the same problems in education as the other Arab states: there is little emphasis on interactive learning, instead rote memorization is employed in every subject (including the sciences); creativity tends to be stifled; there is an overemphasis on the humanities (including religion) at the expense of science and math; teachers are provided with few incentives to stimulate or engage with their pupils; and the entire process is rigidly prescribed by the central government which cares only that students can spit back formulaic answers to standardized tests whose questions generally are never changed for decades. The result is that, like elsewhere in the Arab world, students graduate from the educational systems with little facility for critical thinking, initiative, or creativity, and few of the kinds of job skills needed to compete in the globalized economy.³²

Moreover, Iraq’s educational system has problems unique to itself. For instance, there is a pervasive

³² The most forthright treatment of this subject by a group of Arab public intellectuals remains the United Nations Development Program’s *Arab Human Development Reports*, particularly the 2002 edition.

“culture of violence” in Iraqi schools; teachers employ physical abuse to force unhappy students to obey, creative students to conform, and inquisitive students to stay mute. When the Kurds took over the running of the schools in northern Iraq after 1991, they identified erasing this culture of violence as both one of their highest priorities and biggest problems. It took them a decade to rid their schools of it, but today Kurdish schools tend to be much better in terms of teacher-pupil behavior than those elsewhere in the country.

Ultimately, it will be up to the Iraqis to recognize the failings of their traditional educational methods and move to modernize their schools. However, there are still ways that the United States can help, and in so doing, improve the likelihood that Iraq’s economy will remain stable and productive over the long-term.

- *The United States should offer to fund a high-level and comprehensive study of Iraqi education by leading American educators and education specialists. As always, their ability to conduct their mission will be limited by security considerations. However, American higher education remains the envy of the world and American educational methods remain outstanding—even if not always fully implemented in our private schools. In 1932, a team of American educators made an important study of Iraqi educational practices on behalf of the newly-independent Iraqi government, and 74 years later it might be beneficial to do so again on behalf of the latest, newly-independent Iraqi government.³³ At the very least, this would provide an honest, objective account of what needs to change in Iraqi schools to make their graduates competitive in the global economy. This could then serve as ammunition for those Iraqi politicians who wanted to press the case of reform and as a blueprint if they are able to prevail against the forces of traditionalism.*
- *The government of Iraq should commission a compre-*

hensive education survey to assess a current baseline and needs for rebuilding Iraq’s educational system. To a great extent, the Ministry of Education does not have the basic information that it needs to plan and implement a rebuilding and reform program. It would be important, especially when combined with the new census recommended in Chapters 1 and 2, to conduct such a survey to establish how many school-age children lived in a particular area, what their literacy rates were, the status of schools and teachers, and other basic information regarding education. This was one of the first things that the Kurds did when they took over the educational system in northern Iraq in 1991 and they found it immensely helpful.

- *Use the centralized oil-distribution plan described in Chapter 2, to fund both vocational and higher education through individual education accounts.*
- *Fund programs to teach English throughout Iraq. English is the language of the global economy, at least for now, but likely well into the future. The internet is largely English-based, as is the aviation industry, and a variety of new high-tech industries. It would be a tremendous gift to the Iraqi people to help their children to learn English. Here as well, the Kurds kept lowering the age at which students in schools in northern Iraq began to learn English until now it is taught in primary school, and has displaced Arabic as the second language in Kurdish schools. Moreover, it seems particularly appropriate that since the United States has been the primary occupying power since the fall of Baghdad, we would make a major effort to teach Iraqi children English. *The United States could establish programs to send young Americans to Iraq to teach English (obviously, only in the secured areas of the “oil stain”). It could fund English instruction, purchase English-language textbooks and other teaching materials, and provide language fellowships that would allow Iraqi**

33 Reeva S. Simon, *Iraq Between the Two World Wars: The Creation and Implementation of a Nationalist Ideology*, (NY: Columbia University Press, 1986, pp. 90–95.

students to travel to the United States, Great Britain, Australia, or other English-speaking nations to improve their language skills.

- *Create scholarships for Iraqi students to study in America.* In a similar vein, the U.S. government could fund a variety of scholarships to bring Iraqis over to study in the United States for varying lengths of time for secondary school, college or graduate school. Doing so would likely improve the ties between the American and Iraqi peoples, breed a generation of Iraqis sympathetic to America, and provide them with educational opportunities they could only dream about in Iraq.

Stemming Iraq's nascent brain drain. An issue closely related to the need to overhaul Iraq's educational system is the corresponding need to staunch the flight of Iraq's best and brightest from the country. The problem is not calamitous yet, because immediately after the fall of Saddam many highly-educated and successful members of the Iraqi diaspora returned to Iraq to participate in the revival of their homeland. Likewise, many of those who had never left saw Saddam's fall as an opportunity to create the kind of Iraq of which they had always dreamed. Only in the last 12–18 months have professional Iraqis—doctors, professors, lawyers, and others—begun to make arrangements to leave. A fair number of Iraq's middle class have begun moving to Jordan, although new Jordanian laws are making that more difficult. They are leaving out of fear that Iraq's pervasive violence will finally catch up with them and their families, and despair that Iraq's political and economic problems will prevent them from living the kind of normal, prosperous life they desire. In many cases, they also express fear that the Shi'i parties that increasingly dominate the Iraqi Council of Representatives intend to impose religious codes of conduct under which they do not wish to live.

In the short term, this problem pales in comparison with Iraq's other challenges, but for its long-term prosperity, this is an important issue and should be nipped in the bud as quickly and completely as possible.

Solving the problem obviously requires a number of transformative changes to Iraq's security, political, and economic situations—like securing the population centers where these urban professionals tend to live through a traditional COIN strategy, ensuring personal freedoms, and creating a vibrant economy where people with these skills can fulfill their own ambitions. *However, it would also be helpful for the Iraqi government to think in terms of providing tax and financial incentives to high-tech firms, limiting corporate taxes generally, and providing other benefits for people working in the sciences, engineering, computers, and medicine to make it more desirable for them to remain in Iraq.*

THE IMPORTANCE OF AN INTEGRATED APPROACH

One of the principal themes of this report has been the criticality of better integrating military, political and economic programs to foster reconstruction across the board. There are always bound to be successes and failures in an effort as grand as the reconstruction of Iraq. If these different fields of action are properly integrated, there should be more successes than failures in each field, and the successes in each will be more likely to spark corresponding successes in the others, creating a self-reinforcing process. Unfortunately the opposite is also true. If activities in these fields are not properly integrated, there are likely to be more failures than successes in each, and failures in one field are more likely to cause failures in the others.

Unfortunately, the United States has made a great many mistakes in handling the reconstruction of Iraq and one of the worst, has been the ongoing failure to create a single, integrated military/political/economic strategy and implement it as such. To some extent, this is understandable because it reflects a badly disintegrated policy approach within the U.S. government, where the interagency process has been functioning very poorly. But this is not the only problem. Another part of the problem has been the unwillingness of agencies other than the armed forces to see the reconstruction of Iraq as their highest priority and every

other policy as a distant second. For too much of Washington, the war in Iraq is nothing but a distraction from what they think they really should be doing.

The needs of rebuilding the Iraqi economy illustrate the dangers of this failing most dramatically. According to the Iraqis themselves, economic problems (along with security) are the most important problems they face. Thus, getting the economic piece right will be crucial to the success of reconstruction. Indeed, to some extent, economic progress may be the clearest measure of the success or failure of reconstruction. However, economic progress is wholly reliant on improvements in the security and political situations. Without a safe environment in which goods and people can move around the country, without the rule of law, effective regulatory agencies and practices, and limits on theft and corruption, it is impossible to imagine that Iraq will enjoy any degree of prosperity.

THE SABAN CENTER FOR MIDDLE EAST POLICY

The Saban Center for Middle East Policy was established on May 13, 2002 with an inaugural address by His Majesty King Abdullah II of Jordan. The creation of the Saban Center reflects the Brookings Institution's commitment to expand dramatically its research and analysis of Middle East policy issues at a time when the region has come to dominate the U.S. foreign policy agenda.

The Saban Center provides Washington policymakers with balanced, objective, in-depth and timely research and policy analysis from experienced and knowledgeable scholars who can bring fresh perspectives to bear on the critical problems of the Middle East. The center upholds the Brookings tradition of being open to a broad range of views. The Saban Center's central objective is to advance understanding of developments in the Middle East through policy-relevant scholarship and debate.

The center's foundation was made possible by a generous grant from Haim and Cheryl Saban of Los Angeles. Ambassador Martin S. Indyk, Senior Fellow in Foreign Policy Studies, is the director of the Saban Center. Kenneth M. Pollack is the center's director of research. Joining them is a core group of Middle East experts who conduct original research and develop innovative programs to promote a better understanding of the policy choices facing American decision makers in the Middle East. They include Tamara Cofman Wittes, who is a specialist on political reform in the Arab world; Shibley Telhami, who holds the Sadat Chair at the University of Maryland; Shaul Bakhash, an expert

on Iranian politics from George Mason University; Daniel Byman, a Middle East terrorism expert from Georgetown University, and Flynt Leverett, a former senior CIA analyst and senior director at the National Security Council, who is a specialist on Syria and Lebanon. The center is located in the Foreign Policy Studies Program at Brookings, led by Carlos Pascual, its director and a Brookings vice president.

The Saban Center is undertaking path breaking research in five areas: the implications of regime change in Iraq, including post-war nation-building and Persian Gulf security; the dynamics of Iranian domestic politics and the threat of nuclear proliferation; mechanisms and requirements for a two-state solution to the Israeli-Palestinian conflict; policy for the war against terrorism, including the continuing challenge of state-sponsorship of terrorism; and political and economic change in the Arab world, in particular in Syria and Lebanon, and the methods required to promote democratization.

The center also houses the ongoing Brookings Project on U.S. Policy Towards the Islamic World which is directed by Peter W. Singer, Senior Fellow in Foreign Policy Studies. The project focuses on analyzing the problems in the relationship between the United States and the Islamic world with the objective of developing effective policy responses. The Islamic World Project includes a task force of experts, an annual dialogue between American and Muslim intellectuals, a visiting fellows program for specialists from the Islamic world, and a monograph series.