

## The Economics of Iraqi Reconstruction

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### Introduction

*Postwar reconstructions stand among the most difficult policy achievements. Capitalist liberal democracy cannot simply be manufactured, as illustrated by failures in Cambodia, Bosnia and Angola. It is an open question whether these ideas will win indigenous acceptance and trust.*<sup>[1]</sup>

Iraq has a rich and diverse resource base—the third largest oil reserves in the world, abundant water, and a national labor force of more than seven million people—much larger than any member of the Gulf Cooperation Council. This combination of resources should enable the country to regain its middle-income status it enjoyed earlier. However, as the World Bank notes, to do so the country will need to make three somewhat sequential transformations,<sup>[2]</sup> each of which has an important economic component: from conflict to rehabilitation, from state domination to market orientation, and from oil dependence to diversification.

Unfortunately, in the initial area of recovery and reconstruction progress is much slower than initially hoped. Almost all growth has been in the oil sector, propped up by unusually strong world oil prices. Oil production, however has not risen above prewar levels, and in fact has been falling—reaching just 1.1 million barrels in December 2005, a new record low. The failure of the Iraqi government to expand oil production is one of the main obstacles to economic recovery.

Basic services, such as electricity remain too disrupted to support strong economic growth. As a result, although the non oil sector expanded rapidly in late 2003 and early 2004, it has slowed sharply since then. GDP per capita remains less than a third of what Iraq enjoyed 25 years ago, before the economy began its decline. Recovery has generated few jobs; unemployment appears to have stabilized at between 30 and 40 percent.<sup>[3]</sup>

In the place of a formal economy, a thriving informal economy has developed, perhaps accounting for well over half of the country's output.<sup>[4]</sup> The informal economy is having both positive and negative effects. On the negative side, it has become a source of financing and employment for a criminal class that often helps fund the insurgents.<sup>[5]</sup> But on the positive side, in a country that lacks legitimate economic institutions, and an effective government, informal activities have filled the vacuum providing a livelihood to many who would be otherwise destitute.

Without higher levels of oil production, the government's own financial position remains weak, limiting its ability to make an effective contribution to the reconstruction of the economy and continuing its reliance on U.S. aid. Meanwhile U.S.-backed reconstruction efforts have yet to have a tangible effect on the lives of Iraqis. Perhaps as a result in a recent survey<sup>[6]</sup> of Iraqis, 23 percent strongly approved of attacks on U.S. forces in Iraq, while 24 percent somewhat approved of this action. In the Sunni areas where little reconstruction has taken place, the corresponding figures were 77 percent and 11 percent.

Making matters worse, the United States announced in September 2005 that its reconstruction program in Iraq had been cut back because the U.S. \$18.4 billion allocated by congress was running out. Part of the problem has been a rapid escalation in security costs leaving less for reconstruction projects. "What remains is less than \$3 billion, which we estimate will not permit completion of all projects that were envisioned when the requirement for \$18.4 billion was being determined in late 2003."<sup>[7]</sup>

While there are numerous individual successes to point to—school construction for example, the overall picture is very bleak for the areas that really make a difference in jump starting the economy. For example, in the critical area of infrastructure successes are few and very far between. In fact, of the seven key measures of infrastructure, six have slumped below prewar levels: electrical generation capacity, hours of power available in a day in Baghdad, oil and heating oil production, and the numbers of Iraqis with drinkable water and sewage service. Only the hours of power available to Iraqis outside Baghdad had increased over prewar levels.<sup>[8]</sup>

The International Monetary Fund's assessment<sup>[9]</sup> of the Iraqi economy attributes much of the country's current economic problems to the difficulties involved in implanting policies in a highly constrained environment characterized by the new, fragile and very incomplete institutional setting,<sup>[10]</sup> the public sector's limited administrative capacity and the precarious social, political and security situation.

Clearly the security situation remains the largest obstacle to Iraq's economic growth and it is proving the most difficult problem to resolve. The combination of high unemployment, easily available weaponry, a fast widening gap between the rich and poor and a largely impotent government have combined to produce an environment characterized by poverty, despair and violence.<sup>[11]</sup> Specifically, the violence undermines the government's ability to tackle the economy's four basic problems: The security of the supply of oil, high levels of unemployment, and deficiencies in infrastructure and political difficulties in pushing through much-needed reforms. In turn, widespread poverty and frustrated expectations create an environment conducive to continued violence and increased conflict.

Traditional economic assessments are of somewhat limited value in these situations. For the most part, economic analysis assumes that a complex system of determinants will tend toward a state of equilibrium. In the normal case one can assess fairly easily such things the impact of reconstruction expenditures on per capita incomes and other economic measures. Predictability comes about because for practical purposes these economic measures will not generate feedback loops to other parts of the economic system which in turn alter the composition or level of further reconstruction expenditures.

When this tendency toward equilibrium is absent, as in present day Iraq, economic analysis must resort to a much more complicated (and less precise) construct of vicious (and virtuous) circles to depict the unstable patterns of events. Both circles are complexes of events with no tendency towards equilibrium (at least in the short run). Both systems of events have feedback loops in which subsequent iterations of the cycle reinforces the first (positive feedback). The difference between the two is that a virtuous cycle has favorable results and a vicious cycle had deleterious results. These cycles will continue in the direction of their momentum until an exogenous factor intervenes and stops the cycle.

The sections that follow examine, from the perspective of momentum and cycles, the economics of the reconstruction experience to date—the impact on the Iraqi population, attitudes of Iraqis towards the reconstruction, and lessons learned. Our core hypothesis is that certain key factors may assist the country breaking out of its current vicious circle if they succeed giving the Iraqi people the means to gain control over their lives as well as giving them stake in the economy's success.

## Scope of the Problem

Many reconstruction challenges confronted the coalition after the fall of Saddam Hussein. Some of these were met successfully, while others have presented on-going difficulties and are still present today. In addition new ones have arisen. Of the initial tasks several stand out:[\[12\]](#)

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

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

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

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

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

## Patterns of Success and Failure

Following Henderson,[13] several patterns emerge. Most importantly, the Coalition's success stories shared some essential elements. Its less successful ventures had their own set of distinctive characteristics. Specifically, successful initiatives appear to have imposed no major costs or sacrifices on the population at large. For instance, most Iraqis welcomed the rehabilitation of their schools and hospitals. Also, successful initiatives did not suffer from security disruptions. This was either because the security situation was not a constraining factor—as with creation of new banking regulations—or because effective steps were taken to provide security protection—as with the nationwide distribution of civil-service salaries.

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

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

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

## Ramifications of Delayed Reconstruction

A UNDP[14] household survey documents the impact the slow pace of reconstruction is having on the average Iraqi household:

1. The UNDP survey suggests the poorest 20 percent of the population earns 7 percent of the income, while the top 20 percent earns 44 percent.
2. Iraq's median household income of 144 dollars has dropped from a post-war high of 255 dollars in 2003.
3. One-third of Iraqis canvassed by UNDP described themselves as being among the poor.
4. One-sixth of interviewees met all or most of the criteria suggesting that they lived beneath the poverty line.

A recent internal staff report[15] by the U.S. Embassy and the military command in Baghdad[16] also documents the grim situation across most of Iraq. Addressing the current situation with regard to governance, security and the economic situation, each of Iraq's provinces is classified as follows:

***Stable—Denotes a province that has:***

- A fully functioning government;
- Strong economic development that supports job creation; and
- A semi-permissive security environment where local security forces maintain the rule of law.

**Moderate—Denotes a province that has:**

- A government that functions, but has areas of concern in areas such as the ability to deliver services, the influence of sectarian elements, etc.
- An Economy that is developing slowly, but in which unemployment is still a serious concern; and
- The security situation is under control, but where conditions exist that could quickly lead to instability.

**Serious—Denotes a province that has:**

- A government that is not fully formed or that is not capable of serving the needs of its populace;
- Economic development is stagnant with high unemployment; and
- A security situation marked by routine insurgent activity, assassinations and extremism.

**Critical—Denotes a province that has:**

- A government that is not functioning or not formed or that is only represented by a single strong leader.
- An economy that does not have the infrastructure of government leadership to develop and is a significant contributor to instability; and
- A security situation marked by high levels of insurgent activity, assassinations and extremism.

Overall, six of Iraq’s eighteen provinces were rated “serious” and one “critical ([Table 1](#)).” On the economic dimension seven provinces were considered “serious” and one “critical.” Only the Kurdish region rated stable overall and across governance, security and the economy.

For the most part, a serious economic situation was associated with a similar state of affairs in the security area. High unemployment, deficient infrastructure and the lack of a coherent economic plan or program at the regional level were the main characteristics associated with poor economic performance.

The report contains a number of dire warnings. Of particular concern is the growing power of Iranian-backed religious Shiite parties and rival militias in the south. The Arab-Kurdish fault line in the north is also a major concern with the two ethnicities vying for power in Mosul, where violence is rampant and Kirkuk, whose oil fields are critical for jump-starting economic growth in Iraq.

**Table 1: Iraq Stability Assessment**

Province	Overall	Governance	Security	Economics	Economic Situation
Kurdish Region	Stable	Stable	Stable	Stable	Foreign investment increasing
Ninawa	Serious	Serious	Serious	Serious	High

					unemployment; poor infrastructure
Tamim	Serious	Serious	Serious	Serious	High unemployment; need private investment
Salah and Din	Serious	Moderate	Serious	Serious	Seriously deficient infrastructure; no economic plan or program
Diyala	Serious	Serious	Serious	Moderate	Economic growth, but unemployment
Baghdad	Serious	Moderate	Serious	Moderate	High unemployment, weak infrastructure, political infighting
Anbar	Critical	Serious	Critical	Critical	Infrastructure incapable of supporting economic growth
Babil	Moderate	Moderate	Moderate	Moderate	Poor infrastructure affecting growth, high unemployment
Najaf	Moderate	Stable	Moderate	Moderate	Growth improving but unemployment still high
Karbala	Moderate	Stable	Moderate	Moderate	Growth improving but unemployment still high
Qadisiyah	Moderate	Moderate	Stable	Moderate	Slowly improving, but unemployment still a concern
Wasit	Moderate	Moderate	Moderate	Serious	High unemployment, economic development not sufficiently addressed
Muthanna	Moderate	Moderate	Stable	Serious	Poorest province in Southern Iraq
Maysan	Moderate	Moderate	Moderate	Serious	Little capacity to jumpstart economy
Basrah	Serious	Serious	Serious	Serious	High

					unemployment, weak government
Dhi Qar	Moderate	Moderate	Stable	Moderate	Growth in new enterprises, but unemployment a problem

Source: Compiled from U.S. Embassy Baghdad, Provincial Stability Assessment.

As Schmitt and Wong note; "The patterns of discord mapped out by the report confirm that ethnic and religious schisms have become entrenched across much of the country. Those indications, taken with recent reports of mass migrations from mixed Sunni-Shiite areas, show that Iraq is undergoing a de facto partitioning along ethnic and sectarian lines, with clashes taking place in those mixed areas where different groups meet."[\[17\]](#)

Ethnic strife is also reflected in a consistent pattern of varying perceptions by the various groups over the United States' presence in Iraq. One ABC survey of Iraqis interviewed in late 2005 found that:[\[18\]](#) Only 44 percent of Iraqis say they believe things are going well in their country; 52 percent said they felt the country was "doing badly." Support for the U.S.-led invasion has dropped: In February 2004, 39 percent of Iraqis told us they believed the invasion was wrong, but today that number stands at 50 percent. Even among optimistic Iraqis it appears the U.S. gets little credit for any improvements in their lives. Fewer than one in five Iraqis believes that U.S. reconstruction efforts have been "effective." Most Iraqis now say they "disapprove strongly" of how the U.S. has operated in Iraq. Not surprisingly, the percentage of Iraqis today who oppose the U.S. presence has spiked—from 51 percent to 65 percent.

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

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

These survey results were not unique. Another respected poll undertaken in the first week of January 2006 ([Table 2](#)) found a sharp split between Kurds, Shi'ites and Sunnis over the United States' aid efforts in Iraq. Over the various categories of United States' efforts, 38 percent of the Kurds expressed approval, falling to 30.3 percent for Shi'ites and 4.7 percent for Sunnis. The corresponding figures for disapproval were 11.3 percent, 14.8 percent and 77.7 percent

## Factors Contributing to the Current Economic Malaise

How did this sad state of affairs come about? Needless to say there is no simple and short answer. An examination of successful reconstructions in the past yields some clues. A recent comprehensive assessment of past reconstructions by Rand Corporation[\[19\]](#) yielded produced several main findings:[\[20\]](#)

- Many factors influence the ease or difficulty of nation-building: prior democratic experience, level of economic development, and national homogeneity. However, among the controllable factors, the most important determinant seems to be the level of effort—measured in time, manpower and money.
- Multilateral nation-building is more complex and time consuming than undertaken in unilateral efforts, but is also considerably less expensive for participants
- Multilateral nation-building can produce more thoroughgoing transformations and greater regional reconciliation than can unilateral efforts.
- Unity of command and broad participation are compatible if the major participants share a common vision and can shape international institutions accordingly.
- There appears to be an inverse correlation between the size of the stabilization force and the level of risk. The higher the proportion of stabilizing troops, the lower the number of casualties suffered and inflicted. Indeed, adequately manned post-conflict operations suffered no casualties whatsoever.

**Table 2: Iraqi Attitudes Towards the U.S. Aid Effort in Iraq**

<i>(support shown in percent)</i>	<b>Total</b>	<b>Kurd</b>	<b>Shi'ite Arab</b>	<b>Sunni Arab</b>	<b>Other</b>
<b>Assisting with the Economic Development of Iraq</b>					
Approve and U.S doing a good job	29	36	36	5	26
Approve but U.S. doing a poor job	46	51	53	19	67
Disapprove	25	12	11	76	7
Refused to Answer/Don't Know	*	1	0	0	0
<b>Assisting with the Development of Iraq's Oil Industry</b>					
Approve and U.S doing a good job	28	41	35	4	21
Approve but U.S. doing a poor job	44	46	51	20	55
Disapprove	27	12	14	76	14
Refused to Answer/Don't Know	1	1	*	*	10
<b>Training Iraqi Security Forces</b>					
Approve and U.S doing a good job	33	54	37	6	23
Approve but U.S. doing a poor job	44	42	52	20	67
Disapprove	23	4	11	74	9
Refused to Answer/Don't Know	*	0	*	1	2
<b>Helping Build Iraqi Government Institutions</b>					
Approve and U.S doing a good job	23	37	27	4	5
Approve but U.S. doing a poor job	50	57	59	15	79
Disapprove	27	6	14	80	14
Refused to Answer/Don't Know	*	*	*	*	2
<b>Helping to Mediate between Ethnic Groups</b>					
Approve and U.S doing a good job	17	34	19	3	2
Approve but U.S. doing a poor job	48	54	57	16	81
Disapprove	34	11	24	81	14
Refused to Answer/Don't Know	1	1	*	*	4



<b>Assisting with the Development of Infrastructure</b>					
Approve and U.S doing a good job	20	24	26	4	2
Approve but U.S. doing a poor job	52	57	62	16	81
Disapprove	28	18	12	79	14
Refused to Answer/Don't Know	1	1	*	*	4
<b>Helping Iraqis Organize their Communities to Address Local Needs</b>					
Approve and U.S doing a good job	25	39	29	6	9
Approve but U.S. doing a poor job	45	48	54	14	67
Disapprove	30	11	17	80	23
Refused to Answer/Don't Know	*	1	0	*	2

Source: Compiled from: "What the Iraqi People Want," WorldPublicOpinion.org. Date of survey, January 2-5, 2006.

- Neighboring states can exert significant influence. It is nearly impossible to put together a fragmented nation if its neighbors try to tear it apart. Every effort should be made to secure their support.
- Accountability for past injustices can be a powerful component of democratization. It can also be among the most difficult and controversial aspects of any nation-building endeavor and should therefore, be attempted only if there is a deep, long-term commitment to the overall operation.
- There is no quick route to nation-building. Five years seems to be the minimum required to enforce an enduring transition to democracy.

Clearly most of these conditions either did not exist in Iraq nor did they evolve with time. The semi-unilateral approach taken toward Iraqi reconstruction and its under funding both in terms of finance and manpower have significantly contributed to the current situation.

In addition a series of errors that began with the CPA have compounded the country's reconstruction efforts and have carried over to the present day. In defense of the CPA, many of their miscalculations are easy to see in retrospect. However, many CPA policy lapses did not appear important enough to be taken note of by outside observers at the time. Henderson has documented in detail the main lessons learned. Summarizing some of her more important findings:[\[21\]](#)

***Reconstruction entails painful trade-offs rather than easy choices:***

Perhaps the major made in the early days of reconstruction was a tendency to try to get things done as quickly as possible. To do this the CPA often bypassed Iraqi Ministries and various local groups. More often than not, Iraqis and their viewpoints were not included in the process. This flaw continues to take a toll on the country's reconstruction efforts.

***High hopes and lofty promises are no substitute for sound planning and prudent expectations:***

As we receive clearer accounts of the functioning of the CPA it is shocking to find how little planning went into the effort.

***Control expectations to realistic levels:***

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

***For any actions develop several contingency plans:***

Proper contingency planning taking into account the possibility of infrastructure degradation, persistent violence and revenue shortfalls would have resulted in more realistic reconstruction goals.

***Economic reconstruction depends upon adequate security; yet security depends on successful reconstruction:***

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

***Reconstruction requires coordination of short-term initiatives and long-term structural reforms:***

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

***Don't over-rely on market forces in a conflict setting:***

In part, the loss in reconstruction momentum stemmed from the CPA's assumption that market forces and a surge in private investment would follow the initial reconstruction efforts. Ideological blinders<sup>[22]</sup> and the lack of a contingency plan made it difficult to overcome these errors when confronted with the effects of increased violence and uncertainty.

***Ongoing reforms require empowered owners:***

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

***Broad-based participation is critical for maintaining reform momentum, but requires overcoming centralization tendencies:***

Creating Iraqi ownership of reconstruction also required decentralization of government authority. Decentralization has been shown to strengthen accountability and stimulate economic recovery in other post conflict and transitional settings. Unfortunately the CPA was successful in overcoming

Ministry opposition securing funding for local authorities and Iraqi citizens to participate directly in the reconstruction process.

***Overcoming and controlling corruption is extremely difficult:***

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

**Assessment**

The current reconstruction strategy with its emphasis on market reforms, infrastructure development and private foreign investment is not working and is not likely to revive the economy in the foreseeable future. It is an export-oriented strategy, but other than oil, the country currently has limited potential in this area. Nor under the current circumstances marked by violence and uncertainty is it likely to be competitive in international markets for some time.

As a result the massive expenditures in infrastructure have not produced the significant follow-on investment as Hirschman's[24] unbalanced growth strategy might have anticipated. Instead infrastructure projects have been an easy target for the insurgents and a financial drain for the United States and the Iraqi government. The top-down nature of the post-war strategy is another reason for its limited impact. There has been limited Iraqi input and participation and, consequently many of the investments undertaken are not nearly as productive in the Iraqi context as they would have been if they were indigenously designed to respond to a tangible domestic need.

As the surveys of Iraqis cited above suggest, perhaps the hardest legacy of reconstruction efforts to date to over-come is that of failed expectations:[25]

...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... 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...In part, *it is this expectations gap that could drive Iraq to civil war if reconstruction is seen as continuing to fail.*

The critical question is what can be done to break out of the current vicious circle pulling Iraq toward increased chaos and civil war? Thomas Palley[26] for one has argued that the country's current needs are so pressing that a significant share of oil revenues should be disbursed to the population immediately. His tentative figure was that 25 percent of revenues be distributed although his figure is amenable to change.

In addition he proposes the establishment of a companion fund that would distribute a share of oil revenues to provincial and local governments. This second fund is intended to ensure a fair regional distribution of revenues, thereby reducing the potential for regional grievances, which as noted have led to civil war in several countries and certainly could lead to one in Iraq.

The value of a distribution fund along the lines suggested above is that it has the potential through reorienting the economy from the foreign investment/export orientation to that of developing the domestic market to enable the economy to break out of the vicious circle of high unemployment—>increased violence—>insignificant private investment—>low incomes and high unemployment. Moreover, it is likely that through diverting funds from the public to the private sector it will provide, an improved over-all policy environment. As Palley notes:[27]

Moreover, government may lack the capacity to effectively absorb and dispense these revenues in a welfare maximizing fashion. Under such conditions shifting toward decentralized absorption is desirable. This can be done by distributing oil wealth to the people and letting them spend it on what they deem is needed for their welfare. Economic development surely involves the accumulation of public capital and infrastructure, and this requires government investment. But economic development also requires the accumulation of private capital based on the decentralized decisions of individuals. Putting extra money into the hands of individuals can help this process.

The logical argument against an oil distribution fund with a large share of oil revenues dispensed directly to the public is whether the country can afford such a program.[28] As we have seen the reconstruction costs in Iraq are enormous and that with the United States severely limiting its expenditures in Iraq there will be a large funding shortfall.

Here it is important to note that the so called funding shortfall is a contrived number. It is based on the assumption that funds are being diverted from projects with maximum impact and or rates of return to activities of little economic importance. Given the high costs of these projects due to security costs, foreign staffing and the like together with the limited effectiveness of many this shortfall is largely illusory.

In any case the true test of the expenditure of scarce resources in Iraq should be the total contribution to political and economic development. Expenditure patterns that contribute to the avoidance of the resource curse are likely to be the most productive for the country's eventual recovery and growth. An oil distribution fund is the best way to ensure that outcome. It stands to raise political engagement and improve democracy, reduce government corruption, and reduce the likelihood of civil conflict by diminishing cause for regional grievance. An oil distribution fund also promises to accelerate private sector economic development through a process of demand led growth. And, as the supply side of the economy grows this can provide the tax base needed to fund public infrastructure.[29]

Finally, one area of investment critical to the country's future is the oil sector. Iraqi goals for the sector are to triple current production levels within ten years at an estimated investment cost of \$20 billion.[30] Clearly much of this will have to be foreign investment or financed through borrowing. Iraqi oil in the ground can be used as collateral for such borrowing, but this should still leave current oil revenues free for distribution. Thus investment in the oil industry if appropriately financed is not inconsistent with the creation of an oil distribution fund of the magnitudes outlined above.

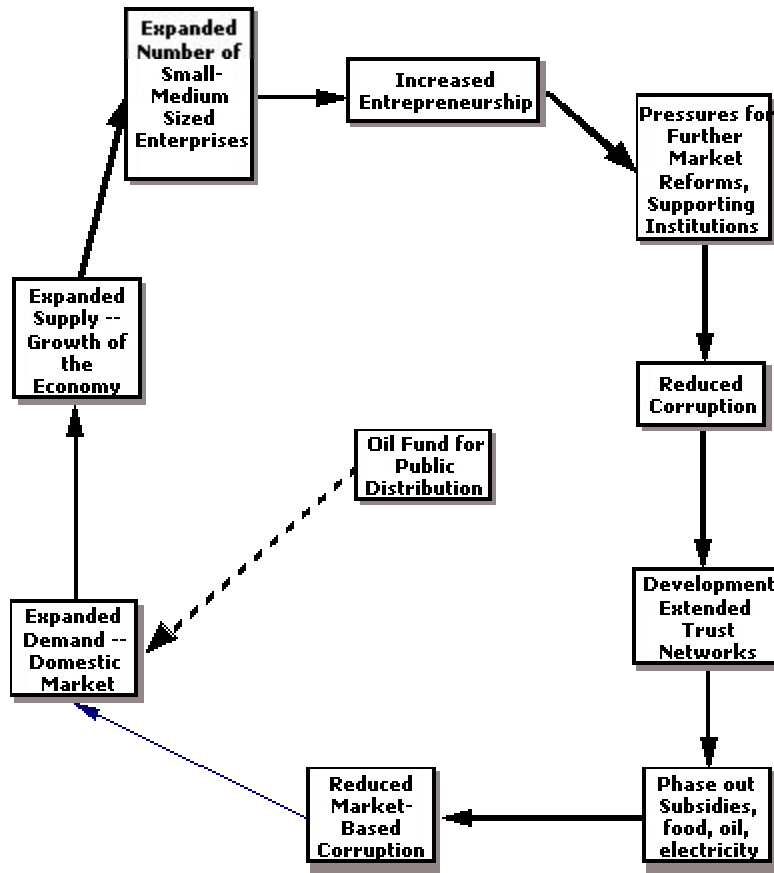
## Conclusions

Summing up, in addition to the obvious popularity of a direct distribution fund, its great strength lies in the prospect of the establishment of a virtuous circle of demand led growth (Figure 1) as opposed to the current vicious circle noted above. Most importantly it would certainly help in overcoming the serious expectations gap and its associated disruptive effects. In addition there would be many tangible benefits associated with a disbursement program of this type, each of which can play an important role in the country's recovery:

1. The Iraqi people would have increased incentive to protect the country's oil facilities by providing intelligence on insurgent groups attempting to disrupt the production and flow of oil.<sup>[31]</sup>
2. It might even help stem the insurgency, especially if much of that activity is driven by Sunni fears that they will receive considerably less than their accustomed amount under the new Constitution;
3. Men and women would receive equal distributions.
4. It would establish an irrevocable personal identity under the law—essential for establishing titled property rights, bank accounts, human rights protection, voter lists and taxpayer lists.
5. It would expand banking and credit access for small and medium business.
6. It could help offset public resistance to gas price increases which will be needed to cut back on gas smuggling. A related benefit is that it would also greatly help the government cut back on gas subsidies which currently amount to billions of dollars a year.
7. Without equitable distribution of oil revenues, competition among various groups for oil money could turn ugly and, even erupt into violent conflict in Iraq. Rifts over oil revenues already run deep, as Iraqi Kurds, Arabs, and Turkmen struggle for control of oil-rich Kirkuk.<sup>[32]</sup>
8. Citizens eligible for fund payouts would have an incentive to monitor the government and participate in the political process to guard the value of their entitlement.
9. A related effect is that oil funds are likely to encourage efficiency in the petroleum sector. Since the size of payments to citizens will depend on the efficiency of the oil industry, this should contribute to political pressure to improve efficiency.
10. Oil funds are expedient—rather than the long time intervals needed to improve government accountability and anti-corruption drives, they can be put in place immediately. They are doubly desirable when governance is weak, and the need for institutions to handle oil revenues is immediate.

Will something like an oil fund be initiated by the new Iraqi government as a possible way out of the country's current vicious circle? Sadly, in the end it turns out that most of Iraq's economic problems are really political problems, and here there is little cause for optimism.

#### **Figure 1: Iraq Virtuous Circle of Demand Led Private Sector Activity**



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