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A Plan for Revitalizing the Iraqi Economy[1]

Strategic Insights, Volume IV, Issue 8 (August 2005)

by [Robert Looney](#)

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Introduction

In December 2002, U.S. Secretary of State Colin Powell, speaking before an audience at the Heritage Foundation, remarked on the emergence of Islamic extremist movements: “A shortage of economic opportunities is a ticket to despair. Combined with rigid political systems, it is a dangerous brew indeed.”[2]

In addition to socio-economic factors, a whole spectrum of motivations for joining Islamic Fundamentalist groups has been documented in the literature. Individuals may join extremist groups to achieve specific political objectives such as sovereignty over disputed territory. Emotional incentives may also play an important role. Members of extremist groups often report on the glamour of being members of such groups. Unknown, lower-class youth can become famous through their military actions, with thousands turning out for their funerals when they are martyred. However, “the single most common emotional feature among *jihadi* militants, regardless of their rank is their feeling that they have been humiliated and treated as 'second class' by government authorities and others—even those *jihadis* from relatively rich countries and advantaged backgrounds.”[3]

Given the myriad of factors enhancing the attractiveness of the extremist message to many in the Islamic world, few concrete generalizations can be made for the purpose of combating the pull of Islamic extremism. No doubt the relative strength of these factors noted above on the attractiveness of extremism will vary considerably from country to country and from time to time. Numerous detailed country case studies[4] will have to be analyzed before any meaningful generalizations can be made.

As a step in this direction, the sections below assess the situation in Iraq. Socio economic factors do not get much attention in the vast literature on Iraq—they are a long run latent factor and it is difficult to point to them in coming up with an instant explanation as to why a certain extremist group did this or that. Or, why extremist groups may be expanding in certain areas after months of silence. Still, while a direct one-to-one relationship between the deteriorating socio-economic factors and extremist recruitment is hard to make, there can be no doubt strong links exist.

The analysis of the Iraqi situation suggests a redirection of its economic policies are needed to produce the type of broad-based sustained growth necessary to combat the destructive pull of extremist groups in that country. The interrelationship between the socio-economic environment and extremism in Iraq is complex, but critical to understanding its dynamics is critical in designing a fresh approach towards economic development in Iraq.

The Post-War Development Strategy

A major problem in designing an economic strategy for Iraq is that the country's economic environment does not fit nicely into a category handled by one of the standard development strategies. In fact, the immediate post-war Iraqi economy could conceivably be viewed from a number of perspectives, each encompassing certain aspects present today: (1) transition economy, (2) failed state, (3) rentier economy, (4) post-conflict economy, and (5) failed take off economy.

However, given the strong pro market orientation of the Bush administration and its aversion at the time to nation building the transition view, especially its shock-therapy variant has dominated U.S. economic policy in Iraq.^[5] A good case can be made that this approach was sound. The region as a whole has been slow to globalize and embrace free markets along the lines suggested by the so-called Washington Consensus. Those advocating a neoliberal or Washington Consensus view stress that only through a private sector led export oriented economic development strategy will the major countries in the region have a chance of coping with the development challenges facing the region.^[6]

Perhaps based on the experience in Chile in the 1970s planners in Washington assumed that with economic growth quickly restored through the exploitation of opportunities in free markets a virtuous circle could be established whereby the early winners in the new Iraq would press for further political and institutional reforms—thus creating more economic growth and a growing group of entrepreneurs with a high stake in pressing for broader and deeper reforms.

Diagnosis

1. In retrospect, given the post-war state of affairs in Iraq, adoption of a neoliberal/Washington Consensus free market development strategy was a mistake.^[7] While an ideal policy mix in certain situations, as applied in Iraq it has gone down a number of dead-ends as a result of serious miscalculations and faulty assumptions.
2. By its nature this strategy largely precludes large segments of the population from the decision making process—only those with the pre-requisites—the proper education, appropriate skills, financial capital to draw on etc. can immediately thrive. Few of these skills or assets exist in today's Iraq.
3. Its main strength is in providing incentives to private investors, but in a conflict country like Iraq this is not enough to offset the high level of uncertainty. As Stephen Glain as observed “In the relatively peaceful months that followed Saddam's removal, it seemed Iraq would no longer need Jordan as an enclave. Two years later, the colony of affluent Iraqis in Amman is a measure of how estranged war-town Iraq has become from its private sector.”^[8] Even in Chile, its main success story, several years of difficult restructuring under a very stable government occurred before investors felt confident in taking a stake in the country's future.
4. While many have argued that a trade-oriented development strategy might provide added incentives for the private sector, shifting international markets and trade relationships might create added instability through sudden drops in the output from industries with limited domestic markets. Also, it appears that reforms in the trade area for countries at Iraq's stage of development are not particularly effective in inducing follow on reforms in key areas of governance.^[9]

5. The neoliberal approach is not evolutionary—when things begin to go wrong, there is not an automatic adaptive policy. In mature economies this adaptation is usually through price movements, but in a country coming out of war, sanctions and a long history of socialism, a period of institution creation and strengthening is necessary before markets can be expected to perform this function.
6. As in other parts of the world, the neoliberal program is an easy target for radical groups. While in abstract terms, it makes a great deal of sense, its stress on openness to trade and foreign investment make it an easy target for arguments contending that the program is just another form of imperialism—a program largely designed for exploitation of weaker countries and groups. The extreme form of neoliberalism introduced in Iraq lends considerable credibility to these claims as does the initial stress on privatization.
7. The neoliberal philosophy also discourages large scale government intervention in the economy. This, together with market instability, creates high levels of uncertainty and the impression that the government is powerless to respond to crisis or adversity. As a result, unemployment has stabilized in the 30 to 40 percent range with large segments of the Iraqi population having a sense of hopelessness concerning their futures.
8. The insurgency aside, it is problematical whether the neoliberal reforms would have jumpstarted the economy. A large shadow economy exists, perhaps accounting for 65 percent of Gross National Product and 80 percent of the labor force. This market is largely outside the normal forces of supply and demand, requiring specific and directed policies to assure its transition into the regular economy.
9. Transition economies with large shadow economies, but much more favorable initial conditions experienced sharp contractions for up to five years after introducing even milder reforms. Even under normal circumstances, this would have been the likely scenario for Iraq.
10. While one intent of the reforms was to dismantle as quickly as possible institutions linked to the previous reform, the neoliberal policies were not, as expected, capable of initiating a process of new institutional development. The resulting vacuum was largely filled by already organized groups: religious, criminal and radical elements.
11. Because the neoliberal reforms were only partially introduced, with a number of controls still in effect, significant and sizeable black markets have developed—the most important in petroleum products. The resulting scarcity of fuels has had a debilitating effect on several important sectors of the economy. It has also lent credibility to extremist claims that the Coalition is only there to appropriate Iraqi oil.
12. In effect the economic system to date has been much more efficient at creating an environment for criminals and extremist elements to thrive than it has for private investors. Much of the funding for extremist groups comes from black market arbitrage, further enabling their recruitment efforts.

The danger today is that the current economic malaise will deteriorate to the point where the economy will stabilize in a poverty/violence trap.

Implications for Extremism

Specifying direct links between the deteriorating economic situation and extremist recruitment in Iraq is also difficult simply because a multitude of factors are at work—some more important for certain individuals, other factors more important for different groups. The development of large numbers of extremist recruits requires at least three elements (1) lack of state capacity, particularly in the areas of police, intelligence, and law enforcement; (2) a “mobilizing belief,” such as Salafist/jihadist extremism; and (3) appropriate agitators who can propagate these ideas and create an effective terrorist force.^[10] Clearly (1) and (3) are present in Iraq with (2) a latent factor and the focus of many of the Jihadis infiltrating into the country.

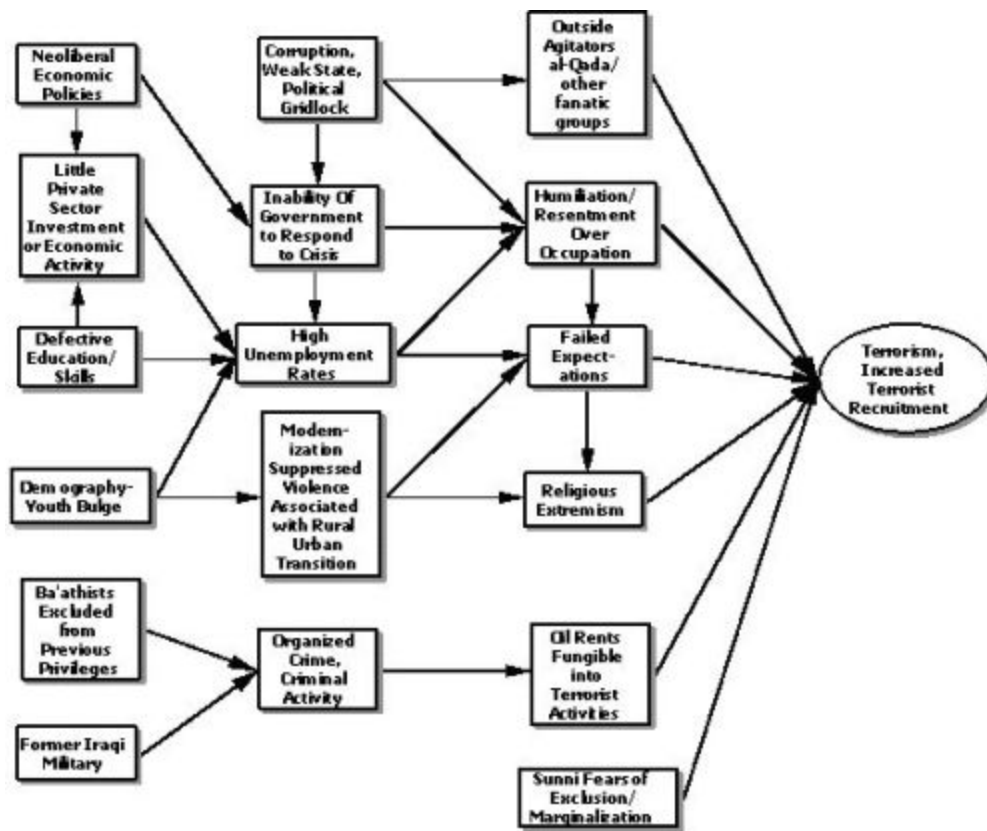
The situation in Iraq is complicated by factors such as ethnic conflicts, a large criminal element hold-over from the period of sanctions, pervasive corruption and whole spectrum of other

contributing factors, some of which are summarized in [Figure 1](#). What is fairly certain is that the longer the economy remains incapable of providing viable work for large segments, and is seen as incapable of doing so in the future, the more attractive extremism will become.

Is the situation hopeless? Middle East expert Ken Pollack feels that the deteriorating security situation in Iraq stems from the fact that an effective counterinsurgency policy is not in place. “We lost in Vietnam for a complicated set of reasons. But the most important was that we refused to use an effective counterinsurgency strategy. We focused more on hunting down Vietcong guerrillas than on protecting the Vietnam people, which in turn prevented the South Vietnamese economy from growing and giving the people an incentive to support our side of the war.”^[11]

Pollack finds putting the population first through improving safety is the key to counterinsurgency efforts in Iraq. A people first approach is also critical to restart the economy. “Reconstruction is most likely to succeed if it can grow from the bottom up. Certainly the top-down approach we are now employing has rarely worked in the past...We need to push resources out from Baghdad or circumvent it shipping supplies directly into the hands of the Iraqis who can help at the local level.” Just as in Pollack’s case where hunting down the Vietcong guerrillas was a necessary but not sufficient condition for success, so too are the neoliberal reforms and a vast amount of foreign aid a necessary, but not sufficient set of policies for economic recovery and growth.

Figure 1: Iraq—Factors Contributing to Extremist Recruitment



Components of a Comprehensive Development Strategy for Iraq

1. Shifting from a neoliberal/Washington Consensus development strategy to one along neo-institutionalist lines as done in several of the Transition countries would reorient the

- development process in a manner encompassing more groups into the country's decision making and development process.
2. In contrast the neoliberal approach of relying on a whole spectrum of reforms, the neoliberal approach would shift attention to certain key areas critical to the building up of a momentum for further reforms.
 3. Instead of the neoliberal stress on liberalization, stabilization and privatization, the evolutionary approach focuses on creating the institutional underpinnings of markets needed to insure strong entrepreneurial development.
 4. While the neoliberal approach has focused on creating a clean slate by breaking up existing state structure, the institutional approach would attempt to use existing institutions to prevent further economic disruption and social unrest while developing new institutions.
 5. A community development based development strategy fits into this general framework enabling Iraqis to participate in designing programs and policies in tune with their direct needs. The result would be better project selection, completion, and satisfaction, lessening the pull of extremist groups.^[12]
 6. The community based strategy should be focused not just on deriving local development plans to be funded through redirected aid allocations. A key element of this strategy is to gradually repair the social capital linkages destroyed by the previous regime. Starting at the local level and expanding to the region and eventually the national level, networks would strengthen not only the workings of the economic system, but also assist in the creation of a viable Iraqi state.
 7. In shifting towards a community development based strategy, programs at the local level should build on three highly successful programs, but to date vastly under-funded: (a) the Commanders Emergency Response Program (CERP), (b) the Local Governance Project (LGP) and Office of Transition Initiatives (OTI).
 8. These three programs have largely operated independently, but should be closely coordinated and their orientation (mainly CERP) expanded to allow the funding of private sector projects. There is some evidence that there has been an over expansion in certain areas—schools, and other public sector activities. At this time the biggest impact per dollar will come from assisting the establishment of private, labor-intensive start up companies.
 9. Distributing a certain percentage of oil revenues to the Iraqi public through the creation of an oil fund, would provide added demand for a wide range of domestic consumer goods. Part of this payment to Iraqis could be made conditional on participation in local clean-up programs while short-term training programs were providing the skills needed by private companies.
 10. A Development Bank should be established, and funded by an additional share of oil revenues. This would be a temporary to allow time for the commercial banking system to gain the expertise to eventually perform this function. The bank would specialize in small loans to start-up companies, encouraging the participation of women in the economy.
 11. A goal of the newly created Development Bank would be regional balance with lending oriented toward a fairly even distribution of new firms across the country.
 12. Within this context, the shift to a dual track development strategy with a focus on supporting small-and medium-sized enterprises (SMEs) would draw many entrepreneurs out of the informal sector, further assisting in the creation of new firms and associated employment.
 13. Two areas of governance are critical for the private sector to take hold and thrive in Iraq: secure property rights and an improved rule of law. In the past deterioration in the rule of law and related institutional enforcement mechanisms has shifted the balance of incentives toward participation in the informal economy.
 14. Improved macroeconomic stability will be critical in providing the right price incentives for private sector investment and activity. With growth inflationary pressures, the government will need to develop an improved stabilization tools, perhaps starting with an oil stabilization fund to better smooth out expenditures, avoiding short run bursts of disruptive austerity measures.

15. In Iraq's case, large allocations of assistance should be directed to two key areas noted above—small scale enterprise development and community development. Particularly in the case of community development the use of grants should be seriously considered. As the Meltzer commission observed, this provides a more effective means of monitoring projects and providing incentives to recipients.
16. Progress, as judged by annual independent audit, of stipulated outputs. This and other safe-guards might also help assure that community programs would not be taken over or reoriented by extremist groups.
17. Once the process is underway, several links between added employment and further demand creation would reinforce in a virtuous cycle-type mechanism the employment creation capability of the economy.
18. Most importantly, with the creation and expansion of a new class of entrepreneurs and those with a stake in seeing the reform process move ahead.
19. Further reforms, the reduction of corruption and the creation of and expansion of extended networks would build up the momentum to hopefully assure the viability and continuance of a liberal market economy.

Taken as a whole, these policy initiatives have the potential of not only significantly expanding domestic employment opportunities, but perhaps more importantly doing so through the creation of a virtuous cycle with feedbacks between the domestic market, further reforms and the labor markets [see [Figure 2](#)].

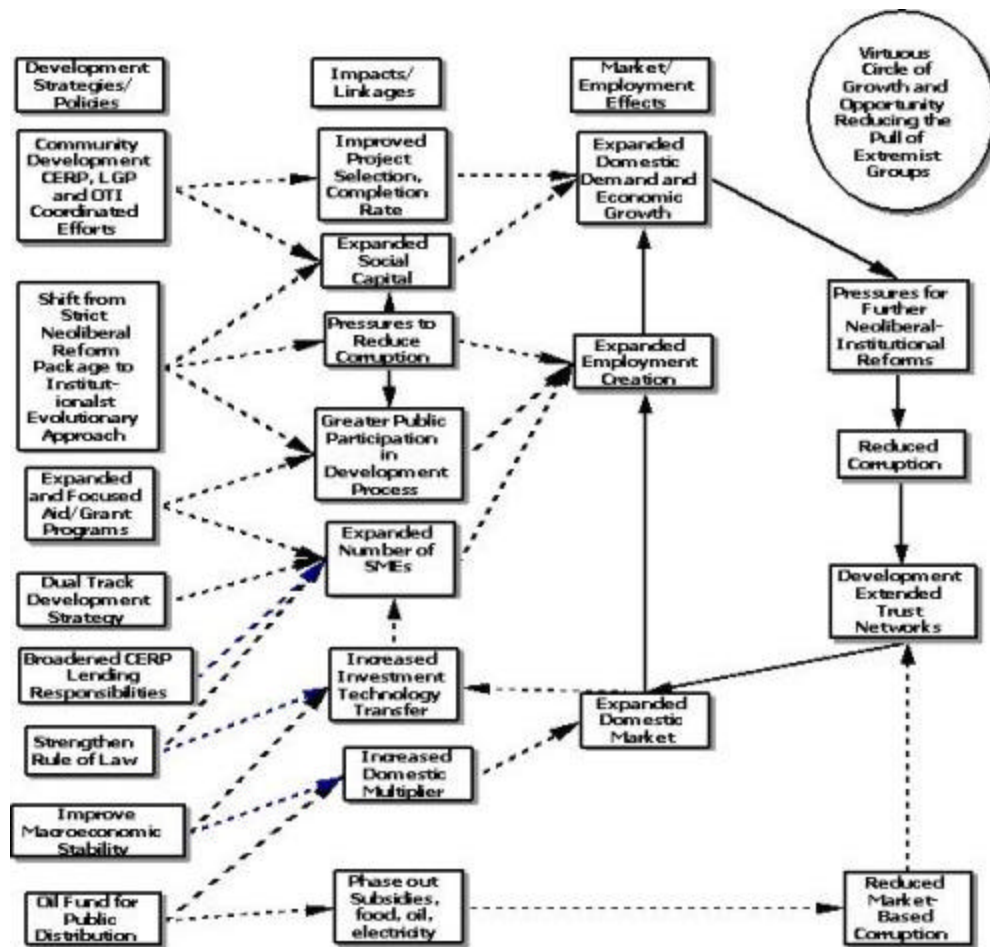
Community development programs should be started and greatly expanded in those areas security permitting. Local participation, project identification and implementation are the most rapid way to attack the current unemployment problems while reducing the insurgency threat. Iraqis must feel they have a real stake in the future and that it is within their control.

In terms of timing, the first priority should be to expand and build on existing, successful programs.^[13] While a number of these programs exist, the CERP program stands out and should have a significant increase in its funding. There is a growing consensus that if this program had had more funding all along we would not be in the mess we are now. The program should be modified slightly to assure its support of overall community development programs. In addition, expanding CERP's scope to include the funding of private sector ventures would probably be the quickest way to obtain an immediate impact on Iraqi jobs and incomes. The capability exists in CERP for this broadened responsibility.

Second, the other two programs mentioned above, LGP and OTI, should also be greatly expanded and their efforts coordinated with the CERP. There has been a natural tendency for LGP and OTI programs to be absent from areas where security is an issue. Teaming them up with CERP is one way of extending their presence to areas of potentially high impact. The close coordination of these two programs with CERP could provide the needed security for the continuity needed to develop and implement quick action programs meeting the needs of the average Iraqi. However, the joining of forces of CERP, LGP, and OTI is not a natural one and will require some creativity in focusing the strengths of each on a common course of action—results will easily justify the effort.

Third, work is underway concerning the rule of law and property rights. This should be given a higher priority and additional resources for speedy resolution. The remainder of the programs noted above—Development Bank, Oil Fund, Dual Development/Informal economy credit programs can be gradually phased in as funding and personnel permit. They are needed programs to sustain the momentum built up by expanded CERP, LGP and OTI efforts.

Figure 2: Iraq—Virtuous Circles to Restore Economic Growth/Combat the Poll of Extremist Groups



Assessment

As noted, a whole spectrum of factors affect terrorist recruitment. Interviews with members of Hamas and Islamic Jihad, suggest these groups actively recruit to fill potential leadership positions while relying more heavily on volunteers to carryout martyrdom attacks and general foot soldier functions.[14] There is little to suggest the situation is fundamentally different for extremist groups operating in Iraq.

Thus for large numbers of Iraqis a poor economic environment and lack of other profitable economic activity can be a major factor in their decision to join a extremist organization. The other options are service in the Iraqi security forces or criminal activity. For many Sunnis the options are only criminal activity or an extremist group. Former Ba'thists and ex-Iraqi military often find their options are even narrower in today's Iraq.

However, for the majority of Iraqis, the job-oriented community development strategy outlined above has the potential to marginalize extremists by strengthening indigenous democratic processes that generate economic prosperity.

For a smaller group of Iraqis, community development and increased prosperity may not be a sufficient step. Disaffected youth are the main recruits into terrorist organizations. Experts cite a series of factors, ranging from social deprivation, to cultural disenchantment and a sense of deep injustice harbored by many Muslims. Within Iraq, former Ba'thists, ex-Military officers, and Sunnis

feeling excluded from the country's future, and others resenting the U.S. presence will somehow have to be integrated back into Iraqi society and political system.

Outside of Iraq, Jihadist leaders who in the past pointed to Palestine or to the United States' enforcement of the United States' embargo of Iraq and America's "cultural aggression" against Muslim lands never generated that many recruits. The invasion of Iraq has incensed even many moderate Muslims to take action.[15]

To further stem the "Iraq effect" on extremist recruitment in Iraq and other countries, the United States will not only have to eventually withdraw from that country, but it must withdraw leaving the start of democratic institutions and a viable, dynamic economy capable of including and benefiting broad segments of the population. While hard core religious fanatics will be largely unaffected by these actions, success in Iraq may represent the most effective *long-run* strategy to stem the pull of extremist groups in Iraq and throughout the Middle East. This is not necessarily an impossible task, but it is one that will require much more thought, acceptance of prior mistakes, planning, and encouragement of Iraqi input than has occurred in the past.

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