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Economic Development During Conflict: The Petraeus-Crocker Congressional Testimonies

Strategic Insights, Volume VI, Issue 6 (December 2007)

by Frank R. Gunter

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Killing insurgents—while necessary, especially with respect to extremists—by itself cannot defeat an insurgency. Gaining and retaining the initiative requires counterinsurgents to address the insurgency’s causes through stability operations as well. This initially involves securing and controlling the local population and providing for essential services. As security improves, military resources contribute to supporting government reforms and reconstruction projects.

--U.S. Army, *Counterinsurgency Field Manual*, FM 3-24, 5, paragraph 1-14.

Introduction

In contrast to the December 2006 report of the Iraq Study Group^[1] (ISG) economic developments in Iraq received significantly more attention in the September 2007 congressional testimony of Ambassador Ryan C. Crocker and, to a lesser extent, in that of General David H. Petraeus. This greater attention to the essential services and economic development logical lines of operation (LLO) is a result of several occurrences.^[2]

Probably most important, the current U.S. military and civilian leadership in Iraq seem to have placed a greater emphasis on economic development as a means of both increasing confidence in the Government of Iraq (GoI) and reducing tolerance for the insurgency. This is consistent with the recent revision of the *Counterinsurgency Field Manual* which states that restoring essential services and accelerating economic development are essential components of successful counterinsurgency. The current MNF-I Commander, General Petraeus USA, was one of the co-authors of this manual, along with Lieutenant General James F. Amos USMC.

Second, the ISG focus was on diplomatic initiatives and changing the military mission in Iraq to achieve a substantial drawdown by the first quarter of 2008.^[3] With this focus and timeline, economic development was a long-term distraction rather than a short-term priority. The Crocker and Petraeus testimonies have a longer term focus.

Finally, good economic news was in short supply when the ISG was released. In his study “Beyond the Iraq Study Group: The Elusive Goal of Sustained Growth,” author Robert Looney accurately stated: “...the country’s economic situation is quite dire.”^[4] However, during the last half year there have been a few signs of economic progress that support Crocker’s statement:

“The cumulative trajectory of political, economic and diplomatic developments in Iraq is upwards, although the slope is not steep.”[5]

The sections that follow will attempt to place the Petraeus and Crocker testimonies into the context both of current economic events in Iraq as well as the new view of the importance of economic development during counterinsurgency.[6] Also, there will be a discussion of several important economic events in Iraq that for various reasons were not included in their testimonies.

What a Difference a Year Makes: Economic Developments in Iraq Since the ISG Report

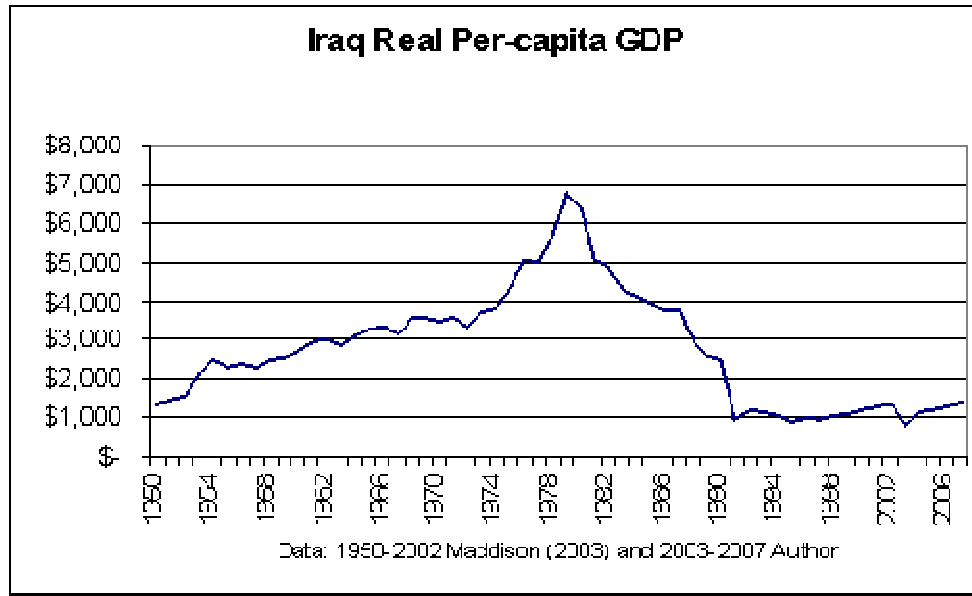
Despite the insurgency, real economic growth in Iraq continues. In its August 2007 report, the IMF estimates that after adjusting for inflation, GDP growth reached 6.2 percent last year compared to 3.7 percent in 2005 and 46.5 percent in 2004. Of course, the last figure represents the bounce from the 2003 invasion. Because of the usual difficulties in measuring activity in the underground or informal economy, the 2006 estimate is probably a lower bound. There is a wide divergence in real growth rates among provinces with the Kurdish provinces experiencing the highest growth rates. As Ambassador Crocker noted, expected real growth in 2007 will be roughly the same as in 2006. [7] While average real growth rates over 6 percent for four successive years puts Iraq in the top 10 percent among all nations, neither the Gol nor the coalition is earning much praise for this performance.

One of the many challenges of the economic LLO of counterinsurgency is that not only must living standards improve but also the public must be aware that living standards have improved and credit the government or the counterinsurgency forces for the improvement. Or as stated in the new *Counterinsurgency Field Manual*: “Counterinsurgency programs for political, social and economic well-being are essential to developing the local capacity that commands popular support *when accurately perceived*.”[8] In other words, improved living standards won't help the Iraqi government if either the public is unaware of the improvement or they credit non-governmental or even anti-governmental organizations for any improvement.

One reason for the dissatisfaction with the rate of economic growth is that many Iraqis in and out of the government compare today's living standards to those of the oil boom of thirty years ago. As can be seen by the figure, while post 2003 real growth has brought the average Iraqi up to the per-capita income levels that followed the invasion of Kuwait in 1991, per-capita income is still only about one-fifth the level of 1979.[9] Of course, per-capita incomes in 1979 reflected both the OPEC oil price boom and an Iraqi population half as large as today.

Despite the collapse of oil export prices and the tremendously expensive war with Iran, Saddam was able to maintain a degree of popular support for his regime by creating an expensive welfare state financed by massive foreign borrowing. By 1991, Iraq had become the second most indebted country in the world and had almost exhausted possibilities for additional borrowing. This supports the Willy Sutton explanation for Iraq's invasion of Kuwait.[10]

Oil has become the curse of Iraq. There is a widespread belief in Iraq that, because of its oil wealth, the average Iraqi should have the kind of high income-high leisure existence that is associated with residents of Iraq's Persian Gulf neighbors, Saudi Arabia, Qatar and the UAE. This belief feeds into insurgent propaganda that Iraq was prosperous before America and her allies came to “steal” Iraqi oil in 1991 and, when the invaders finally depart, Iraq will be prosperous again.



Unfortunately, the doubling of the Iraqi population combined with the low volumes of oil exports render this oil-financed socialist paradise a fantasy. Even assuming that oil prices remain at their current high levels, oil exports double from the 1.74 million barrels a day achieved in September 2007, and no funds are spent on oil-related maintenance and infrastructure, then total oil revenues would amount to only \$2,300 per person. Added to expected non-oil GDP, the average Iraqi will receive an inflation adjusted income that is less than that of the average current resident of Lebanon or Jordan.

However, to the extent that this propaganda of future oil wealth is widely accepted, it creates adverse incentives in Iraq. First, almost every Iraqi region, ethnic group, and bureaucratic organization seeks to control, or at least achieve secure access to, oil revenues. Each Iraqi entity acts as if a failure to win today's battle over oil revenues will doom their region, ethnic group, or bureaucracy for a generation. It becomes a battle that none can afford to lose since it is about more than money—it is about power. As Ambassador Crocker noted in his testimony concerning the Iraqi debate over sharing oil revenues: "This legislation also has to do with the vision of the future Iraqi state."^[11]

Second, just as the expectation of receiving a large inheritance tends to adversely change the behavior of young heirs, the expectation that Iraq will receive large oil revenues adversely changed the behavior of both institutions and individuals. The ministerial bureaucracies in Baghdad and their associated state-owned enterprises (SOEs) see their role as not providing necessary regulation or production but rather providing large scale employment for favored regional political, sectarian, or ethnic groups. Many individuals in Iraq prefer government employment to entrepreneurship or working for a private firm because employment at oil-financed government agencies combine higher incomes with reduced work intensity. And high 2007 oil prices have provided ministries with generous funding which has reduced the already weak incentives for adopting modern, more efficient, management procedures.

Through the first nine months of 2007, Iraq's earnings from petroleum exports benefited both from increased volume as well as higher world prices.^[12] As a result, Iraq is expected to exceed its target for oil export revenues for the second year in a row. This will impact currency reserves, inflation, and the value of the Iraqi dinar.

Iraq is caught in an almost unique dilemma. Over the last three years, the Gol has only been able to execute a fraction of its capital infrastructure budget primarily because of inadequate managerial capacity and political disputes. In 2006, the Gol spent only 22 percent of the amount budgeted for non-provincial capital and reconstruction. For the oil sector, only 3 percent was spent.^[13] Despite this under-spending, rigidities in the Iraqi economy, shortages of skilled labor as well as wide-spread mismanagement and corruption mean that much of the spending that did occur resulted only in higher prices for existing products and assets—not increased output. Rapid money growth combined with much slower increase in the production of goods and services led to the current estimated 2007 year-to-date consumer inflation rate of 41 percent—roughly the same pace of price increases as the 65 percent inflation of 2006.

Normally, a domestic inflation rate greater than that of one's trading and investment partners results in a depreciation of a nation's currency, but not in Iraq. Instead, the Iraqi dinar has appreciated by 17 percent!^[14] Therefore, not only do Iraqi businesses and consumers struggle to deal with rapid inflation but also non-petroleum exports face a loss in competitiveness from exchange rate appreciation—a case of the Dutch Disease.^[15]

The inability to actually spend the budgeted amounts combined with high crude oil prices over the last eighteen months have resulted in large accumulations of dollars in the Gol account at the New York Federal Reserve. By mid-July 2007, these holdings had reached an estimated \$21 billion.^[16] By the rule of thumb that a nation ought to keep reserves equal to three months imports, Iraq has approximately \$14 billion in “excess” currency reserves. In addition, the Gol ended up with a fiscal surplus of 12 percent in 2006, approximately the same scale as in 2005. As a result, the Development Fund of Iraq reached \$8.6 billion at the end of 2006.^[17]

Since Iraq has great need for infrastructure investment in essential services and energy, one would think that these excess reserves should be rapidly spent. In his testimony, Crocker stated that the Gol is already spending its \$10 billion 2007 capital budget at about twice the rate of last year.^[18] The expectation that this rate of spending will continue through the rest of the year may be overly optimistic. The experience of 2006 shows that the managerial capacity of both the Baghdad ministries and provincial governments is only slowly improving from a very low level. The 2007 budget of \$10 billion of spending in one year will probably exceed the capacity of the government authorities in both Baghdad and the provinces. As a result, it is unlikely that either the Baghdad ministries or the provinces will spend most of their 2007 capital budgets, and some of the funds that are spent will be wasted through general inefficiency, security issues, shortages of skilled labor, and corruption.

In other words, unless there is a sharp drop in oil prices, the binding constraint on effective capital investment in Iraq, including the critical oil industry, is *not* a shortage of funds but rather insufficient managerial capacity at both the national and provincial level. While Iraq may not need any additional investment capital, it desperately needs the knowledge of navigating a transitional economy that could be provided by the World Bank and other international organizations as well as the managerial skills that accompany foreign private investment.

But all attempts to restore the infrastructure and accelerate economic development will be wasted unless corruption, the abuse of public power for private benefit, can be controlled. ^[19] While Petraeus stated that competition for power and resources is the fundamental source of conflict in Iraq, he includes various forms of corruption, along with lack of capacity and sectarian mistrust, as adding to Iraq's challenges.^[20]

The Political Economy of Corruption in Modern Iraq

Iraq is not the most corrupt country on Earth, North Korea is probably the holder of that dubious honor. But according to the 2007 Transparency International Corruption Perceptions Index, Iraq is

in second to last place of the 180 countries for which reliable corruption surveys were available.[\[21\]](#)

As stories of Iraqi corruption proliferate in the media, including a leaked U.S. Embassy corruption study, there is a greater awareness of the scale of corruption in that country. Corruption ranges from senior government bureaucrats in Baghdad accepting bribes of hundreds of millions of dollars to buy defective military equipment to flour agents in poor southern villages selling bushels of wheat intended as charity for poor families. While Iraq has a generation-long history of large scale corruption, it has worsened since the 2003 invasion by the U.S.-led coalition. While corruption under Saddam was severe, it was also organized and, to an extent, predictable. Since Saddam's fall, corruption has become entrepreneurial, resulting in a sharp increase in corruption-related uncertainty.[\[22\]](#) It has reached the point where corruption is so pervasive that it may be a greater threat to the future of Iraq than the insurgency. Stuart Bowen, the Special Inspector General for Iraq Reconstruction refers to corruption as Iraq's "second insurgency."

Less attention in the media has been paid to the question: "Why is Iraq so corrupt?" Researchers have identified some environmental or cultural characteristics that tend to be associated with higher levels of corruption and Iraq possesses many of them. Countries tend to show higher levels of corruption if they have an inhospitable climate, French or socialist legal system, Catholic or Muslim religion, high rates of cousin marriage, and corrupt neighbors.[\[23\]](#) All of these characteristics describe Iraq and little can be done about changing them.

There is also a symbiotic relationship between corruption and the insurgency. Corruption is good for the insurgency. Corrupt activities, including official theft, extortion and "ghost workers," provide funding for the insurgency. Organizations and ratlines that handle smuggled or stolen goods provide routes and safe houses for insurgents, IED makings, and provide part of the logistics tail for the insurgency. Finally, corruption undermines public confidence in both the Gol and the Coalition. And the insurgency is good for corruption. The reality of terrorist attacks justifies bypassing procedures and provides a ready excuse for corruption related losses. Fighting the insurgency increases the urgency of getting things done regardless of the cost, which facilitates bribes and extortion.

It is too early to know whether the symbiotic relationship cuts both ways. Will the recent decrease in insurgent violence lead to a reduction in corruption?

The Gol has made limited efforts to fight corruption through better governance and attempts to prosecute the corrupt. These efforts have been undermined by the willingness of the various ministers, including Prime Minister Nuri al-Maliki, to block corruption investigations using Article 136B of the Criminal code. This Saddam era article, that was suspended under the CPA and then later restored, requires investigators to get the permission of the minister of an agency before it can take any case involving that agency to court. Judge Rahdi Hamza al-Radhi, who has the well deserved reputation of being both brave and honest, testified that the use of Art. 136B as well as repeated threats and acts of violence against corruption investigators have stalled most high-level anti-corruption investigations.[\[24\]](#)

While al-Radhi's and other recent reports emphasize failures to successfully investigate and prosecute corruption, some progress has been made in reducing the economic incentives for corruption as well as mobilizing public anger at the corrupt.

Under pressure from the IMF, Saddam-era fuel subsidies have been sharply reduced and in some cases eliminated. Previously these subsidies not only ensured huge gains to those who had the influence to divert fuel supplies into the black market but also necessitated massive government financed fuel imports. A diversion of a single tanker truck load of fuel into the black market could result in \$6,000 to \$7,000 profit for the smuggler. Refinery constraints, smuggling,

and excessive consumption of almost free fuels led to large scale fuel imports. For example, during one week in September 2005, Iraq imported at market prices and then distributed at large discounts about two-thirds of its diesel and gasoline needs.[25]

Over eighteen months, as a result of the subsidy reductions, fuel prices increased dramatically. For example, regular gasoline which sold for 5 cents a gallon in September 2005 had risen to \$1.05 a gallon by June 2007.[26] Gasoline prices and other fuel prices are now roughly in line with those of Iraq's neighbors, which has reduced the incentives for fuel smuggling and the associated bribes. Progress in eliminating other major subsidies, such as electricity, water and food, is much slower.

NID per liter	September 2005	December 2006	June 2007
LPG (12kg)	250	1,000	3,000
Regular Gas	20	250	350
Premium Gas	50	350	Market Price
Blended Gas	N/A	350	450
Kerosene	5	75	200
Diesel	10	150	350

Of course, the reduction in subsidies by itself will not eliminate corruption in Iraq. Smugglers and others continue to adapt to the changing economic environment. But the fuel subsidy reduction disrupted old ways of doing (illegal) business, reduced insurgent finances, and changed the incentives towards corruption in many related markets. Corruption continues but now it is harder to earn a dishonest dollar.

The sharp reduction in fuel subsidies was not only directly advantageous to the Iraqi economy but also may have changed beliefs about what is now politically possible in Iraq. The fuel subsidy reductions and the accompanying increase in the prices paid by the average consumer were very unpopular politically—leading to widespread protests and a few riots. It was widely believed that the new Gol would take counsel of its fears and stop or even reverse fuel price increases. However, despite the political fallout, the Government successfully completed the fuel liberalization program. Possibly the dramatic increase in fuel prices is unique because the IMF made it clear that progress in negotiations to reduce Iraq's huge post-war foreign debt depended on the Gol demonstrating that it could eliminate or at least sharply reduce subsidies. A more optimistic view is that the Gol is gradually becoming more confident that it can successfully defy violent street protests if it can convince most of the public that changes are needed.

The extensive coverage and criticism of government successes and missteps illustrates another favorable trend in gradually reducing the prevalence of corruption in Iraq, the growth of a vibrant non-governmental media.

Under Saddam, all media was a state monopoly and coverage of government corruption was non-existent. In contrast, Iraqis are now able to choose from fifty-four commercial TV stations (compared to zero in the pre-war period), 114 commercial radio stations (compared to zero pre-war) and an estimated 268 independent newspapers and magazines (also zero).[27] While many of these outlets are associated with various parties or sectarian groups; stories, editorials and biting cartoons against corruption are a common denominator. And surveys show that the average Iraqi has greater trust in the media than in political parties, the legislature, or even the judiciary. Studies of successful anti-corruption efforts reveal the importance of a free press in changing the culture of corruption.[28] While reducing incentives for corruption and marshalling the power of a free press have weakened the corruption culture in Iraq, further progress will require improved governance as well as more effective anti-corruption law enforcement.

Of course, an anti-corruption campaign is only part of the economic component of successful counterinsurgency. What other expensive and bloody lessons has Iraq provided in the economics of counterinsurgency?

The Economic LLOs and Counterinsurgency

According to the *Counterinsurgency Field Manual*, the economic components of counterinsurgency can be divided into restoring essential services and economic development. Essential services include police, fire protection, water, electricity, schools, transportation networks, medical availability, sanitation, food supply, fuels, and basic financial services.^[29] Economic development is not directly defined in the *Counterinsurgency Field Manual*, but from the context in which it is used. Economic development activities are those that will lead to a robust improvement in the population's living standards. Examples of these activities are job creation, local investment, clarifying property ownership and conflict resolution, protecting property rights, market creation, and vocational training.^[30]

One critical difference between efforts to restore essential services and achieve economic development is sequencing. According to the *Counterinsurgency Field Manual*, restoration of essential services must begin immediately regardless of the security situation in the country. In fact, restoration of essential services is stated to be a key component of any successful counterinsurgency operation. On the other hand, economic development must often wait until security is essentially restored. This dichotomy is noticeable in the treatments of economic development in the testimonies of General Petraeus and Ambassador Crocker. Except for the single reference to corruption noted above, Petraeus is silent on economic development while Crocker devotes a section to this subject.^[31] Possibly this reflects the General's focus on the five provinces where most of the violence is occurring while the Ambassador pays more attention to events in the other fourteen provinces including the six with little or no violence.

What lessons can we glean from the Iraqi experience concerning the roles of essential services and economic development in a successful counterinsurgency? There is a widely held belief among military thinkers that while soldiers, weapons, and tactics may change dramatically, there are basic rules of combat that are as true now as in the days of Sun Tzu or Caesar. Two of these old chestnuts describe some of the important lessons of the economic LLO in Iraq. First, in combat it is important to look unimportant. Second, battles almost invariably take place at a time or location that maximizes the difficulty of coordinating action.

Try to Look Unimportant—the Enemy May Be Low on Ammunition

While providing essential services using a complex interdependent system may be most efficient during periods of civil order, during an active insurgency such a system is extremely vulnerable to both insurgent activity and intra-provincial/sectarian/ethnic disputes. During an insurgency one is usually better off pursuing simpler redundant systems for providing essential services that are less efficient but more robust. The continuing struggle to bring reliable electricity to the people of Iraq exemplifies this maxim

Despite three years' expenditure of massive amounts of blood and treasure, Ambassador Crocker acknowledged that the electricity supply in Baghdad is still "woefully inadequate."^[32] Nationwide, it was only in September 2007 that the average amount of electricity generated in Iraq exceeded August 2004 levels (4,975 megawatts).^[33] The primary reason for the lack of progress is insurgent activity. The electricity grid with its complex system of generating plants, step-up transformers, high voltage transmission lines, substations with step-down transformers, low voltage transmission lines, and connections to individual businesses or homes is an insurgent's dream. This long chain of carefully coordinated activities is clearly visible, cannot be protected everywhere and a break anywhere in the chain usually leads to a cascading national

power failure. If one of the goals of the insurgency is to undermine the confidence of the Iraqi people in the capability of the Gol then attacks on the electrical grid provide a high payoff in public chaos at low cost and low risk to the insurgency.

An alternative approach is to accept that the national electrical grid cannot be consistently operated until the insurgency has been degraded to where it is just a problem for the police rather than a threat to national sovereignty. The alternative with the least vulnerability is distributed generation (also called onsite distribution) where electricity is produced using smaller, often mobile, generators on multiple grids that may supply power to only a single factory, office, or residential district. Electricity from distributed generation is much more expensive than that from a nationwide grid but it is much less vulnerable to insurgent activities. And if the fuel for the small generators is delivered by trucks with their inherent flexibility of routes and timing then the vulnerability of a nationwide power loss is lessened even further. Anyone who flies over Baghdad when the national electric grid is down sees the proof that the private sector has adopted distributed generation. The city is a sea of lights powered by a redundant unconnected maze of private generators with fuel provided by fleets of trucks.

To an extent, this choosing of multiple redundant—hopefully more robust—suppliers over a theoretically more efficient integrated solution is increasingly reflected in overall coalition strategy in Iraq. There is greater willingness to bypass Baghdad—less emphasis on a “made in Baghdad” nationwide solutions—not only with respect to economic initiatives but also to political programs as well. And more reliance on efforts at the provincial and local level to restore essential services and facilitate economic development. Although Ambassador Crocker notes that provinces lack the ability to generate funds through taxation,^[34] there is an increasing effort to allocate funds, \$3 billion in 2007, directly to the provinces and the Kurdish regions for spending. While the provinces have similar problems to the Baghdad ministries with respect to managerial capacity and corruption, it is believed that provincial authorities are both more responsive to their populations and more open to advice from NGOs and the U.S. government provincial reconstruction teams (PRT) than the Baghdad ministries. But this shift to a provincial focus will increase the difficulty of coordinating the economic LLO.

Battles Always Occur at the Intersection of Two or More Maps

While the *Counterinsurgency Field Manual* distinguishes between restoring essential services, which should occur simultaneously with security operations, and economic development, which should follow such operations—the reality on the ground often makes it difficult to tell which side of the line one is on. Six provinces have experienced relatively low levels of violence against either Iraqi police or civilians (Dahul, Irbil, Sulaimaniya, Qadisiya, Misan and Muthanna) and therefore should definitely be engaged in economic development. On the other hand, another five provinces have relatively high levels of violence (Ninevah, Baghdad, Babil, Anbar and Basra)^[35] and, according to the *Counterinsurgency Field Manual*, it would be premature to aggressively pursue economic development in these provinces. But whether and to what degree to pursue economic development in any except the most peaceful provinces is a difficult judgment call. If economic development projects begin too soon then disrupting them may just provide more trophy scalps and accompanying propaganda victories for the insurgency. On the other hand, delay economic development too long and one misses the opportunity to undermine the insurgency by more rapidly building public support for the government.

The most dramatic example of this judgment call is when a commander must choose between a short-term gain in security and long-term mission success. This is the subject of several of the “Paradoxes of Counterinsurgency Operations” discussed in the *Counterinsurgency Field Manual*.^[36]

One current dispute over whether the focus should be on the short-term or the long-term has led to dueling policy recommendations by the Departments of State and Defense. This is the Bremer-Brinkley state-owned enterprises (SOE) controversy.^[37] Paul Bremer advocated the liquidation or privatization of SOE, a view that is supported by the U.S. Department of State in Iraq. Paul Brinkley with the support of the Department of Defense, believes that SOE should be reopened both to provide goods and services as well as jobs.

Since the formal or legal private sector is relatively small in Iraq, estimates of unemployment range up to 60 percent. However, these estimates generally ignore employment in the large and growing informal or gray market sector of Iraq. When employment in the informal sector is included, surveys point to a national unemployment rate of 18 to 22 percent which is excessive by OECD standards but roughly equivalent to unemployment rates in other Middle Eastern countries and the transitional countries of Eastern Europe.^[38] So Iraq faces two problems. In the short-term, employment must be found for the currently unemployed—mostly unskilled labor. But in the long-term, jobs must be found in the future for the almost 40 percent of Iraq’s population that is less than 15 years old.

One difficulty in growing non-government jobs for Iraqis is the opposition of the ubiquitous and yet grossly inefficient Iraqi government bureaucracy. The bureaucratic complexity required to legally run a private business combined with the vulnerability of firms in the formal economy to demands for bribes from government officials and extortion demands from various insurgent groups provide strong incentives for firms to “hide” in the informal economy.^[39] Below is a comparison of Iraq, other countries in the Middle East and the OECD countries of some of the costs of legally doing business.^[40] Starting a business refers to the administrative requirements to incorporate an entity. The rigidity of hours index refers to restrictions on weekend and night work, requirements relating to working time and mandated annual paid leave. Export delay includes the time required to obtain the necessary government approval and inspections for an export. Finally, since there is no record of any Iraqi firm going legally bankrupt since 2003, there is no way to judge how long the process might take.

	Iraq	ME Region	OECD
Start a business	77 days	39 days	15 days
Rigidity of hours	60	42	39
Export delay	102 days	25 days	10 days
Bankruptcy	None	3.7 years	1.3 years

Not only does the bureaucracy impose severe time delays on establishing a business but, disregarding bribes, it is expensive. The World Bank estimates that it will cost almost 94 percent of the average Iraqi’s income to establish a firm. One of the most depressing entries in this table is that it takes at least 102 days (and \$3,400!) to legally export a non-petroleum product from Iraq compared to less than a month (and less than \$1,500) for its Middle East neighbors.^[41] Iraqi exporters face these hurdles in addition to the sharp appreciation of the dinar. The barriers to establishing a legal business mean that as much as 25 percent of GDP and maybe as much as half of employment is in the informal economy.

Further complicating the unemployment challenge is Iraq’s dependency on a single natural resource that provides relatively low levels of employment. While petroleum accounts for over 90 percent of government revenues and almost 66 percent of GDP, it only provides 2 percent of the jobs in Iraq. Saddam, a believer in the Ba’ath Arab Socialist Party agenda, developed a system of SOEs to provide almost 600,000 jobs for his supporters. Like such firms elsewhere, Iraq’s approximately 200 SOEs tend to be low-quality, high-cost producers with little chance for expansion without significant subsidies.

The long-term solution is to attempt to restore the vibrant and relatively efficient private sector economy that existed before the Ba’athist Party solidified its control in the mid-1970s. Because

the SOE imposed inefficiencies on other firms, required huge subsidies and tended to hoard labor and resources, it was believed that the revival of a private economy in Iraq would require the dismantling of the SOE. And in fact, the Development Strategy of the Government of Iraq, based on the advice of former U.S. occupation administrator Paul Bremer and the IMF, called for the liquidation of SOE empty shells and the privatization of the rest with the possible exception of certain strategic industries.^[42] This policy was generally opposed by the Baghdad ministries and as a result of ministerial delaying tactics, mismanagement, and corruption, none of the SOEs has yet been liquidated or privatized.

The lack of progress in reviving the market economy led U.S. commanders in Iraq to advocate a short-term solution of quickly reopening SOEs. These commanders believe that poor, unemployed young men were joining the insurgency both as a way of gaining status among their peers and as a source of spending money. If reopening the SOEs can provide these young men with incomes and status then their support for the insurgency will lessen—saving the lives of the coalition and Iraqi security forces. The commanders are well aware of the corruption and waste associated with the SOEs but their focus is on reducing the level of violence.^[43]

Under the lead of Deputy Undersecretary of Defense Paul Brinkley, an effort to reopen some of the SOEs has begun. The targeted firms formerly produced medical supplies, flour, ceramics, carpets, textiles and buses. It has been difficult both to raise financing and interest investors as well as to persuade other firms to purchase SOE products. As a result, progress has been slow during the first year of this program with fewer than twenty factories reopened, creating approximately 5,000 jobs.^[44]

Who is right in the Bremer-Brinkley state-owned enterprise (SOE) controversy? Brinkley is right that in the short-term rapidly providing jobs should reduce support for the insurgency. But this favorable impact requires that the jobs be forthcoming in a reasonable period of time. Despite many optimistic announcements, few new SOE jobs have been created in the first year of the program. Bremer is right that in the long-term a vibrant free market is more likely to provide enough jobs in the future for the large number of young Iraqis. But efforts to liquidate or privatize SOEs have stalled and, especially since the 2005 elections, the United States' ability to pressure the GoI into liquidation or privatization has decreased. The difficulty of coordinating economic development disputes such as the SOE debate reflect, in part, differences in organizational commitment to counterinsurgency in Iraq between the U.S. Departments of State and Defense.

The most obvious sign of the differences of commitment are the policies towards manning. To the Department of Defense (DoD), filling positions in Iraq (and Afghanistan) is the priority and orders to a war zone are difficult to refuse. Not only are most positions filled most of the time with an appropriately trained soldier, sailor, aviator or Marine; an expensive effort is made to ensure that these individuals don't depart the war zone until after their successors arrive in order to have a smooth transition.

The Department of State (DoS) and other U.S. agencies followed a different policy. Until November 2007, DoS personnel could refuse assignment to Iraq, tended to stay for shorter periods of time, and often left before their successors arrived. As a result, there was a continuing gap in the middle among non-military personnel in Iraq.

The heads of each Embassy section are first rate and some are the top experts in their field. And each section has some young people on one of their first assignments, but there is usually a shortage of mid-career DoS personnel. This gap in the middle made for unnecessary frustration in coordination between military and civilian personnel on restoring essential services and economic development. Embassy section heads tended to have overflowing inboxes since they often had no experienced personnel to whom to delegate decisions. And if a critical Embassy section was temporarily without a head then decisions are delayed until he or she can be

replaced, kicked upstairs to a more senior Embassy official, or made without effective Embassy input.

The shortage of DoS staff degraded the effort to rapidly establish effective Provincial Reconstruction Teams (PRTs). Among other priorities, the mission of the twenty-five PRTs is to help the provincial governments with economic development and meeting the basic needs of the provincial population. As Crocker stated in his testimony, these PRTs have a critical role in helping the Iraqi authorities rebuild communities when the shooting stops. Among the programs that PRTs are attempting to establish across Iraq are vocational training for the unskilled and microfinance to support the private economic sector.[45]

However, because of the inability of the DoS and other non-military U.S. departments to provide all of the qualified personnel required, the establishment of particular PRT were delayed or rendered less effective. Often military personnel with limited knowledge about providing essential services or facilitating economic development were assigned these responsibilities. Possibly more worrisome, the shortage of DoS personnel combined with DoS restrictions on travel inside Iraq gave some PRTs a “military face” that contradicted efforts to grow Iraqi civilian capabilities.

Fortunately, this situation has recently changed. Beginning on November 12, 2007, in the largest call-up of U.S. diplomats since the Vietnam War, the DoS began to assign people to Iraq. Supposedly, failure to accept such an assignment may result in sanctions including dismissal from the Foreign Service.[46] This should alleviate the problem of divergent manning policies between DoD and DoS.

What Should be Done?

The challenge is how to accelerate economic development in Iraq not only as part of the counterinsurgency effort but also to increase the living standards of the average Iraqi. Based on realities on the ground in Iraq as well as the increasing consensus of what is required for a successful counterinsurgency, there are several policies that should become priorities.

Pervasive corruption is the most serious roadblock to achieving stability, economic development and a democratic future in Iraq. Regardless of the blood and treasure expended, failure to reduce corruption to tolerable levels will doom efforts to build a new Iraq.

At the individual level, corrupt acts are inequitable. They allow some to avoid laws, regulations and practices that others must follow. Thus, corruption undermines the average Iraqi’s confidence that success results from individual effort, rather than from bribery or political connections. Further exacerbating the impact of corruption in Iraq is the symbiotic relationship between corruption and the insurgency. In addition, there is a growing body of research that corruption tends to have an adverse impact on a country’s economy.

Some commentators argue that, like sand after a desert storm, corruption permeates every corner of Iraqi society because it is part of the national culture. Therefore, the argument continues, efforts to eradicate corruption are doomed, and it is better to just learn to live with it. Eradication of corruption is impossible—no nation has ever achieved this goal. But the level and damage done by corruption is not static. In the absence of an aggressive anti-corruption effort, corruption in Iraq will steadily worsen. It would be ironic if so many coalition military and Iraqi people died to create a more perfect kleptocracy.

Experience in other countries transitioning from socialism to markets has shown that successful investigation, prosecution, and conviction of the worst offenders is necessary but not sufficient to substantially reduce corruption. Successful anti-corruption efforts require a coordinated effort incorporating better governance, reducing perverse economic incentives, increased rule of law, a

free press exposing the culture of corruption, and an aroused citizenry that is unwilling to accept the corruption status quo. In fact, Iraq has two advantages in its fight against corruption that many nations at similar levels of development lack: Literacy levels are relatively high and, within the memory of the older members of the community, Iraq was a relatively honest nation—widespread corruption seems to be a product of the last 35 years.

Complex interdependent national systems for providing essential services and establishing a framework for economic development during an insurgency are extremely vulnerable to both insurgent activity and intra- and international political disputes. Essential services and economic development should generally be provided using simpler redundant systems crafted to fit local conditions. These local solutions can be expected to be less efficient but more robust.

One joke that economists tell is that no economic statement that you make about Iraq can ever be completely wrong—whatever economic claim you make is true somewhere in Iraq and false somewhere else. Like many jokes, this one reflects part of reality. Success on the economic LLOs requires a keen awareness of local conditions along with flexibility of implementation.

The twenty-five PRTs provide this awareness. And the decision to provide PRT leaders with their own pot of funds to leverage the rebuilding of institutions after the shooting stops (or at least slows) should allow the needed flexibility.^[47] High oil prices combined with daily oil exports recently exceeding 1.7 million barrels a day mean that current Iraq reconstruction and economic development efforts are no longer constrained by a shortage of funds. However, limited management capacities at the provincial and local levels of government make it very difficult to spend on restoring essential services or facilitating economic development without excessive corruption and waste.

Of course, for the PRTs to provide credible advice and guidance based on an accurate knowledge of local conditions requires not only that PRT positions are filled with qualified people but also that security requirements are flexible enough to allow PRT personnel daily contact with their Iraqi counterparts. While the DoS's recent decision to direct personnel to Iraq assignments will probably take care of the first requirement, solving the second problem, establishing a security protocol that will allow regular contact with Iraqi counterparts, is likely to be more difficult. This difficulty is exacerbated in view of the controversy surrounding Blackwater USA, one of the three largest DoS security contractors in Iraq.

But in the long-run, success in the economic LLOs is primarily dependent upon continuing improvement in the security environment. If security continues to improve then the argument over the best way to provide essential services and economic development will continue. But if security deteriorates then even the best crafted economic policy will fail. Whether security progress will continue is the great unknown. As General Petraeus stated: "In fact, our experience in Iraq has repeatedly shown that projecting too far into the future is not just difficult, it can be misleading and even hazardous."^[48]

About the Author

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3. Baker and Hamilton, [Op. Cit.](#), xvi.
4. Robert Looney, "[Beyond the Iraq Study Group: The Elusive Goal of Sustained Growth](#)," *Strategic Insights* VI, no. 2 (March 2007), 1.
5. "[Statement of Ambassador Ryan C. Crocker, United States Ambassador to the Republic of Iraq, Before a Joint Hearing of the Committee on Foreign Affairs and the Committee on Armed Forces](#)," September 10, 2007, 1.
6. Whether this is in fact a "new" view is subject to controversy. The prescient Marine Corps [*Small Wars Manual*](#) (1940) emphasizes the importance of providing essential services and economic development in a successful "small war." In 2003, many Marine Commanders brought their well-thumbed copies of the *Small Wars Manual* to Iraq. .
7. "[Statement of Ambassador Ryan C. Crocker](#)," [Op. Cit.](#), September 10, 2007, 6.
8. U.S. Army, [*Counterinsurgency Field Manual*](#), U.S. Army Field Manual 3-24, Marine Corps Warfighting Publication No. 3-33.5, Paragraph 2-5, 55. Italics added by the author.
9. The Iraqi real GDP data for 1950 through 2002 is from Table 5c of Angus Maddison (2003), *The World Economy: Historical Statistics*, 186. This data is presented in 1990 international Geary-Khamis dollars. The author's extension to 2007 is a rough approximation based on adjusting real GDP growth as reported by the IMF by estimated population change.
10. Willy Sutton, who spent half his life in jail for robbing over 100 banks in the early 20th century, was supposedly asked why he kept robbing banks. He responded: "because that's where the money is."
11. "[Statement of Ambassador Ryan C. Crocker](#)," [Op. Cit.](#), September 10, 2007, 4.
12. Bureau of Near Eastern Affairs, U.S. Department of State, [*Iraq Weekly Status Report*](#), September 26, 2007, 21.
13. U.S. Government Accounting Office, [*Securing, Stabilizing and Rebuilding Iraq*](#), September 2007, 64.
14. International Monetary Fund, "[Fifth Review Under the Stand-By Arrangement](#)," July 18, 2007.
15. Exports of primary products such as petroleum tend to lead to an appreciation of the exchange rate. Higher exchange rates make exports more expensive and imports cheaper. Thus the prospects of non-primary exports are diminished. Named after impact of gas exports on the manufacturing exports of the Netherlands.

16. *Asharq Al-Awsat* (Arabic language newspaper), "Iraq Central Bank Governor, Sinan Al-Shabibi Talks to Asharq Al-Awsat," July 29, 2007.
17. International Monetary Fund, "[Executive Board Concludes 2007 Article IV Consultation with Iraq](#)," August 14, 2007, Public Information Notice No. 07/103, 2 and 5.
18. "[Statement of Ambassador Ryan C. Crocker](#)," Op. Cit., September 10, 2007, 6.
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20. David H. Petraeus, General, "[Report to Congress on the Situation in Iraq](#)," September 10-11, 2007, 2.
21. Transparency International, "[Corruption Perceptions Index 2007](#)," online at: www.transparency.org.
22. In 1930s Chicago it was said that you knew who the honest judges were because, "Once you have bought an honest judge, he stays bought." One source of the increased corruption related uncertainty in Iraq is that even after bribes are paid, the promised service by the government official is often not provided—the judges don't stay bought.
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24. Rahdi Hamza al-Rahdi, "Testimony to the House Committee on Oversight and Government Reform on the Status of Corruption in the Iraqi Government," October 4, 2007.
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26. International Monetary Fund, "[Staff Report for the Article IV Consultation](#)," July 18, 2007, Table 9, 33. The conversion from dinars per liter to dollars per gallon was made by the author.
27. Brookings Institution, "[Iraq Index](#)," October 1, 2007, 47.
28. For example, see Aymo Brunetti and Beatrice Weder, "A Free Press is Bad News for Corruption," *Journal of Public Economics* 87, nos. 7-8, 1801-1824.
29. U.S. Army, *Counterinsurgency Field Manual*, U.S. Army Field Manual 3-24, Marine Corps Warfighting Publication No. 3-33.5, Table 8.2, 272.
30. U.S. Army, [Counterinsurgency Field Manual](#), U.S. Army Field Manual 3-24, Marine Corps Warfighting Publication No. 3-33.5, para 8-49, 278.
31. "[Statement of Ambassador Ryan C. Crocker](#)," Op. Cit., September 10, 2007, 6-7.
32. *Ibid.*, 6.
33. Brookings Institution, "[Iraq Index](#)," Op. Cit., 40.

34. "[Statement of Ambassador Ryan C. Crocker](#)," Op. Cit., September 10, 2007, 5.
35. Brookings Institution, "[Iraq Index](#)," Op. Cit., 22.
36. U.S. Army, [Counterinsurgency Field Manual](#), U.S. Army Field Manual 3-24, Marine Corps Warfighting Publication No. 3-33.5, para. 1-148 to 1-151, pages 47-51.
37. Also sometimes referred to as the Paul-Paul controversy for L. Paul Bremer and Paul Brinkley.
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40. World Bank, "[Doing Business 2008](#)," September 2007.
41. [Ibid.](#), 42.
42. [Iraqi Development Strategy](#), XXX
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