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Exploring The Structural Problems With Iraq’s Economy, Interview With Lehigh University Prof. Frank Gunter

Iraq’s economy is based upon a contradiction. It has huge natural wealth with its petroleum reserves that are being developed, and provides most of the country’s revenues. At the same time that industry hardly provides any jobs. That is a classic dilemma posed by the oil curse. To help explain this issue and others that the issue is Lehigh Professor of Economics Frank Gunter. Previously, Prof. Gunter was the lead economist to the U.S. military in Iraq from 2005-2006 and 2007-2009. And he is the author of The Political Economy of Iraq: Restoring Balance in a Post-Conflict Society (Edward Elgar Publishing, 2013).

1. Iraq is a classic example of the oil curse. Can you briefly explain what that theory is and how it applies to Iraq?

The oil or natural resource curse — also known as the paradox of plenty — concerns developing countries whose economies are dominated by the production and export of a single natural resource. Such countries tend to have worse economic and political outcomes than countries with more diversified economies. Iraq is seriously vulnerable to the oil curse. Not only is it the most oil-dependent country among the Middle East and North Africa (MENA) countries, Iraq is the most natural resource dependent country in the world. Oil production and exports account for roughly two-thirds of the country’s GDP and provide almost 95% of government revenues.

One aspect of the oil curse is the Dutch disease where a large value of exports leads to an appreciation of a country’s currency. In Iraq, the dinar has appreciated about 20% since December 2005, which reduced the competitiveness of the country’s non-oil exports and contributed to a flooding of the Iraqi economy with cheap imports.

Also, the large and growing revenues from oil exports have not only allowed the Iraqi government to increase the number and compensation of government workers but also oil wealth has fundamentally changed the relationship between the government and the people. Concentration of economic power tends to lead to concentration of political power. If the party that controls the government also controls the economy then those in power begin to believe that choosing the national leadership is too important to entrust to the voters.

There is also an important psychological effect. In most long-lived democracies, the major source of government revenue is tax receipts. People in such countries feel that they are “buying” government services and if the government fails to provide, at reasonable cost, the services demanded by the taxpayer-citizens then they will attempt to “hire” the government through the ballot box. But in Iraq, the government doesn’t need to tax citizens. Cynically, the primary role of Iraqi citizens is to receive — and be grateful for — whatever level of service that the government decides is appropriate. In this sense, Iraqi citizens are not independent entities that support the government. Rather they are symbolically, and often in reality, clients of a “beneficent” government. As Samuel P. Huntington stated in 1991: “No taxation without representation” was a political demand; ‘no representation without taxation’ is a political reality.

Iraq might best be described as having partially evolved from Saddam-era central planning to state-guided capitalism in which government tries to guide the market by supporting particular industries that it expects to become ‘winners’ or that are important sources of employment. But, if oil continues to dominate the economy, there is a real danger that Iraq’s state-guided capitalism is only a way station to becoming an oligarchic/communist state — like most of the other countries in the Arab Middle East — in which the bulk of the power and wealth is held by a small group of individuals and families. Despite wealth from natural resources, such oligarchic capitalist states tend to have great income inequality, sluggish growth, large informal or underground sectors, and massive corruption.

2. You’ve argued that failure to develop the economy away from the oil industry is a national security issue for Baghdad. What kinds of risks are involved if Iraq doesn’t break away from its oil dependency?

In the absence of economic diversification, there are both short-term and long-term threats to political stability. Due to the dominance of oil revenues in the national budget, government capital expenditures are on a roller coaster of world oil prices. When oil prices are high as in 2008 and 2011-2013 then the government can expand the number of civil service jobs, increase wages and pensions, increase spending on the social safety net and essential services, as well as accelerate infrastructure investment. However, during years of lower oil export revenues such as 2009-2010 then the government responds by slashing capital expenditures in order to preserve funds for...

current expenditures such as the government’s wage bill.

Since public investment accounts for over 90% of total fixed capital formation when the government cuts such investment in response to lower oil prices, the effect is serious. Most infrastructure and other investment in roads, electricity, schools, clinics, water supply, etc. now or grinds to a stop. Partially completed multi-year building projects are abandoned for months or years until investment spending is restored in a future budget. When projects are restarted, it is often discovered that previous work must be redone due to looting, vandalism, environmental damage, or plan revisions. This waste and delay tend to have the most serious impact on private sector firms and workers resulting in increased unemployment. As discussed below in response to another question, this rise in unemployment threatens political stability.

3. Baghdad says that it is committed to diversifying the economy and promoting the private sector. The country consistently ranks as one of the worst business environments in the world however. What kind of regulatory barriers do entrepreneurs face, and how might that be solved?

MENA countries are not known for their friendliness towards private businesses, Iraq is one of the worst in the region. It ranks 176th in the world with respect to the World Bank’s Ease of Doing Business survey. It is particularly difficult in Iraq to legally start a business, get credit, or engage in international trade. And in one category, closing a business, Iraq ranks dead last. Considering the competition from sub Saharan Africa, this is quite a dismal achievement.

Ever since the first post-Saddam National Development Strategy of 2005, the importance of diversifying the economy has been recognized. Unfortunately, while the economic necessity of diversification is strong, the political will to make the difficult decisions is weak. It is important to recognize that the regulatory hostility towards the private business sector in Iraq is not an unforced act of the Saddam era but rather is carefully maintained by the leadership of the bureaucracy. The great regulatory complexity and expense provides strong incentives for businessmen to offer bribes to help government officials. Also, harsh regulation of private businesses reduces competition for the state-owned enterprises. These state-owned enterprises tend to be high cost/low quality producers.

What can be done? Iraqi government efforts to rewrite its own commercial code will probably take more than a decade and will provide multiple opportunities for officials to extract bribes in return for inserting clauses favorable to one group or another. The World Bank and other international organizations can provide a “model” commercial code that Iraq could adopt. However, there is Iraqi concern that to adopt a “western” code would be inconsistent with the business structures of Islam. Probably the most practical option would be for Iraq to adopt with minor modifications, the commercial code of another Islamic state such as the UAE.

4. If Iraq were ever able to build up a vibrant private sector how would that contribute to stability in the country?

In the long-term, Iraq must deal with a severe demographic challenge. Unlike Iran, its neighbor to the east, which is experiencing a demographic collapse, Iraq still is a young country with a high fertility rate. As a result, even after adjusting for the low labor force participation rate of women in Iraq, the number of new job seekers is expected to grow by at least 250,000 this year and even more in the future. And this is in a country where the combined unemployment and underemployment rate among the young is already an estimated 80%. The experience of other low-income countries is clear: a rising number of permanently unemployed young men is politically destabilizing.

Moreover, Iraq must create enough jobs to not only absorb this annual increase but also shrink the pool of current unemployed and underemployed. It is unlikely that increased public sector employment will be sufficient. Public sector entities are already severely overmanned. In addition, in the absence of a sharply higher oil export earnings, the public sector will be hard pressed to achieve its current infrastructure investment goals much less substantially increase government employment.

In developing countries, most jobs are created by new small private businesses engaged in services and light manufacturing. Of the three institutional requirements for such job creation – favorable regulatory environment, available small business finance, and widespread literacy – Iraq only has the third. In addition to regulatory hostility, the banking system is narrow and while microfinance still reaches relatively few Iraqi businesses.

5. You’ve argued that the new Iraq has led to “entrepreneurial corruption.” Can you explain what that means?

If corruption is the abuse of public power for private gain then, under Saddam, corruption in Iraq was controlled from the top in a classic case of “state capture”. It was expected that Saddam, his family, or his supporters would financially benefit from every public and private economic activity. As a result, corruption under Saddam differs in at least two ways from that in post-Saddam Iraq. First, Saddam’s family and his immediate ring of supporters captured a large proportion of the total gains from corrupt activities. While lower levels of government were corrupt, they captured a smaller proportion since Saddam and his immediate supporters were careful to ensure that lower levels of the bureaucracy didn’t divert flows of corrupt money from reaching the top. Second, under Saddam corruption was more “honest” – honest in the ironic sense of the old Chicago joke about an “honest judge” who, when he accepts a bribe, actually performs the service that he was hired to perform!
In post-Saddam Iraq, gains from corruption are more widely distributed. While the top levels of the Iraqi government tend to be very corrupt, they seem to be less able or willing to constrain corruption at lower levels of government. Post-Saddam corruption is more widespread and competitive, in a sort of "entrepreneurial" way. Government officials at all levels are creatively engaged in sometimes cooperative, sometimes competitive efforts to extract maximum rents from not only private persons but also from other branches of the country's bureaucracy. As a result of this entrepreneurial corruption, bribe takers tend to be more "honest"; corrupt members of the bureaucracy are often unable to actually provide the services for which they accepted bribes.

It is likely that, although Saddam and his supporters were able to steal a larger proportion of the nation's income, current entrepreneurial corruption imposes a more serious burden on the Iraqi people because of the increased uncertainty resulting from entrepreneurial corruption.

6. Another side effect of the bureaucracy and corruption is the growing and vibrant underground economy. What is that sector like?

Private businesses in Iraq must choose between seeking to become a legal enterprise, which due to regulatory hostility is a difficult and expensive process, or operating in the underground economy with all of the associated inefficiencies. One characteristic common to both options is the necessity of paying bribes to a long line of corrupt officials. One survey of corruption in Iraq showed that one-fifth of private businesses reported paying 40% or more of their firm's total revenues in bribes.

Excluding agriculture, an estimated 6% of the labor force is employed by private legal enterprises while 20% is employed in the underground economy. Firms in the underground economy tend to be small-scale, engaged in services or light manufacturing. In many cases, underground enterprises are engaged in illegal activities such as selling black market fuel or smuggling across Iraq's long open borders. However, other underground firms are engaged in other legal activities that are concealed to avoid the choice of tempting auditors or paying bribes to inspectors to ignore violations. As expected, workers in the underground economy lack legal protections and there are stories of workers being denied pay or even physically abused. Generally, firms in Iraq's underground economy are very efficient. This inefficiency arises not only from the usual small-scale production but also from the necessity of operating in such a way as to avoid coming to the attention of rapacious officials.

7. Iraq's economy also suffers from political interference. How have politicians attempted to manipulate and control the economy for their own gain?

Most politicians in Iraq -- like everywhere else -- seek to do the right thing for their country as long as it doesn't injure their own self-interest. Just because a person has been elected or appointed to a responsible government position, doesn't make him or her more virtuous. And like in other countries, politicians in Iraq manipulate the economy to achieve a better life for themselves in at least two ways.

First, as discussed above, politicians engage in corrupt activities and some have succeeded in stealing vast amounts for themselves and their families through such illegal activities.

Second, politicians can personally benefit through activities that, although they are not illegal, have an adverse effect on Iraqi economic development. A major source of status and political influence for politicians in Iraq is their control of large numbers of government jobs. It is irrelevant that a ministry in incredibly ineffective or that a state owned enterprise is a low quality/high cost producer of a good or service; what is important for the status of a high level government official is the number of jobs that they control. As a result, the ministries and state owned enterprises tend to be seriously overmanned. As one example, the Iraqi publicly owned railroad industry has over 10,000 employees running a system that in other countries would require one-fourth to one-tenth as many. And that is true with other state owned enterprises, these workers can not be fired for failure to perform their assigned tasks to expected standards or even have their pay docked for failure to show up for work.

Proponents of excessive ministerial and state owned enterprise employment argue that it reduces political instability by providing jobs for unskilled young men. However, expanded government employment in Iraq may actually be destabilizing. It is not uncommon for a state owned enterprise or ministry to be "captured" by a religious sect, party, sect or tribe as a means of providing funding for the organization as well as jobs for its members. Thus government employment can be destabilizing by supporting - with government funds - members of political parties or other groups that may be in opposition to the rule of law.

8. Iraq has huge needs in terms of its infrastructure and services, and that is drawing in increasing amounts of foreign investment. Do you think that these foreign companies can help diversify the economy and help the private sector grow?

To date, almost all of the foreign direct investment (FDI) flowing into Iraq has been associated either with one of the ministries or one of the almost 200 state owned enterprises. In other words, very little of this investment is purely private. Association with a government agency has both advantages and disadvantages. A government partner can help cut through bureaucratic red tape especially with respect to bringing capital equipment and key personnel into Iraq. In addition, having a government partner can reduce the demands for bribes.

However, the government partner probably expects to benefit from the relationship with the foreign investor in ways that may not be clearly delineated in a partnership agreement. Several examples might illustrate this expectation. One European corporate investor agreed not to fire any workers in a severely overmanned Iraqi factory. Apparently, the foreign firm thought that it could gradually reduce the workforce through attrition until it reached efficient levels. However, the Iraqi government partner not only demanded that a new worker be hired to replace each one who departs but also that the government agency alone should select the new workers. As discussed above, this demand reflected what the government agency saw as political reality that the agency’s influence in Baghdad was a function, in part, of the number of jobs that it provides for Iraqis. Another example involved a foreign hotel management company that was informed rather late in contract negotiations that the rooms on one floor of the hotel would be reserved for the sole use of the Iraqi government partner without payment although it was expected that the foreign management company would be responsible for maintaining these rooms.

As long as most foreign investment continues to take the form of partnerships with public entities, it will have little effect on the degree of economic diversity in the Iraq economy.

9. What direction do you see Iraq moving in the future? Will its private sector eventually start to grow or will it remain oil dependent with a large state-sector or something in between?

Over the next decade, Iraq’s future will be determined to a great extent by the degree to which the civil war in Syria on Iraq’s western border and the dispute over nuclear sanctions between Iraq’s eastern neighbor, Iran, and the west affect Iraq. So far these two disputes have had an adverse impact on Iraq’s political stability as well as greatly complicated economic policymaking but—surprisingly—these ongoing conflicts seem to have a favorable effect on Iraq’s real economy. However, the price of oil will remain the dominant determinant of economic development and political stability in Iraq for the next decade.

In 2012, the U.S. Energy Information Administration estimated three price scenarios for 2025: a high scenario where the world price of oil is $180 per barrel (pb), a reference scenario of $120 pb, and a low scenario of $50 pb.

The impact on Iraq of $180 pb in 2025 will probably be mixed. If Iraq is able to raise its exports to 10.0 mbpd then Iraq’s export earnings would reach $657 billion (in 2010 dollars) compared to $50 billion in 2010! With an expected population of 71 million, average per-capita income would reach about $16,000 (in 2010 dollars)—seven times greater than in 2010. This is about the same level of per capita income as Saudi Arabia had in 2010. With this massive increase in oil export earnings, everything would be possible: increased government employment and higher wages for government workers, sharp rises in investment, generous provision of free essential services, agricultural restoration, accelerated construction of homes, factories, and government offices. New soccer stadiums would appear in every town. The al Rahman Mosque in Baghdad would finally be completed. However, there would also be negative effects. There would be an explosion in corruption. Efforts to diversify the Iraqi economy away from its dependency on oil would probably grind to a stop. And, as discussed above, without diversification, Iraqi nascent democracy would be threatened.

At the other extreme, how likely is $50 pb oil? Increased petroleum and natural gas production from Iraq, the USA, and other countries; reduced energy demand from Brazil, Russia, India, and China; further improvements in energy conservation; and peaceful resolutions of the conflicts in Syria and Iran resulting in a reduction in oil risk premium could lead to a return of $50 pb oil. After all, adjusting for inflation, average oil prices were below this level for almost two decades from 1986 through 2005. The adverse impact on Iraq’s political stability of an extended period of $50 pb oil would be severe. The Iraqi government must earn at least $55 pb (in 2010 dollars) in order to pay its salary, pension, food assistance, and security commitments. There would be no funds available for infrastructure investment or expanded spending on internal or external security. If world oil prices fall below this level for a year or two then the government of Iraq would be able to pay for its basic expenditures by exhausting its Development Fund for Iraq reserves, about $18 billion at the end of 2012; by persuading the Central Bank to substantially revise its international reserves policy to make some of its $70 billion available for fiscal purposes and by taking advantage of the country’s limited access to world capital markets.

However, if there are more than two years of low oil prices then not only will there be rising levels of unemployment and underemployment but also the government will be forced to cut salaries and pensions. If Iraq’s past is any guide to its future, cuts in wages and pensions will cause the bureaucracy to turn against the government—undermining its policies, participating in street protests, and possibly engaging in violent acts. Losing the support of government workers and pensioners will increase the likelihood of a return of an authoritarian government—another Saddam or Saddam-lite.

To insure against this outcome, Iraq must define the resource curse by restoring balance—diversifying—its economy. Achieving such economic diversification will not only require difficult economic choices but also entail serious political risks. More than in any period since 1958, the future of Iraq is in the hands of the Iraqis. Over the next decade, Iraq will make—or fail to make—critical irrevocable decisions. Rich countries with long histories of stable government can afford to make stupid decisions. Iraq cannot.

**SOURCES**

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1 comment:

Steve Donnelly, AICP said...

Excellent overview and outlook.

At one point, the NDP recognized the need to restore domestic agriculture in order to: (1) develop employment, and (2) internalize the oil funds otherwise used to purchase foreign food.

The problem, as Prof. Gunter notes, is that oil keeps the Iraqi dinar high, discouraging internal markets, and encouraging imports. Unless strong tariffs and import controls, together with capital and agribusiness infrastructure, are essential (but, perhaps, too complicated to implement).

His notion of the conundrum between Iraq and Afghanistan is a compelling reminder; both, for opposite reasons, are not essentially conducive to typical democratic engagement (taxes, budgets) since Iraq’s government and economy are based on oil, and Afghanistan has no central government or money. Black markets abound for the most obvious and basic reasons—the only way distributive systems can and do work.

Thanks, again.

September 16, 2013 at 8:12 AM

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