

Reconstructing Iraq's Economy

To establish even a marginally functioning economy out of the wreckage of Iraq would have been a daunting task. Despite decades of a heavily controlled, state-run economy; the deterioration caused by a succession of wars; a decade of international sanctions; and the looting and sabotage that followed the 2003 war, the U.S. government set its sights high after toppling Saddam Hussein: to create a liberal, market-based Iraqi economy, a key piece of its broader goal to bring democracy to Iraq. Immediately after Saddam's ouster, Undersecretary of the Treasury for International Affairs John B. Taylor noted that the United States hoped to turn Iraq into a "well-functioning market economy that is growing, creating jobs, and is promising a future" for the Iraqi people.¹ Ambassador L. Paul Bremer III, the U.S. civilian administrator of Iraq, added in May 2003 that "Iraq is open for business."² Establishing a functioning market economy in Iraq is a cornerstone of the Bush administration's goals of bringing lasting prosperity to Iraq and creating a model that could lead to the spread of free markets throughout the Middle East. In addition, the United States hopes that a free-market Iraq will be a bonanza for U.S. companies, providing a wide-open market for U.S. investment.³

The challenge of remaking Iraq's economy is twofold: to transform a centralized economy into a market economy and to reconstruct a war-torn economy. In postconflict countries, the task of rebuilding the economy is one of the central challenges⁴ intimately connected with security, governance, and justice, as Iraq showed all too clearly in the first year of the occupation. Reconstruction projects were delayed and, in some instances, halted because of Iraq's dire security situation: civilian workers were under

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attack and often could not travel outside heavily fortified compounds; security and insurance costs ate away at the money available for programs; and sabotage of key infrastructure often destroyed ongoing projects. Foreign investors refrained from investing, citing the lack of a legitimate Iraqi government and an unclear legal situation. Yet, the problem is cyclical: a lack of economic opportunity only fuels social and political instability.

Prior to the U.S. transfer of sovereignty to an interim Iraqi government on June 28, 2004, the Coalition Provisional Authority (CPA) implemented some major regulatory and legal reforms that could lay the foundation for a transition to a market economy and present a welcome climate for business in Iraq within the next several years. Yet, the long-term impact of those reforms remains uncertain for three reasons. First, security problems and political instability in Iraq will continue to hamper economic reconstruction efforts, delaying rebuilding efforts and discouraging foreign investment. Second, because the CPA was an occupying power, the status of its legal reforms after June 28 is uncertain. Third—and related to the second—the CPA pursued its economic program with minimal Iraqi input, calling into question whether an Iraqi government, particularly a representative one, will continue to pursue the CPA's goals and policies. Moreover, even if an Iraqi government respected the CPA's laws on paper, Iraq's institutions and enforcement mechanisms might not be strong enough to ensure their survival in practice in a country and region traditionally hostile to some of the changes the CPA imposed, such as allowing foreign ownership of Iraqi assets.⁵ Ultimately, it will not be the CPA's legal and regulatory reforms but rather what Iraq's new interim government and the transitional government to be elected next January do to usher in a market economy in the coming years that will be the real determinant of the future of Iraq's economy.

Out with the Old: Iraq's Economy under Saddam

Transforming Iraq into a market economy is particularly challenging because the features that made Iraq function as a command economy are precisely the opposite of those needed for a market economy. Iraq as a command economy lacked any of the legal, regulatory, political, and economic institutions that form the basis of market economies. Saddam's command economy had its relatively successful moments: Before 1990, Iraq was one of the more prosperous and economically advanced countries in the Arab world, boasting a sizeable middle class; technical capacity; and, compared to other Middle Eastern countries, relatively high standards of education and health care, as well as high numbers of women educated and contributing to the economy.⁶

Iraq's fortunes began to change, however, in the 1990s, particularly after the 1990–1991 Persian Gulf War, which followed closely on the heels of the Iran-Iraq War of the 1980s. The wars, compounded by the crippling international sanctions regime imposed by the United Nations after the Gulf War, seriously damaged Iraq's infrastructure and closed off Iraq's economy from the rest of the world. Since the early 1980s, Iraq's economic indicators had trended severely downward. Iraq's annual per capita income in the early 1980s was an estimated \$3,600; by 2001, it had dropped to \$770–1,000.⁷ Since 1980, Iraq had suffered absolute declines in its gross domestic product, chronic inflation, a depreciated currency, and a lack of foreign investment. Further, it had accumulated a crippling international debt burden.⁸

When the United States entered Iraq with grandiose plans to remake the economy in 2003, it had expected to find decent infrastructure; but the international community, including international financial institutions, had been largely absent from Iraq since the early 1990s, meaning there was little reliable data available about Iraq's economy. The Bush administration's unreasonably high expectations about the state of Iraq's infrastructure were but one example of its failure to plan and prepare adequately for the postwar phase in Iraq.⁹ In reality, the United States found an economy that essentially needed to be rebuilt from scratch, crushed by decades of wars, sanctions, and atrophy due to Saddam's neglect of the population's needs. Because the United States seriously underestimated the state of Iraq's economy, it did not plan adequately for key tasks such as restarting the power, supplying water, and creating jobs. Delays in addressing these needs, in turn, complicated U.S. efforts to win over Iraqis' hearts and minds, thus contributing to the violence that increased as the occupation wore on.

The problem is cyclical: a lack of economic opportunity fuels instability.

In with the New: CPA Efforts and Challenges

Notwithstanding this dilapidated infrastructure, the United States persisted in its efforts to transform Iraq's economy. Prominent economists criticized U.S. goals as too radical, portending problems along the lines of those experienced in eastern Europe and the former Soviet Union, where so-called shock therapy of privatization and institutional reconstruction took place in the 1990s.¹⁰ Despite these warnings, however, the CPA stuck to its plans to privatize Iraq's state-owned enterprises (SOEs) rapidly and open Iraq to for-

The interim and transitional governments will determine Iraq's economic future.

eign ownership and investment. The lack of economic opportunities and the political sensitivities surrounding Iraq's long-standing tradition of oil and food subsidies, combined with the reality that more than 60 percent of Iraq's population continues to rely on the government to meet its food needs, dictated that the United States put certain of its plans on hold, such as the rapid privatization of Iraqi SOEs and the end of those oil and food subsidies.

The CPA enacted many radical reforms, however, that will fundamentally transform the nature of Iraq's economy, if maintained by an Iraqi government.

In practice, economic reconstruction in postconflict settings is dependent on providing basic security and law and order and can involve many different factors, including establishing a market-based financial system; developing a legal and regulatory framework; setting up functioning governing institu-

tions; privatizing SOEs; rebuilding critical sectors of the economy; providing basic services, including health care, education, power, and water; creating jobs; and normalizing relations with the outside world. The CPA undertook efforts in all these areas, but what made the CPA's efforts radical was its unusually early attention to reforming Iraq's financial sector and creating a business-friendly investment climate as well as the fact that it imposed significant legal reforms as an occupying power without the involvement of a legitimate Iraqi government.

Rebuilding Iraq's banking sector and financial system was a necessary part of resuming normal economic activity. It enables investment as well as capital allocation and movement throughout the economy and provides a consistent mechanism to pay salaries to civil servants, police officers, teachers, and health workers, among other critical service providers. The CPA drafted a modern, commercial banking law to govern Iraq's private banks,¹¹ reopened the Central Bank and passed a law mandating its independence,¹² and opened a Trade Bank of Iraq to facilitate international transactions that existing Iraqi banks could not handle. The U.S. Department of the Treasury placed advisers in Iraq's interim Finance Ministry and ran classes on banking standards and technology for Iraqi bankers. All this marked a decisive departure, on paper, from banking practices under Saddam, where there were no independent banks and lending decisions were made on the basis of who you knew. Saddam dictated the policies of the Central Bank and state-owned banks; although there were some private banks, they held only a nominal amount of total bank assets in Iraq. The CPA made considerable

progress in reforming some of the outdated and corrupt banking practices of Saddam's days. Yet even under the CPA, Iraq still functioned as a cash economy, and most Iraqis continued to keep their money outside the formal banking system.¹³

In fact, implementation of the CPA's financial sector reforms progressed slowly. To encourage the infusion of technical knowledge and modern technology into the country, the Central Bank granted several foreign banks licenses to operate in Iraq in January 2004, but security concerns remained so serious throughout the U.S. occupation that not a single foreign bank had opened its doors by the time the CPA transferred sovereignty to an Iraqi interim government in late June.¹⁴ U.S. officials lauded initial steps taken toward establishing a modern legal and regulatory framework for the financial sector but acknowledged well into the occupation that such a framework was still lacking.¹⁵ There were allegations of serious corruption in the financial system. For example, news media and international nongovernmental organizations (NGOs) reported that government ministers were withdrawing money from ministry bank accounts for personal use.¹⁶ The CPA made some headway in establishing a framework for a market-based financial system, yet the ongoing political instability and nascent justice system in Iraq meant the mechanisms to enforce that framework were weak at best. Moreover, as discussed below, the lasting status of the CPA's reforms remains an open question.

The CPA also implemented significant reforms to make Iraq's commercial environment more business friendly. Probably the most controversial was CPA Order 39 of September 19, 2003, which reversed decades of Iraqi economic policy limiting investment in Iraq's state-owned assets to Iraqis and residents of other Arab countries. Order 39 permits 100 percent foreign investment and ownership in and management of Iraqi business entities except those in natural resource sectors (including oil), banks, and insurance companies.¹⁷ Iraqis expressed concern that Order 39 could lead to multinational firms wiping out Iraqi businesses.¹⁸ Outside observers worried that the "instant discarding" of Iraq's commercial culture could create serious distortions in Iraq's economy and that, in any event, the CPA lacked the legal authority to impose such radical reforms.¹⁹

In addition, the CPA abolished Saddam-era licensing requirements for trade as well as import and export tariffs and instead imposed a 5 percent "reconstruction" tax on most imports. Iraq's open borders and lax border security during the occupation resulted in little if any monitoring of goods entering or exiting the country. The CPA wrote new securities laws with the goal of opening a modernized Baghdad stock exchange. (Iraq's stock exchange opened for the first time since Saddam's fall on June 24, 2004.)²⁰

Prices were also liberalized, with the significant exceptions of food and gas prices, and the CPA replaced Saddam's tax rate of 45 percent with one that caps at 15 percent on personal and corporate income tax.²¹ The CPA modeled its tax code reforms on the experiences of other countries transitioning from controlled economies, such as Russia. Critics and proponents of the reforms alike labeled the 15 percent cap the flat tax that has long been the dream of fiscal conservatives in the United States.²² Saddam's government did not enforce tax collection, and it is difficult to believe that the new government will have much success in this task, especially given the high unemployment rates in Iraq and the active informal economy.

One of the CPA's most successful reforms was the transition from Iraq's two old currencies, the "Saddam dinar" and the "Swiss dinar" (used in northern Iraq), to a new Iraqi dinar. The security situation dictated that the new currency had to be delivered to banks across Iraq in heavily armed convoys, yet the CPA managed to organize the distribution of an estimated two billion pieces of new currency in the midst of a full-blown insurgency.²³ Iraqis have embraced the new currency, eager to see the last of their almost worthless old currency and use one that does not bear Saddam's likeness. The currency steadily appreciated after its introduction in January 2004, and inflation was kept in check.

Strong opposition among Iraqis and the threat of widespread rioting, however, forced the CPA to surrender some of its original goals, including the aforementioned elimination of subsidies on oil and food as well as SOE privatization. High unemployment rates, lack of food security, and long gas lines were just a few of the realities that led the CPA to reconsider its initial plans. Thus, rather than put hundreds of thousands more people out on the street without work by closing or privatizing the SOEs, the CPA instead paid SOE workers, even though most sat idle due to a lack of work and competition from abroad.²⁴ In the long run, eliminating heavy subsidies and privatization will be essential to turning Iraq into a market economy, but on these particularly sensitive issues, the CPA opted to let a sovereign Iraqi government take the lead (and the political heat).

Although the CPA did not carry out privatization and many of its other reforms also exist only on paper thus far, Iraq did become more hospitable to private-sector activity under the CPA. Local markets reopened and were bustling in Baghdad and cities around Iraq. Consumer goods flooded across the borders, and avid Iraqi consumers snatched up everything from satellite dishes and washing machines to electronics and earth-moving equipment. Middle-class incomes rose (although unemployment and underemployment remained high). Cellular phone service became available throughout Iraq, and telephone usage jumped. New shops, manufacturing firms, and Internet cafes

opened in Baghdad and other cities, and new construction was booming.²⁵ In fact, Iraq was called “the world’s leading country for pent-up demand.”²⁶

Nonetheless, security and political instability dampened international firms’ enthusiasm about investing in Iraq. Those international companies that did invest during the occupation tended to be from other countries in the region or were owned by Iraqi expatriates; most made only small-scale investments that will not provide the boost needed to reinvigorate Iraq’s economy. Most firms appeared to be holding out for a more stable security and political environment before making major investments. Despite efforts by the U.S. government to entice U.S. companies to the Iraqi market with a series of trade conferences, U.S. firms remained largely absent. The only one to make a major investment under the occupation was PepsiCo Inc., which invested \$100 million in its old soft-drink bottling plant in Baghdad.²⁷ Coupled with almost nonexistent bank lending, the lack of foreign investment meant that Iraqi businesses had difficulty securing the credit they needed to start or reopen business ventures.²⁸ The wide availability of cheap, often superior goods from abroad that flooded across Iraq’s open borders also squeezed out Iraqi businesses, which had been protected from international competition for years under Saddam.

Diversifying the economy will be an important part of Iraq’s economic revitalization.

The CPA’s efforts to restart the provision of basic services, particularly electricity and water, and the export and production of oil also lagged, seriously complicating efforts to revitalize Iraq’s economy. After Iraqis suffered through the hot summer months of 2003 with severely limited power, the CPA was finally able to return electricity production to prewar levels around October 2003, although delivery was still irregular, with several blackouts per day. The CPA had promised the Iraqis 6,000 megawatts of power by the summer of 2004 to meet peak demand levels. Continuing delays in fixing plants, sabotage on power lines, and cuts in oil production due to sabotage, however, meant that delivery remained stuck at an average of around 4,000 megawatts in late June 2004. With no signs of meeting the CPA’s goal, another summer of debilitating blackouts threatened.²⁹ The CPA’s efforts to fix water treatment plants were also behind schedule at the time sovereignty was transferred. Although water availability had by that point risen to around prewar levels,³⁰ Iraq—a country blessed with water—was still importing bottled water, and repairs of water supply systems remained months or years away.³¹

Finally, perhaps the most watched of the CPA’s economic efforts was restarting Iraqi oil production, the dominant sector of Iraq’s economy. As with

its efforts to restart the power, the CPA initially struggled to increase oil production to prewar levels of around 2.5 million barrels per day. When the CPA shut its doors, production hovered around two million barrels per day.³² This was enough to ensure a more regular source of revenue for Iraq's government through exports but not enough to meet domestic demand, thus necessitating that Iraq continue to import oil. Moreover, frequent attacks on Iraq's oil pipelines and power grid undermined the country's ability to export oil, key to Iraq's economic vitality. During the 14 months of the

occupation, sabotage attacks targeted Iraq's oil infrastructure an estimated 66 times, resulting in a loss of at least \$200 million.³³

U.S. government auditors, KPMG (the U.S. auditing firm hired by the international oversight board overseeing oil spending in Iraq), and the NGO Iraq Revenue Watch, among others, faulted the CPA for not transparently handling Iraq's oil revenues and U.S. reconstruction funds during the occupation.³⁴ According to UN Security Council Resolution

1483 of May 2003, the Development Fund for Iraq (DFI) was to store Iraq's revenues from oil, with the CPA as the occupying authority granted control over spending DFI resources. (Control over the DFI transferred to Iraq's interim government on June 28, 2004.) An International Advisory and Monitoring Board (IAMB) was established and charged with overseeing DFI revenues and spending, but it was slow to get off the ground, in part due to U.S. recalcitrance in approving its mandate. As a result, the IAMB did not review most of the CPA's oil-revenue spending decisions during the occupation.³⁵

The CPA also was criticized for focusing too heavily on the oil sector to the exclusion of other historically productive sectors of Iraq's economy, including agriculture and light manufacturing. Diversifying the economy will be an important part of Iraq's economic revitalization, as it will allow for the creation of an alternative tax base. Maintaining a single-source economy could enshrine class and economic divisions in Iraq.³⁶ Diversification will also be key if Iraq is to avoid the so-called resource curse, whereby natural resource wealth perversely increases a country's prospects of violent conflict, low economic growth, poor human-development indicators, bad governance, and human rights abuses.³⁷

In fact, the question of how Iraq handles its oil revenues is tied not only to its economic prospects but also to the development of democratic institutions. The CPA was pressed initially to devise a plan to distribute Iraq's oil revenue to the Iraqi population through an oil trust fund or some other

The CPA began to keep its success stories hidden for fear of creating insurgent targets.

mechanism, but it decided to leave this particular decision to Iraq's new leaders, probably as an acknowledgement of the heightened sensitivities surrounding U.S. intentions for Iraqi oil. The resolution of these questions will determine whether Iraq can avoid the resource curse, prosper economically, and flourish as a democracy.³⁸

When the CPA transferred power to Iraq's interim government, it left behind a framework of laws, regulations, oversight commissions, and new institutions that could undergird the development of a market economy in Iraq. Yet, its reforms existed largely on paper, left to a fledgling Iraqi government to enforce in the face of possible antipathy to the CPA's initiatives (not to mention their questionable legal status). The security situation threatened to continue to undermine economic efforts; infrastructure projects had already been significantly delayed. Moreover, public services were still spotty, and Iraqis desperately needed jobs. These were the central issues confronting Iraqis in the summer of 2004, not the possibility that Iraq might become a market economy some day in the future.

The Road Ahead: Rocky, or Paved with (Black) Gold?

The myriad problems that impacted both the CPA's rebuilding efforts and investors' interest in the Iraqi market have made the long-term effect of the CPA's economic efforts unclear. Security and political stability, legal certainty, and Iraqi buy-in—all which remained unanswered questions in late June 2004—will determine whether the CPA's efforts will lead to realization of U.S. goals in Iraq and the economic revitalization that would mean greater prosperity for the Iraqi people.

SECURITY AND POLITICAL CONCERNS

The sabotage of economic projects and the overall dire security situation that characterized the CPA's stay in Iraq undercut economic efforts across the board. The CPA transferred power to Iraqis amid a full-blown insurgency. Not only did regular attacks on U.S. forces continue throughout the country during the CPA's tenure, but by the spring of 2004, Iraqi and international civilians, including aid workers and contractors engaged in rebuilding infrastructure, were also being attacked.

Persistent hostilities and attacks on foreigners made traveling around the country to reconstruction project sites difficult for coalition officials and contractors, delaying the completion of work. By the time the CPA transferred power, most foreigners rarely ventured from heavily fortified compounds and then did so only with a heavy private-security presence. Some

countries and companies pulled their workers out of Iraq altogether in response to the attacks. For example, Germany and Russia pulled power companies out of Iraq after attacks on their workers during the spring of 2004. South Korea pulled all its civilians out of Iraq after a South Korean aid worker was kidnapped and beheaded by Islamic terrorists in June.

The sabotage of key infrastructure by Iraqi insurgents became so common during the occupation that the CPA began to keep its success stories hidden for fear of creating further targets. In May 2004, for example, the CPA did not publicize the fact that Bechtel had managed to start sewage treatment in Baghdad for the first time in 10–15 years.³⁹

Without a radical reduction, debt servicing will tie up Iraq's oil revenues.

On the other hand, the private security business thrived. Private contractors providing security in Iraq numbered an estimated 20,000 in early June, making international private-security firms the second-largest contributor of “troops” after the United States. Dozens of new security firms cropped up to meet the demand for security needs. Some were hired by the U.S. government to protect U.S. civilians in Iraq or to carry out

military-related tasks; others were hired by private contractors to protect their employees working on reconstruction projects.⁴⁰ This need for private security to protect international contractors working in Iraq ate away at U.S. reconstruction funds available for Iraqi projects. The CPA had originally anticipated that about 10 percent of the \$18.6 billion appropriated by Congress for Iraq's reconstruction would fund security costs; in June, Deputy Secretary of Defense Paul Wolfowitz testified before Congress that 10–15 percent of project costs were going to a “security tax.”⁴¹ Contractors working in Iraq claimed the reality was closer to 20–25 percent.⁴² Some estimated that insurance and security-related costs for personnel in Iraq totaled more than 50 percent of their operating costs.⁴³ Whatever the actual figure, security needs meant considerably less money was available for economic reconstruction projects.

The uncertain political situation in Iraq also dampened foreigners' investment appetites, donors' willingness to engage, and the CPA's ability to implement long-term economic reforms. While Iraq was under occupation, many companies were simply unwilling to make major investments, preferring to wait until the country had a legitimate, permanent government. Companies considering substantial, long-term investments, such as in the oil sector, deliberately put their decisions on hold until a sovereign government was in place. The World Bank and International Monetary Fund ab-

stained from lending to or investing in Iraq under the occupation, arguing that their constitutions prohibit involvement in a country lacking a sovereign government. Bilateral donors other than the United States and the United Kingdom were hesitant to provide assistance funds over which the CPA would have control. Thus, in Madrid at the October 2003 International Donors' Conference for the Reconstruction of Iraq, donors established a World Bank–run trust fund—the International Reconstruction Fund Facility for Iraq—to enable them to provide money for reconstruction efforts through an international fund outside the CPA's purview.

Similarly disconcerting for the longer-term prospects of Iraq's economy, corruption is rampant and ingrained. In part, this is a vestige of the Saddam era, where a thriving black market took root. A new brand of corruption sprang up in post-Saddam Iraq, however, with allegations that corruption in Iraq in the form of unfair contracts, price gouging, and kickbacks was consuming up to 20 percent of U.S. reconstruction funds.⁴⁴ The CPA was generally unable to oversee Iraqi government spending to prevent corruption because CPA officials were holed up inside the high-security Green Zone in Baghdad. The CPA enacted anticorruption measures, such as establishing a Board of Supreme Audit, a Commission on Public Integrity, and the post of inspector general in each government ministry. Most were adopted in the CPA's waning days, however, and it is not at all clear whether they will meet their mandates, given the country's unfamiliarity with government transparency or accountability and the daunting task of instilling both in the absence of law and order.

Iraq's enormous international financial burden also hovers ominously over any discussion of the Iraqi economy's long-term prospects. Iraq is estimated to owe \$120 billion in debt to international lenders.⁴⁵ Although Iraq's creditors have pledged to work toward a substantial reduction of that overall burden, the United States and other creditor nations continue to disagree about how much they are willing to forgive. Without a radical reduction, debt servicing will tie up Iraq's oil revenues.⁴⁶ Moreover, Iraq's overall financial obligations include tens of billions of U.S. dollars in Gulf War reparations claims, which already consume 5 percent of Iraq's oil revenues under a system enshrined in multiple UN Security Council resolutions. Uncertainty over how these debts and claims will be resolved clouds Iraq's economic future and will continue to make investors squeamish.

Even after the Iraqi interim government obtained power, it was not clear that investors or donors would immediately reconsider engaging in Iraq. For one, given continuing U.S. influence over major policy decisions and uncertainty about whether the Iraqis would accept the new government as legitimate, questions remained about the government's sovereignty and authority.

Security problems compounded concerns about the capacity of the fledgling government to withstand Iraq's spiraling into chaos. According to Iraq's interim constitution and UN Security Council Resolution 1546, elections for a transitional government are to be held no later than January 2005. Endemic insecurity, however, threatens to delay the UN's ability to organize elections by that date, adding further murkiness to the political scene in Iraq.

LEGAL UNCERTAINTY

Legal uncertainty has thrown yet another cloud over investors' outlooks and the viability of the CPA's economic efforts. International law experts have argued that the CPA overstepped its authority as an occupying power in implementing some of its more radical economic reforms, particularly Order 39, which permits 100 percent foreign ownership in Iraqi assets for the first time in Iraq's history. Such arguments were reinforced by Resolution 1483, passed in May 2003, which confirmed the CPA's status as an occupying authority and reiterated its obligation to abide by the Hague Regulations of 1907 and the Geneva Conventions of 1949.⁴⁷ Article 43 of the Hague Regulations calls on the occupier to "reestablish and ensure, as far as possible, public order and safety, while respecting, unless absolutely prevented, the laws in force in the country."⁴⁸ Article 64 of the 1949 Geneva Convention similarly sets forth that an occupying power must respect the laws in force in the occupied country unless they "constitute a threat to [the] security" of the occupying power or present an obstacle to the enforcement of the Convention. It stipulates limited conditions under which an occupier is entitled to make reforms in the occupied country: "to fulfill its obligations under the present Convention, to maintain orderly government of the territory, and to ensure the security of the Occupying Power."⁴⁹

Former U.S. ambassador-at-large for war crimes David Scheffer has argued that occupation law was the wrong model for postwar Iraq, given that the United States set out to accomplish a transformation of Iraq's political and economic structure. That law "was not designed to transform society. It permits tinkering at the edges of societal reform, but it is not a license to transform."⁵⁰ Other experts have described an occupier's powers as having been "liberally interpreted to allow economic reforms that would improve living standards in the occupied country. But there is much less precedent for enacting irreversible reforms that could not be undone by future governments, such as selling off immovable government-owned property."⁵¹ In essence, the law of occupation mandates that an occupier is to protect the status quo, in so far as practicable and with certain limited exceptions; it does not bestow authority to fundamentally transform a country's basic structures. The CPA, however, set about to transform Iraq's

economy radically, repealing Saddam-era laws and passing new laws that will, if respected by future Iraqi governments, overhaul Iraq's economic history and traditions.

The CPA contended that it was entitled to undertake drastic reforms because improving Iraq's economy was intricately linked to the coalition's security efforts. It also argued that Resolution 1483 provided the legal basis for its economic actions because it called on the CPA to "promote the welfare of the Iraqi people through the effective administration of the territory including in particular working towards the restoration of conditions of security and stability."⁵² The CPA's counsel, Scott Castle, argued, "We believe the CPA can undertake significant economic measures in Iraq particularly where those measures support coalition objectives and the security of coalition forces. There's a close nexus between the economic health of Iraq and the security of Iraq."⁵³ Yet in passing laws such as Order 39, the CPA's intent appears to have gone beyond force protection or security needs. This was an attempt to transform Iraq's economic landscape and set up a framework for a Western-style market economy, rather than just stabilizing the economy for security purposes.

Occupation law does not grant authority to fundamentally transform a country.

The possible illegitimacy under international law of some of the reforms may not in and of itself dissuade foreign investment in Iraq. It is likely to increase wariness about acting on the basis of the CPA's laws, however, particularly for companies considering significant investments in Iraq.

In fact, the status of the CPA's laws generally remains uncertain post-June 28. Iraq's interim constitution, the Transitional Administrative Law (TAL) passed in March 2004 by Iraq's Governing Council, sets forth that CPA laws, regulations, and orders are to remain in force after the transfer of sovereignty unless a duly enacted piece of legislation rescinds or amends them.⁵⁴ Iraq's new interim government might encounter difficulty passing such legislation in light of its mandate as laid out in Resolution 1546 of June 8, 2004 and its lawmaking authorities as spelled out in the TAL and its annex. According to Resolution 1546, the interim government is to refrain from taking any actions that will affect Iraq beyond the interim period, which is to last until elections for a transitional government are held no later than January 2005.⁵⁵ An elected Iraqi government, however, could (and might) choose to rescind or amend CPA laws, thus discouraging investors from making decisions on the basis of such laws, at least until a permanent government and constitution are in place, which, according to the TAL, is slated to occur by the end of 2005.

Complicating matters further, Resolution 1546 makes no mention of the TAL, in deference to strong Iraqi Shi'a opposition to certain provisions. Iraq's interim prime minister has pledged to honor the TAL until an elected government comes to power, and an annex to the TAL, passed on June 1, 2004, states that the interim government is to operate under the TAL. The annex maintains that the interim government may only pass a law, including a law to amend or overturn the CPA's laws, if the interim Council of Ministers agrees to it with the unanimous approval of the president and the two vice presidents.⁵⁶ The United States, though, was worried enough about the continuing applicability of the CPA's orders after June 30 that it chose in late June explicitly to extend Order 17, which grants U.S. troops and civilians immunity under Iraqi law.⁵⁷

Even assuming that all this uncertainty is resolved in a manner that satisfies potential investors, Iraq's legal and regulatory system remains nascent at best, raising other concerns, such as the ability to enforce contracts entered into in Iraq.⁵⁸ Moreover, Iraq has no effective system of property rights, with deeds and titles either unclear or nonexistent. Both contract enforceability and a system of property rights are critical to investors, who need to ensure that their investments will be protected and property rights recognized.

FOR THE IRAQI PEOPLE ... BY THE IRAQI PEOPLE

In addition to passing new laws and regulations, the CPA's economic strategy included specific efforts to jump-start economic activity in Iraq, including using U.S. reconstruction funds to rebuild infrastructure, create jobs, and capitalize the Iraqi economy. The United States hoped to revitalize the economy in the short to medium term by pumping in large amounts of reconstruction assistance that would have led to the creation of Iraqi jobs, increased business opportunities for Iraqi firms, and injected much-needed cash into Iraq's local economy, in addition to providing lucrative contracts for U.S. firms engaged in reconstruction projects. In October 2003, the U.S. Congress approved the president's supplemental budget request of \$18.6 billion in funds for Iraq's reconstruction. The CPA had hoped to spend close to \$13 billion of that amount in 2004, enough potentially to make a real difference. The U.S. government's contracting procedures caused major delays in spending, however, as did infighting in Washington over which U.S. agency would manage the contracts. (The Department of Defense eventually won that debate.) By mid-June, the CPA had committed just \$7.6 billion of the funds to actual contracts and had spent a mere \$333 million on reconstruction projects in Iraq.⁵⁹

Moreover, most of the money that was spent went to U.S. contractors rather than Iraqis, and even after June 28, U.S. contractors were set to re-

ceive the bulk of U.S. reconstruction funds. The Bush administration's reliance on large U.S. contractors to perform reconstruction work in Iraq is not only far more expensive than hiring Iraqi companies, it also means that too small an amount of U.S. reconstruction funds is being used to hire Iraqis, capitalize Iraq's economy, and build local capacity. As discussed above, a significant portion of the reconstruction funds is going to security-related needs; profits for U.S. companies, CPA and Department of State administrative costs, and corruption will eat up still more.

The CPA had promised to create 50,000 jobs with the \$18.6 billion it received from Congress, yet as of the middle of June, projects funded by that money had hired only 15,000 Iraqis,⁶⁰ representing less than one-quarter of 1 percent of Iraq's estimated total workforce of around 7 million. Overall, the CPA claimed

Most of the money that was spent went to U.S. contractors rather than Iraqis.

to have created more than 400,000 jobs during its tenure, most of which were created using funding other than the \$18.6 billion and the majority of which were in the security sector.⁶¹ When the CPA handed power to the Iraqi interim government, estimates on the level of unemployment ranged from 25 percent to 50 percent (the CPA estimated that the prewar unemployment level was 60 percent,⁶² but little accurate data about the economy during Saddam's time was available, and even postwar estimates are unreliable and range greatly). Most Iraqis and outside observers blamed the high levels of unemployment for contributing to Iraq's security problems.

The CPA's failure to tackle Iraq's unemployment problem effectively was just one immediately visible sign that Iraqis were not adequately involved in the CPA's economic reconstruction efforts. Because CPA officials remained largely confined to the Green Zone, their lack of firsthand knowledge about Iraq complicated their efforts to reform its institutions.⁶³ For the most part, the only Iraqis involved in developing the CPA's economic program at all were members of the Iraqi Governing Council; in reality, even they mostly just rubber-stamped the CPA's decisions. Already facing Iraqi claims that the council was illegitimate, its members' detached involvement will do little to change the perception that the CPA's reforms were U.S.-imposed.

The CPA's goals for Iraq's economy were laudable. To be viable, however, they must become Iraqi goals. Having conducted its economic program as if Iraq was a laboratory for Western, market economic policies, the CPA compromised its enduring legitimacy by not enabling Iraqis to chart their own economic future. The question that now remains is whether the Iraqis will embrace CPA goals and policies as their own. It will be essential for the United States to relin-

quish the reins of economic decisionmaking and allow Iraqis to become invested in the economic rebuilding process in their country.⁶⁴

Helping Iraqis Build an Indigenous Economy

Experts have predicted that Iraq's economy, given its oil resources and human capital, has steady growth potential. Even assuming a future Iraqi government does not decide to undo the CPA's market-oriented policies and legal changes, however, Iraq's economic recovery in the short to medium term remains wholly dependent on the key variables discussed—security and political stability, legal certainty, and Iraqis buying into the CPA's economic program. That program had the right goals, but the CPA paid insufficient attention to involving Iraqis in the design of the plan, just as it did to ensuring that Iraqis, rather than U.S. companies, received the greatest benefit from U.S. reconstruction funds and that economic programs were geared to building up local capacity. All three variables are still too early to call.

If coalition and Iraqi security forces are able to keep Iraq's chaotic security environment in check, major infrastructure and public-service projects should be able to continue; unemployment levels should decrease; and elections could occur on schedule in January 2005, all of which would bring greater stability to Iraq's economic environment. Although Iraq's interim leaders have professed a commitment to moving Iraq toward becoming a market economy, nothing guarantees that an elected Iraqi government will not reverse course, deciding to keep Iraq's economy closer in line with what it was historically, which included a nationalistic bias against foreign ownership. Moreover, because the CPA's banking laws, for example, do not reference Islamic laws, they could become controversial for an elected Iraqi government.⁶⁵

Postwar economic reconstruction is always a challenge. The uniqueness of Iraq's early postwar period as a country under U.S. occupation made it even more so. Although the United States had lofty goals for Iraq's economy and succeeded in implementing some important economic reforms, ultimately only the Iraqis can determine whether they want a market economy. Whether the new Iraqi leadership will pursue the CPA's economic reforms will depend on the extent to which Iraqis make the reforms homegrown. The United States must now move away from dictating the economic course in Iraq and work instead to develop Iraqi desire for market economic reforms, empower Iraqis to undertake concrete efforts to achieve those reforms, and improve security.

The U.S. goal of establishing the underpinnings of a market-based economy in Iraq was not objectionable per se, and it is certainly a key piece of establish-

ing democracy in Iraq. The United States can be faulted, however, for placing too high a priority on its own goals for the future shape of Iraq's economy without first effectively meeting the basic economic needs of Iraqis after Saddam fell, especially security, basic services, and jobs. To instill in Iraqis the desire for a market economy, Iraqis must see tangible improvements in their lives stemming from opportunities created by their economy. What they have experienced so far is uneven delivery of public services, unemployment, and rampant insecurity.

Going forward, the United States must focus on helping the Iraqis establish the basic law and order that will be necessary for economic rebuilding to take root. It must also direct U.S. assistance to projects that create Iraqi jobs rather than pay for profits, security, and insurance for U.S. companies. Putting money directly into Iraqi hands through local, community-level projects would immediately revitalize Iraq's economy and start giving Iraqis some input into how U.S. money is spent.⁶⁶ This will mean moving away from too heavy a focus on massive, capital-intensive infrastructure projects.

Moreover, the United States must let go of the reins on economic decisions and U.S. money and let Iraqis define their own priorities and make their own mistakes. Even after transferring power to an Iraqi government, the United States continues to control spending of its reconstruction funds, the largest pot of money in Iraq. The new Iraqi leaders must be given the opportunity to decide the economic course for Iraq, even if that means walking away from some CPA laws. They must also have a real say in defining Iraqi priorities for spending U.S. and other international reconstruction funds. Unless Iraqis see their own government charting the economic future of their country, including deciding whether to continue with the CPA's market-oriented economic program, they are unlikely to accept that program as an Iraqi one.

Iraqi buy-in is critical if Iraq is to have any hope of realizing a new economy that is diversified, attracts foreign investment, creates jobs, and ultimately brings prosperity for the Iraqi people. It also presents the only possibility that Iraq's economic aims will ultimately align with what the United States originally set out to achieve.

The U.S. must let Iraqis define their own priorities and make their own mistakes.

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