Iraqi Economic Reconstruction and Development

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TABLE OF CONTENTS

SECTION I: IRAQI ECONOMY UNTIL MARCH 2003 ............................................. 5
A. 1921-1958: THE HASHEMITE MONARCHY................................................... 5
B. 1958-1968: MILITARY RULE........................................................................ 7
C. 1968-2003: BA’ATH PARTY RULE & SADDAM HUSSEIN.......................... 9
   The National Development Plan 1970-1974.................................................. 9
   Development Planning After 1974 .................................................................. 10
   Iran-Iraq War: Demise of Economic Development ........................................ 12
   Invasion of Kuwait: Destruction of Economic Development ........................ 14
   Post Gulf War Sanctions and Oil For Food Program Period .......................... 14

SECTION II: MARCH 2003- JUNE 2004: CPA CONTROLLED ECONOMY .... 16
THE INITIAL PICTURE.......................................................... .................................................. 16
CPA REFORMS .................................................................................................................. 17
   Financial Sector ........................................................................................................ 19
   Liberalization of Labor and Capital Markets and Foreign Investment.............. 19
   SOEs, Subsidies and Oil ............................................................................................ 18
   Use of US Funding During CPA Control .............................................................. 20
EFFECTS OF CPA POLICIES ON IRAQIS ......................................................... 19
THE CPA LEGACY AT THE TRANSFER OF POWER .............................................. 20

SECTION III: IRAQ AFTER THE CPA UP TO AUGUST 2005 .................. 21
A. STATUS OF VARIOUS SECTORS OF THE ECONOMY AND THEIR NEEDS: .... 21
   Employment ............................................................................................................. 21
   Infrastructure ............................................................................................................ 23
   Water & sanitation ................................................................................................. 25
   Telecommunications .................................................................................................. 25
   Electricity .................................................................................................................. 27
   Housing .................................................................................................................... 26
   Agriculture .............................................................................................................. 28
   Financial Sector ....................................................................................................... 29
   State Owned Enterprises .......................................................................................... 30
   Overall Subsidies ...................................................................................................... 30
B. CURRENT IRAQI FINANCIAL STRUCTURE AND BUDGET: ..................... 31
C. STATUS OF OIL REVENUES .............................................................................. 33
   Nature of Oil Prices ................................................................................................ 34
   Unfeasible Production & Export Expectations .................................................... 34
   Illegal Oil Trade ...................................................................................................... 36
   Dutch Disease ........................................................................................................ 37
   Unemployment Effects ........................................................................................... 37
D. DIFFERENCES IN ECONOMIC EXPECTATIONS AMONG IRAQIS ........ 37
   Kurdish Expectations ............................................................................................. 37
   Shia Arab Expectations ......................................................................................... 38
   Sunni Arab Expectations ....................................................................................... 39
E. CHALLENGES OF CONSTRUCTING A FUNCTIONING ECONOMY WITH WAR AS A BACKDROP .... 40
   Draining Resources ............................................................................................... 40
Burden on the Budget ................................................................. 41
Limitations on US and Other International Private Investments ........ 41
F. STATUS OF IRAQ’S INTERNATIONAL FINANCIAL OBLIGATIONS: ........................................ 42
   Gulf War Reparation Claims .................................................... 42
   Pending Contracts .................................................................... 43
   Foreign Debt ........................................................................... 43
G. IRAQI GOVERNMENT’S CAPACITY TO FINANCE RECONSTRUCTION: ................................ 45

IV. STATUS OF FOREIGN RECONSTRUCTION AID ........................................... 47
   A. US AID ................................................................................ 47
       Lack of Strategic Planning ...................................................... 48
       Lack of Oversight, Benchmarks and Metrics ......................... 50
   B. NON-US FOREIGN AID ........................................................... 53
       The International Reconstruction Fund Facility for Iraq (IRFFI) .......... 53
### Table of Figures

- **Figure 1**: NDP: Target and Actual Values of Certain Economic Indicators, 1974 (ID Millions). Page 10
- **Figure 2**: Changing Composition of GNP, 1970-1989. Page 10
- **Figure 3**: Military Expenditures and GDP, 1970-1989 ($ billions). Page 13
- **Figure 4**: GDP 2000-2003. Page 18
- **Figure 5**: 2004 Iraqi Budget. Page 31
- **Figure 6**: 2005, 2006 and 2007 Iraqi Budget. Page 32
- **Figure 7**: Iraqi Crude Oil Production & Revenue. Page 34
- **Figure 8**: Iraq’s Oil Production & Consumption, 1980-2005E. Page 35
- **Figure 9**: Iraq’s International Obligations. Page 44
- **Figure 10**: Iraqi Capital Investments, 2004-2007. Page 45
Section I: Iraqi Economy until March 2003

Building a sound Iraqi economy is one of the main prerequisites for success in creating a stable and democratic Iraq. While Iraq’s proven oil reserves are the second largest in the world, after those of Saudi Arabia, there are major obstacles to reconstructing Iraq’s shattered economy and reintegrating it back into the international community as an independent economic power. Lack of proper hard infrastructure, low living standards, inefficient public sector, lack of a functioning private sector and the large international debt are only some of the major problems that remain to be addressed. These problems are the legacies of both Iraq’s previous governments and the actions taken since the fall of Saddam Hussein and it is important to understand what went wrong before the US invasion to appreciate the true nature of the present issues, and to craft the right solutions for them.

A. 1921-1958: The Hashemite Monarchy

Britain established a colonial monarchy in Iraq in 1921 under the rule of King Faysal I, a prominent member of the Hashemite family. In 1932, Iraq became an independent country yet Britain maintained its colonial influence over Iraq, actively participating in its affairs through bilateral treaties, particularly regarding defense, trade and foreign affairs. Considerable British influence continued until the military coup of 1958 and the consequent proclamation of Republic of Iraq.

Although oil exploration dates back to the latter part of the nineteenth century, oil was first struck in commercial quantities in 1927. The multinational Iraq Petroleum Company (IPC) obtained three concessions from the Iraqi government that covered the total area of Iraq. British Petroleum, Shell Petroleum, Compagnie Francaises des Petroles, Exxon and Mobil were the partners of IPC.

Iraq’s revenues largely benefited these concession holders until the price revolution of 1952. According to the concessions, the Iraqi government received a fixed payment per unit of production, which in practice did not exceed 5% of the actual revenues. In 1952, the new agreement between the Iraqi government and IPC entitled the government to receive 50% of the profits from oil exports, as well as the right to receive up to 12.5% of the net production, which it could sell at any price. The significance of the new system for the Iraqi economy was that for the first time the government acquired a direct interest in crude oil prices. With the United States becoming a net importer of oil in 1948, and the worldwide increase in demand for crude oil, Iraq expanded its oil output. Revenues the Iraqi government received increased to $0.84 per barrel in 1952 from $0.22 per barrel in 1950.

Iraq’s oil production accelerated from 0.091 million bbl/d in 1949 to 0.697 million bbl/d in 1952. The resulting increase in oil revenue, which went from ID 31 million to ID 74 million during the same period, prompted the government to channel oil revenue for development purposes. This policy was reinforced by the World Bank, which made a $12.8 million loan to Iraq conditional upon the creation of an autonomous agency for development. The result was the “Development Board”, established in 1950, which produced multi year plans with emphasis on three major fiscal priorities:
Agricultural development, including irrigation and flood control,

Transportation and communications,

Construction.

The Board set ambitious development goals for the four periods from 1951 through 1961. It envisioned large capital investments for agricultural, transportation, communication, building, housing and other basic industries. The actual outcome, however, fell short of the goals, and real expenditure lagged considerably behind planned figures. By contrast, actual revenues received tended to be very close to planned revenues. While the Board planned to spend ID 312 million during the period 1951-1958, actual expenditure was only ID 178 million, or 57% of the anticipated amount. Real revenues for the period, on the other hand, were close to 93% of projected revenue.7

The Board’s overemphasis on agriculture, and lack of focus on industry and human resources, alienated two increasingly important constituents: the educated elite and the workers.8 The educated urban elite and the agricultural workers were disenfranchised by the system, and later provided political support to the military coup in 1958.

The land tenure system promoted a large financial and social gap between the landowners and laborers. The Iraqi monarchy did not change the system, and even supported it under the planned development programs with grants to the agricultural sector. While the Board’s allocations for agricultural sector did not yield much productivity due mostly to the land tenure system, the industrial sector suffered even more greatly from lack of attention. The Board not only allocated a small share of funds for industrial development, but also failed to achieve its modest goals in actual implementation.9

The Iraqi Monarchy’s economic policy outcomes can be summarized as follows:

- Increased dependency of the economy on oil
- Consolidated and strengthened the feudal base of the economy
- Neglected industrialization
- Failed to develop a public sector to exercise leadership in the economic growth
- Created corruption in the bureaucracy.10

These economic practices laid the foundations for Iraq’s modern economy and many of the problems faced by the Iraqi economy in 2005 are partly legacies of the monarchic period. The heavy reliance on oil revenues in the Iraqi budget for the years 2005, 2006 and 2007 can also be found in the 1940s and 50s. Additionally, the monarchy’s strengthening of the feudal base of the economy not only discouraged efficiency, but also prevented the formation of a large private sector, still a minor part of Iraq’s economy as of 2005. Moreover, the Hashemite
Monarchy put in place a strong central government with a large bureaucracy that was open to corruption and neglected industrialization and agriculture.

What is striking is that several of these issues are identical with some of the major macro economic challenges that Iraq faces in 2005. Some important policy conclusions to draw from Iraq’s experience before the military takeover in 1958 can be summarized as follows:

- **Reduce economic dependence on oil and do not neglect industrialization**: The dominant industry of the Monarchy’s economy was the oil sector. This capital-intensive industry did not create employment opportunities for Iraqis, whose number increased from 3.5 million in 1932 to 4.8 million in 1947. Growing population and lack of employment due to lack of investment in labor-intensive sectors, such as industry, created increasing numbers of unemployed Iraqis, and led these individuals to support the military coup.

- **Get the agricultural policy right**: Although the monarchy invested heavily in agriculture, it only reinforced the inefficient and unfair tenure system and disfranchised the agricultural workers, who constituted 80% of the workforce in 1953. These individuals, as a result, welcomed the end of monarchy.

- **Create incentives for local private sector**: The 1921-58 regime did almost nothing to break the feudal economic base, which hindered the financial opportunities for entrepreneurialism and thus the creation of a private sector. This in return highlighted the authority and control of the central government.

- **Control and supervise the central authority**: The monarchy’s emphasis on the central government gave Baghdad hegemony over the country’s resources. Yet the lack of supervision over the officials with the power created widespread corruption. According to many Iraqis at the time, a few officials were eating away most of Iraq’s revenues and the government. This perception was one of the chief factors to trigger the coup.

A coup took place in July 1958 that had the support of the majority of Iraqis, partly thanks to the economic policies of the Monarchy. The coup did away with the British installed rule. It came in the midst of the Development Board’s fourth general program, and a new era of development planning in Iraq was ushered in.

**B. 1958-1968: Military Rule**

General Abd al-Karim Qasim, who led the coup d’etat of 1958, proclaimed the fully independent Republic of Iraq, terminated the country’s ties with the West, and began a process of alignment with the Soviet Union. The new regime set out to introduce numerous changes to reorient and broaden Iraq’s economic priorities. The changes in economic policy included:

- Undertaking agrarian reform that established ceilings on land ownership.

- Introducing more generalized social programs.

- De-linking the Iraqi Dinar from the British pound sterling by leaving the sterling area, establishing economic relations with the Soviet Union and East European countries, stressing the importance of industrial development.

- Initiating the long process that eventually led to the nationalization of the oil industry and the creation of a national oil sector.
The new regime replaced the Development Board with the Provisional Economic Plan (PEP), which increased the allocation for the industry and housing sectors. PEP’s plan allocated 12.2% to agriculture, 12.5% to industry, 26% to transportation and communication, 49% to housing and building. Actual spending, on the other hand, was again different from the targeted figures. Agriculture received 42%; industry 52%, transportation and communication got 36.5%, while building and housing received 53.4% of the designated funds.

Qasim’s socialist regime wanted to strengthen the industry as a means of eliminating class related income differences due to the oil dependent nature of the economy. While his agrarian reforms did not take their full effect until 1963, they succeeded in raising the capital of the Industrial Bank and extending more protection to domestic industry. The PEP’s allocation for industry was nearly 2.5 times what was allocated to the sector in the last six year plan drawn by the monarchy.

The military rule of General Qasim also made serious attempts to develop a national oil sector. By enacting Law 80 in 1961, the government expropriated all parts of the oil concession area that were not actually utilized by the foreign owned companies –the IPC group.

A series of ethno-sectarian and regional differences caused considerable civil unrest throughout the first military era, and led to the 1963 coup by Generals Abd al-Salam Arif and Abd al-Rahman Arif. The new administration took a more moderate position in relations with the West, yet retained close ties with the Soviet Union.

The new government continued to use Qasim regime’s PEP until it designed its own Five Year Plan (FYP) in 1965. The FYP of 1965 is known to be the most articulate and sophisticated of all the plans that had been drawn up since the inception of development planning in Iraq since 1950. The Plan articulated overall quantitative general objectives and provided an outline of target specific economic and social goals and an outline of conditions for the success of the plan, stressing also the importance of the role of fiscal, monetary, trade and wage policies.

However, the destiny of the FYP, which was in place from 1965 to 1970, was similar to that of its predecessors. Total actual expenditure was less than 55% of designated targets. All sectors failed to reach their expenditure goals. In agriculture, which had suffered a decade of stagnation prior to the plan’s period, actual spending failed to reach one third of planned investments. (Planned to receive ID 173.6 million, actually received ID 53.6 million) Both the industrial and the housing sectors received 53% of their goal allocation, while the transportation and communication sector was able to spend 60% of its allocation. The plan failed to reach its sector based spending targets, yet was able to increase employment level by 427,000 compared to the projected 262,000 in the five year period. Yet the GNP in the five-year plan period increased by 29% instead of the projected 45%. Similarly, the total increase in output was 31% instead of the planned 48%.

The FYP did help to decrease the oil dependency of the national economy from 22.8% of GNP in 1964 to 20.4% in 1969—but it continued to represent 85% of all Iraqi exports. This period also witnessed the introduction of modern technologies in industry, power generation,
transportation and communications. Average personal income in real terms increased by 12% in five years, despite the increase in population.\(^\text{18}\)

The FYP was in its fourth year when the Ba’ath Party seized power in 1968. The new regime allowed the Plan to complete its course while a new five-year plan was being prepared.

Military rule in Iraq started the country’s infrastructure building. Introduction of modern technologies and development of industrial sector in Iraq was started during this period. The military ruled economic policies marked the beginning of Iraq’s economic development, which led the World Bank to categorize the country as an upper middle-income level country until the sharp economic decline in 1980.

### C. 1968-2003: Ba’ath Party Rule & Saddam Hussein

The Ba’ath Party overthrew the Military regime in 1968 and one party rule was quickly established. The most important element of the Party’s early years of political economic policies was the ideology of Arab Nationalism, which had many elements of social economic policies similar to that of its military predecessors. Until the war with Iran, Iraq’s rich oil revenues allowed the Ba’athist administration to continue its socialist model without suffering from trade-offs between solvency and fiscal priorities such as welfare benefits, infrastructure development and military modernization.\(^\text{19}\)

The start of Baa’th Party regime marked a significant turning point in Iraq’s economic policy making and is the greatest cause for the economic condition Iraq is in as of 2005. The Party ruled Iraq from 1968 until the US occupation in 2003. The Ba’ath leadership started its economic shift with doing away with the military rule’s multi-year economic plan and later proceeded to devise its own plan shortly after it established firm control over Iraq’s economy in 1970.

Starting in 1973, numbers and figures of the national economy became progressively less available for public use, and economic data became more secretive. The legacy of the Party’s rule is in its key decisions under Saddam Hussein’s leadership, to increase military spending throughout late 70s, declare war on Iran in 1980 and later invade Kuwait in 1991. These are the main reasons for Iraq’s heavy debt burden, lack of infrastructure, high rate of unemployment and the country’s overall deteriorated economy.

### The National Development Plan 1970-1974

The new government took two years to formulate its first National Development Plan (NDP), which covered the period of 1970-1974. This plan was unique in Iraqi economic history in that it was the first development plan to be drafted, implemented and allowed to run its full course under the same political power structure. The plan was also novel in that it was able to draw upon a wealth of studies, planning, technical experience and administrative competence that Iraq had never been able to attain over the previous decades. Another advantage the Ba’athist NDP enjoyed was that it came at a time when oil prices were increasing sharply following the conclusion of the Tehran price agreement of 1971 and the oil price explosion of 1973-74.\(^\text{20}\)
The NDP had general economic and social objectives, as well as detailed and quantitative sector specific objectives with clear deadlines. Despite the new regime’s rhetoric of revolution, socialism and radical changes, the Plan was a faithful continuation of past development plans, especially the 1965-69 plan. The implementation of sector specific goals was also similar to the performance of NDP’s predecessors where none of the targets were fulfilled. (See Figure 1)

The agricultural sector received 73% of its planned budget, while the rate for Industry was a high 84.3%, 67% for transportation and communications, with 40% for building and housing. The shortage of spending on key economic industries came despite the overall increase in GDP and national revenues. Due to the increase in the oil prices, the share of oil in GNP increased from 26.4% in 1970 to 60.4% by 1974. By contrast, the roles of agriculture and manufacturing in the GNP declined to 6.9% and 5.2% respectively as of 1974.21

**Figure 1**

**NDP: Target and Actual Values of Certain Economic Indicators, 1974 (ID Millions)**

<table>
<thead>
<tr>
<th>Economic Indicator</th>
<th>Target</th>
<th>Actual</th>
<th>Percentage Actual to Target</th>
</tr>
</thead>
<tbody>
<tr>
<td>GDP</td>
<td>1163</td>
<td>3347</td>
<td>288</td>
</tr>
<tr>
<td>Oil Extraction</td>
<td>409</td>
<td>2023</td>
<td>495</td>
</tr>
<tr>
<td>Total Exports</td>
<td>465</td>
<td>1943</td>
<td>418</td>
</tr>
<tr>
<td>Total Imports</td>
<td>263</td>
<td>906</td>
<td>344</td>
</tr>
<tr>
<td>Agriculture</td>
<td>317</td>
<td>232</td>
<td>73</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>401</td>
<td>176</td>
<td>44</td>
</tr>
<tr>
<td>Construction</td>
<td>174</td>
<td>69</td>
<td>40</td>
</tr>
<tr>
<td>Transportation &amp; Communication</td>
<td>186</td>
<td>124</td>
<td>67</td>
</tr>
<tr>
<td>Electricity &amp; Water</td>
<td>35</td>
<td>14</td>
<td>40</td>
</tr>
<tr>
<td>Private Consumption</td>
<td>684</td>
<td>1047</td>
<td>153</td>
</tr>
<tr>
<td>Public Consumption</td>
<td>321</td>
<td>477</td>
<td>149</td>
</tr>
<tr>
<td>Employment (Thousands)</td>
<td>3165</td>
<td>2800</td>
<td>88</td>
</tr>
</tbody>
</table>


**Development Planning After 1974**

The Ba’ath Party’s decision to expose economic planning to the approval of the “Revolutionary Command Council” (RCC) brought multi-year planning to an end. This meant that the precious practice of economy under the control of technocrats was replaced by economy under the control of Ba’ath Party leadership. Following the NDP, there were three annual investment programs for 1975, 76 and 77. At the end of 1977 annual investment plan, RCC declared its adoption of the National Development Plan to be effective through 1980. Unlike the previous years, the government did not make its objectives or allocations public; hence there is no detailed data regarding this plan.
Despite the lack of economic data for this period, data is available that indicates the following growth rates for certain sectors between 1975 and 1980:

- GDP: 11%
- Mining: 6.5%
- Agriculture: 2.6%
- Industry: 14.2%
- Construction: 15.8%
- Transportation and communications: 20.3%
- Government services: 13.2%.

One significant economic reality of Iraq from 1976 to 1980 was the rapid increase of “other items” expenditures. As Iraq’s oil revenue increased from ID 3.1 million in 1976 to ID 8.9 billion in 1980, “other allocations” section under its budget increased from a mere ID 61 million in 1976 to ID 1.6 billion in 1980.

Although no public data are available for the breakdown, experts assert that the majority of these funds were spent on military industry and armament. Iraq’s military spending increased from ID 341.4 million in 1971 to ID 921.4 million in 1974—the last year that public data on military spending was available. The share of defense and police forces expenditures in 1974 was 53.3% of the GNP. (See Figure 3) One can conclude from the pattern that it is not unnatural for Iraq to be spending most of its resources on armament in the wake of the war with Iran.

Overall, the Iraqi government spent $14.2 billion on economic development in the 1974-80 period. Heavy industrial complexes such as the petrochemical complex in Basra, the iron and steel mill at Khor al- Zubair, the development of sulphur and phosphate extraction and processing and the fertilizer industries were developed during this period.

The second half of 1970s also witnessed a high rate of growth in oil output, oil revenue, national income, per capita income, industrial growth, construction, public and private consumption. Iraq also had a balance of payments surplus of $40 billion of foreign exchange on the eve of the decision to invade Iran. The development process that Iraq had been practicing for the previous thirty years came to a halt with the start of the War in 1980 and continuously regressed after this date (See Figure 2 for the changing GNP and regression across major sectors).

**Figure 2**

**Changing Composition of GNP, 1970-1989**

<table>
<thead>
<tr>
<th>Average Growth Rates of Selected Economic Indicators</th>
<th>1970-80</th>
<th>1980-85</th>
<th>1985-89</th>
</tr>
</thead>
<tbody>
<tr>
<td>GDP</td>
<td>11.7</td>
<td>-8.1</td>
<td>-1.7</td>
</tr>
<tr>
<td>Government Consumption</td>
<td>13.6</td>
<td>-1.3</td>
<td>-4.4</td>
</tr>
<tr>
<td>Private Consumption</td>
<td>13.2</td>
<td>-7.6</td>
<td>-4.6</td>
</tr>
<tr>
<td>Gross Fixed Investments</td>
<td>27.6</td>
<td>-0.3</td>
<td>-1.5</td>
</tr>
<tr>
<td>Exports</td>
<td>4.4</td>
<td>-8.8</td>
<td>-1.1</td>
</tr>
</tbody>
</table>
Iran-Iraq War: Demise of Economic Development

Before the Iran-Iraq War, Iraq was one of the more prosperous and advanced countries of the Arab world, thanks to the Iraqi development efforts starting in 1950s. It was an upper middle-income economy with a substantial middle class, considerable technical capacity, some female participation in education and economy and decent standards of education and health care. After the war, Iraq witnessed a regression in all these segments. By 1988, Iraq had an impoverished economy in crisis and the minor economic turnaround following the Iran-Iraq War proved to be trivial when compared with the economic disaster that engulfed Iraq following Saddam Hussein’s decision to invade Kuwait in August 1990.

Iranian and Syrian retaliation to Iraq’s attacks on Iran caused the suspension of up to 2.5 million bbl/d of Iraq’s export capacity. The war, which the Iraqi government thought would be short, instead took eight years and had major economic consequences which can be regarded as another set of root causes of Iraq’s current economic problems. At the end of the eight year-long war, Iraq’s total monetary losses are calculated to be $452.6 billion.

These losses include, among others:

- $91.4 billion in potential GNP losses: losses incurred in the oil sector as well as, industry, agriculture, energy, telecommunications, housing and health sectors,
- $197.7 billion in oil revenue losses,
- $78.8 billion losses in foreign exchange reserves due to the loss of $35 billion in original reserves, plus the accumulated interest earnings for the duration of the war,
- $80 billion potential losses in foreign exchange reserves resulting from high military spending.

The scale of war’s negative effects on the Iraqi economy from an oil revenue perspective can be summarized as follows:

- Total national oil revenue from 1931 to 1988: $179.3 billion
- Total war loss estimates: $452.6 billion
- Ba’ath regime spent 254% of all the oil revenue Iraq received in fifty-seven years during the war with Iran.

Aside from loss of Iraq’s national wealth, another important impact of the war with Iran on Iraq’s current economic problems is the financial claims to Iraq’s resources by other nations.
The war result also forced the diversion of the country’s resources to underwrite the cost of the conflict. In 1980, Iraq spent $19.8 billion, 38.8% of its GDP on defense. As shown in Figure 3, US Arms Control and Disarmament Agency (ACDA) data indicate the share of military spending proceeded to absorb between one-half to two-thirds of GNP during late 80s.29

**Figure 3**

**Military Expenditures and GDP, 1970-1989 ($ billions)**

<table>
<thead>
<tr>
<th>Year</th>
<th>Military Expenditure (Milex)</th>
<th>GDP</th>
<th>Ratio of Milex to GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>1970</td>
<td>.7</td>
<td>3.6</td>
<td>19.4</td>
</tr>
<tr>
<td>1975</td>
<td>3.1</td>
<td>13.8</td>
<td>22.5</td>
</tr>
<tr>
<td>1980</td>
<td>19.8</td>
<td>53.6</td>
<td>38.8</td>
</tr>
<tr>
<td>1981</td>
<td>24.6</td>
<td>37.3</td>
<td>66.0</td>
</tr>
<tr>
<td>1982</td>
<td>25.1</td>
<td>43.7</td>
<td>57.4</td>
</tr>
<tr>
<td>1983</td>
<td>25.3</td>
<td>42.5</td>
<td>54.4</td>
</tr>
<tr>
<td>1984</td>
<td>25.9</td>
<td>47.6</td>
<td>54.4</td>
</tr>
<tr>
<td>1985</td>
<td>19.0</td>
<td>49.5</td>
<td>38.4</td>
</tr>
<tr>
<td>1986</td>
<td>11.6</td>
<td>47.9</td>
<td>24.2</td>
</tr>
<tr>
<td>1987</td>
<td>14.0</td>
<td>57.9</td>
<td>24.2</td>
</tr>
<tr>
<td>1988</td>
<td>12.9</td>
<td>55.9</td>
<td>23.1</td>
</tr>
<tr>
<td>1989</td>
<td>12.9</td>
<td>64.4</td>
<td>20.0</td>
</tr>
</tbody>
</table>

Source: US Arms Control and Disarmament Agency, "World Military Expenditures and Arms Transfers" (Annual)

The same ACDA figures in 1980 also indicate that military spending absorbed 75% of Iraq’s oil income. In subsequent years, the government spent several times the country’s oil revenue on its war expenditures. Thus, during the 1981-85 period, military spending amounted to $119.9 billion, or 245% of the same period’s oil revenue, which was a total of $48.4 billion. In other words, while oil revenue averaged $9.7 billion a year, military spending was $23.9 billion per year.

The $71.5 to $80 billion gap between spending and revenues was financed by grants (or loans) mostly from Saudi Arabia and Kuwait, as well as from other forms of credit agreements with various governments.30 Government of Iraq has always maintained that these funds, especially those from the Sunni Governments of Gulf States should have been supplied as assistance rather than loans, to help it in its war with the Shia Iran. This is one of the problems in today’s foreign debt repayments that the new Iraqi government must deal with and is explained in more detail in the following chapters regarding Iraq’s International Financial Obligations.

The growing economic burdens of the Iran-Iraq war caused Saddam Hussein to deviate from the strict socialist policy of his party and adopt more pragmatic economic regulations. In 1987, the government:

Abolished a law that guaranteed full employment and laid off thousands of government workers – including many foreign nationals.
Transferred other civil service workers to factory jobs.

Took steps to privatize government owned enterprises (GOE) including Iraqi Airways, bus companies, gas stations, agricultural enterprises, department stores and factories.

Announced that it would offer inducements for foreign companies to operate in Iraq through relaxing restrictions on foreign direct investment.

Removed price controls on commodities.31

These measures helped but scarcely coped with the impact of the Iran-Iraq War. In the aggregate, war with Iran lasted eight years, produced close to a million casualties, drained the Iraqi economy of its surplus from oil revenue, caused the direction of resources away from economic development towards armament and forced the government into borrowing $ 80 billion mainly from Gulf States. Over the 1980-88 period, the Iraqi economy lost $ 178.3 billion in armament, incurred $ 91.4 billion in potential GNP losses, and suffered from a total of $ 197.7 billion due to oil export limitations. Iraqi economy in the aggregate wasted $ 467.4 billion on the War with Iran as well as incurred this $ 80 billion foreign debt.

**Invasion of Kuwait: Destruction of Economic Development**

Iraqi economy following the Iran–Iraq War was characterized by inflation, partial demobilization, unemployment, heavy debt burden, low oil revenue, currency depreciation, non-responsive private sector, stagnant output, falling living standards, general impoverishment, and lack of funds for reconstruction. Yet the Iraqi government did not focus seriously on Iraq’s economic challenges following the end of the War in August 1988.

Increasing military expenditures, heavy dependence on oil, lack of improvement of unemployment were some of the factors that caused a 9% decrease in 1989 real GDP over the 1988 level.32 The Iraqi government realized that it could not finance its ambitions or meet its debt obligations, and needed drastic inflows of revenues, which it could not attain with its oil exports, given the price of oil in the world market.

This need for more oil revenues was one of the factors that led the Ba’athist government to turn to the oil rich, small and defenseless neighbor: Kuwait. Iraq’s ambitions for Kuwait’s natural resources become obvious when the Iraqi deputy prime minister for the economy said that Iraq would now be able to pay its debts in less than five years; that the “new Iraq” would have an oil production quota of 4.6 million bbl/d instead of 3.1 million bbl/d, and that the oil income would reach $ 38 billion per year “when the two economies were integrated”.33

Rather than enable Saddam Hussein’s Regime to buy its way out of its mistakes, the Iraqi occupation of Kuwait resulted in a major military defeat by the US led coalition. This defeat shattered the already worsened Iraqi economy and most infrastructure, labeled Iraq as a pariah state and exposed the country to stringent economic sanctions. Economic sanctions imposed by the Security Council in 1991 banned all transactions with Iraq, and sealed Iraq’s economic fate for years to come. Iraq’s economy is totally dependent on the world market for its oil exports, foreign exchange earnings, imports of foodstuffs, consumer goods, raw materials, technology,
spare parts and capital goods. Without international trade, Iraq’s economy was destined to come to a full stop.

The international embargo caused oil production to decline from a peak of 3.3 million bbl/d level before the invasion to only 0.5 million bbl/d level in the subsequent months following the Security Council’s decision. The six week bombing campaign of the US led coalition forces, which started on January 1991, then destroyed some of the civilian infrastructure including power stations, transportation and telecommunication networks, oil facilities, iron and steel plants, bridges, hospitals, storage facilities, industrial plants and civilian buildings. Coupled with the economic regression caused by sanctions, the picture of the economic situation in Iraq was grim, as stated by the UN envoy, “the recent conflict had wrought near-apocalyptic results”. 34

The Arab Monetary Fund estimated the value of the Iraqi assets destroyed during the Coalition campaign to be $ 232 billion. 35 This analysis grossly, if not incredibly, exaggerated the physical damage done by the bombing. Aerial and satellite photography proved conclusively that Iraqi claims were exaggerated or false in case after case. Nevertheless, the war did both damage and paralyze the economy, and, the Iraqi government compounded these problems both by failing to organize an effective recovery effort, and honoring the ceasefire in ways that would encourage aid and investment and allow exports.

Iraq’s economy at the end of the Gulf War was characterized by:

- Absolute declines in GDP since 1980s
- Chronic hyperinflation
- Wholesale depreciation of its currency
- Virtually non-existent foreign investment
- Accumulation of a crushing debt burden
- Damaged or destroyed petroleum, transportation, power and industrial infrastructure.

**Post Gulf War Sanctions and Oil For Food Program Period**

The end result was an international embargo that isolated the Iraqi economy from all kinds of international transactions and brought the country’s economy to a practical stalemate. UN Secretary-General’s mission assessed that the Iraqi people could “soon face a further imminent catastrophe, which could include epidemic and famine, if massive life-supporting needs are not rapidly met.”36

The negotiations between the international community and Iraq to open limited exports of oil in return for basic foodstuffs and medication throughout 1991 did not bear fruit until 1995. As a result of the negotiations with Iraq, the Security Council adopted resolution 986, which established the "oil-for-food" program, providing Iraq with the opportunity to sell oil to finance the purchase of humanitarian goods, and various mandated United Nations activities. The
program was intended to be a "temporary measure to provide for the humanitarian needs of the Iraqi people, until the fulfillment by Iraq of the relevant Security Council resolutions".

Although the program was established in April 1995, its implementation only started in December 1996, following the signing of the Memorandum of Understanding (MOU) between the United Nations and the Government of Iraq on 20 May 1996. The first Iraqi oil under the Oil-for-Food Program was exported in December 1996 and the first shipments of food arrived in March 1997.

In the initial stages of the program, Iraq was permitted to sell $2 billion worth of oil every six months, with two-thirds of that amount to be used to meet Iraq’s humanitarian needs. In 1998, the limit on the level of Iraqi oil exports under the program was raised to $5.26 billion every six months, again with two-thirds of the oil proceeds earmarked to meet the humanitarian needs of the Iraqi people. In December 1999, Security Council removed the ceiling on Iraqi oil exports.

A total of 72% of all Iraqi oil export proceeds funded the humanitarian program, of which 59% was earmarked for the contracting of supplies and equipment by the Government of Iraq for the 15 central and southern governorates and 13% for the three northern governorates, where the United Nations implemented the program on behalf of the Government of Iraq. The balance included 25% for a Compensation Fund for war reparation payments; 2.2% for United Nations administrative and operational costs; and 0.8% for the weapons inspection program.

There were nine United Nations agencies and organizations involved in the program: FAO, UNESCO, WHO, ITU, UNICEF, UNDP, WFP, UNOPS, UN-Habitat.

By 28 May 2003, $28 billion worth of humanitarian supplies and equipment had been delivered to Iraq under the Oil-for-Food Program, including $1.6 billion worth of oil industry spare parts and equipment. An additional $10 billion worth of supplies were in the production and delivery pipeline.

During the sanctions regime, Iraq was almost completely dependent on imports for basic foodstuffs and medicine. Although the Program was essential for maintaining the mere livelihood of an overwhelming majority of Iraqis, it could not prevent Iraq from being reduced to a low-income economy as of 2000. The sanctions regime strangled all economic activity in Iraq other than oil production. Since the only item Iraq was allowed to export was oil, all other industries, agriculture in particular, were abandoned. According to UN Statistical Yearbook, Iraq’s GNP in 1989 was $26.9 billion, it reached a low of $6.5 billion in 1996. Population growth for the same period, on the other hand, was an increase from 17.5 million to 21. GDP per population for this period declined from $1,537 per capita to $343.

By 2000:

- Life expectancy in Iraq fell to 61 years from 63 in 1989.
- Mortality rate for children under five rose to 12.1% from 9.5% in 1980.
Primary school enrollment rate fell to 88% from 100% in 1980.

Secondary school enrollment rate declined to 20% from 57% in 1980.

GDP fell to $31.8 billion from $66.2 billion in 1989 (further declined to $26.1 billion in 2002).  

GDP per capita dropped to $770-1,000 in 2001 from $3,600 in 1980. 

When the US led coalition rolled into Baghdad, the country’s economy was in a state of complete stalemate dating to the beginning of the Iran-Iraq War in 1980. Under the pressure and destruction of war and the subsequent economic sanctions, Iraq’s development and growth was reversed in all sectors, dependency on oil revenues had increased, foreign debt, hyperinflation and unemployment were at their peaks, and there was very little economic infrastructure left.

One of the gravest economic legacies of the Hussein led Ba’ath party regime was the overproduction of oil, and the deteriorating condition of the oil fields. There was significant optimism in the international community for Iraq’s economic reconstruction based on the estimates of its oil reserves. What the coalition on the ground found was run down oil fields due to excessive oil production and water injection, lack of proper technology and maintenance. As will be discussed in detail in the section on the status of oil revenues, the deteriorated oil fields inherited from Saddam’s era is one of the major challenges of today’s economic development in Iraq.

Section II: March 2003- June 2004: CPA Controlled Economy

The US led coalition occupation of Iraq in March 2003 led to the lifting of sanctions and a major effort to liberalize and reform the economy. The Security Council lifted civilian sanctions on Iraq on May 22, 2003 with the adoption of resolution 1483. The UN Secretary-General then appointed a Special Representative to work with the occupying forces in rebuilding Iraq; opened the way for the resumption of oil exports, with revenues deposited in a Development Fund for Iraq held by the Central Bank; and provided for the termination of the Oil-for-Food Program within six months, transferring responsibility for the administration of the remaining Program activities to the Authority. The Program was completely terminated as of November 2003.

The Initial Picture

Starting in March 2003, the country witnessed efforts to abandon the absolute control of the central government over the economy, create independent financial and private sectors, bring physical infrastructure to humane levels, reduce unemployment and uplift the overall economy. These goals were designed to serve the overarching objective of creating a new and united Iraq with a liberal economy. The following sections will study the success and focus of these efforts.
Iraq’s economy had heavily deteriorated. Decades of heavy state control over all kinds of economic activity, deterioration caused by successive wars, a decade of international sanctions and the looting that followed the invasion were some of the elements of Iraq’s economic picture at the time of invasion. (See Figure 4). Yet the US government set high goals for the immediate economic reconstruction of Iraq; to create a liberal, market based Iraqi economy. According to Undersecretary of the Treasury for International Affairs John B. Taylor, the US hoped to turn Iraq into a “well functioning market economy that is growing, creating jobs, and is promising for a future”.

**Figure 4**

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<tr>
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<tr>
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<td>31.8</td>
<td>27.9</td>
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<tr>
<td>GDP per capita ($ at current prices)</td>
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<td>770</td>
<td>596</td>
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<tr>
<td>GDP per capita ($ at PPP)</td>
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<tr>
<td>GDP (% real change)</td>
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<td>-6</td>
<td>-6.5</td>
<td>-21.8</td>
</tr>
<tr>
<td>Consumer Prices (% change pa)</td>
<td>5</td>
<td>16.4</td>
<td>19.3</td>
<td>29.3</td>
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* The IMF threshold for Low Income Economies is $ 450

Remaking the Iraqi economy faced two broad challenges; firstly transforming a centralized economy into a market economy, and secondly reconstructing a war torn economy. These broad challenges were essentially intertwined with the level of infrastructure readily available. Notwithstanding the shattered infrastructure, the Authority proceeded with its plans to transform Iraq’s economy. Despite warnings from many economists against CPA’s plans for post soviet era type of radical economic reforms, known as “shock therapy”, the Authority practiced many radical reforms.

**CPA Reforms**

In general, post conflict economic reconstruction involves establishing a market based financial system, setting up functioning governing institutions, privatizing SOEs, rebuilding critical sectors of the economy, providing basic services such as education, power, water, health care and creating jobs as well as normalizing relations with the world, against a backdrop of basic security and functioning environment of law and order. Economic reforms are conventionally carried out along with a comprehensive legal and regulatory framework to oversee and coordinate the coherence of changes in various sectors. The CPA’s economic reform “package”, however, deviated from the norm in its:

- Premature reform of the Iraqi financial sector.
- Focus on the business friendly investment climate and the instant liberalization of labor and capital markets.
- Imposition of significant legal reforms as an occupying power.
Financial Sector

Among the Authority’s reforms, those in the banking sector, the creation of an independent Iraqi Central Bank in particular, were the most plausible steps in turning the economy to a market oriented one. The US Department of Treasury placed advisors in Iraq’s Finance Ministry and ran classes on banking standards and technology for bankers. Albeit not sufficient, these measures mark a significant change from the era of Iraq under Saddam Hussein’s rule where there were no independent banks, and the central bank was under absolute control of the president.

The CPA’s currency reform was another success. The new Dinar was successfully introduced on January 15, 2004. Its value has since been stable and, in fact, appreciated against the US dollar through the summer of 2005. Yet the overall measures taken by the CPA to reform Iraqi financial sector caused serious allegations of corruption. Iraqis citizens at large and many NGOs believe that government ministries were withdrawing money for personal uses. This notion seriously reduced credibility and trust for CPA’s intentions in reforming Iraqi economy.

Liberalization of Labor and Capital Markets and Foreign Investment

The provisional Authority was also criticized for the decision to enact “CPA Order 39”, which opened Iraq’s business entities to 100% foreign investment and management. The objective was to make Iraq’s commercial environment more business friendly. The rationale behind the full liberalization of international flows of capital and goods was that it would allow the Iraqi society to consume a combination of good beyond its own production possibilities, thereby increasing Iraqi well-being.

Yet this laissez-faire rule did away with the longstanding Iraqi rule of limiting investment in Iraq’s state owned assets exclusively to Iraqis and residents of other Arab countries. The exclusion of key resource sectors such as oil, banking and insurance from the jurisdiction of the order did not prevent wide spread sentiment among Iraqis that the US government was essentially selling out the Iraqi economy.

Many economists also expressed concern over the provision’s effort to quickly discard Iraq’s long-standing commercial culture, and its potentially serious distortions to Iraq’s economy. More importantly, many analysts observed that CPA did not possess the legal authority to implement such a fundamental change. The Authority also eliminated import tariffs and other restrictions on trade while instituting a 5% reconstruction surcharge duty as well as considerably reducing corporate taxes.

SOEs, Subsidies and Oil

On the other hand, CPA’s decision to abandon its goals for the privatization of SOEs and termination of oil and agricultural subsidies, pending decisions by a legitimate Iraqi government, seems to have been an optimal decision for the short term. As the World Bank cautioned, the implementation of these goals without the necessary macro economic stability would have had severe repercussion on the daily lives of Iraqis. On the legal front, privatizing
Iraqi SOEs and terminating oil and agricultural subsidies would have been problematic for the CPA, since it was merely an occupation force, and was not a legitimate sovereign government. This scarcely means, however, that the status quo of SOEs and agricultural subsidies is economically desirable. These are outstanding issues as of August 2005 and require urgent focus.

The Authority’s efforts to transform the oil industry, on the other hand, were far less effective. The official target of raising oil production to the prewar levels of 2.5 million barrels per day could not be accomplished. During the time of CPA control, Iraq also continued to import refined oil products in volumes that grew sharply because of subsidized low prices. The Authority failed to address the question of both the need to renovate Iraq’s oil and refinery industries, and making a significant adjustment in fuel subsidies. Iraq’s lack of capacity to refine its crude oil causes it to import a large portion of oil based product consumption such as diesel, gas or kerosene. The subsidies over these products are inefficient costs that could be eliminated by investment in refinery capacity building. There were no projects undertaken during the Authority’s tenure to address the problem.

Another important failure of CPA’s economic policies was the significant corruption involving US and Iraqi officials as well as US contractors. US government auditors, KPMG and the Iraq Revenue Watch – an independent NGO- found considerable lack of transparency in CPA’s handling of Iraqi oil revenues and US reconstruction funds. The CPA was generally unable to monitor Iraqi government spending to prevent corruption because CPA officials were held up inside the high security Green Zone in Baghdad.

Use of US Funding During CPA Control

The American government hoped to rejuvenate the Iraqi economy in the short to medium term by channeling large amounts of reconstruction assistance that in theory would create:

- Considerable amount of jobs for Iraqis
- Business opportunities for Iraqi companies
- Liquidity in the local economy

To this end, the Congress appropriated $ 18.4 billion in October 2003, which added major funding to the pool of assets acquired from the Iraqi government and UN Oil For Food Program, and previous UN and international aid. The CPA planned to spend $ 13 billion in 2004 to make a real impact. However, due to delays caused by US government’s contracting procedures and struggles over which agency would control the contracts, the Authority spent only $ 333 million on reconstruction projects in Iraq by mid June, 2004.

Effects of CPA Policies on Iraqis

The bulk of American funding during CPA’s tenure went to US and foreign contractors, and not Iraqis. The use of large US corporations rather than Iraqi companies for reconstruction not
only prevented the use of money for intended purposes, but also was an obstacle before building local capacity, which is crucial for economic reconstruction and combating insurgency.

As will be discussed in more detail on the section on “US Aid”, the exclusion of Iraqi workforce from Iraq’s economic reconstruction helped strengthen the insurgency.

The CPA set a formal goal of employing 50 000 Iraqis in the reconstruction activities, but the actual number as of June 2004 was a poor 15 000, who were mostly employed on weekly or monthly basis with minimal wages. 15 000 workers represent less than one quarter of 1% of Iraq’s estimated total workforce of 7 million people.49

Another stark discrepancy between the CPA’s objectives and its practices was the number of Iraqis effectively put out of work. According to analysts at the Federal Reserve Bank of Boston, the Authority fired 500 000 Iraqis who were state employees, and an additional 25 000 to 30 000 who were former Ba’athists.50 This figure indicates that the CPA laid off 8% of the active Iraqi work force during its tenure. While there is controversy over the exact unemployment rates, the fact remains that none of the employment targets set by the US administration or the CPA were actually fulfilled. Therefore, there is broad consensus that the Coalition policies were not effective at reducing the overall level of unemployment in the country, and some experts argue that it even worsened the situation.

Other macroeconomic indicators show that the Iraqi economy dropped during CPA rule:

- Decline in GDP, GDP per capita and GDP % real change.
- Increase in consumer prices.
- Inefficiency in generating electricity:
  CPA electricity generation target by July 1, 2004: 6,000 MW
  Actual electricity generated as of July 1, 2004: 4.293 MW

**The CPA Legacy at the Transfer of Power**

At the time of the transfer of power from the CPA to the provisional authority in June 2004, Iraq had a new set of laws, regulations, oversight commissions and new institutions which lacked a strategic framework linking all these changes to an overarching unity. Most of these reforms remained on paper, and their execution was left to the fragile interim government.

Some economists also criticize the CPA for adopting inappropriate economic policies. They maintain that the abrupt liberalization of prices and markets, which were implemented for improving efficiency in the allocation of resources and to expand output resulted in joblessness, prompted insecurity and reduced Iraq’s already low capacity to absorb investments.51
According to many analysts, the CPA should have applied its reforms incrementally. The Authority’s prescription for Iraqi economy was comprehensive and simultaneous liberalization of all sectors, similar to the economic reforms that took place in Eastern Europe and Russia. Some economists believe that instead, the CPA should have endorsed economic transformation known as the Chinese style, which means taking step-by-step measures to sequentially liberalize a centrally run economy.\(^\text{52}\)

At the time of the transfer, most infrastructure reform projects were severely delayed due to security problems, public services were spotty, and Iraqis were in desperate need of jobs.

In short, the CPA’s legacy was marked by:

- Declining GDP
- A drop in living standards
- Increase in overall prices of tradable goods
- Increase in malnutrition\(^\text{53}\)
- Rise in infant mortality\(^\text{54}\)
- Rise in unemployment\(^\text{55}\)
- Rise in corruption\(^\text{56}\)

The CPA’s failure to appreciate the consequences of its economic policies minimized the positive effects of the reform process. Its policies created unemployment, isolated Iraqis from the development effort and incidentally did not reduce the insurgency. The fact that CPA reforms focused on radically restructuring the economy rather than adopting a people-centered concern caused the reforms to miss the point. What Iraq really needed was policies that aimed to increase the living standards of the poorest and the most desperate, not exclusively business-oriented priorities that the Coalition Authority chose to focus on.

**Section III: Iraq after the CPA up to August 2005**

The end result has been that the CPA created more problems than it solved, and added to Iraq’s massive economic problems rather than reduced them. The years that have followed have seen a further net deterioration in spite of improved policies, driven largely by the forces of war.

**A. Status of various sectors of the economy and their needs:**

**Employment**

It is estimated that unemployment and underemployment in Iraq was at about 50% of the labor force as of August 2005. Some 40% of the employed were estimated to work in the formal sector while the majority of the labor force took up jobs in the informal sector-many in
marginalized economic activities—in difficult and most importantly unstable conditions with minimal to insufficient pay.

Women represent around 52 percent of Iraq’s population, but constituted only 23% of the formal work force in mid 2005, mostly as middle level professionals in the public and service sectors and in rural areas as seasonal agricultural workers. According to data from 2001, 72% of the population is under the age of 25. This fact adds tremendous pressure to the employment situation, which must be considered as a key to achieving any form of sustainable stability in Iraq. This immensely large youth will be the primal source of instability should joblessness persist. Addressing these critical levels of unemployment is a fundamental key to success for stability in Iraq.

It should be understood that it is very difficult to obtain and report accurate data on the exact rate of unemployment in Iraq. There are three surveys popularly referred to, which are carried out by the Central Organization for Statistics and Information Technologies (COSIT)\(^57\) in October 2003, May 2004 and July 2004. These surveys reported national unemployment at 28.1%, 10.5% and 26.8% respectively.

These rates, however, may be severely misleading. COSIT uses International Labor Organization (ILO)’s definition of unemployment in its analysis of the results. The application of this definition is misleading in the Iraqi context for the following factors:

ILO’s definition of an unemployed individual does not include “discouraged” persons. A discouraged individual is one who is not actively seeking employment. Exclusion of these types of persons under normal circumstances is a fair representation of the actual unemployment rates. However, the Iraqi case is different in that due to loss of hope for employment and lack of opportunities, a total of 1 390 000 Iraqis were defined as not seeking jobs\(^58\). Many of these individuals, although classified as “discouraged” persons, are actually willing to work if they find employment opportunities. Their exclusion distorts the real unemployment figures. When this sector is included, for instance, the 10.4% unemployment rate in the May 2004 survey goes up to 18.5%.

The unemployment definition utilized in the survey does not account for disguised employment, which is at high levels in Iraq. According to State Department figures, 150,000 Iraqis were employed as permanent and temporary workers in Iraq as of June 1, 2005. While these individuals are reported in the survey as “self employed” and hence are regarded as part of the active work force, their stable work can be as short as a month. Besides the official State Department figure, there are hundreds of thousands of Iraqis who find temporary jobs on a daily basis mostly for foreign contractors. According to the UNDP Iraq Living Conditions Survey, 35% of work force in Baghdad is “self employed”, and many of them do not have any prospect of stable employment. It is very important therefore, to distinguish between levels of real employment and disguised employment in Iraq.

The COSIT surveys’ unemployment rates need to be put into the context of Iraqi demographic conditions for the best grasp of reality. Iraq has a very young population. 40% of the 27 million Iraqis are under the age of 15 years and the mean age in Iraq is an incredible low of 23.8 years. Another significant factor is the low number of middle-aged men—due mostly to Iran-Iraq war and recent wars—and the high number of middle-aged women. Considering the earlier is conventionally the household income producer, and the latter traditionally does not engage in income generating employment activities according to Iraqi culture, lack of middle-aged men creates higher dependence on the young Iraqi men. In fact, UNDP Iraq Living Conditions Survey carried out in 2004 indicates that average dependency ratio in Iraq is 73.97%. This points out to the fact that of ten Iraqis, seven are dependent on the other three, who are overwhelmingly young Iraqi men.
While young Iraqi men are the segment of the population most important to its military and political stability, the unemployment rate among them is officially 33.4%. The figure reaches “an astonishing level of 37.2% for young men with secondary or higher education”.59 This could be increasingly alarming when one factors in the underestimation of official figures.

When all these issues are considered, it becomes more understandable why the Iraqi Trade Minister stated in January 2004 that the actual rate of national unemployment and underemployment in Iraq was 50 to 60%,60 or the Iraqi Labor and Social Affairs Ministry reported “unemployment to be […] at more than 60%”.61 At this point, the precise figure for unemployment loses relevance. Given these data, and the fact that almost all surveys held in Iraq make unemployment a top concern-rivaling security-, Iraqi unemployment is clearly at alarming levels and must be dealt with far greater efficiency.

It is critical to create job opportunities quickly. Employment generation programs could be in the form of make work schemes where the objective would mainly be to transfer cash in a rapid and efficient manner through activities as basic as cleaning and painting. Another opportunity for creating jobs would be the labor-intensive reconstruction and rehabilitation activities. The agriculture and irrigation, transportation as well as urban and rural infrastructure rehabilitation sectors have the potential to create thousands of jobs.62

The projects attracting these options, and most Iraqi development activity, are carried out largely under USAID Department of Defense controlled contracts. Unfortunately none of the contracts determine employment of Iraqis as a quantifiable goal or contain provisions obliging contractors to create employment opportunities for Iraqis.63 This is despite the various employment targets set by the State Department, USAID or the Department of Defense. This lack of focus requires coordination and making job creations part of contracts. Immediate needs to deal with the employment aspects of establishing a market based Iraqi economy include:

- Nationwide employment of Iraqis at maximum numbers possible in reconstruction programs, especially the young Iraqi men with little or no education.

- Inclusion of mandatory levels of employment of Iraqis in government contracts.

**Infrastructure**

Iraq’s infrastructure has seriously deteriorated as a result of years of armed conflict, deferred maintenance, weak technical and management capacity and neglect. Most investment in infrastructure came to a halt with the start of the war with Iran in 1980, when the population of Iraq was 16 million, which as of July 2005 is estimated by the CIA to be 26 million.64

A majority of Iraqis today have limited, if at all any, access to essential basic services such as water, or must rely on costly alternatives for electricity and water services. Billing systems and associated revenues that maintained operations have collapsed and need to be reinstated as a critical priority. Serious environmental and health risks associated with contaminated water
supplies, inappropriate handing of solid waste and disposal of sewage threaten to burden the already severely stressed health system.

Infrastructure reconstruction is not vital only to the improvement of service quality and coverage across a range of sub-sectors, but also to the enhancement of Iraq’s competitiveness as it seeks to attract investment and promote development of its private sector. Infrastructure investments are also critical in facilitating the import and distribution of strategic commodities and construction inputs necessary for the overall reconstruction effort. The rehabilitation of the Port of Umm Qasr, for instance, was vital in the shipment of food and oil.

Immediate infrastructure construction is also needed to rationalize and realign regulatory oversight and delivery mechanisms across various economic sectors. Years of highly centralized and politicized control of capital investment financing have led to large-scale neglect of routine maintenance of assets. It is also critical that Iraqi policy makers and other authorities increasingly take greater ownership in determining the future course of the sectors for which they are responsible. Projects determined in Washington DC, and carried out by American contractors in Iraq – without adequate consultation with Iraqi officials – may simply create logistical problems in the future.

Water & sanitation

Iraqi water and sanitation sectors made real progress until the 1991 Gulf War. While Iraqi government claims ignored a serious deterioration in the growth and quality of services during the Iran-Iraq War, the government did not grossly exaggerate in claiming that safe potable water was accessible by 95% of urban and 75% of rural populations. A total of 218 conventional water treatment plants and 1191 compact water treatment units were operational as of 1990. Sanitation service coverage reached up to 75% of urban communities with varying degrees of adequacy. In the course of the past thirteen years, however, much of these capacities were damaged, ruined, deteriorated, or failed through lack of parts and neglect.

Iraqi medical claims were also often grossly exaggerated, and UN and international agencies made a weak and incompetent effort to validate them. Nevertheless, there is at least some element of truth in claims that diseases related to unsafe water and poor sanitation reached alarming rates by 2000, where one third of all children in the south and central governorates were reported to be suffering from malnutrition, and mortality rates to be more than doubled. According to the assessment of the International Committee of the Red Cross (ICRC), of the 177 water treatment plans reviewed, only 34 were good, 98 acceptable and 45 poor.

According to the UN/World Bank Needs Assessment report of October 2003, none of Iraq’s sewage treatment plans were operational, and 50% of the generated wastewater i.e. raw sewage was being discharged to rivers and waterways, which was consequently used as drinking water by overwhelming majority of Iraqis who do not have access to potable water.

This remained largely unchanged as of July 2005, as USAID reports on the progress of the sewage system: “[USAID is] expanding and rehabilitating one water treatment plant and constructing another to increase capacity by approximately 120 million gallons per day;
rehabilitating sewage treatment plants. The sewage treatment system in Baghdad [...] will be restored to almost 100- percent capacity, serving 80 percent of Baghdad’s population". There is no date for the completion of the only sewage treatment project in progress.

Sanitation infrastructure has a considerably worse status than that of water. Only 9% of the urban population outside of Baghdad is served by a sewage system, while the rural areas and the north do not have piped sewage systems at all. Lack of sanitation system is becoming a serious environmental and health concern. According to current reports, none of the sewage treatment plans are operational, and raw sewage is being disposed to rivers and waterways, which is consequently used as drinking water by overwhelming majority of Iraqis who do not have access to potable water. In addition, it is estimated that 50% of the generated wastewater in Iraq is being discharged to rivers and waterways everyday. Baghdad contributes as much as 75% of all sewage discharged to rivers in the country.

Solid waste collection in Iraq was based mostly on expensive technology, which significantly deteriorated even before the Gulf War. Of the 800 garbage collection vehicles, only 80 survived the 1991 Gulf War and the period of sanctions. At the present, there is little sanitary landfill facility for solid wastes. The USAID development efforts to restore the sector to standards of pre US invasion include water tankers to mitigate water borne diseases, repairs of water and sanitation facilities, water quality monitoring, procurement of needed water treatment chemicals, garbage collection and promotion of hygiene education. However, these efforts lack overall strategic coordination, cohesiveness, and scale and have only marginal impact.

Water and sanitation facilities’ maintenance during Saddam Hussein’s rule were contracted out. As a result, the Iraqis in this sector are not well trained or equipped to service these high maintenance systems once international contractors withdrew. Likewise, the “compact unit” water treatment technologies that are highly sophisticated proved difficult to sustain during sanctions.

In response to the needs of these two key sectors, policies need to be reviewed with the aim of building public sector capacity to regulate and set standards, including training personnel, introducing information technology to better plan and manage assets, revise tariff structure and strengthen master planning for urban water and sanitation infrastructure services. The UN/World Bank assessment goals put forth for water and sanitation sectors are still to be fulfilled. Neither the USAID nor the Department of Defense have set goals to provide all Iraqis with these most basic services.

**Telecommunications**

The existing telecommunications, post and internet services systems that are now in place in Iraq are poor. The effect of past wars, economic sanctions, and the devastation created by recent invasion has left this vital sector underdeveloped. Iraq’s teledensity of 5.6% in 1990 declined to 4% after the war in 1991. The Oil For Food Program brought the rate to 5.2%. The recent invasion and the subsequent lootings, however, destroyed twelve of the thirty-eight telephone exchange centers in Baghdad, and severely damaged the international switches and
satellite earth stations as well as the radio link connecting Baghdad with Basra. As a result, telephone access using landlines is almost non-existent for ordinary Iraqis.

Cell phone use, on the other hand, is increasing due to the unreliability of landlines. Iraqna – the only cell phone operator in Iraq - has 1.1 million subscribers as of July 2005. Cell phones do not provide ideal communication, due mostly to the US forces jamming to disrupt enemy communications. But, cell phones are still more reliable for most Iraqis than landlines. On the whole, the sector needs significant amount of resourced and policy changes in order to attain the level of services that existed before March 2003 and to become competitive regionally. It is crucial that a modern and integrated national long distance backbone network with international connectivity be established.

Electricity

The total installed electricity generating capacity of Iraq was 9,295 MW in 1990, with a peak domestic consumption of 5,100 MW and with 87% of all Iraqis having full access to electricity. The generation stations were damaged during the Gulf War, reducing the operating capacity to 2,325 MW, and repair efforts were badly mis-managed. Consumption reached a nadir of 300 MW in Baghdad and 500 MW nationwide in May 2003.

USAID efforts to develop levels of electricity generated and consumed remain uncertain. The stated goal of reaching 6,000 MW by July 1, 2004 has not been fulfilled as of July 2005 and now falls far short of actual demand.

The actual amount of electricity consumed in July 2004 was 4,293 MW. As of June 2005, nationwide electricity consumption was at 4,035 MW, with 9.4 hours of average electricity available - far from the USAID target of 6,000 MW.

Another shortcoming of the US reconstruction effort, particularly with respect to electricity was the lack of focus on the use of indigenous resources to deal with this situation. The Iraqi Commission of Electricity (CoE) has considerable human resource capacity but needs to upgrade technical knowledge and provide comprehensive training programs in all aspects of operations. Much greater direct involvement of staff from the CoE and the operating companies in the management of the rehabilitation programs is essential.

Coupled to failure to increase electricity production, there is also considerable distortion in the pricing of electricity produced. The subsidies in the provision of electricity from government plants are around 47%. As stated in Iraq’s National Development Strategy, “implicit subsidies for the consumer in the electricity sector are estimated at $ 4 billion due to fuel prices charged to generators below opportunity costs, as well as depreciation of equipment which [are] not taken into account in pricing. Adjustments need to be made in the pricing of electricity.”

Housing

At the macro level, the share of housing and construction as part of GDP declined from 6.5% in 1989 to a grim 0.47% in 1996, while the population increased from 17 to 21 million.
Housing construction increased during the OFF Program, yet remained far from producing substantial results. At the present, Iraqi housing sector is 2.8 million square meters short of the minimum requirement of housing its current population.

The quality of existing housing has further declined dramatically in the recent years due to overcrowding, lack of maintenance, and war. With nearly 30% of urban residents living near the poverty line, reconstruction efforts should focus on housing strategies that reflect the needs of the urban poor.

**Agriculture**

Iraqi agriculture constitutes 9.8% of the GDP and supports a rural population of seven million Iraqis – some 20% of national employment.\(^7\) The sector has declined since the 1980s and is underperforming. Over the past fifteen years, agricultural production declined by 1.1% per year on average, resulting in the decline of per capital agricultural production by 3.9% per year.

A Public Food Distribution (PFD) system was established under the OFF Program regime to provide food rations to all Iraqis, support food security at the household level and ensure adequate nutrition to most of the population. PDF was somewhat instrumental in providing very basic foodstuffs to Iraqis, yet it failed in avoiding mass malnutrition, as 50% of Iraqis remained vulnerable to food security during OFF Program.\(^7\)

The low productivity and negative growth rates associated with the agricultural sector are largely attributable to the following past governmental policies:

- **Fix food prices:** All previous Iraqi governments adopted the policy of fixing food prices at artificially low levels with direct subsidies to farmers.

- **Production controls:** Iraqi governments in the past purchased all crops produced. The Ministry of Agriculture declared the quota for each crop at the beginning of the year, thereby controlling all agricultural production.

- **Lack of marketing:** Because the Iraqi government was the single official buyer of all agricultural output, there was almost no marketing activity on the part of the agricultural producers.

- **Insufficient maintenance and funding for agricultural sector:** As stated in the previous sections, Iraqi governments in the past did not have an economically efficient and sustainable growth policy for agriculture. The sector was always secondary to oil, and did not receive a strategic economic focus, which meant very limited funding and maintenance.

Those inefficient policies have degraded agricultural services and physical infrastructure and the extensive irrigation network. The extensive looting that took place after the US invasion damaged a range of government and private agricultural production and service facilities such as animal health and artificial insemination centers, poultry production facilities and plant quarantine units, particularly in central and southern Iraq.

By the time of the invasion, Iraq inherited an unsustainable food security environment dominated by declining productivity, a weak policy regime and a government subsidized food...
supply scheme costing the country over $2 billion a year, with no targeted strategy to assist vulnerable groups.

According to World Food Program assessment undertaken in 2002/2003, 60% of Iraqis are dependent on food ration system and lack sufficient purchasing power independent of the food aid. That rate is believed to continue today, and it is estimated that it will take a long time before private distribution and food markets develop, therefore it is crucial that the government maintains the state importation and public distribution of basic foodstuffs. Over half of Iraq’s total food consumption is imported.

Generous agricultural subsidies were used all throughout Saddam Hussein’s rule. The UN/World Bank Joint Iraq Needs Assessment report of October 2003 cautions against the radical elimination of these subsidies and the potentially adverse effects thereof, particularly on the farmers. Yet the new Iraqi government has been under heavy pressure from the US administration especially the USAID agricultural experts to dramatically reduce and eliminate agricultural subsidies. This causes grave concerns on the part of Iraqi officials who do not want to increase unemployment by putting agricultural production to disadvantage given the fact that agriculture provides 20% of Iraqi national employment. As of August 2005, the Iraqi government did, however, significantly reduce direct agricultural subsidies, and begin to subsidize agricultural inputs such as pesticides, fertilizers or improved seeds.

Financial Sector

The financial sector remains weak. There is almost no financial intermediation, existing financial institutions are ineffective, and the regulatory framework is poorly organized. While CPA’s success in creating an independent Central Bank of Iraq is a considerable accomplishment, the Bank still lacks a normally operating branch system to sustain a reliable payment process and liquidity in the country.

The main component of Iraqi financial sector is the banks, given the fact that capital markets – with the exception of government debt instruments- are largely non-existent. All Iraqi insurance companies are state owned, and none of them are currently functioning. The banking system is composed of twenty-two banks and the Central Bank. Two of these banks are public (Rafidain and Rasheed Banks, which account for over 90% of commercial banking assets and 75% of branch bank network), sixteen are private sector commercial banks and four are specialized public banks. In aggregate, the banking system has only some US $2 billion equivalent in assets. The Central Bank’s Banking Control and Auditing Department is set up to supervise the banking system, but is not functional due to lack of specific banking and supervision provisions, organization, technology, human resources training, development of procurement and operational manuals as well as supervisory framework.

The new banking order that was enacted in August 2003 opens Iraq’s financial sector to foreign investment. Yet there are critical basic needs for the financial sector to gain elementary functionality:
Critical assistance such as refurbishing and reconstructing offices and branches, updating technology, providing technical assistance and training to the two main commercial banks so as to enable their resumption of operations.

Establishing an effective operational framework for the supervisory branch.

Providing assistance to the Iraqi Central Bank for accounting and auditing proponents of the sector to ensure congruence with internationally applicable standards.

It is crucial that immediate action is taken to form a properly functioning banking sector, which is inclusive of legal and regulatory aspects to develop a modern and sound financial sector.

**State Owned Enterprises**

Throughout Iraq’s contemporary history, its national economy has been centrally planned, and public enterprises have dominated key sectors of the economy. They have operated under high protection levels with controlled and subsidized input and output prices. Saddam Hussein’s regime did not allow non-Arab foreign direct investment, and the post Gulf War sanctions essentially created an economy fully isolated from the world, with a substantial black market.

The 192 state owned enterprises (SOE) are notorious for their lack of modern technology, and have caused decapitalization of assets by keeping production costs artificially high due to absence of any incentive to lower costs. The looting that followed the US invasion further deprived these organizations of value. Today, their net worth is assessed to be little higher than the value of their land and buildings. There is no credible public information on the current status of SOEs. There is no report of major privatization of the entities.

**Overall Subsidies**

As has been mentioned earlier, Iraq’s economy suffers from the cost of direct and indirect subsidies. Direct include:

The Oil For Food Program’s food baskets, now called the Public Distribution system. In 1996, under the UN OFFP, Iraq’s food ration system was expanded to provide Iraqis with a basket of basic food items to avoid malnutrition. These items are rice, flour, sugar, tea, cooking oil, milk powder and salt. In 2004, about $ 5 billion was allocated to the Public Distribution System for purchasing, handling and distribution of food to consumers, as a subsidy from the Iraqi Government. It is estimated that 60% of Iraqis are in real need of the rationing system, while all Iraqis currently benefit from it. In the short tem, the remaining 40% should be eliminated.74

Refined Oil products. As discussed before, these are the imports of oil based products due to Iraq’s lack of refinery structure.

Gas

Indirect subsidies include:

Discounted prices of crude oil that is supplied to refineries,

Electricity,
Water,

Agricultural inputs.

Direct and indirect subsidies consume a major part of Iraqi government revenues. While the cost of indirect subsidies can only be estimated, the cost of direct subsidies are more than ID 10.2 billion of the public budget in 2005, its share in GDP being more than 37%. Elimination of subsidies should therefore be a high concern for Iraq’s economy.

**B. Current Iraqi Financial Structure and Budget:**

The Iraqi national budget for 2004, (Summarized in Figure 5), was prepared jointly by experts from the Iraqi Finance and Planning Ministries in close consultation with experts from the US treasury. This budget only contains provisional estimates for FYs 2005 and 2006. The formal budgets for these years and 2007 were prepared in July 2005 (presented in the following pages). The Congressional Budget Office has extrapolated numbers from the FY2004 budget as well as Iraqi Ministries’ guidance for FY2005 and FY2006 to forecast a provisional budget prediction for 2007. The table below shows these numbers. (It should be noted that numbers for FY2007 have not been approved by Iraqi officials.)

The Iraqi government used returned Oil For Food Program funds to make up for a $ 0.6 billion deficit in FY2004. The remaining balance of these funds is uncertain, as the UN program phases out and there is still discussion between UN and Iraqi officials in regards to the future use of the funds.

There are two major items funded by the Iraqi oil revenues as part of this account that raise serious issues:

*Investigation into the mismanagement of the Oil For Food Program:* Iraqis do not want their hard currency from oil exports to fund the investigation on corruption charges for former regime officials and the UN authorities who were in charge of a program, which itself was financed with billions in Iraqi oil revenues. The investigation had a cost of $ 30 million up to June 2005, and the Inquiry committee chairman is expected to ask for an additional $ 3-4 million soon, which is expected to be granted.

*United Nations Monitoring, Verification and Inspection Commission (UNMOVIC).* The UN body established to disarm Iraq of weapons of mass destruction has spending reaching $1 million a year and the new Iraqi government is getting impatient with the cost of an agency which has no clear purpose as no such weapons have been found in the country.
Figure 5

2004 Iraqi Budget

The Iraqi Government’s Budget Plans
(As of January 2004)
(In Billions of US Dollars)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Revenues</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Oil exports</td>
<td>12.0</td>
<td>18.5</td>
<td>19.3</td>
<td>19.3</td>
<td>69.1</td>
</tr>
<tr>
<td>Customs duties</td>
<td>0.3</td>
<td>0.4</td>
<td>0.0</td>
<td>0.0</td>
<td>0.7</td>
</tr>
<tr>
<td>Income taxes</td>
<td>0.0</td>
<td>0.1</td>
<td>0.2</td>
<td>0.2</td>
<td>0.4</td>
</tr>
<tr>
<td>Returns from SOEs</td>
<td>0.4</td>
<td>0.1</td>
<td>0.1</td>
<td>0.1</td>
<td>0.7</td>
</tr>
<tr>
<td>User fees &amp; charges</td>
<td>0.1</td>
<td>0.1</td>
<td>0.1</td>
<td>0.1</td>
<td>0.4</td>
</tr>
<tr>
<td>Other taxes and income</td>
<td>0.1</td>
<td>0.1</td>
<td>0.1</td>
<td>0.1</td>
<td>0.3</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>12.8</td>
<td>19.2</td>
<td>19.8</td>
<td>19.8</td>
<td>71.5</td>
</tr>
</tbody>
</table>

| **Expenditures** |        |        |        |        |                 |
| Operating expenses * | 12.1 | 13.0   | 13.1   | 13.1   | 51.3            |
| Reparations from the invasion of Kuwait ** | 0.6  | 0.9    | 1.0    | 1.0    | 3.5             |
| Interest on foreign debt *** | 0.0 | 0.2    | 0.2    | 0.2    | 0.6             |
| Capital investment | 0.7    | 5.1    | 5.4    | 5.4    | 16.7            |
| **Total**         | 13.4   | 19.2   | 19.7   | 19.7   | 72.1            |

| **Surplus/ Deficit (-)** | -0.6  | $     | $      | $      | -0.5            |

Sources: Republic of Iraq, Ministry of Finance and Ministry of Planning, 2004 Budget, October 2003
Congressional Budget Office, Paying for Iraq’s Reconstruction

Notes:

2005 & 2006 come from the fiscal guidance for those years provided in the 2004 budget. Figures for 2007 are based on an extrapolation of those for 2006. $ = Between zero and $ 50 million

* Actual expenses could be higher, depending on the policies and priorities of the Iraqi government. Additional security (other than that already programmed into the budget) could cost another $ 100 million to $ 300 million per year.

** UN Security Council Resolution 1483 requires Iraq to pay 5% of its gross revenues from oil exports to meet reparations claims for the 1990-1991 Gulf War. Out of the approved $ 52.5 billion, $ 19 billion has been paid so far and $ 33.5 billion is outstanding.

*** UN Security Council Resolution 1483 provides for a moratorium on interest and principal repayments of Iraq’s foreign debt until the end of 2004.
The budgets prepared by the Iraqi Ministry and Development Cooperation for FY 2005, 2006 and 2007 presented in Figure 6 show clear changes from the earlier plans shown in Figure 5. The new budget’s provisions for oil revenues are clearly higher. The economic viability of this point will be discussed in detail in the following section.

Other significant differences between the former budget plans and the latter plan include the deficit/surplus value. While the January 2004 calculations envision a balanced fiscal year for 2005, 2006 and 2007, July 2005 budget shows a deficit of $4.8 billion for 2005, and $1.5 billion for the 2005 and 2006 years respectively, followed by a $0.5 provisional surplus in 2007.

**Figure 6**

**2005, 2006 and 2007 Iraqi Budget**

(As of July 2005 in Billions of US Dollars)

<table>
<thead>
<tr>
<th></th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Revenues</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Oil Exports</td>
<td>20.8</td>
<td>26.3</td>
<td>29.2</td>
</tr>
<tr>
<td>Taxes</td>
<td>0.62</td>
<td>0.72</td>
<td>0.76</td>
</tr>
<tr>
<td>Non Tax Revenue</td>
<td>1.60</td>
<td>1.92</td>
<td>1.93</td>
</tr>
<tr>
<td>Total Domestic Revenues</td>
<td>23</td>
<td>29</td>
<td>32</td>
</tr>
<tr>
<td>External Funds (Grants/Loans)</td>
<td>9</td>
<td>10</td>
<td>7</td>
</tr>
<tr>
<td><strong>Grand Total Revenues</strong></td>
<td><strong>32</strong></td>
<td><strong>39</strong></td>
<td><strong>39</strong></td>
</tr>
<tr>
<td><strong>Expenditures</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Wages &amp; Pensions</td>
<td>5.5</td>
<td>6.7</td>
<td>6.9</td>
</tr>
<tr>
<td>Goods &amp; Services</td>
<td>4.9</td>
<td>6.3</td>
<td>7.5</td>
</tr>
<tr>
<td>Transfers</td>
<td>10.3</td>
<td>9.4</td>
<td>8.4</td>
</tr>
<tr>
<td>Interest Payments</td>
<td>0.19</td>
<td>0.27</td>
<td>0.3</td>
</tr>
<tr>
<td>War Reparations</td>
<td>1</td>
<td>1.3</td>
<td>1.5</td>
</tr>
<tr>
<td>Capital Investment</td>
<td>5.9</td>
<td>6.5</td>
<td>6.8</td>
</tr>
<tr>
<td>Total Domestic Expenditures</td>
<td>27.8</td>
<td>30.5</td>
<td>31.4</td>
</tr>
<tr>
<td>External Funds (Grants/Loans)</td>
<td>9</td>
<td>10</td>
<td>7</td>
</tr>
<tr>
<td><strong>Grand Total Expenditures</strong></td>
<td><strong>36.8</strong></td>
<td><strong>40.5</strong></td>
<td><strong>38.4</strong></td>
</tr>
<tr>
<td><strong>Deficit/Surplus</strong></td>
<td><strong>-4.8</strong></td>
<td><strong>-1.5</strong></td>
<td><strong>0.6</strong></td>
</tr>
</tbody>
</table>

While the budgetary provisions for capital investment account for the cost of oil facilities’ reconstruction and rehabilitation costs, wages and pensions do not fully take into account the potential and very probable increase in security costs. The budgets for these years incorporate security costs of only 125,000 Iraqi security forces personnel, yet the number of these forces had already increased to 172,000 as of June 2005 (40% increase), and there are plans to expand the number further to 226,000. This could add between $500 million to $1 billion in additional expenses over the 2005-2007 periods.

One significant ambiguity in the Iraqi fiscal structure is the division of jurisdiction among Iraqi agencies and the control of funds, a problem compounded by unclear lines of provincial and local authority, and the prospect of new federal regions and complex national, regional and local allocations of oil revenues. Due to the lack of an overarching comprehensive financial framework for various government agencies, it is not clear exactly which ministry is in charge of revenues and reserves. The vagueness of jurisdiction is especially predominant over oil revenues, which constitutes 95% of Iraqi national income. Clear demarcation lines need to be drawn especially between Ministries of Oil, Finance and Planning to define authority. Interdependence of and cooperation among these entities is not only natural but also vital, yet a market-oriented economy necessitates clarity of control.

This lack of clarity with regards to financial control paves the way for corrupt officials to pocket large sums of money. There have been numerous reports of Iraqi ministry officials taking out hard cash from Iraqi Central Bank to use it for “their ministries purposes”. The labor and transport ministers of the interim government are now charged with waste of public funds and are among the 44 Iraqi Interim Government officials who have been issued legal warrants.

The accuracy of Iraqi budgeting and accounting aspects is at best unclear. Budgeting does not account for the war conditions the country is in, therefore the cost of an increasing number of security force. In addition, the budgeting structure does not draw clear lines of jurisdiction on the use of revenues among Iraqi government branches and ministries. Control of different segments of the national economy is not clearly defined. Extra financial burdens of the UN OFF Program investigation and the weapons inspection commission drain valuable resources, while the status of debt repayment remains ambiguous.

A further complication in the budgeting and accounting of the Iraqi economy is its link with the US and international aid process. There is lack of information on the interface between the US economic reconstruction funding and budgeting of Iraq’s revenues, especially for capital investment projects. This is a very important issue, and there should more information made available.

C. Status of Oil Revenues

The Iraqi budget has a very high reliance on oil revenues. (According to CBO, oil exports will account for 97% of Iraqi national budget revenues between 2004 and 2007). Budgetary predictions envision 90%, 91% and 92% of all national income to be generated from oil.
exports for 2005, 2006 and 2007 respectively. This is economically worrisome in a number of ways:

**Nature of oil prices**

The Iraqi government’s revenue calculation of oil revenues in its budget planning is based on a conservative $38 per barrel for 2005 and $40 per barrel for 2006 and 2007, although the price of Iraqi Crude Oil was $52.60 per barrel as of July 8, 2005. Nonetheless, such prominent dominance of a commodity that is explicitly vulnerable to radical price fluctuations is worrisome. The government budgeted for 1.5, 1.8 and 2 million barrels per day exports for FY2005, FY 2006 and FY2007, while average export levels remained only at 1.3 and 1.4 million bbl/d for 2004 and 2005 respectively.

The government was able to compensate the financial difference in 2004 between the planned high exports, and the actual figures by high oil prices, yet this is not an ideal avenue for fiscal budgeting. Should oil prices return to their pre 2003 levels, the Iraqi government could not meet its operating expenses at the current production and export levels. (See Figure 7 below for production trends and revenues.)

**Figure 7**

**Iraqi Crude Oil Production & Revenue**

<table>
<thead>
<tr>
<th></th>
<th>Production</th>
<th>Revenue</th>
</tr>
</thead>
<tbody>
<tr>
<td>2003 June</td>
<td>453</td>
<td>0.2</td>
</tr>
<tr>
<td>July</td>
<td>573</td>
<td>0.36</td>
</tr>
<tr>
<td>August</td>
<td>1,053</td>
<td>0.44</td>
</tr>
<tr>
<td>September</td>
<td>1,403</td>
<td>0.73</td>
</tr>
<tr>
<td>October</td>
<td>1,753</td>
<td>0.89</td>
</tr>
<tr>
<td>November</td>
<td>1,853</td>
<td>1.21</td>
</tr>
<tr>
<td>December</td>
<td>1,953</td>
<td>1.26</td>
</tr>
<tr>
<td><strong>2003 7 Month Av</strong> 1,292</td>
<td><strong>0.72714</strong></td>
<td></td>
</tr>
<tr>
<td>2004 January</td>
<td>2,103</td>
<td>1.26</td>
</tr>
<tr>
<td>February</td>
<td>2,003</td>
<td>1.1</td>
</tr>
<tr>
<td>March</td>
<td>2,203</td>
<td>1.61</td>
</tr>
<tr>
<td>April</td>
<td>2,303</td>
<td>1.5</td>
</tr>
<tr>
<td>May</td>
<td>1,903</td>
<td>1.36</td>
</tr>
<tr>
<td>June</td>
<td>1,703</td>
<td>1.28</td>
</tr>
<tr>
<td>July</td>
<td>2,003</td>
<td>1.4</td>
</tr>
<tr>
<td>August</td>
<td>1,803</td>
<td>1.24</td>
</tr>
<tr>
<td>September</td>
<td>2,303</td>
<td>1.75</td>
</tr>
<tr>
<td>October</td>
<td>2,203</td>
<td>1.99</td>
</tr>
<tr>
<td>November</td>
<td>1,703</td>
<td>1.25</td>
</tr>
<tr>
<td>December</td>
<td>1,903</td>
<td>1.44</td>
</tr>
<tr>
<td><strong>2004 Av</strong></td>
<td><strong>2,011</strong></td>
<td><strong>1.4317</strong></td>
</tr>
</tbody>
</table>

Sources: State Department Weekly Status Reports  
US Energy Information Agency (EIA)

**Unfeasible Production and Export Expectations**

According to International Energy Agency’s Oil Market Report of April 2005, Iraq’s sustainable production capacity is 2.5 million bbl/d. According to the same report, the country was able to exploit only 1.81 million barrels of its capacity per day as of March 2005. Out of
that, only 1.4 million barrels were actually exported, the remaining amount was used for domestic consumption.

The Iraqi government, has plans to increase exports to 2.0 million barrels per day by 2007, and aggregate production to 3.3 million bbl/d. This production level has not been reached in Iraq’s history. (See Figure 8) In other words, the Iraqi government’s budget is constructed on the prediction that Iraqi production will exceed the International Energy Agency figure of Iraqi sustainable production capacity of 2.5 million bbl/d. An era of high oil prices could compensate for the problems in such plans, but they do not seem feasible at the present for a variety of reasons:

Figure 8

Aging infrastructure: Iraqi oil production facilities are severely outdated. Many Iraqi oil fields have been exposed to high levels of corrosion due to excess fuel oil injection used to pump out oil, and some have danger of collapsing.

Lack of new technologies: Iraqi oil facilities are furnished with outdated equipment from mid to late 80s, which in turn minimizes production efficiency and maximizes costs.

Lack of exploration: There have been no explorations for new oil fields in Iraq since mid 80s. Aging fields with old infrastructure and high levels of corrosion are not replaced with new fields equipped with high technology.

Note: Production includes crude oil, lease condensate, natural gas liquids, ethanol, and refinery gain.
**Over pumping:** Many oil fields, especially Kirkuk have exposed to production levels that exceed their optimal levels. Production at the Kirkuk vicinity has reached as high as 680,000 bbl/d, much higher than the 250,000 bbl/d optimal level of production. This in turn has increased “water cut” and reduced the quality of crude oil.

**War and Security of oil infrastructure:** The production facilities are open to attacks by insurgents, and a single attack on these facilities can halt production for many days.

**Security of pipelines:** The 4000 plus oil and gas pipelines across Iraq are vital to the country’s ability to export oil. According to Mr. Jihad, an Iraqi oil ministry official, the country’s damage from 300 attacks on oil infrastructure and pipelines between June 2003 and May 31, 2004 is as high as $11.34 billion. The creation of a new pipeline security force may or may not help this situation.

**The Continuing Feasibility Project:** In order to better understand the state of the Kirkuk reservoir, a contract was signed in early 2005 for Exploration Consultants Ltd. and Shell to carry out an integrated study on Kirkuk, with work scheduled to be completed by early 2006. A separate study of Rumaila will also be conducted at the same time. It would be difficult, if possible at all, to reach maximum optimal production levels before the completion of these projects. The Iraqi and US governments are criticized for the lack of these projects all across Iraq, and placing exports above oil field rehabilitation and modernization.

**Illegal Oil Trade**

High oil prices do provide added revenues, but they also increase the price of subsidies and have other negative effects. Official Iraqi budget calculations were based on $22.2 bbl/d for 2004 and 2005 fiscal years. However, the average price of Iraqi crude oil per barrel during mid-2004 to mid-2005 has been almost double that amount. While the amount of production and exports have been short of official expectations, the radical difference in the price of oil was expected to create positive impacts on the daily lives of Iraqis. Among the reasons for the gap between oil revenues and improving living conditions is the growing problem of income loss due to smuggling and outright theft of revenues. This not only creates a “leaky bucket” in the fiscal revenue system, but weakens the Iraqi public’s faith in the country’s new government and its financial policies.

Smuggling also has an ethno-sectarian nature. The previously centralized regime of Saddam Hussein had a firm grasp over the oil production facilities. In today’s Iraq, on the other hand, there is more room for tribal and partisan control of the revenues. Mr. Jamal Qureshi, an oil market analyst with PFC Energy—an international consulting firm—says “in many cases, the technocrats are no longer in charge, so you have a lot of potential for partisanship and local interests to win out over the common national good”. Mr. Qureshi and other oil market analysts assess the loss caused by smuggling to be 5 to 10% of national revenues. The oil fields around Kirkuk in the north, and those surrounding Rumalia in the south are being exploited and smuggled from by Kurds and Shiite respectively.
Dutch Disease

The dominance of oil revenues as a percent of national revenues has the potential to de-industrialize Iraq’s economy in the five to twenty year period. Increasing oil exports are causing the value of Iraqi Dinar to appreciate, in spite of comparatively low exports volumes and could make future Iraqi manufacturing and exports of all other non-oil products less competitive. As a result, imports may increase while non-oil exports decline. Economic diversification, and the prevention of over-reliance on oil revenues, should be given a priority if Iraqi economy is to maintain a healthy balance.

Unemployment Effects

Unemployment in Iraq is a serious problem. Yet the dominance of a capital-intensive oil sector reinforces the lack of employment opportunities. Development of labor-intensive sectors such as agriculture and industry is needed in the medium to long terms. Iraq’s economic history has shown that previous governments’ over reliance on oil prevented the development of industry and other labor-intensive economic activity. This mistake should be avoided.

Other factors that require careful consideration of dependence on oil revenues include the effects of oil revenues on the Kurdish and Shia separatism. While the oil revenues are considered as Iraq’s national revenues by non-Iraqis, many Kurds and Shia do not want to share the oil wealth of their respective regions with others. Differences among Iraqis over how to share oil wealth are detrimental to the country’s future development.

D. Differences in Economic Expectations among Iraqis:

The sharing of oil wealth in Iraq has traditionally been managed and controlled by the central government, with almost no local control over the resources. In the political remaking of Iraq, however, authority is being localized and federalized, and growing differences in economic expectations are emerging among Iraqis. The variations among the three major ethno-sectarian fractions play a significant role in Iraq’s economic development, and will continue to do so until these differences are resolved. The division pertains to whether oil revenues should be allocated at the national, federal, or local level. There are three main positions on this issue:

Kurdish Expectations

The Kurds make up about 17% of Iraq’s population, and have had broad autonomy from Baghdad since the Gulf War in 1991 - after being brutally oppressed by the Ba’ath regime under Saddam Hussein for decades. The isolation of the Kurds from Baghdad allowed them, among many other things to have their own border patrol and security forces known as the peshmerge. They received extensive financial aid from the international community and the US. The international aid ensured building of basic infrastructure, something the rest of the country was mostly deprived of since 1980.

The 2004 UNDP survey shows that the three Kurdish provinces have much better basic living conditions than the rest of the country:
The percentage of household with unsafe water in the Kurdish governorates is 7%, while the rate rockets to 33% in the Shia Arab dominated south and is 16% Central governorates.

53 of 100 homes in the north are connected to sewage systems while the number decreases to 8 in the Central provinces, and 18 in the south.

Out of 100 children, only 13 were not enrolled in primary school in the Kurdish provinces. The number increases to 23 and 24 in the South and the Center of the country respectively.

Median income in the Kurdish provinces is 412,667 Iraqi Dinars. The figure is 366,000 in the southern governorates and 328,000 in the Central provinces.

While 33% of Iraqis in the south and 39% of Iraqis in the central governorates reported to have weapons shot in their neighborhood everyday, the figure dropped to 1% in the Kurdish regions – This is significant as one of the most significant indicators of living standards is safety.

The Kurds in Iraq gained extensive rights and representation after the January 30, 2004 elections. There is now a Kurdish Parliament independent of the Iraqi National Assembly and a Kurdish flag. The new Iraqi president, Jalal Talabani is a Kurd.

The economic importance of Kurdish Iraq depends heavily on its proximity to nearby oil resources, and the degree of control the Kurds gain over such resources. About 1 million bbl/d of 3-million bbl/d pre war oil production of Iraq came from oil fields in the north. The Kirkuk oil field is the second largest oil production site in the country, producing 550,000 to 700,000 bbl/d.

The Kurds argue that Kirkuk is a Kurdish city, and hundreds of Kurdish families have moved to the city since Saddam’s fall to numerically prove their claims to the city and its oil reserves. Arab officials in the city have been assassinated, and hundreds of Arabs and ethnic Turkmens have been kidnapped.

Kirkuk’s oil wealth could potentially sustain a prosperous autonomous Iraqi Kurdistan if the revenues from it were given to the Kurds. While some Kurdish officials have expressed their ultimate desire of independence, the prospect of a free Kurdish north is highly unlikely in the near future. President Talabani has cautioned the Kurdish Iraqis against separatism. With all the gains they achieved and the resources that are located in the Kurdish areas, the current political and economic goals of Iraqi Kurds are two fold:

- Push for the loosest form of federal system for new Iraq with strong regional governments that exercise maximum autonomy,
- Make Kirkuk and its oil reserves of petroleum part of an autonomous Iraqi Kurdistan.

**Shia Arab Expectations**

The Shia are located mostly in the south of Iraq, and make up the 60% majority of Iraqi population. The central authority, particularly Saddam Hussein, has oppressed them for decades. The UNDP Iraq Living Conditions Survey 2004 shows that overall infrastructure and
basic living standards in the Shia south are worse than those of the Kurdish north, and Sunni center. Yet, the Shia part of Iraq produces more than two third of all Iraqi oil. According to US Department of Energy figures, the north and south Rumaila fields alone produce 1.3 million bbl/d. When the West Qurnah, Az Zubair, Misan/ Buzurgan, Majnoon, Jabak Fauqi, Abu Ghurab and Luhais fields, all of which are located in the Shia south, are added, the amount reaches to 2 million bbl/d.

Unlike the past, the Shia now have the largest political representation in the Iraqi National Council and the government. Islamic sentiment is also widespread among the Shia members of parliament as well as the Shia writing committee for the constitution. The committee chairman Humam Hammoudi, initially insisted that the country’s official name be changed to “Federal and Islamic Republic of Iraq” from the current “Republic of Iraq”. The desire for federalism also has strong support among the Iraqi Shia. The number of Shia members of parliament who want a loose system of decentralization for the new Iraq is increasing.

The main political and economic goals of the Shia are:

Creating an Islamic political structure.

Having a new Iraq that is federal.

Treating oil revenues locally rather than nationally (where oil money is retained by local governments rather than Baghdad).

While the Shia desire for an Islamic Iraq is opposed by many secular Kurds, it is important to note that the economic interests and future economic expectations of the Kurds and the Shia mostly converge, and that this is particularly true in the case of federalism.

Sunni Arab Expectations

The Sunni Arabs are located mostly in the center and the southwest of the country. They have been in control of Iraq since Ottoman rule despite the fact that they constitute only 20% of the Iraqi population. In contrast to their long-standing position in power, the Sunnis are largely excluded from the parliament since most of them protested against the January 2004 elections and refused to vote.

Sunnis are the group that most preferred the pre-US occupation status quo and there is a strong anti-occupation sentiment among them, hence the dominant role Sunnis play in the insurgency. The international community and the US have urged the Kurds and the Shia to include the Sunni minority in the political process, but Sunni Arabs are opposed to the weakening of the control of central government over the oil revenues. The Sunni political economy has one major objective: keep the oil revenues national.

These differences further act as obstacles to developing a national Iraqi economy. There are increasing reports that the Shia in the south, for instance, are involved in heavy smuggling of the oil from the fields to the international market, bypassing the central government’s authority. This is among the factors why increasing oil prices do not translate to increasing
national revenues for Iraq at large. While oil smuggling in the south is widely known and acknowledged in Baghdad, the Shia majority government is tacitly turning a blind eye to the facts. The same phenomenon is eminent in the Kurdish North. Experts estimate that 5 to 10% of national oil revenues are being lost to smuggling, and the percentage is increasing.\(^9\)

The current budgeting process and fiscal projections are based on the traditional way of treating Iraqi oil revenues as national income. Yet with the Shia and Kurds seeking to decentralize oil revenues, the central government’s role and authority over oil money is coming under serious question. Any change in the treatment of oil income will have severe consequences on the macro and micro levels of Iraqi economy.

There are projections for possible outcomes if the oil revenues are completely decentralized. A rich and almost independent Iraqi Kurdistan, a wealthy and Islamic Shia south, and an underdeveloped Sunni center, tied together under a loose federation is one of these projections. Whatever the real consequences may be, the sharing of the oil wealth must be addressed. Ambiguity over the only real economic resource that will bring liquidity to the country in the immediate near future is causing loss of potential income and unbalanced shift of economic power within the country.

**E. Challenges of constructing a functioning economy with war as a backdrop:**

While the different economic expectations of various Iraqi groups undermines the development of a sound national Iraqi economy, the continuing insurgency is a more pressing threat to economic reconstruction efforts in the country. Assessing reconstruction efforts in Iraq is difficult as the country is still in a state of war. This state of conflict has three major implications for Iraqi economic reconstruction and development efforts:

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**Draining resources**

One is the massive diversion of aid funds and state revenues. A significant portion of the $22 billion appropriated by Congress to boost Iraqi reconstruction and economic development is used to provide security. In his testimony before Congress in June 2004, former Deputy Secretary of Defense Paul Wolfowitz stated that 10-15% of project costs were going to security expenses.\(^91\) According to a more recent report from the US Energy Information Agency of the Department of Energy, as much as 40% of the $18.4 billion appropriated in 2004 was actually spent on providing security, not on reconstruction as of June 2005.\(^92\)

This means that even less of the funds appropriated for the economic reconstruction projects is actually available for reconstruction. War also disrupts every aspect of day-to-day life and economic activity.

A single attack on the Karch Water Treatment Plant north of Baghdad, for instance, caused the electrical control mechanisms to be destroyed, and seriously limited the amount of water released into Baghdad from July 1 through July 3. The plant was repaired by US Army Corps of Engineers at a cost of $40 million and the recent attack caused a damage of an estimated $20 million.\(^93\)
This, and the similar incidences that take place on a daily basis, also act as a major disincentive to private investment, raise unemployment, impoverish many Iraqis, and encourage others to participate in private or organized crime.

**Burden on the Budget**

Second, Iraqi financial budgeting does not account for the scale of the war in the country. As stated in the Budget section of this work, Iraqi government’s operating expense projections for years 2004, 2005 and 2006 based on 125,000 Iraqi security forces. As of June 2005, this number is already 172,000 with higher number of forces coming down the pipeline.

There are no additional funds in the Iraqi budget for these additional troops that are necessary to fight the war. This puts forth the question of accuracy of Iraqi budgeting, and how reliable estimates are or how much of the increasing cost of security is expected to be financed by foreign aid. The Iraqi budget does not include provisions for the use of foreign funds in individual segments of the economy.

**Limitations on US and other international private investment**

Third, the persistent fighting, high levels of crime, and attacks on international civilians - including contractors engaged in rebuilding infrastructure - render the country a highly unfavorable place to invest in. The already limited number of international companies operating in Iraq during the early stages of the occupation pulled out as a result of the attacks. German and Russian power companies left Iraq after attacks on their workers during the spring of 2004.

Leading US companies, such as Proctor & Gamble or GM put their joint venture plans on hold due to level of insecurity in the country. Despite all the efforts of post-March 2003 administrations to attract international private investment, most international companies considering substantial, long-term investments - particularly in capital intensive areas like the oil sector - deliberately put their decisions on hold until the conflict in the country reaches a stable and low level. The IMF Macroeconomic Assessment Report of 2001, among all other reports regarding Iraqi economy, warned that “a persistent lack of security could be disruptive to economic activity and significantly inhibit private investment and donors’ involvement in Iraq’s reconstruction.” The situation remains unchanged since IMF’s caution in 2001.

Economic reconstruction and security in Iraq are intertwined where security is directly correlated with economic policies, if not strictly contingent upon them. It should also be noted that the relationships between economic policies and security are reciprocal rather than linear. (See chart below)
The Iraqi economic reconstruction is thus sharply dissimilar to the post war economic development of Germany or Japan, where little or no money appropriated for economic rehabilitation had to be spent on security and counter insurgency. It is equally important to realize that low level of security has direct financial repercussions that consequently worsen the security environment. This is also a reason why economic policies that aim to produce tangible macro economic results such as increasing Iraqi national employment, would almost certainly help improve the level of security in Iraq.

Starting with the 1980-1988 war with Iran, Iraq’s Ba’ath Party ruled government borrowed extensively from foreign governments as well as international credit lending institutions to pay for its defense spending. Coupled with the compensations the country is obligated to pay for the losses it caused by invading Kuwait in 1991, the foreign debt stock reaches a considerable amount. If not addressed, Iraq’s financial obligations will be a major revenue loss for the country’s economy.

F. Status of Iraq’s International Financial Obligations:

Iraq’s international financial obligations are another source of economic instability. The resulting financial obligations will limit the full use of funds for Iraqi economic reconstruction in two ways. First, the heavy debt burden inherited from Saddam Hussein’s regime will deviate serious amount of revenues that could otherwise be used for revamping Iraqi economy. Secondly, Iraq’s foreign debt and other monetary obligations as they stand are obstacles before the country’s economic integration into international capital markets. These international financial obligations are of three main types:

**Gulf War Reparation Claims**

The first includes the compensation claims brought against the Iraqi government by individuals, families, companies and governments on the basis of their losses due to Iraq’s invasion of Kuwait and the consequent military conflict.

The United Nations Security Council delegated the mission of assessing applications and awarding compensation to the UN Compensation Commission (UNCC), which finalized its
investigations and awarded a total of $52.5 billion in compensations. Security Council Resolution 1483 requires Iraq to put 5% of its revenues from oil exports into a UN fund to pay for these claims. As of June 30, 2005, this fund had paid $19.2 billion of the total reparations awarded, leaving $33.3 billion to be paid by Iraq. The fund continues to pay around $200 million per fiscal quarter.⁹⁷

**Pending Contracts**

The second category of claims includes contracts signed with public and private foreign companies during Saddam Hussein’s regime. The overwhelming majority of these contracts have been with Russia, although companies from the Netherlands, Egypt, United Arab Emirates, China and France also have been identified.⁹⁸

These contracts have been estimated to have a total value of $57.2 billion ($52 billion with Russian companies, $5.2 billion other nations), primarily in the energy and telecommunications sectors.⁹⁹ Many of these contracts have not been executed due to sanctions regime, and it is unclear whether they will be honored.

**Foreign Debt**

Iraq’s foreign debt, the third category, is due mainly to its war with Iran, and its arms purchases during the war in particular. After the war with Iran, Iraq had a short-term debt of $35-45 billion, which today remains unpaid.¹⁰⁰ As the country continued its arms build up, it did not pay its debt all through Saddam Hussein’s regime. As a result, the amount owed steadily increased, and Iraq now faces a large amount of foreign debt. The exact amount is not known, and there are various estimates:

- CIA reports Iraq’s foreign debt as $125 billion.¹⁰¹
- US Department of Energy’s figure for Iraq’s foreign debt is $100 billion (discounting the Paris Club debt forgiveness).¹⁰²
- The US Embassy in London reported $120 billion worth of Iraqi debts.¹⁰³
- A London based brokerage quoted in CBO paper said that Iraq owed $116 billion in foreign debt.¹⁰⁴
- The World Bank/Bank for International Settlements’ 2001 estimate is $127.7 billion.

The disparities in these estimates are partly due to a disagreement between Iraq and its neighboring states over the nature of approximately $30 billion in assistance given to Iraq by several Gulf States during the Iran-Iraq War. Iraq argues that these payments were given as grants while creditor states consider them as loans. None of the figures above, with the exception of the Energy Department’s estimate, account for the debt forgiven by the Paris Club nations in November 2004.

The Paris Club relief effort was largely a result of the Bush Administration’s efforts to lobby the international community to forgive Iraq’s past debts, and much of the success is attributed to the efforts of former Secretary of State James Baker who visited Paris Club member states.
countries to convince them to support the debt relief. The amount forgiven and the structure of the relief have been widely misquoted in the printed and visual media.

The total amount of debt Iraq owed to Paris Club prior to relief was $38.9 billion. This amount will be forgiven in several phases. Phase one is the immediate cancellation of 30% of the debt stock ($11.6 billion) as of January 1, 2005. (This step has been implemented as of August 2005) Phase two includes the writing off of an additional 30% ($11.6 billion) contingent upon the approval of IMF standard program and this phase is outstanding as of August 2005 since the IMF program is yet to be approved. The last phase is the forgiveness of an additional 20% of the debt upon completion of the last IMF Board review of three years of implementation of standard IMF programs. This step will be completed as of 2008 or 2009. The relief, at the end of its finishing point, will reduce the total debt of Iraq to Paris Club from $38.9 to $7.8 billion, equaling a debt forgiveness of $31.1 billion in total.105

While the exact amount of the Iraq’s foreign debt total remains ambiguous, US official figures are within the $120 to 127.7 billion range. After the $31.1 billion Paris Club relief, estimates of Iraq’s total foreign debt come down to $89-97 billion. A large majority of this remaining amount is owed to the Gulf States. The Bush Administration is expecting these states to follow suit in reducing the amount. Some analysts believe that there is not enough emphasis on the topic in US public diplomacy. Yet Gulf States, on the other hand, such as Qatar, the United Arab Emirates and the largest creditors Saudi Arabia and Kuwait have said that they would consider forgiving debts, although they would only deal with a sovereign Iraqi government.106 These countries have not made statements on the issue since the new government came to power.

Figure 9

Iraq’s International Obligations

<table>
<thead>
<tr>
<th>The gross total of Iraq’s three types of financial obligations:</th>
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<tbody>
<tr>
<td>Gulf War Reparation Claims</td>
</tr>
<tr>
<td>Pending Contracts</td>
</tr>
<tr>
<td>Foreign Debt</td>
</tr>
<tr>
<td><strong>Iraq’s Total International Obligations</strong></td>
</tr>
</tbody>
</table>

Any amount approaching the total shown in Figure 9 can act as a serious hindrance in Iraq’s economic reconstruction in the period following 2007. Gulf War reparation claims will continue to be served with the 5% share of oil revenue, while pending contracts and foreign debt will be immune from payment until the end of 2007 due to the Security Council resolution 1483, which declares that Iraq’s oil export earnings are immune from legal proceedings until that day. However, the interest accrual on the capital will be continuing until this date, pushing the total amount up.

Iraq needs a restructuring or relief program for all its foreign debt stock, and a resettlement of its pending contracts before the end of 2007, as it will be required to pay back its debts after this date. This will also be crucial in Iraq’s medium to long-term integration into international
financial markets. A country with unsettled debt stock of this magnitude will not be an ideal environment for Iraq’s international borrowing or attracting foreign investment.

**G. Iraqi Government’s Capacity to finance reconstruction:**

Iraq also faces severe limits on what it can pay for its economic reconstruction. The Iraqi government’s official figure for its spending on the country’s reconstruction was 0.7, 5.1 and 5.4 billion USD for 2004, 2005 and 2006 respectively as of January 2004. (See Figure 10 for the breakdown of these figures across various sectors.) These numbers were Iraq’s own revenues, and do not include foreign aid.

**Figure 10**

**Iraqi Capital Investments, 2004- 2007**

*Breakdown of Capital Investment Plans, by Sector, in the Iraqi Budget, 2004- 2007*

(In Millions of US Dollars)

<table>
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<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Electricity</td>
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<td>1650</td>
<td>1650</td>
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<td>500</td>
<td>500</td>
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<td>500</td>
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<td>1562</td>
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<tr>
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<td>150</td>
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<td>665</td>
<td>1994</td>
</tr>
<tr>
<td>Mine Clearing</td>
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<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
</tbody>
</table>

**Subtotal**                          | 574  | 3620 | 3940 | 3940 | 12074           |

| Oil                                 | 0    | 1000 | 1000 | 1000 | 3000            |
| Security, Police and Justice        | 42   | 200  | 200  | 200  | 642             |
| Environment                         | 1    | 20   | 40   | 40   | 101             |
| Culture                             | 1    | 15   | 15   | 15   | 46              |
| Human Rights                        | 1    | 5    | 10   | 10   | 26              |
| Science and Technology              | 5    | 10   | 10   | 10   | 35              |
| Religious Affairs                   | 5    | 0    | 0    | 0    | 5               |
| Youth & Sports                      | 3    | 50   | 50   | 50   | 153             |
| Foreign Affairs                     | 6    | 10   | 10   | 10   | 36              |

**Subtotal**                          | 64   | 1310 | 1335 | 1335 | 4044            |

| Other *                             | 107  | 161  | 161  | 161  | 590             |

**TOTAL**                             | 745  | 5091 | 5436 | 5436 | 16708           |
The new Iraqi Budget as of July 2005 for FY2005, 2006 and 2007 call for different levels of capital investment than the Budget as of January 2004. (See Figure 6) While the 2004 version planned for $5.1, 5.4 and 5.4 billion for years 2005, 2006 and 2007 respectively, the 2005 Budget’s numbers increase to $5.9, 6.5 and 6.8 for the same years. While the previous budget does not account for aid formally, the 2005 budget envisions $9, 10 and 7 billion external funding for the overall Iraqi economy in the 2005-2007 period. What proportion of these external funds will be spent on capital investment is not clear.

The United Nations/World Bank Iraq Needs Assessment report of October 2003 indicates that there is a need for $55.3 billion over the course of 2004 to 2007 to fund the immediate and medium term economic needs of the country. The State Department Iraq country report indicates that the US has already appropriated $21 billion as of July 2005 with another $13 billion pledged from other countries. (These figures will be scrutinized in detail in the following section on non-US international aid.)

Iraq thus seems to need to raise $21.3 billion from its own resources to meet the World Bank target of reconstruction by 2007, and this figure ignores wartime damage, the cost of crime, the cost of security, and the cost of corruption. Yet the figures in the 2005, 2006 and 2007 Iraqi budgets indicate to a total of $19.2 billion worth of capital investments. Assuming the Iraqi budget figures are accurate and all of the funds pledged by the international community and appropriated by the US Congress are indeed disbursed, there is still a shortage of at least $2.1 billion.

In reality, this $2.1 billion figure is little more than a “guestimate” because the October 2003 UN/World Bank assessment does not account for the cost of security that economic reconstruction has to bear in Iraq and the level of insurgency there is in Iraq as of August 2005. Bearing in mind the estimates of the Department of Energy that up to 40% of all US funds were being spent on providing security and not on reconstruction as of June 2005, the World Bank’s $55.3 billion could increase to a higher figure, and as a result, so does the gap between what is needed, and what is available to achieve planned reconstruction. 107
Another element of unpredictability is oil prices and production. The Iraqi government’s contribution to capital investment could change depending upon the amount of Iraqi oil produced and exported as well as the world price of oil. If the production increases steadily and reaches the targeted export level of 1.8 million bbl/d by 2006 and the price of oil stays higher than the planned $40 per barrel level, the Iraqi economy’s capacity to fund reconstructions would increase. For the reasons mentioned in the earlier sections, however, the amount of oil produced and exported does not seem likely to increase in the predicted fashion, and it is highly unlikely to even reach the targeted level.

IV. Status of Foreign Reconstruction Aid

Iraq’s rich natural resources were not sufficient to finance its economic reconstruction and development immediately following the end of Saddam Hussein’s regime. The Iraqi government’s ability to raise revenues remains questionable and thus, bulk of finances for the country’s economic reconstruction is expected to come from the US. American funds are the backbone of Iraq’s economic development, and the effectiveness of the US aid will dictate the success of the outcome. Having the right strategy in American economic reconstruction of Iraq is key to attaining the goal of a stable and sustainable liberal Iraqi economy.

A. US Aid

According to the State Department’s Report on Iraq Relief and Reconstruction as of July 2005, total US aid appropriated for economic reconstruction in Iraq was $26.5 billion. Of this amount, $2.5 and $18.4 billion were appropriated by the Congress for the Iraq Relief and Reconstruction Fund (IRRF) in April 2003 and November 2004 respectively. FY 2005 DoD supplemental also provides $5.3 billion and an additional $320 million in Commanders’ Emergency Relief Program (CERP) funds for financing of economic reconstruction projects.

The State Department report states that as of June 29, 2005, $13.6 billion (74% of the 18.4 billion provided in the IRRF) had been obligated, and $6.35 billion had been disbursed. This level of US funding for Iraq represents America’s largest assistance effort in a single country since the Marshall Plan that helped transform Europe following World War II.

This enormous commitment is organized and maintained by a large and complicated bureaucracy. The CRS Report for Congress shows that the primary US agencies responsible for the use of American funds in Iraq are:

- US Agency for International Development (USAID)
- Department of Defense (DOD) and US Army Corps of Engineers (USACE)
- US Department of Commerce (DOC).
Lack of Strategic Planning

US aid is the backbone of Iraqi economic reconstruction and it is impossible to achieve economic development in the country without the right use of American funds. This significant financial commitment is not only critical to establishing the foundations of the new liberal Iraqi economy, but will also heavily determine the political outcome in the short, medium and long hauls. The management of these funds therefore, requires maximum efficiency and effectiveness. Analysis of the activity, on the other hand, indicates serious shortcomings in the distribution and management of US funds.

Currently, there are hundreds of ongoing projects across Iraq, maintained by contractors and/or US agencies. These projects are sometime useful, yet are not necessarily economically optimal, and sometimes are not even what is needed.

For example, the State Department’s 2207 Report of July 2005 boasts the completion of the majority of $ 1.6 billion Phoenix I project which reactivated the generation capacity of Gas Combustion Turbine stations in Bayji, PetroChem, Shuaba and Buzurgan sites. The goal of this project is to increase Iraq’s electricity capacity in the short term, and all the sites completed under the project are gas turbine units, which require suitable fuel to generate electricity. In a country where refinery capabilities to produce fuel are limited and almost all of the fuel is being imported, fuel-based electricity generation sites may not be optimal projects to devote resources.

The high number of activities of similar standing show that there is a tendency in the administration of US aid funds to choose projects that produce good outcomes, yet are not necessarily aligned with the overall macro needs of the Iraqi economy. US money ought to be devoted to projects that fulfill three major criteria:

Serve a sector of economy with high priority.

Meet overall national needs.

Actually produce significant progress.

The failure to designate projects that fulfill these criteria is especially present in the oil sector. Oil revenues constitute over 95% of Iraq’s national budget and increasing oil exports is on the top of Iraq’s economic needs. Yet there are obvious problems associated with Iraq’s deteriorated oil infrastructure and its negative impact on limiting oil production.

The US reconstruction efforts, have largely neglected these problems. July 2005 State Department report states that projects on “facility assessment” have been awarded. This in many ways is a worrisome fact. While Iraq’s economy is in urgent need of major oil field rehabilitation to reach the provisional level of exports, the actual conditions of the biggest oil fields are unknown, and assessments are yet to be conducted.
Additionally, there is a lack of focus on increasing refinery capabilities. Iraq today imports 80% of its liquefied petroleum gas (LPG), 74% of its gasoline, 49% of its kerosene and 46% of its diesel needs on an average basis, same as prewar levels. These imports and the subsidies associated cause the Iraqi economy hundreds of millions of dollars, yet US reconstruction efforts have largely bypassed the development of refineries and hence not decreased the amount of imports.

A similar failure to address the essential needs of a basic industry is the management of Iraqi electricity sector. The Department of Defense’s July 2005 report states “an integrated energy plan remains as an outstanding issue”. Despite the billions of dollars spent to increase electricity generated, there is no comprehensive energy plan as of June 2005. Such a plan is crucial to make the optimal decisions for each individual project, which should fit into an overall strategic national energy plan for Iraq. Clear reform plans for agriculture, state industries and financial services are similarly non-existent.

There seems to be also a lack of focus on the effects of abandoning militarism and military industries under Saddam Hussein, and the resulting effects on unemployment and economic development. During CPA’s tenure, the creation of new Iraqi army caused the loss of almost half a million jobs that constituted 8% of the labor force. Iraq’s official military spending was 5.5% of its GNI as of 1999.

The Saddam era investment in military and security forces and the overall security industry is hard to quantify due to lack of data, but undoubtedly totaled over 10% of the national economy. Economic reconstruction of the country must account for the effects of the loss of jobs and investment associated with the end of Saddam-era militarism. At the same time, the end of such militarism interacts with the failure to link long-term aid planning to estimates of long-term budget costs in the military field.

These inefficiencies also lead to an inability to create the immediate results that are needed on the field. Despite the more than $6 billion disbursed out as of June 2005, the country’s electricity supply is far from meeting demand, oil production is below prewar levels and barely half of Iraqis report having access to safe, stable supplies of potable water. Unemployment remains between the 25 to 50% margin and food and fuel subsidies have resulted in a significant budget deficit.

Iraqi planning minister Mr. Barham Salih expressed his government’s disappointment in major portions of the American rebuilding program, which he said failed to produce quick results despite the expenditure of more than $6 billion. He suggested that the mega-projects, though essential, have not succeeded in providing Iraqis’ basic needs like electricity, water and sanitation. The country needs quick and effective results that can be produced by realistic strategic planning at the macro level for the Iraqi national economy first, and then subsequently by planning of the various economic sectors to produce results that are in most dire need.
Lack of oversight, benchmarks and metrics

The projects undertaken by US funds are not being openly or transparently assessed in regards to their effectiveness or performance, and accounting is lacking or minimal. The billions of dollars spent on mega projects are simply entrusted with the contractors without any supervision during or after the project.

The CPA Inspector General’s Audit Report dated July 2004 states that “Project and Contracting Office (PCO) faces challenges in ensuring that tasks performed under these contracts fully meet the US Government’s requirements and are economically and efficiently executed”. This report only refers to an audit conducted for six projects. There is almost no auditing or supervision for the remaining hundreds of projects undertaken by private contractors paid for by US funds, or by US agencies. The unannounced recent audits of the special inspector general for Iraq reconstruction produced some alarming results.

The following are some findings from Mr. Stuart Bowen’s January 30, 2005 report:

The American office in charge of doling out reconstruction funding in Hillah, Iraq paid a contractor twice for the same work.

A US official was allowed to handle millions of dollars in cash weeks after he was fired for incompetence.

Of the $119.9 million allocated for regional projects, $89.4 million was disbursed without contracts or other documentation. An additional $7.2 million could not be found at all.

The US officials failed to keep track of $9 billion US money transferred to Iraqi government ministries, which lacked financial controls and internal safeguards to prevent abuse.

One Iraqi ministry cited in the audit inflated its payroll to receive extra funds, claiming to employ 8,206 guards when it only employed 600.

An Army soldier serving as the assistant to an American boxing coach admitted to gambling half of $40,000 he was given to cover the expenses of an Iraqi athletic team during a trip to the Philippines.

US contracting officers in Hillah left Iraq with no record of how they had spent the nearly $1.5 million that could not be found by investigators.

Inspector General Bowen’s report states the “detailed systemic management failings, lax or nonexistent oversight and apparent fraud and embezzlement on the part of the US officials charged with administering the rebuilding efforts”. In response to these findings, Paul Bremer - the former head of CPA - criticized the report for expecting the occupation authority, amid postwar chaos to follow accounting standards that “even peaceful Western nations would have trouble meeting”. Yet the US should establish supervision and oversight over reconstruction funds precisely because it is an occupying power.

Besides these non-systemic and retroactive audit performances, there is no meaningful US Government agency accountability report on how the funds are being used. The USAID FY 2004 Performance and Accountability Report, for instance, does not contain information
regarding any of the 11 projects and 5 grants it gave in FY 2004 for Iraqi economic reconstruction, totaling over $4 billion.

The Agency’s weekly updates on Iraqi reconstruction do not have any audit value, and simply give updates on the progress of given projects with little—or if any at all—reference to the fulfillment of benchmarks, cost effectiveness or the impacts of the progress made on the overall Iraqi macro economy and population. The rare benchmarks mentioned in the weekly updates are mostly arbitrary Saddam-era levels of performance rather than a result of objectively assessed infrastructure needs of today’s Iraq.

The Department of Defense’s report to Congress, on the other hand, takes a different approach to measuring the effectiveness of projects carried out by contractors. The report uses the stability of the new Iraqi currency; increase in the number of private business registrations and the establishment of economic zones as indicators for the success of the use of US funds in economic reconstruction projects. The use of these items to assess the performance of individual projects on developing infrastructure and reducing unemployment is not accurate. Rather than looking at the price of the New Iraqi Dinar against the US dollar to assess the success of US funded projects, the focus should be on the specific tangible goals set for each individual project in line with the overall requirements of their relevant sector.

Just as there are no tangible benchmarks to assess the success of projects while they are being carried out, there are no metrics in place to measure their impact on Iraqi needs after their completion. As mentioned in the previous section of this work, Iraq is a country where there are clear differences between ethno-sectarian regions. The failure to map the impact of aid across these groups and regions is coupled with a lack of tracking of the consequences of aid on political and social equity. The complex demographic make up of Iraq requires a sophisticated approach to economic reconstruction. A reliable data collection system to measure the impact and the success of US funded projects is essential.

The giant American bureaucracy in charge of handling reconstruction efforts reduces the level of effective coordination. The US AID Iraq department officials in Washington DC, for instance, do not know the official status of SOEs or agricultural subsidies. There is no clear data available for public use on what is happening to eliminate or reduce subsidies and phase out key distractions such as cheap food imports.

More importantly, there is insufficient inclusion of Iraqis at the decision-making or implementation levels of the reconstruction efforts. The projects to be carried out are determined exclusively by US officials, contracted out to US or other non-Iraqi companies, which mostly employ non-Iraqis. In other words, the Iraqis are sometimes largely an audience to the massive US efforts at reconstruction of their country. This helps lead to the failure to create employment opportunities, puts almost no money in Iraqi pockets, prevents the creation of local capacity and terminates the potential for Iraqi ownership of reconstruction.

Resentment among Iraqis towards their exclusion became evident during the International Donors’ Meeting in Amman on July 18, 2005, when the Iraqi officials expressed their frustration with the current US reconstruction policies, and stated that they wanted to see more
Iraqi experts, contractors and labor incorporated both in the decision making and implementation stages of projects.\textsuperscript{119}

There are efforts, albeit insignificant in magnitude, at the level of the US Embassy in Iraq to make the reconstruction process more inclusive of Iraqis. The new Iraqi Provincial Reconstruction Development Committees (PRDC), composed of Provincial Council members, representatives of the Governor, and the local Director’s General of the national ministries attempts to get local Iraqi authorities involved in the reconstruction efforts. This initiative however, does not have jurisdiction over large projects and has so far received a poor funding of $ 241 million, most of which has been spent on administrative functions.\textsuperscript{120}

Hopefully, this situation is changing. The new American ambassador to Iraq, Zalmay Khalilzad, showed signs of a shift in US aid policy to be more inclusive of Iraqis. Shortly after his appointment, he stated that he wanted to give Iraqis “great control and responsibility” for the reconstruction effort. His proactive style may bring a new phase to the current US economic aid policy in Iraq.\textsuperscript{121} Yet, there is much work to be done to achieve that goal. There is a lack of a clear picture of Iraqi central, provincial and local government ability to take over the planning and management of aid and economic development activity. The US economic aid officials in the American Embassy in Baghdad suggest that Iraqis are not yet ready to take the responsibility of multi billion dollar projects.\textsuperscript{122}

The US aid picture today seems to be one where reconstruction is almost entirely under the control of USAID, IRMO, DoD and PCO whose employees are exclusively confined to the Green Zone and do not speak Arabic. Almost all Iraqis are excluded from the economic development of their country. There are many competent Iraqis at the central and local level who can participate in determining the type of project their country needs, numerous Iraqi companies that can be hired to carry out reconstruction projects, and millions of Iraqi young men and women who can provide the labor for the foundations of new Iraq. As Frederick D. Barton suggested in his testimony before the US Senate, “a new approach [in US economic aid policy] should emphasize Iraqi ownership in the process. In short, trust more in the Iraqi people.”\textsuperscript{123}

The current US aid policy for Iraq’s economic reconstruction is inefficient, inaccurate and haphazard. The main shortcomings are:

- Lack of projects that address the real needs of Iraqis and deliver accurate, tangible results with real macro economic impacts.
- Lack of focus on the needs of the oil sector, especially with regards to:
  - The need of oil field rehabilitation,
  - Refinery capacity building.
- Lack of clear reform policies on:
  - Agriculture,
  - SOEs,
  - Financial sector,
  - Military industry.
Lack of an overall national and sector based economic strategy according to which projects are chosen.

Lack of financial audit or supervision of billion dollar projects serviced by US agency officials or independent private American and foreign companies.

Lack of benchmarks to assess the cost effectiveness and efficiency of project completion.

Lack of data collection upon project completion to assess the real life impacts of completed projects on Iraqis.

Lack of inclusion of Iraqis in their own country’s economic reconstruction, no Iraqi participation on the fields of:

- Economic decision making,
- Contracting out,
- Labor.

Lack of assessment of Iraqi capacity at local and national levels to carry out parts of economic development.

Lack of overall Iraqi ownership of the entire process.

Post-conflict economic reconstruction is not easy. What makes the Iraqi case even more challenging is the fact that it is not yet post-conflict. The ongoing insurgency, Iraqi concerns over the lack of ownership and rapidly decreasing US funds increase concern over the economic reconstruction policy. A shift in policy to address the above-mentioned points, relinquish the reins of economic decision making and allow Iraqis to become invested in the economic rebuilding process in their country will largely help the overall mission in Iraq.

While the US funds constitute the largest financial element of reconstruction effort in Iraq, there is also considerable amount of non-US foreign aid pledges. Support for rebuilding Iraq’s economy from countries other than the United States is significant not only for monetary purposes, but also for reasons of international legitimacy of the Iraqi government. The last section of this work will hence focus on the status of non-US aid to Iraq as of August 2005.

**B. Non-US Foreign Aid**

Financial contributions from international organizations and countries other than the United States are in three major categories.

**The International Reconstruction Fund Facility for Iraq (IRFFI)**

The fund includes 20 donor countries, the European Commission, the IMF and the World Bank, all of which pledged financial aid for Iraq’s economic reconstruction. The IRFFI fund has had three meetings so far.

**Madrid Conference**, October 2003: The meeting authorized the establishment of the IRFFI, which is a trust fund that combines country contributions with the World Bank funds for Iraq.

**Tokyo Meeting**, October 2004

The donors reaffirmed their support for Iraqi reconstruction in the last two meetings. The pledges to IRRFI are as follows:

<table>
<thead>
<tr>
<th>Currency</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Foreign Governments</td>
<td>$8 billion</td>
</tr>
<tr>
<td>Lending from World Bank &amp; IMF</td>
<td>$5.5 billion</td>
</tr>
<tr>
<td><strong>Total pledges to IRRFI</strong></td>
<td><strong>$13.5 billion</strong></td>
</tr>
</tbody>
</table>

* All of these funds are to be disbursed between 2004 and 2007.

As of July 2005, over $2.9 billion of the assistance had been disbursed. Some $2.5 billion of this amount came from foreign governments, and $436 million was IMF assistance. Because this amount is being channeled for implementation through trust funds, contractors, NGOs and international organizations, however, much of the impact on the ground in Iraq has been limited.124

There is no public information available as to how these funds disbursed are being used, which Iraqi agency is responsible for their distribution, and channels through which they are planned to reach the Iraqis. An additional $10.6 billion remains to be disbursed from the fund.

Iran

Iran agreed to extend $1 billion credit facility to Iraq during the Iraqi Prime Minister Mr. Al Jaafari’s visit to Tehran. The facility will include loans to the Iraqi private sector as well as direct lines of credit to the Iraqi government.125 The detailed calendar of the assistance was still in the process of negotiation as this paper was being written.

Islamic Development Bank

The Islamic Development Bank agreed to extend $500 million directly to the Iraqi government during the IRFFI donors’ conference in Amman, Jordan in July 2005.

The significance of the two latter assistance programs is that they are extended directly to the Iraqi government rather than the US agencies, trust funds or international organizations. The agreement with Iran is particularly significant in that it shows both the improvement of bilateral relations between the two neighbors, and Iran’s growing influence in Iraq. Iran- Iraq relations are particularly important for the economic future of Iraq since a significant portion of Iraqi exports are and will increasingly continue to be shipped through the strait of Hormuz in the Persian Gulf. Iran’s investment in Iraq’s economic future is particularly promising for the strategic future of Iraqi oil exports.

The credits from Iran and the Islamic Development Bank also indicate that the Iraqi government is recognized by a major Islamic organization and its neighbor as a legitimate and sovereign entity, which can conduct its affairs responsibly. This in return should place responsibility on the Iraqi government to spend the funds responsibly and without discriminating against various ethnic and sectarian groups. The government spending of these funds should at all costs be prevented from becoming another de facto element to aggravate civil unrest.

When the Iraqi budget and capital investment requirements of the country are taken into account, however, the non-US international contribution remains very small relative the scale
of the need. International community’s contributions are rather marginal in value. These funds are symbolic gestures of support to Iraq’s reconstruction rather than significant financial support. Assessments of expectations from US and/or Iraqi allies ought to be conducted in a realistic way, which does not rely heavily on the financial support of these countries.

What the American and Iraqi officials can do to increase support for Iraq’s economic reconstruction, on the other hand, is to encourage their allies to:

Follow through with their donation pledges,

Forgive Iraq’s debt and extend reparations relief if they have not yet done so –especially the Gulf States, Saudi Arabia and Kuwait in particular,

Cooperate with the Iraqi government on the training of Iraqi security forces in Iraq.

Start diplomatic representation in Iraq.