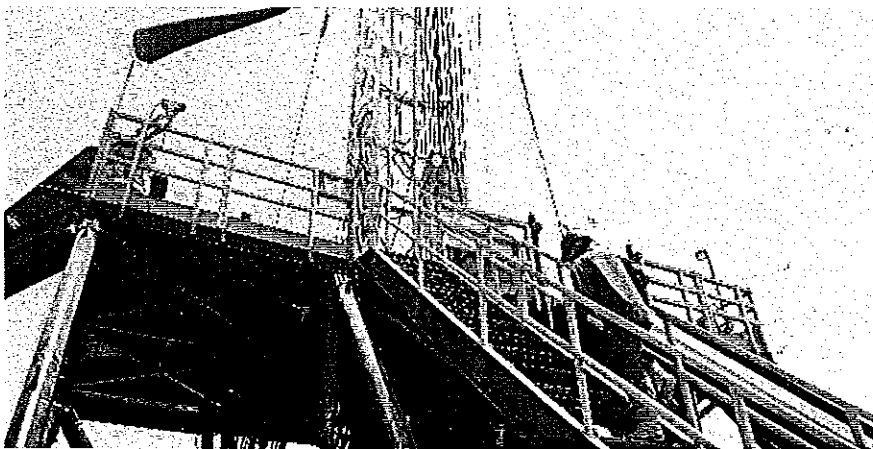


Analysis: The future of Iraq's political economy



A worker climbs a drilling rig at the Rumaila oil field in Basra. (BEN VAN HEUVELEN/Iraq Oil Report/Metrography)

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Iraq is afloat on a sea of oil, and high oil prices combined with rising export volumes could lead to a dramatically higher standard of living for the average Iraqi. But this economic potential is in danger.

Not only does Iraq face a revived al-Qaida insurgency, but it is also threatened by corruption and regulatory hostility towards private business. If the country fails to deal with these problems, then it will become increasingly vulnerable to political instability driven by either an oil price collapse or a surge in youth unemployment.

Iraq has the third-largest conventional oil reserves in the world, and only about 10 percent of the country has been explored with modern techniques. It is engaged in an aggressive attempt to increase oil production to 10 million barrels per day (bpd) by 2017, compared to 2.95 million bpd in 2012.

For technical and political reasons, it is unlikely that Iraq will achieve this goal. However, even if the country is only able to increase its production to 5.5 million bpd, and assuming a real price of oil of \$100 per barrel, then the government of Iraq will experience a \$80 billion - 85 percent - increase in revenues in half a decade.

This windfall could lay the foundation for a vibrant and diversified Iraqi economy. Unfortunately, if the past is any guide to the future, most of the increased revenue will either be diverted by corruption into private hands or absorbed by a rapidly expanding bureaucracy.

Bigger bureaucracy, more corruption

Over the last decade, in years of expanding oil export revenue, Baghdad has not only increased the number of government workers but also raised wages and pensions. Almost half of the Iraqi labor force is directly or indirectly employed by the government at wages that are 40 to 60 percent greater than those paid for similar work in the small private sector.

Even when government revenues have been lower than expected, as in 2006 and 2009, there was no contraction of the government's wage bill. Instead, the Baghdad bureaucracy sharply reduced government investment in order to conserve funds for wages and pensions.

The impact on reconstruction efforts and broader economic activity was severe, because public investment accounts for over 90 percent of fixed capital formation. Work ground to a stop on projects to improve roads, electricity, schools, clinics, and water infrastructure. Partially completed multi-year building projects were abandoned for months until rising revenues allowed a restoration of investment spending. And when projects were restarted, it was often discovered that previous work had to be substantially redone due to looting, vandalism, environmental damage, or corruption.

Iraq is not the most corrupt country in the world, but according to Transparency International it is in the bottom ten. Corruption – the abuse of public power for private gain – is ubiquitous in Iraq.

High-level government officials steal hundreds of millions of dollars while small businesses have to pay bribes to petty officials to get water piped to their shop. All around the world, the adverse economic impact of such corruption on economic development is clear: honest countries are generally rich while corrupt ones are poor. Among the major causes of corruption in Iraq are the hostile regulatory environment facing private businesses and the continuing dominance of state-owned enterprises. According to the World Bank's Ease of Doing Business metric, Iraq has one of the most hostile regulatory environments in the world, ranking 165th out of the 185 countries evaluated.

It is especially difficult to start a business in Iraq, obtain credit, trade internationally, or resolve insolvency through a declaration of bankruptcy. In fact, Iraq has the worst

ranking in the world with respect to bankruptcy regulations – which, considering the competition from sub-Saharan Africa, is quite a dubious accomplishment. These hostile regulations are not unloved artifacts from the Saddam era. Rather, the rat's nest of bureaucratic red tape is carefully maintained, since it simultaneously motivates businessmen to pay bribes as well as protect the inefficient state-owned enterprises from private sector competition. Iraq's hostile regulatory environment forces most private businesses to operate in the underground economy, since doing so is cheaper than bribing an unending line of corrupt government officials in order to operate legally. As a result, about two-thirds of the country's private sector employees work in the underground economy with its low wages and lack of labor protection.

Economic vulnerabilities

This combination of severe government dependency on oil revenues and a moribund private sector leave Iraq vulnerable to several possible economic blows that could destabilize the political system.

One nightmare scenario is a steep drop in oil prices. The Iraqi government depends on oil for about 95 percent of its revenue, and must earn at least \$55 per barrel (in 2010 dollars) in order to be able to pay its salary, pension, food assistance, and security commitments.

If the global prices fall below this level for one or two years then the government has three options to continue to pay for its commitments: it can exhaust its Development Fund for Iraq reserves, which amounted to \$18 billion at the end of 2012; it can persuade the Central Bank to fundamentally restructure its international reserves policy to make some of its \$70 billion available for fiscal purposes; or it can take advantage of its limited access to world capital markets.

But if oil prices fall below \$55 for three years or more, then the government will be forced to cut wages or pensions. If Iraq's past is any guide to its future, cuts in wages and pensions will cause the bureaucracy to turn against the government – undermining its policies, participating in street protests, and, possibly, engaging in violent action.

How likely is an extended period of low oil prices? In its June 2012 Annual Energy Outlook, the US Energy Information Administration (EIA) developed oil price scenarios for 2025. While the EIA's "reference price" scenario was an average of \$120 per barrel (in 2010 dollars), there was also a more pessimistic scenario. Several factors could coincide to raise supply and reduce demand – including increased production from Iraq, the United States, and other countries; reduced petroleum demand as a result of the continuing economic slowdowns in Brazil, Russia, India, and China; and further improvements in energy conservation – all of which could result in an extended period of \$50 per barrel oil.

Another challenge to Iraqi political stability is growing unemployment and underemployment among the young. Currently about half of the country's total labor force is either unemployed or underemployed. For those between the ages of 15 and 19, the combined unemployment and underemployment rate is over 80 percent.

Since Iraq has a young population with a high fertility rate, the number of young people seeking employment is rapidly increasing. Even after adjusting for the low labor force participation rate of women in Iraq, the labor force is expected to grow by at least 250,000 a year for the foreseeable future.

Because increases in public and private sector employment are not expected to be large enough to absorb this expansion, unemployment and underemployment among the young will grow over the next decade. While the impact might not be as immediate as a large drop in oil prices, the experience of other low-income countries is clear: a rising number of mostly uneducated, unskilled, and unemployed young males will be politically destabilizing.

A key moment

More than in the last five decades, the future of the country depends upon the decisions currently being made by Iraqis to deal with some very difficult challenges.

It is tempting to produce a laundry list of dozens of policy recommendations to deal with the challenges discussed above. But in view of the difficult political situation in Baghdad combined with the still limited managerial capacity of the Iraqi government, a better strategy might be to focus attention on the most serious challenge to the Iraqi economy and political stability – corruption. As a former Iraqi Minister of Finance stated, the adverse impact of corruption on Iraq is worse than that of the insurgency.

Reducing corruption is an enormous challenge. Most attempts have failed to achieve long-term effect because they have consisted of little more than exhortations to virtue, as well as the scattered arrests of officials who are politically out of favor.

The world has produced few model anti-corruption efforts, but those that have succeeded have had a third component: they reduced the economic incentives of corruption. So far, this key element has been missing from Iraq's anti-corruption strategy.

The strongest economic incentive for corruption in Iraq is the severe regulatory hostility towards private business. Even a simple activity such as starting a new business requires 77 days for administrative processing, for which the government charges fees that exceed the average Iraqi's annual income. It should be no surprise that Iraqis are willing to pay substantial bribes to cut through this regulatory thicket.

Such systemic problems went unaddressed in 2008, when the Iraqi government issued an 18-part anti-corruption initiative. It called for improved governance, more aggressive investigation and prosecution, and greater cooperation with international anti-corruption agencies. It was silent with respect to changing the economic incentives that encourage corruption.

As they say in the New York Police Department: "Getting rid of the rotten apples without getting rid of the rotten barrel means that you'll have to do it again next year." While the World Bank, the USA, and others are ready to advise Iraq on rationalizing its business regulations, there is concern that changes recommended by western groups might be inconsistent with Iraq's cultural and religious traditions. Indeed, developing a new Iraqi commercial code from the ground up would probably take a decade or more – time that Iraq does not have. A better route to regulatory reform would be to adopt the commercial code of a regional Islamic neighbor such as the UAE.

Increased oil revenues have given Iraq a second chance for sharply improving the living standards of the average Iraqi. However, the political system has – so far – been unable to rationally deal with the serious challenges facing the country. Rich countries with long histories of stable government can afford to make stupid decisions. Iraq cannot.

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