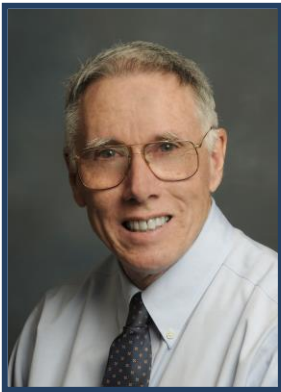


DRAINING THE SWAMP IN IRAQ

By Frank Gunter



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The recent explosion of violence in Iraq has several interrelated causes. In part, it is a spillover from the Syrian civil war and a reaction to Iraqi Prime Minister Nouri al-Maliki's heavy-handed pro-Shi'a policies. These events have reopened the wounds of the terrible sectarian violence of 2006 and 2007. But the Syrian war may be coming to an end either through negotiations or through a bloody "victory." And Maliki – the consummate politician – appears to be trying to modify policies perceived to be anti-Sunni both to undermine support for the ISIS and al-Qaeda insurgent groups as well as improve his standing in advance of the April 30th election.

It will be more difficult to deal with the economic causes of this violence. High oil prices and a gradual increase in oil export volume have flooded Iraq with oil money. However, mismanagement and massive corruption have diverted much of this oil money either into unproductive domestic investments or capital flight to foreign sanctuaries. As a result, many of Iraq's young face a grim future.

OIL AND BIRTHRATES

Despite the small decrease in world oil prices in 2013, Iraq earned about \$87 billion from its oil exports, up almost 90% in only five years. Iraq is now the most natural-resource-dependent country in the world, with exports of a single natural resource amounting to about two-thirds of the country's gross domestic product. However, the oil industry creates relatively few jobs. Only 2-3% of Iraq's labor force is employed in oil exploration, development, transportation, refining, or export.

But oil is not the only valuable resource that Iraq possesses in abundance. Compared to its regional neighbors, Iraq has an exceptionally young, rapidly growing population. Almost 41% of the population is less than 15 years old reflecting a fertility rate of 4.5 (children per adult female). In contrast, only 24% of Iran's population is younger than 15 years and its fertility rate is less than replacement – 1.6. As a result of Iraq's rapid population growth, every year an estimated 850,000 Iraqis become old enough to work. However, these young men and women face a combined unemployment and underemployment rate of over 80%! The impact of large numbers of un- and underemployed poorly educated, unskilled young men is especially destabilizing. Without a good job, a young man cannot get married and start a family; he becomes an object of pity or scorn in Iraqi society. Is it any wonder that many such men attempt to gain respect by picking up a gun in support of a religious, tribal, ethnic or criminal group?

Even after adjusting for retirements, migration, and the extremely low labor force participation rate of women, Iraq needs about 250,000 new jobs each year simply to keep the pool of unemployed and underemployed young men

from growing. For six decades – before, during, and after Saddam’s regime – the Iraqi government’s primary response to rising unemployment has been to increase the number of government jobs, either directly or indirectly. This policy is based on the hope that gainfully employed young men are less likely to participate in insurgent violence. Increasing government employment is a popular policy in Iraq since working for the government provides better pay, more benefits, stronger job security, and a much reduced work intensity compared to private sector jobs. Also, since 2003, international agencies have advised the Iraqi government to rapidly expand public employment since it provides a measurable means of reducing unemployment – especially among difficult to employ uneducated/untrained young men – and puts money in circulation. But there are four problems with continuing a policy of the “government as the employer of first resort” in order to maintain political stability.

UNEMPLOYMENT CHALLENGES

First, the Iraqi government has passed any reasonable limit for increasing government employment. Government bureaus and state-owned enterprises are massively over staffed. For example, the Iraqi Republic Railroads has over 10,000 employees inefficiently running a 2300 km (1,400 mile) system that in other countries would require one-fourth to one-tenth as many employees. Some state-owned enterprises actually have zero production but continue to pay a large work force that shows up only to receive their pay.

Second, does an expansion of government employment actually reduce political instability in Iraq? It is often a misnomer to refer to the expansion of government employment as real job creation. A job implies an exchange. The worker provides something of value to his or her employer – his labor and human capital – and, in exchange, the employer provides something of value to the worker – a paycheck. Since this exchange is valuable to both parties, they develop a commonality of interests – a limited form of loyalty – since if the firm goes out of business then both the owner and the workers are worse off.

Contrast this with government employment in Iraq. The loyalty of government workers is rarely to the Iraqi government or to the public at large but rather to the particular political, religious, tribal, militia, or family member who arranged for their government paycheck. This is especially true if the government job requires little labor or even attendance. In Iraq, it is thought that in some government Ministries, as many as 25% workers are “ghosts”. These ghost workers receive a regular paycheck without having to show up for work. The combination of a government paycheck, little or no work, and an intense loyalty to whoever arranged this bounty can be a recipe for instability. Political, religious, tribal, or militia leaders in Iraq often have loyal forces of supporters being paid by the government they may actively oppose.

Third, oil exports provide over 90% of the national budget. Since the country has only about \$6.5 billion worth of fiscal reserves in the Development Fund of Iraq and a severely limited ability to borrow internationally, the government’s expenditures are determined by the world price of oil. If the government’s response to the loss of revenues in 2006 and 2009 are a guide to the future, then the government responds to a large loss in revenues by sharply reducing non-oil infrastructure investment and freezing government employment. Both of these actions will lead to a politically destabilizing rise in unemployment and underemployment especially among uneducated unskilled young men.

How likely is a fall in world oil prices? In view of the slowing growth and demand for petroleum imports of the BRIC countries combined with the sharp increase in energy production from the United States and Canada, the main prop of \$100 plus oil prices is regional disruptions such as the sanctions dispute with Iran, Russia’s invasion of the Crimea, and political disruption in Egypt that threaten oil shipments via the Suez Canal. If a resolution of Iran’s sanction issues and a restoration of political stability in the other nations of the Middle East and North Africa (MENA) occurs, then one could expect sharply lower oil prices. While any decline in oil prices would be challenging to the Iraqi government, an extended period of world oil prices below approximately \$55 per barrel – a level experienced as recently as 2005 – will require unprecedented budget cuts including reductions in politically sensitive salaries and pensions.

Finally, like sand after the desert storm, corruption permeates every corner of Iraqi society. While Iraq is not the most corrupt country in the world – North Korea and Somalia are tied for that dubious honor - Transparency International ranks Iraq as tied with Haiti as the eighth most corrupt country. Corruption in Iraq extends from the ministries in Baghdad to police stations and food distribution centers in small towns. At the high levels of

government, the corruption has led to a massive diversion of public oil export earnings into private pockets. A portion of this corrupt money has gone toward expensive cars and homes as part of a luxurious lifestyle led by high government officials.

However, a large portion appears to have been smuggled out of the country – capital flight. The lack of reliable data on Iraq’s international trade and financial transactions makes it difficult to estimate capital flight from Iraq. But a crude estimate based on unexplained balance of payments transactions points to a minimum of \$6-9 billion a year of capital flight equal to about 10% of the country’s oil export earnings. The actual volume of capital flight may be twice as great.

PRIVATE SECTOR TO THE RESCUE?

Can the Iraqi private sector create enough new jobs to keep the army of unemployed young men from growing with all of the accompanying political instability? The creation of private sector employment in Iraq faces a series of policy barriers. As a reflection of Iraq’s socialist DNA that has dominated during decades of conflict, the regulatory environment of private business is best described as hostile. Even by the standards of the MENA, Iraq makes it extremely difficult to operate a private business. According to the World Bank’s 2014 Ease of Doing Business Survey, Iraq ranks 169th (out of 189 countries) in the ease of starting a business. If a potential business owner knows exactly what procedures to follow and refuses to pay bribes to shortcut the process, then it takes a month to start a new business and costs almost 40% of the annual income of the average Iraqi.

It is also difficult for a private sector business to obtain credit – Iraq ranks 180th in the world. Not only are creditor rights weak under Iraqi law but also credit registries are almost non-existent. With respect to foreign trade, Iraq is 179th in the world. To administratively process – not actually ship – a container for export or import takes almost 80 days with administrative costs of over \$1,750. Finally, Iraq is tied for last in the world when it comes to resolving insolvency. The average MENA creditor receives about 30 cents on the dollar when a firm goes bankrupt; the average Iraqi creditor receives nothing.

In view of the regulatory hostility, it should be no surprise that the informal or underground economy accounts for an estimated two-thirds of all private sector activity. And this regulatory hostility is not simply an unloved artifact of the Saddam era. National and provincial bureaucracies carefully maintain the complexity and expense of Iraq’s regulatory rat’s nest since it facilitates the extraction of bribes. Corruption and regulatory hostility are not separate issues in Iraq but two facets of the same problem.

Unfortunately, it is unlikely that the Maliki government will be motivated to make serious efforts to curb corruption and regulatory hostility in order to increase private sector employment. Of course, Maliki has shown himself many times to be a master politician capable of surprising observers. Following the 2010 election, he outmaneuvered former Prime Minister Ayad Allawi’s Iraqiya party, which had received a plurality of the votes, and formed the government. And in 2008, his unexpected military operation, “Charge of the Knights”, returned control of Basrah City to the government. However, like most members of an elite, his initial reaction to a crisis tends to be to reward his traditional supporters while excluding newcomers and their ideas.

In the long-term, increasing the availability of productive private sector jobs should reduce political instability and violence in Iraq. The means are there – the country’s large oil wealth – to finance a restructuring of the Iraqi economy that will make better use of the country’s most valuable assets, its young people. However, Iraq’s political class, distracted by a series of short-term domestic and international crises, appears unable to take a long-term view on anything except to encourage oil production. They are trapped in a classic conundrum. *It is hard to think about draining the swamp when the alligators are attacking. But if you don’t drain the swamp, then the alligator attacks never end.*

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