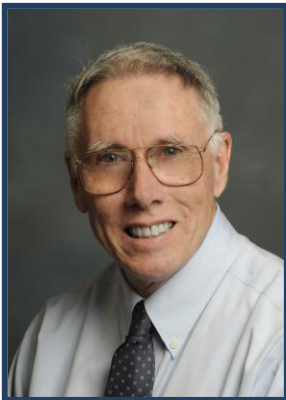


THE ISIL INVASION OF IRAQ: ECONOMIC WINNERS AND LOSERS

By Frank R. Gunter



*Frank R. Gunter, Ph.D., is a Professor of Economics at Lehigh University, a Senior Fellow at the Foreign Policy Research Institute, and retired U.S. Marine Colonel. Based on his two years in Iraq as an economic advisor, he wrote *The Political Economy of Iraq: Restoring Balance in a Post-Conflict Society* (E. Elgar, 2013). This book was selected as one of the "Outstanding Academic Titles" of 2013 by Choice Magazine. He can be contacted at: frg2@lehigh.edu*

Amid the chaos of the conquest of a large part of Iraq by the Islamic State of Iraq and Levant (ISIL, also known as ISIS, the Caliphate, or the Islamic State), there has been a great deal of attention paid to the political, military, social, humanitarian, and even religious implications. However, there has been little discussion of the economic impacts beyond a rise in the price of oil and drop of Iraqi oil exports. Extrapolating from incomplete reports, the author's two years in Iraq as an economic advisor, and the economic trends discussed in *The Political Economy of Iraq: Restoring Balance in a Post-Conflict Society*, this article attempts to identify the economic winners and losers created by the (temporary?) division of Iraq into sections controlled by the government in Baghdad, the Kurdish Regional Government (KRG), and the ISIL.

ISIL-CONTROLLED IRAQ

How much of the territory and population of Iraq is currently controlled by ISIL? There are not only contradictory claims of territorial control by ISIL, the KRG, and the government in Baghdad, but also the situation on the ground changes daily. However, it appears that the mostly Sunni ISIL now controls about 40 percent – 50 percent of Iraq's land including most/all of the provinces of Anbar, Ninawa, Salah ad Din, a large part of Kirkuk (T'a'mim) and possibly portions of Diyala and Babel provinces. Estimating the population of this ISIL-controlled area is subject to two serious challenges. First, since Iraq hasn't performed a national census since 1987, pre-conflict provincial population estimates were considered very unreliable. Second, the conflict and associated ethnic cleansing has led to massive movements of refugees. However, based on crude extrapolations from pre-conflict surveys, about 25 percent – 35 percent of Iraq's population (9 to 13 million persons) resides in ISIL-controlled territory.

	Territory	Population	Recent Exports	Oil	Estimated Reserves	Oil
ISIL-Controlled	~40%	25%-35%	0%		~11%	
KRG-Controlled	~10%	15%-20%	~16%		~9%	
Baghdad-Controlled	~50%	45%-60%	~84%		~80%	

The economic situation of the ISIL-controlled territory is dire. While the ISIL territory contains maybe 11 percent of the oil and gas reserves of Iraq, they are undeveloped and pre-conflict production was *de minimis*. It will take a great deal of time, investment, and foreign expertise before substantial amounts of oil or gas can be produced from these fields. And hopes of exporting the oil or gas to finance imports of food and other necessities will require more than investment in pipelines and processing plants. Existing oil export flows either go north to Turkey through area controlled by the KRG or south to the Persian Gulf through Baghdad-controlled territory. It is unlikely that either will cooperate with ISIL oil exports. Refining the crude oil into fuel within the ISIL territory is almost as challenging. As a result of deferred maintenance and mismanagement, the largest refinery in ISIL territory (the Baiji refinery in the Salah ad Din governorate) is extremely inefficient, producing an excessive amount of heavy fuel oil, which few electrical generators in the ISIL territory can use.

While the two largest hydroelectric dams are in the ISIL territory, both have problems. As a result of bad design, the Mosul dam, located northwest of the ISIL-controlled city of the same name on the Tigris River, has been in a state of slow-motion collapse since the day it was dedicated. It is only as a result of daily infusions of cement that this dam still stands. If it failed, the resulting flood would devastate the city of Mosul. Less dramatic, the Haditha dam on the Euphrates River suffers from reduced flow leading to less electricity production. The widespread lack of electricity from any source to run refrigerators and air conditioners leads to a public health crisis in an area where summer temperatures average 40°C (100°F). But even more serious than the shortage of energy is a possible shortage of food.

At first, a food shortage in ISIL-controlled territory seems unlikely since farming there is a major activity. Agriculture accounts for an estimated 33 percent of total employment in Anbar and 40 percent in Salah ad Din compared to the national average of 18 percent. However, farming in the arid/semi-arid land of the ISIL territory requires irrigation from the Euphrates River, which has been disrupted by internal and external factors. Internally, the chaos caused by the ISIL takeover has disrupted the complicated process of managing water flows. As irrigation water is diverted to those with better political connections, reduced food production is likely. There are also external factors to be considered. The Euphrates River originates in Turkey and flows through Syria before reaching Iraq. Even before the ISIL takeover, diversion of water for agriculture and power generation in Turkey and Syria was expected to result in an almost 50 percent decrease in the volume of water in the Euphrates. When this occurs, the Euphrates was expected to run dry before it reached Southern Iraq. In view of the hostility between Turkey and the ISIL as well as the civil war in Syria, it can be expected that not only will the diversion of water from the Euphrates accelerate but also that remaining flows will become more unpredictable resulting in reduced food production. In addition, the civil war in Syria combined with the conflict in Iraq has led to a breakdown in the previous attempts to reduce water pollution. As a result, increased fertilizer runoff and industrial waste are rendering water from the Euphrates increasingly unusable for agriculture.

Before the ISIL takeover, families throughout the area could rely on monthly “food baskets” from the Public Distribution System (PDS) to provide sufficient calories to prevent malnutrition even if they couldn’t afford to buy food. Most of the flour in these PDS baskets was imported. ISIL will have to decide whether to continue this expensive program or run the risk of increased malnutrition accompanied by disease. Much media attention has been made of the \$500 million to \$1 billion dollars that were liberated(?) by the ISIL from the main Iraq public banks, Rafidain and Rasheed. However, there are several reasons why these funds will not go far. First, the

continuing conflict is expensive. Second, an unknown portion of these liberated funds was intended to pay salaries and pensions of Sunni government employees and retirees in the occupied territories. If these payments are not made, then it would undermine popular support for ISIL. Third, the ISIL authorities are believed to have severe problems with corruption. A portion of the liberated funds will probably disappear into the personal accounts of some of the ISIL leadership. Finally, without a rapid recovery of the economy in the ISIL territory, it will become very expensive to purchase imported power and food even if sources can be found. In summary, the ISIL controlled territory is in the worst economic situation in Iraq – great economic needs but severely constrained resources.

KRG-CONTROLLED IRAQ

Subject to the same data limitations discussed above, the KRG currently controls about 10 percent of the territory of Iraq. This includes the provinces of Dahuk, Arbil, and Sulaymaniyah and part of Kirkuk Province. This area contains an estimated 15 percent – 20 percent of the population of Iraq. As a matter of scale, this entire territory has a smaller population than the city of Baghdad alone.

While the KRG has a more favorable economic situation than in the ISIL territory, it also faces economic challenges – some of its own making. On a good day, the KRG is able to export almost 0.4 million barrels per days (mbpd), about 16 percent of Iraq's total oil exports. However, good days have become increasingly rare. The main oil export pipeline travels from fields controlled by the KRG to the Turkish port of Ceyhan. But this pipeline has been periodically damaged by insurgent activity. The volume of oil that can be exported using an alternative pipeline or fleets of tanker trucks is limited. But even if the KRG can restore exports to a steady 0.4 mbpd or more, it will face a self-inflicted financial crunch. While oil exports provide most of the KRG's revenue, the oil industry directly provides few jobs, less than 3 percent of total employment.

To compensate for the shortage of oil industry jobs, KRG authorities over the last two decades have sharply expanded government employment. An estimated 32 percent of the Dahuk's and 30 percent of Arbil's labor force currently work directly for the government compared to a national Iraqi average of 19 percent. And when employment at state-owned or -financed enterprises is included, approximately half of the population of the KRG is paid directly or indirectly by the KRG state. When the monthly pension commitments and the increased expenses for the KRG security force, the Peshmerga, are included; it is likely that the security, salary, and pension expenses of the KRG exceed the amount it can earn on 0.4 mbpd, even with oil selling for \$100 per barrel. And this assumes that there will be zero expenditures on much delayed investment in energy, water, education, health, and transportation infrastructure.

And the employment problem is expected to worsen as a flood of refugees from the ISIL-controlled territory continues to arrive in KRG cities and towns. Some of the Christian and Muslim refugees are highly skilled or possess substantial real or financial assets. But many are destitute and will immediately require either private charity or public assistance. In the long run, these new residents may provide substantial benefit to the KRG economy but only if they are able to find employment. Since the financial constraint discussed above limits the ability of the KRG government to be the "employer of first resort," can the non-oil private sector in the KRG provide jobs for the rapidly growing labor force? There is great potential in the areas of tourism – the KRG is renowned for its verdant mountains and historical sites – construction, and small manufacturing. However, a substantial expansion of the KRG private sector would require a more business-friendly regulatory environment and a substantial reduction in corruption. Unfortunately, neither of these initiatives is a priority with the KRG authorities.

BAGHDAD-CONTROLLED IRAQ

Forces loyal to the government in Baghdad still occupy all or most of eleven Iraqi provinces with almost 50 percent of the country's territory and 45 percent – 60 percent of the population. Baghdad remains the major population prize with about 21 percent of the pre-insurgency population. Therefore in the unlikely event that ISIL is able to absorb this one city, it will then have over half of the population of Iraq. Despite the loss of large amounts of territory and population, Baghdad in a strange way may have improved its economic situation. Unlike the ISIL and the KRG, the Baghdad-controlled territory can trade internationally without going through an intervening state. Through the ports south of Basrah, Baghdad can continue to import grain for the PDS and oil industry supplies while exporting oil by ocean tanker. With respect to internal transportation, while the Euphrates and Tigris are no longer navigable from Basrah to Baghdad, the Baghdad South Line of the Iraqi Railway system and several highways connect the

two cities to the Persian Gulf. As a result, Baghdad still controls the production and export of about 84 percent of the country's oil but now has a much smaller population to care for. Even with increased military expenditures, if Baghdad ceases payment of salaries and pensions to Iraqis in the ISIL- and KRG-controlled territories as well as stops investment in infrastructure in those areas, then Baghdad will probably have a large budget surplus in the first year after the division of the country!

With respect to the small private sector in the Baghdad-controlled territory, the situation is not as optimistic. Large-scale sector investment in the oil and tourism industry will probably continue. Najaf and other sacred cities of the Shi'a denomination of Islam are in the Baghdad-controlled territory and are expected to continue to attract several million religious tourists every year primarily from Iran. The situation in other parts of the small private sector is depressed due to a combination of political uncertainty, regulatory hostility towards private businesses and ubiquitous corruption.

CONCLUSIONS

A cynical way of interpreting the current situation in Iraq is that Baghdad has unintentionally disposed of an area that it could not control – the KRG – and an area that was a net drain on Iraq's economic resources – the ISIL-controlled territory. As a result, Baghdad not only has a territory with a much more homogeneous population but also continues to control most of the country's most important asset, its oil and gas. The situation of the other territories is not nearly as favorable.

The KRG may be closer to independence but faces severe short-term budget challenges as it attempts to pay for a bloated public sector labor force and increased military expenditures without the substantial subsidies that it formerly received from Baghdad. With its petroleum resources, Mediterranean type climate, and the influx of skilled Christians and Islamic Kurds fleeing the ISIL, the KRG has the potential of achieving a substantial acceleration of private sector growth. However, this will require a reduction in regulatory hostility towards the private sector and a reasonably successful anti-corruption campaign.

Economically, ISIL's current situation is untenable. A continuing stream of political and military victories may satisfy the population of the occupied territory for a time but further deterioration of the economy will have an adverse political impact. The leadership of the ISIL has shown little interest in economics beyond a crude socialism – confiscating the property of their enemies and distributing it to their supporters. However, if current electrical outages and fuel shortages are followed by increased unemployment and sharply higher food prices, then support for the ISIL authorities will weaken. And this loss of support will accelerate if rumors of widespread corruption of the ISIL leadership turn out to be true.