

# The Economic Reconstruction of Iraq\*

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## Abstract

This paper analyzes the economic reconstruction of Iraq following the 2003, U.S-led invasion. Tracing the foundations and trajectory of the reconstruction, I explain how efforts have fallen prey to the four reconstruction traps identified by Coyne and Pellillo (2010). These traps have hampered attempts to rebuild Iraq's economy. I then conclude with forward-looking policy suggestions regarding Iraq's economy.

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## **1. Introduction**

This chapter analyzes the economic reconstruction of Iraq following the 2003, U.S.-led invasion. In general, economic reconstruction includes building and rebuilding physical infrastructure and services and fundamentally reforming institutions and policies related to economic activity in the wake of conflict. In the context of Iraq, economic reconstruction was an important part of the broader Iraqi reconstruction effort, which also focused on the reconstruction of legal, political, and social institutions. Until handing over sovereignty to Iraqis in June 2004, the U.S. oversaw all aspects of economic reconstruction. Following the transfer of sovereignty, the U.S. has remained heavily involved in efforts to rebuild the economy in a variety of ways.

The results of economic reconstruction efforts have been mixed at best. Following the invasion, Iraq's economy came to a virtual standstill. The removal of sanctions, coupled with heavy investment by the U.S., generated positive results in some macroeconomic indicators. For example, since the fall of Saddam Hussein, estimates of annual economic growth rates in Iraq range from 4 to 17 percent (see Beehner 2007). Given the devastation following the war, as well as the state dysfunction stemming from the Hussein regime, any positive economic growth must be counted as a success. Further, significant amounts of Iraqi debt have been forgiven, Iraqi currency has been reformed, and some markets have been opened to international trade, allowing for the importation of cheap goods from China and other countries (Beehner 2007).

Despite these improvements, there are significant concerns regarding the long-term robustness of Iraq's economy. External aid has been a critical factor in economic recovery, and it remains to be seen whether Iraq's economy can be self-sufficient when this support is reduced or ended. Two other major concerns are unemployment—currently around 50%—and the continued prevalence of corruption. Where job creation has taken place, it has largely been in

the public sector (see Gunter 2009). This poses several problems. First, the creation of additional public sector jobs without significant changes to the existing ‘culture of corruption’ could potentially exacerbate the magnitude of the corruption problem. Second, wealth creation takes place through innovation in the private sector. By focusing on the creation of public sector jobs over private sector jobs, Iraq’s government is failing to provide adequate incentives for productive entrepreneurs to start new businesses or expand existing businesses. A key factor stifling private initiative is the burdensome regulation on private business (see Gunter 2009). Third, the increase in public sector employment, coupled with the fall in oil prices, has put enormous strain on the national budget. The budget of the Iraqi government is largely driven by revenues from petroleum exports and external support. With the recent fall in oil prices, petroleum revenues have decreased sharply, putting increasing pressure on the national budget. The absence of an environment conducive to private business has limited the tax base, further straining the budget. Gunter (2009) argues that this pressure will place a hard constraint on the further expansion of public sector jobs, making it even more important to focus on providing incentives for private business.

Finally, there are major concerns over state capacity regarding the provision of security, as well as the staffing and maintenance of reconstructed infrastructure. U.S. officials have recently expressed concern that there are not enough qualified Iraqis to staff reconstructed facilities once Americans leave the country (see Williams 2009). The fear is that in the absence of trained staff to maintain and operate facilities, basic services will not be provided to Iraqi citizens, leading to economic stagnation. In the extreme, the lack of basic services, in conjunction with high unemployment, could lead to a backlash by Iraqi citizens.

In what follows, I trace the foundations and trajectory of the economic reconstruction of Iraq, explaining how early reconstruction efforts fell prey to four reconstruction traps identified by Coyne and Pellillo (2010). These traps include: (1) the credible commitment trap, (2) the political economy trap, (3) the bureaucracy trap, and (4) the fatal conceit trap. In applying these traps to the Iraq reconstruction experience, my purpose is twofold. First, I illuminate why the efforts to rebuild Iraq's economy have largely failed to meet their goals. Second, I provide forward-looking policy recommendations for Iraq's economy which avoid the pitfalls created by these traps.

This chapter proceeds as follows. The next section provides an overview of the U.S. occupation and economic reconstruction of Iraq. Section 3 applies four reconstruction traps to the early economic reconstruction of Iraq. I discuss how the dynamics of each trap hampered efforts to rebuild Iraq's economy and has made more recent reconstruction efforts more difficult. Section 4 concludes with the policy implications of the analysis.

## **2. Background on the Economy and Economic Reconstruction of Iraq**

### **2.1 Iraq's prewar economy**

Under the Hussein regime Iraq was a mixed economy. Approximately a third of the labor force was employed in public jobs—government, military, state-owned enterprise—while the rest worked in the private sector. The private sector in Iraq was largely informal which constrained the extent of trading networks and economic activity (see Looney 2006; Simon 2004: 4). For the most part, private sector jobs were limited to small-scale production such as agriculture and self-employment. While the government allowed the price of most goods to freely fluctuate, it did require that private firms act in accordance with the government's "national plan." The

government also controlled the prices and revenues of refined oil products and centrally controlled the rationing of food to all citizens. Prior to the Iran-Iraq War in the 1980s and the first Gulf War in 1991, Iraq's economy was one of the more developed in the Middle East (Crocker 2004: 74). However, several interrelated factors negatively affected Iraq's economic fortunes starting in the 1980s.

The first was the corruption that was rampant in the government. Iraq's government was a rent-seeking apparatus where elites secured resources and wealth at the expense of the broader society. Rent seeking is an inherently unproductive activity that focuses on redistributing existing resources to those in favorable positions. As such, rent-seeking behavior contributes nothing to growth and instead is harmful to the process of wealth creation. At the extreme, rent seeking can bankrupt a country (Olson 1984). Rent seeking extended beyond Saddam Hussein's inner group and was rampant across all of Iraq's ministries, as well as the secret police (Foote et al. 2004: 9-11). Corruption was magnified as significant resources were allocated to finding ways of subverting the UN sanctions placed upon the Iraqi government in August 1990 (Allawi 2007: 114).

The second factor was the aforementioned informal activity which was a substantial part of the country's overall economy. This informal activity was due to dysfunctional institutions, corruption, and the threat of public expropriation put severe limits on the extent of the market. For example, in order to obtain a legal business license, applicants had to wait up to a year and had to go through a screening process to see if they had any relatives or acquaintances belonging to what were considered opposition groups (Foote et al. 2004: 10). This, as well as other barriers, provided a disincentive for citizens to participate in the above-ground economy.

Third, a lack of public investment in basic infrastructure and services negatively affected Iraq's economic development. Over time, the lack of investment led to a stagnation in both human and physical capital (Foote et al. 2004: 6-7). This was further exacerbated by the physical destruction of the first Gulf War, during which infrastructure such as electric grids and telecommunication networks were targeted by coalition forces.

Fourth, the sanctions imposed under Section 41 of the UN Charter, which lasted for twelve years, had significant negative effects on Iraqi citizens while failing to achieve the goal of changing the behavior of the government. Targeting sanctions on leaders was extremely difficult, as government officials found means of avoidance, which shifted most of the costs onto Iraqi citizens (del Castillo 2008: 193). The Oil-for-Food program, which allowed the Iraq government to use the profits from oil sales to purchase food and other humanitarian goods for its citizens, was intended to offset the negative effects of the sanctions. However, the program was fraught with corruption and abuse, and government officials were able to profit from the program while the sanctions continued to impose significant costs on Iraqi citizens (Foote et al. 2004: 9-10; del Castillo 2008: 193). In addition, the Oil-for-Food program distorted local incentives by discouraging local food production because of the increased food imports (Foote et al. 2004: 7-8).

The final factor negatively affecting Iraq's economy was the government's fiscal instability. The majority of government income came from oil revenues, yet these funds were sporadic at times given disruptions to oil markets in the country during the Iran-Iraq war and later UN embargos. Widespread poverty and the significant underground economy meant that internal taxation constituted a very small percentage of government revenues. International debt markets were able to offset some of the lost revenue for several years, but ultimately the

government turned to printing money to pay for its operations. Between 1989 and 1994, inflation rose from 6% to 500% (Foote et al. 2004: 6-7). Further, it is estimated that Iraq's foreign debt totaled \$125 billion at the time of the U.S. invasion (del Castillo 2008: 208-9).

In sum, when the U.S. entered Iraq in 2003, they found "...an economy that essentially needed to be rebuilt from scratch, crushed by decades of wars, sanctions, and atrophy due to Saddam's neglect of the population's needs" (Crocker 2004: 75).

## **2.2 The governing body of Iraq's initial economic reconstruction**

The Office for Reconstruction and Humanitarian Affairs (ORHA) was established on January 20, 2003, two months prior to the U.S. invasion of Iraq, to serve as a transition administration following the overthrow of the Hussein regime until a new government could be democratically elected (Rathmell 2005: 1020-3). The ORHA consisted of four departments to oversee humanitarian relief, reconstruction, civil administration, and finance. Jay Garner, a retired U.S. Army Lieutenant, was appointed as the initial director and was put in charge of overseeing the Iraq reconstruction effort.

The ORHA was replaced by the Coalition Provisional Authority (CPA) on April 21, 2003. Garner remained in charge of the CPA until early May, when he was replaced by L. Paul Bremer. Among the explanations for Garner's removal was that the ORHA failed, under his leadership, in its mission to provide security and basic public services (Allawi 2007: 104-5; del Castillo 2008: 195). There was also tension over the "de-Ba'athification" process which involved removing members of the Baath party from positions of public service (Bennett et al. 2003). The ORHA was never officially dissolved, but its staff and activities were absorbed by the CPA.

Under UN Security Council Resolution 1483, passed on May 22, 2003, the CPA was made the legitimate governing and security authority of Iraq. In addition to granting the CPA executive, legislative, and judicial authority over Iraq, Resolution 1483 lifted all sanctions against Iraq. The CPA, under the leadership of Bremer, was the central administrative body through which economic reconstruction was carried out. Peter McPherson, former President of Michigan State University and current chairman of Dow Jones & Co., served as the CPA's Director of Economic Policy for four months and oversaw many of the reforms associated with economic reconstruction, including currency and banking reform, as well as the CPA's plan to privatize Iraq's state-owned enterprises.

### **2.3 Economic reconstruction**

Immediately after the war, Iraq was plagued by widespread looting, theft and arson generating damages estimated at \$12 billion (Diamond 2005: 282; Rathmell 2005: 1023-4). Government buildings were set ablaze, records pertaining to the operation of the Iraqi government were stolen or destroyed, and many top Iraqi bureaucrats fled fearing repercussions from the U.S. The result was disorder and chaos surrounding the arrival of the members of the ORHA. Upon arriving in Bagdad, the members of the ORHA hastily attempted to keep the remaining Iraqi bureaucrats involved in order to maintain basic government operations. They were successful in some cases, but the result of this expediency was that the ORHA had to empower Iraqi officials, who had not been vetted, with decision-making which contributed to ongoing corruption (Allawi 2007: 117-8). The creation of the CPA further contributed to the confusion regarding the operation of the government, ultimately resulting in a "perpetuation of a system with ingrained working habits



and practices, overseen by a bureaucracy that was fundamentally little different from its predecessor” (Allawi 2007: 118).

The CPA was the centerpiece of the broader reconstruction effort and its scope was defined by 12 Regulations which were “...instruments that define the institutions and authorities of the Coalition Provisional Authority” (Coalition Provisional Authority 2003a). Regulation 1, signed by Bremer on May 16, 2003, established the mission and authority of the CPA indicating that it “shall exercise powers of government temporarily in order to provide for the effective administration of Iraq” (Coalition Provisional Authority 2003b). It also gave Bremer the executive, legislative and judicial authority required to achieve the objectives of the CPA. Regulation 1 did not indicate how long the CPA would remain in this role.

The CPA attempted to utilize the remnants of the Hussein-era government to carry out its efforts. Each ministry had a team of advisors who were supposed to serve as liaisons between Iraqis and the CPA. However, in many cases the role of the advisors mutated into that of an administrator possessing decision-making power, as compared to liaison working with Iraqis in these ministries (Allawi 2007: 120). The CPA also worked to set up local governing structures to ensure that centralized decisions regarding the reconstruction could be implemented throughout the country. CPA-appointed administrators were placed in charge and controlled local finances, while possessing key decision-making power. While local neighborhood elections were held, the higher provincial councils “...were seen as tools of the occupation and were not considered as either representative or democratically elected” (Allawi 2007: 119). This highlights a broader issue that the CPA faced. The U.S. characterized the occupation as an exercise in liberation and self-determination. At the same time, self-determination at the local level often ran counter to the goal of establishing an effective central government. The result

was that the post-war government hierarchy remained largely unchanged from the Hussein-era government, including the perpetuation of the norm that locals were not to make decisions that ran counter to the dictates of the central government for fear of the repercussions. This had the unintended effect of preventing the emergence of self-governing mechanisms at the local level.

As for the specifics of the economic reconstruction, the U.S. government, operating through the CPA, had a vision of reconstructing Iraq's economy based on 'free market' principles including privatization, reduced government intervention, and openness to foreign investment and trade (King 2003). The CPA introduced these reforms in the form of 100 orders that were "...binding instructions or directives to the Iraqi people that create penal consequences or have a direct bearing on the way Iraqis are regulated, including changes to Iraqi law" (Coalition Provisional Authority 2003a).

The CPA orders covered a wide range of issues and activities. For example, Order 1 declared the "de-Ba'athification of Iraqi Society" while Order 2 dissolved the Iraqi army and intelligence service. Order 12 suspended all tariffs, duties, taxes, and surcharges for goods imported or exported from Iraq. Order 17 granted immunity from Iraqi legal processes to members of the CPA, as well as to foreign contractors. Currency reform was addressed by Order 18, which provided for the independence of the central bank, and Order 43, which called for the introduction of the new Iraqi Dinar. Many consider currency reform to be one of the few major successes of the economic reconstruction (see Crocker 2004: 78-9; Allawi 2007: 126; del Castillo 2008: 204-5), although there is not complete consensus on this point (Hanke and Sekerke 2004). Order 49 reduced the tax rate on Iraqi corporations from 40% to a flat rate of 15%.

Four of the CPA orders dealt with banking reform. The first was the previously mentioned Order 18, which suspended the old banking laws and created an independent central bank. The second, Order 20, established the Trade Bank of Iraq to manage the funds from the Development Fund for Iraq and to assist Iraqi businesses finance imports. The third, Order 40, opened the previously state-run banking system to foreign banks and established rules regarding capitalization and management. Order 40 was later rescinded with the issuance of Order 94, which provided updated laws and rules for Iraq's private banks.

Order 39 established the guidelines for foreign investment and called for the privatization of state-owned enterprises (SOEs). The SOEs posed a particular problem for the CPA and, in many ways, illustrate the broader problems with the economic reconstruction effort. As discussed in the previous section, most private economic activity in Iraq was small-scale and took place in the informal economy. Prior to the invasion, the almost 200 SOEs were major sources of employment as well as the main providers of public services and consumer products, accounting for 90% of Iraq's industrial production (Special Inspector General for Iraq Reconstruction 2009: 90). In the wake of the invasion, many of the SOEs were closed due to looting and rioting. The CPA initially made the decision to freeze the assets of the SOEs while severely limiting subsidies, because they were viewed as inefficient remnants of the Hussein era, which should be quickly privatized. While it is true that the SOEs suffered from significant corruption and inefficiency, they constituted a central part of the country's economic activity. The initial decision to keep the SOEs closed negatively affected economic recovery and eventually led the CPA to change course regarding the privatization of SOEs. In July, only four months after the initial invasion, the CPA provided funding to SOEs producing goods

contributing to the reconstruction effort. By the end of the summer, about one-third of the SOEs had been reopened (Special Inspector General for Iraq Reconstruction 2009: 91-2).

At the time the 100 orders were being written and issued, there was debate within the CPA about the vision for Iraq's economy, as well as the best means of achieving that vision (Special Inspector General for Iraq Reconstruction 2009: 90). A similar debate was taking place among academics and those in the media. *The Economist* (2003) called the CPA orders a "wish-list that foreign investors and donor agencies dream of for developing markets." Others, such as Nobel Laureate Joseph Stiglitz (2004), noted that the economic reforms in Iraq were "...an even more radical form of shock therapy than pursued in the former Soviet World," which would cause problems similar to those experienced in eastern Europe and the Soviet Union following the collapse of communism.

Due to the situation in Iraq, as well as administrative limitations facing the CPA, not all of the orders were actually implemented. For example, security concerns and opposition by Iraqi citizens forced the CPA to shelve its plans to end oil and food subsidies and to privatize state owned oil enterprises as per Order 39 (Weisman 2004). This included reestablishing the nationalized food distribution network originally implemented under the Hussein regime. Ironically, the CPA later claimed the food distribution network as a success, although achieving this goal ran counter to the original reconstruction plans, which called for ending the distribution network (Allawi 2007: 126). This highlights one of the fundamental tensions facing occupiers, not only in Iraq, but in many post-conflict economic reconstructions. Occupiers need to develop policies that simultaneously meet short-run needs while also providing the foundations for a market system over the long-run. As the aforementioned example illustrates, this can be a difficult balance to achieve.

As noted in the Introduction, Iraq's economy has achieved positive growth. However, the initial CPA orders have failed to generate widespread benefits as the Iraqi economy has struggled to recover following the initial invasion and war. A report by the World Bank (2006: 1) emphasized that "oil production and exports have yet to reach prewar levels, and nonoil sectors remain sluggish. High unemployment, poverty, and weak social protection systems dominate public concerns and threaten the fragile democracy." The report also noted that 8-10 percent of the Iraqi population was living in absolute poverty while another 12-15 percent of the population was vulnerable to falling into that category (2006: 8).

Although it is too early to pass judgment on Iraq's long-term performance, it is far from clear that reconstruction efforts have established the foundations of a sustainable market economy. As noted in the Introduction, reconstructed institutions continue to be fragile and reliant on external support, while violence and corruption continue to be a real concern for citizens and investors (*The Economist* 2009c, 2009d). Moreover, onerous business regulations have constrained the expansion of the private sector (Gunter 2009). It should be noted that there has been some foreign investment in Iraq. A central issue will be whether these investments yield adequate returns and whether further large-scale investment will be made after the U.S. presence is further reduced (*The Economist* 2009a). Also unresolved is the role that foreign investment will play in Iraq's oil industry in the absence of an established oil law (*The Economist* 2009b).

By early 2004, the CPA had largely abandoned its original agenda for sweeping market reforms, instead focusing on smaller reconstruction projects and the political transition (Special Inspector General for Iraq Reconstruction 2009: 93). On June 29, 2004, the CPA ended its operations when it turned sovereignty over to Iraqis. Despite the transfer in sovereignty, the U.S.

has remained heavily involved in the economic reconstruction of Iraq. In addition to the provision of security, the U.S. has provided significant development support, including aid (monetary and humanitarian) and technical expertise. For example, the United States Agency for International Development (USAID) continues to oversee a wide variety of reconstruction projects in Iraq and plays an important role in overseeing the Iraq Reconstruction and Relief Fund, which was established by the U.S. Congress in 2003 to aid the reconstruction of Iraq.

In order to avoid past pitfalls in the future and to understand what is feasible in Iraq, we need to grasp what went wrong with the early economic reconstruction of Iraq. To accomplish this goal, the next section applies the reconstruction traps developed by Coyne and Pellillo (2010) to the economic reconstruction of Iraq. In illuminating what went wrong with the CPA's efforts to reconstruct Iraq's economy, these traps also provide insight into forward-looking policies to avoid similar pitfalls in the future.

### **3. The Traps of Economic Reconstruction in Iraq**

#### **3.1 The credible commitment trap**

Reforms, which are central to economic reconstruction, are agreements to change behaviors in future periods. In order for reforms to be effective, policymakers must have the incentive to deliver instead of renege on their promise. The 'credible commitment trap' occurs when reform efforts associated with reconstruction fail to appreciate the importance of incentives for directing action (Coyne and Pellillo 2010). Such reforms are doomed to fail because they neglect the importance of signaling a credible commitment on the part of policymakers so that citizens buy in to the reform.

The credible commitment problem can be understood as follows. Without a binding commitment to reforms that is credible, policymakers may have an incentive to renege on the announced reform in future periods. Credibility becomes an issue when there is a disjoint between those holding power (policymakers) and the beneficiaries of announced reforms (citizens) because policymakers can renege on their promise down the line and citizens have limited recourse when they do so (Acemoglu and Robinson 2006: 193). Anticipating this behavior on the part of policymakers, citizens must be confident that the political elite will deliver on their promise in order to buy into the reform in the first place.

Solving the credible commitment problem is not simply a matter of establishing constraints on the activities of policymakers. To initiate successful reforms policymakers must simultaneously establish constraints *and* send a strong signal to citizens that they are sincere in their commitment to reform. Once a credible signal is sent it can create sustainable change based on the repeated dealings between policymakers and citizens. Credible commitment problems have plagued the economics reconstruction of Iraq (Coyne and Boettke 2009). There are at least three significant barriers that prevented the emergence of credible reforms in Iraq.

The first are indigenous religious and ethnic divisions in Iraq. Successful reforms needed to satisfy members of Iraq's major ethnic groups—the Arabs and Kurds—and religious groups—the Shi'a and Sunni Muslims. The tensions in Iraq go beyond the major religious and ethnic groups discussed above. In addition to the issues with inter-group interactions there are also intra-group tensions that create problems for reforms. For example, there are various intra-group factions in the broader Sunni and Shi'a groups in Iraq at both the national and local levels. Further, Shi'a political leaders are divided into at least four major sub-parties and there are factions within those sub-parties (Fearon 2007: 10). Given the historical tensions between these

groups, and sub-groups, compromise and consensus around reforms has proven difficult because many citizens do not view those in power, who are outside their circle of trust, as credible.

In addition to contributing to the failure of reconstruction efforts, the absence of a solution to the credible commitment problem also threatens the achievement of sustained peace. In general, when political leaders lack credibility they cannot make binding promises to potential insurgents (Keefer 2007). The absence of credibility makes the likelihood of continued insurgency that much more likely. This in turn, has contributed to the inability of occupiers and reformers to carry out other aspects of the economic reconstruction such as building infrastructure.

The second barrier to overcoming the problem of credible commitment in Iraq is the dynamics of the U.S. occupation. In addition to interaction between the indigenous groups and sub-groups within Iraq, these same groups also interact with the occupiers. In addition to expectations regarding how other indigenous groups would act, those in Iraq also had expectations regarding the actions of the occupiers. Along these lines, Larry Diamond (2005: 44) has noted that, “Deep local suspicions of U.S. motives combined with the memory of Western colonialism...generate a massive lack of legitimacy for the occupation authority.” As such, many Iraqis have responded with resistance to the efforts of the occupiers. In the context of the CPA’s policies, given the suspicion of Iraqis toward the U.S., many Iraqi citizens failed to view the CPA’s economic reforms as credible which contributed to their failure.

This highlights the importance of perceptions in reconstruction. In order to be successful, occupiers must not only ensure that incentives are aligned so that announced reforms are credible over time, but also ensure that indigenous citizens view the reform and incentives in a manner which is legitimate and sincere. Given differing perceptions based on historical experiences and



cultural differences, this can be difficult. In the case of Iraq, “Part of the problem was that Garner and Bremer never comprehended how Iraqis perceived them...Thus the coalition never grasped, for example, the fact that, although most Iraqis were grateful for having been liberated from a brutal tyranny, their gratitude was mixed with deep suspicion of the United States’ real motives (not to mention those of the United Kingdom, a former colonial ruler of Iraq)...” (Diamond 2005: 43). The result is that many of the reforms announced by the U.S. lacked credibility in the eyes of Iraqis and therefore failed to take hold. In general, when occupiers fail to understand the underlying belief systems of indigenous citizens, including how those citizens perceive and interpret the occupiers and the proposed reforms, reconstruction efforts are more likely to fail.

The third barrier to solving the credible commitment problem in Iraq is the presence of ‘regime uncertainty’ which refers to the stability, or lack thereof, of rules and institutions. When regime uncertainty exists, both domestic and foreign exogenous actors cannot be confident in the stability of rules over time. The economic reconstruction in Iraq has suffered from, and contributed to, regime uncertainty in numerous instances. For example, some of the orders passed by the CPA included the possibility of “adoption or replacement” by future Iraqi governments (See Looney 2004). There were also issues of the legality of the economic reforms implemented by the CPA (See Eviatar 2004). Specifically, there was debate over whether the drastic changes in laws regarding economic activity fell under the purview of The Hague Regulations and Geneva Convention. Further, as discussed in the previous section (Section 2.3) the CPA changed course regarding state-owned enterprises, among other policies, which created further uncertainty regarding announced reforms and the actual actions of the CPA.

In sum, in order to buy into the reforms associated with economic reconstruction, Iraqi citizens need to be confident that reforms are binding and will not be undermined by other citizens, the new government in Iraq, and the governments and citizens of other countries. For the reasons discussed above, this confidence has largely been absent contributing to the failure of economic reconstruction to date. The credible commitment trap in reconstruction is a multi-pronged problem. First, reformers (i.e., politicians, occupiers, etc.) must have the incentive to deliver on their promises and they must effectively signal to citizens that those incentives are credible. Second, reformers must ensure that citizens perceive the signal sent in a manner which communicates credibility. Absent the appropriate incentives and the appropriate credible signal, reforms will fail. Going forward, reformers in Iraq must ensure that reforms are viewed as credible by Iraqi citizens.

### **3.2 The political economy trap**

Economic and political reconstructions are intertwined because political institutions affect economic activity and vice versa. To understand this, consider that political institutions characterized by corruption and unchecked power will stifle economic activity because citizens will have a disincentive to invest, innovate, and trade. The ‘political economy trap’ refers to the idealized view of politics and democracy which pervades reconstruction efforts (Coyne and Pellillo 2010). This romanticized view is problematic because it ignores the status quo in the country being reconstructed, as well as the potential costs of democracy.

In addition to focusing on constructing a market economy, reconstruction efforts typically aim to construct the foundations of a democratic political system. Consider, for instance, the mission of the recently created U.S. Office for the Coordinator for Reconstruction and

Stabilization (S/CRS), which is charged “To lead, coordinate and institutionalize U.S. Government civilian capacity to prevent or prepare for post-conflict situations, and to help stabilize and reconstruct societies in transition from conflict or civil strife, so they can reach a sustainable path toward peace, democracy and a market economy.”<sup>1</sup> Unfortunately, focus is typically placed on the benefits of democracy, while the potential costs and harms of democratic political systems are neglected.

Democracy is a means of selecting outcomes, not an end in itself. In its ideal form, democracy is a means of self-governances whereby the preferences of citizens are communicated through the voting process, and the winners of elections are constrained through a set of checks and balances. In reality these ideal conditions do not exist. Kenneth Arrow (1950) showed that no voting system can unambiguously aggregate preferences across voters. Further, creating appropriate checks and balances is no easy task, and social scientists and practitioners lack the knowledge of how to design effective constitutional rules that will stick over the long run. This is because formal institutions, such as constitutions, must be grounded in informal customs and belief systems, which are largely beyond the reach of policy (Boettke, Coyne and Leeson 2008). Absent effective constraints, democracy can produce illiberal outcomes—political and economics—that can do real harm.

Recognizing that the ideal model of democracy is an inappropriate starting point shifts focus to the importance of the status quo. All reforms must start from the ‘here and now’ by recognizing the status quo and the associated constraints (Buchanan 1975, 2004). The status quo is characterized by existing formal institutions (constitutions, laws, regulations, government organization, etc.), vested interests, and existing informal institutions (norms, belief systems,

etc.). Although the status quo varies from case to case, in all instances it creates constraints which limit what can be achieved.

The failure to appreciate the status quo has contributed to the failure of reconstruction in Iraq. Ba'athist government institutions had been in place for over three decades. This included both national institutions, such as ministries, and local government institutions. In addition to the formal government, there was a complex 'shadow' government, including the secret police and intelligence and Saddam Hussein's inner circle. Instead of rebuilding government institutions from scratch, the CPA decided to remove certain people from the government, through the process of de-Ba'athification, while maintaining the existing government apparatus. The logic behind this decision was that working within established institutions would minimize disruptions following the invasion. In reality, this created problems for the broader reconstruction effort for at least two reasons (Allawi 2007: 161-2).

First, given the sheer size of the Hussein government, the CPA did not have enough competent staff to operate the government machinery. As noted earlier, following the invasion, many Iraqi government officials fled or were removed through the de-Ba'athification process. The structure of the Hussein government was highly centralized such that "...the removal of ministers did not simply allow subordinates to take over and carry on" (Rathmell 2005: 1024). This meant that the staffing issue facing the CPA was not only one of numbers, but also one of context-specific knowledge regarding government operations (Rathmell 2005: 1026).

The second problem was that corruption increased. While corruption was a way of life under Saddam Hussein, the secret police and intelligence services served as check on its magnitude. Under Saddam Hussein, it was smarter for officials to continually engage in small-scale corruption to avoid drawing the attention of the police. When the police and intelligence

services were disbanded, this check was removed and corruption ran rampant. The CPA lacked the resources to effectively run the government, let alone to monitor and punish corruption. The result was that while Ba'athists were removed from government positions, the status quo of corruption remained the same. As one senior U.S. State Department official noted, corruption in Iraq is "real, endemic and pernicious" (De Young and Pincus 2007). The norm of corruption hampered both economic and political reconstruction.

Another implication of the political economy trap is that there is often a tension between the dual goals of establishing democratic political institutions and constructing the foundations of a market economy. Those carrying out the reconstruction want to implement their plan to reform the economy. However, allowing for self-determination through democracy often leads to demands by citizens that run counter to these plans. When this happens it presents a conundrum because implementing reconstruction plans requires either preventing democratic participation or ignoring the results. Denying political participation, or ignoring the outcomes of participation, is tantamount to denying political liberties and self-determination, which are important aspects of reconstruction efforts. In describing the situation in Iraq, Klein (2004: 18) captured this dilemma when she wrote, "On one side are the occupation forces. On the other are growing movements demanding economic and voter rights in Iraq." What Klein is highlighting is the tension between the goals of occupiers and the demands of Iraqi citizens.

To provide a concrete example, consider the tensions between the goals of the CPA and the calls for elections by Grand Ayatollah al-Sistani, the highest ranking Shi'a Muslim scholar in Iraq (see Wong 2004). In June 2003, al-Sistani issued a *fatwa* urging Iraqis to push for general elections. This put the CPA in a bind because they wanted to have oversight over the design and content of the constitution (Allawi 2007: 210-1). At the same time, by ignoring al-Sistani's calls

for elections the U.S. would clearly be choosing the imposition of its vision over democratic participation. The CPA ultimately abandoned its plans to appoint a body to write a constitution. This had real effects on political and economic reconstruction because a constitution that was viewed as legitimate by Iraqis would have provided a foundation for a permanent government, which would have provided predictability and stability encouraging economic activity.

One potential solution to the dilemma between political and economic reconstruction is to prioritize one over the other. Del Castillo (2008: 41), a proponent of this approach, notes that “...should a conflict arise between peace (political) and development (economic) objectives, the first one should be paramount at all times. Because peace is a precondition for sustainable development, all actors should recognize and accept that political priorities will often constrain economic policymaking.” To the extent this approach is followed, it places important limits on the scope and scale of economic reconstruction efforts. Large-scale and first-best reforms (e.g., privatize all state-owned-enterprises, remove all trade barriers, etc.) are unlikely to be feasible because of the tensions between political participation and economic reconstruction described above.

In Iraq, no matter what strategy is pursued going forward, discussions of reconstruction must shift focus away from assuming an ideal form of democracy and instead focus on finding realistic mechanisms to resolve the political economy trap. Reformers must understand and appreciate the status quo and the trade offs between political and economic reconstruction.

### **3.3 The bureaucracy trap**

The reconstruction of Iraq has been criticized for a lack of effective planning and coordination among the agencies involved. This has led to numerous calls for improved coordination between

bureaucratic agencies (see, for example, Special Inspector General for Iraq Reconstruction 2009: 333-4). However, focusing solely on improved coordination between agencies fails to appreciate what bureaucracies can realistically achieve in the context of economic reconstruction. The ‘bureaucracy trap,’ is the overreliance on bureaucracies for the design and implementation of reconstruction plans (Coyne and Pellillo 2010). Reconstruction efforts fall prey to this trap when policymakers fail to recognize the limits of bureaucratic activity. Avoiding this trap involves an understanding of the incentives and constraints faced by bureaucrats who hold non-elected positions in government.

Government bureaus receive their budgets from elected officials in order to provide goods and services to citizens. Budgets are allocated based on relationships with legislators, as well as on the needs of the bureau. In this regard, each bureau is competing with other agencies over a limited budget. The incentives created by this process result in predictable behaviors. First, bureaus will expend resources lobbying legislators to establish relationships and convince them that their services are needed in greater amounts than currently exist. This typically involves investing resources in signaling the relative importance of one bureau over others. Second, bureaus will tend to exhaust their entire appropriated budgets while continually seeking to increase their budgets in order to increase the size of the agency. Third, government bureaucracies do not face the same feedback mechanisms as private firms—profit/loss, capital markets—and therefore struggle to gauge the effective allocation, and reallocation, of resources to high-return uses (see Mises 1983). Further, in addition to be judged on funds spent, bureaucracies are typically judged on other readily observable outputs which don’t necessarily coincide with long-run economic development (Easterly 2003).

How does this influence the reconstruction process? Bureaus involved in reconstruction efforts will lobby legislators to secure the biggest possible portion of the reconstruction budget and associated power. This creates an important tension in reconstruction efforts. Agencies are supposed to be united in the common goals of reconstruction, but they are also competing with one another for money. This leads to efforts to carve out a niche that differentiates one agency from the others in order to secure a larger part of the fixed budget. Each bureau has its own agenda, which may clash with the agenda of other agencies as well as with the overarching goal of achieving a successful reconstruction. These tensions can generate perverse outcomes in the larger reconstruction process. Further, there is constant pressure to spend down the appropriated budget which runs counter to ensuring that costs are minimized while benefits are maximized. Finally, there is an emphasis on easily measureable outputs which may not contribute to the long-term goals of the reconstruction. For example, focusing on hospitals and schools constructed as an indicator of success means little if this infrastructure cannot be used by citizens because of a lack of security or lack of qualified staff.

The realization that bureaus are in a constant competition helps explain the confusion and infighting before and during the reconstruction of Iraq. Phillips (2005: 7) notes that in planning for the reconstruction, “Relations between the Office of the Secretary of Defense (OSD) and the State Department became increasingly acrimonious. U.S. officials vied for control over the Iraq policy.” Similarly, Diamond (2005: 28-9) indicates that “A number of U.S. government agencies had a variety of visions of how political authority would be reestablished in Iraq. In the bitter, relentless infighting among U.S. government agencies in advance of the war, none of these preferences clearly prevailed.”



This logic also offers insight into the widely reported waste associated with the reconstruction effort as bureaus attempted to exhaust their allocated budget to signal effective performance. Waste and inefficiency was magnified because of the absence of effective feedback and accountability mechanisms (see Glanz 2006). For example, consider the \$644 million “Community Stabilization Program” (CSP) in Iraq, which was suspended due to fraud and waste. The program was intended to weaken the insurgency by paying Iraqis to perform public services. However, an audit by the USAID’s Inspector General found significant bureaucratic inefficiencies resulting in fraud due to overbilling and payments to “phantom” employees (USAID Office of the Inspector General 2008). Perhaps most shockingly, the audit noted that “‘millions of dollars’ from these projects were fraudulently going to insurgents, as well as to corrupt community leaders and CSP representatives (USAID Office of the Inspector General 2008: 8). Amazingly, the U.S. appears to have been providing funding to the very insurgents it was fighting. Not surprisingly, one of the key recommendations of the audit was improved coordination between CSP officials, USAID officials, and military personnel (USAID Office of the Inspector General 2008: 39).

Given these issues, it is easy to see why there are calls for increased coordination and bureaucratic reorganization to centralize reconstruction decision making. In theory, a centralized hierarchy would overcome issues of competing agendas and visions for reconstruction efforts. However, even if reorganization is effective in solving this problem, increased centralization creates an entirely new set of problems. Bureaus are typically operated by rigid rules established at the top of the hierarchy and passed down to the lower levels. While centralization does offer a unified vision for reconstruction, it also constrains the flexibility of those further down the hierarchy. This is problematic in the case of reconstruction because those who are on the ground

often need flexibility to react to local conditions. This flexibility, however, runs counter to the rigidity associated with hierarchical bureaucracies. These tensions were evident in Iraq, as indicated by Rathmell (2005: 1026) who notes that “bureaucratic politics in Washington also noticeably affected the CPA; the rising influence of the National Security Council (NSC) over Iraq policy in late 2003, for instance, led to increasing reporting requirements from Baghdad.” The increased layers of bureaucracy reduced the flexibility of CPA operations in Iraq and limited how staff could react to changing conditions.

The gap between the dictates of the CPA and what military personnel were experiencing in Iraq is another example of this logic. The removal of members of the Baath party from positions of public service placed the military dealing with the daily operations of Iraq in the precarious position of determining how to deal with the fired Baathists. In the hopes of incorporating the Baathists into the reconstruction process, some members of the military ignored the dictates of the CPA in order to create employment programs and grant local exemptions to former Baathist party members. The CPA viewed these efforts as undermining their authority while the military viewed the CPA as being out of touch with the actual conditions in Iraq (Chandrasekaran 2006: 37; Ricks 2006: 209-212).

The bureaucracy trap becomes a problem when reconstruction efforts are overly reliant on bureaucratic design and implementation of reconstruction plans. The bureaucracy trap does not indicate that bureaucracies can never achieve their goals, but it does mean that there are limits on what bureaucracies can achieve. Continued focus on improving coordination ignores these constraints and the limits of what bureaucracies can actually achieve in post-conflict situations.

The main takeaway for future efforts in Iraq is that those involved in reconstruction must be cognizant of the limits of bureaucratic activity. Success will require not only an appreciation of these constraints, but a strategy which strikes a balance between the involvement of numerous agencies and clear limits on the extent of bureaucratic activities. Also important is ensuring that adequate accountability and feedback mechanisms are in place. As the experience with the bureaucratic delivery of foreign aid indicates, such mechanisms are critical although they are often difficult to establish (see Easterly 2003, 2006).

### **3.4 The fatal conceit trap**

While the bureaucracy trap emphasizes the incentives and constraints facing bureaucrats, the ‘fatal conceit trap,’ focuses on the knowledge problem involved in economic reconstruction (Coyne and Pellillo 2010). The fatal conceit is the presumption that “man is able to shape the world around him according to his wishes” (Hayek 1988: 27). Economic reconstruction attempts to design a market economy based on the plans of those carrying out the reconstruction. This fundamentally assumes that planners can possess the knowledge to design a market economy; the reality is they cannot (Coyne and Mathers 2010). Attempts to plan and implement markets through economic reconstruction efforts ignore the complex chain of experiments, choices, errors, and informal institutions which must emerge for functioning markets to operate. Markets are not planned, but instead are largely the result of emergent norms and institutions which lead to increased interaction and exchange.

As noted earlier, the reconstruction of Iraq led to comparisons to the debate over shock therapy following the collapse of communism (Stiglitz 2004). The idea behind shock therapy, as compared to gradualism, was that comprehensive economic reforms needed to take place all at

once because reforms in one area would fail if not complemented by reforms in other areas. The problem with shock therapy was that it fell prey to the fatal conceit trap by assuming that the entire economy could in fact be reformed, and that planners could possess the necessary knowledge to design and carry out comprehensive reforms.<sup>2</sup> As Murrell (1993: 115) noted, “this top-down policy [shock therapy] is considered viable because the knowledge of how to create market institutions is viewed as readily available and easily implemented.” In order to carry out these large-scale, top-down reforms, planners had to abstract from complex context-specific intricacies such as historical experiences, informal institutions, and local belief systems, because there was no way for them to accumulate this information in any meaningful way. This implies that although reforms differ in magnitude, all reforms are partial because there is no way to plan and reform an entire economy at once.

The issue then becomes the scale of reforms and the conditions under which it is more likely that mistakes will be made or corrected. The knowledge problem, and related potential for negative unintended consequences, is likely to be minimized with smaller-scale reforms (Coyne and Mathers 2010). However, this runs counter to the standard approach taken in reconstruction efforts, which typically rely on plans for widespread and sweeping reforms intended to implement an entire free market economy.

In the case of Iraq, the CPA attempted to dictate the foundations of a free-market economy through its 100 Orders. The underlying assumptions were that these reforms would be effectively implemented and that they would sustain and operate in the desired manner. These assumptions neglected not only the reconstruction traps discussed above, but also the array of complementary informal institutions necessary for well-functioning markets.

For example, a large literature discusses the importance of trust and social capital for facilitating impersonal exchange, which is a necessary requirement for increases in the extent of the market and economic development (Fukuyama 1986; Knack and Keefer 1997; Woolcock 1998). In the case of Iraq, “one of the main impediments to a formal market...is the absence of trust at most levels...Not only did Ba’athism hamper the emergence of a market economy, it corrupted the judicial and legal institutions needed to create and nurture trust” (Looney 2006: 12). The process of de-Ba’athification may have removed party members from positions of public service, but it could not undo the damage done to the informal institutions necessary for a functioning market economy. Changes to embedded informal institutions, such as trust, are typically beyond the reach of reforms and policies (Fukuyama 2005). As discussed earlier (Section 3.2), the status quo constrains what reforms can achieve. Since issues of trust impact practically all interactions, the existing situation in Iraq placed real constraints on what reformers could accomplish in terms of economic reconstruction. The CPA was either unaware of these issues or choose to ignore them as it attempted to implement sweeping market reforms. In either case, there was a significant gap between what reformers wanted to achieve and what they could achieve, given the realities in Iraq.

Like many economic reforms, the reforms underpinning the Iraq economic reconstruction have been based on the orthodox model of complete markets found in a majority of economics textbooks. This frictionless model is based on core assumptions including perfectly informed market participants, well-defined and enforced property rights, and the presence of the informal institutions—e.g., norms, trust, organizational forms, etc.—that are so important in the development and maintenance of economic relationships. Similar to the idealized model of democracy discussed earlier (Section 3.2), problems arise when the orthodox model is used as a

foundation for policy because the assumptions of the model imply a perfect market which does not, and cannot, exist in an imperfect world.

The only solution to the fatal conceit trap is a deeper appreciation for what can and cannot be rationally designed through human reason. As subsequent economic reforms are undertaken in Iraq, policymakers must be careful not to be overly reliant on the model of complete markets. Smaller scale reforms, which appreciate the limits of human reason, are more likely to succeed.

#### **4. Conclusion – Implications for Policy**

The reconstruction traps identified by Coyne and Pellillo (2010) provide insight into why past efforts to rebuild Iraq's economy have been unsuccessful. These failures provide important lessons that should inform future policies and reforms. First, reforms must be credible. In addition to ensuring that reforms provide the appropriate incentives to policymakers and citizens alike, reformers must also send a clear signal that the reform is credible. For example, Rodrik (1989) notes that in order to send a clear signal, reformers may need to overshoot and go beyond what they would normally do in order to signal that they are, indeed, credible. Reforms that are not clearly credible should be postponed or reformulated, since it is likely that they will be ineffective.

Second, prior to implementation, reformers must understand the status quo and how it influences the feasibility of potential reforms. Reformers must also appreciate the trade-off between a commitment to citizen participation through democracy and broader economic reconstruction efforts. As noted above, in some cases democratic participation can undermine

broader economic reforms and vice versa. Understanding the relationship between politics and economic reforms is crucial to adopting effective reforms.

Third, instead of focusing solely on improving coordination between bureaucratic agencies, reformers need to appreciate the limits of bureaucratic activities. This includes ensuring that there are clear mechanisms ensuring accountability and feedback. The absence of such mechanisms will result in waste and inefficiency.

Finally, reformers must recognize the limits of human reason and design reforms accordingly. The more complex the reform, the less likely it is that reformers possess the knowledge necessary to effectively implement change.

A concrete example will illustrate these implications. As noted in the Introduction, Iraqi citizens are currently burdened by onerous regulations that stifle private business. Consider, for instance, the World Bank's annual "Doing Business" index which measures how burdensome business regulations are in each country. In 2010, Iraq ranked number 153 out of 183 rated countries. Easing business regulation is one area where meaningful reform could be undertaken while avoiding the traps discussed in this chapter.

For example, if business regulations were removed, a credible commitment could be sent to citizens by permanently closing the bureaus or agencies that previously enforced those regulations. This approach would also overcome the bureaucracy trap, since these reforms limit bureaucratic activity by removing them from the process of regulating private business. Moreover, reforms to ease the cost of doing business would appreciate the status quo, which currently consists of a disincentive to engage in private enterprise and an incentive to engage in corruption to avoid burdensome regulations. At the same time, these reforms would not tax the knowledge of reforms because they would entail removing existing regulations instead of

designing complex interventions in the hopes of fixing Iraq's economy. Reforms to reduce the cost of establishing or expanding private business would not only appreciate, and avoid, the reconstruction traps discussed in previous sections, but they would also contribute to overcoming the persistent problems of unemployment and corruption that have plagued Iraq. Similar logic should be applied to other reforms associated with economic reconstruction in Iraq.



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<sup>1</sup> See the S/CRS official website: <http://www.crs.state.gov/>.

<sup>2</sup> For a discussion of shock therapy that appreciates these knowledge problems, see Boettke (1993).