

## Success Conditions for Iraq's Oil-Rentier Economy: Special Theory of Economic-Rent and Free Market Efficiency

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*Iraq's phoenix burns itself on a funeral pile of misuse of oil-rent and political power and social intolerance will rise from its ashes young again with the power of individual and social liberties, democracy, human development, and efficient utilization of natural resources.*

### Theory Generalization and Reality

Four and a half years after the fall of the late Saddam's dictatorial regime, attempts were made to assess and draw conclusions about the relevancy of the applied policies for liberalizing the political and economic systems and for the creating of flourishing democratic practices in Iraq. These were mainly based on dominant U.S. political and economic thinking, as well as on the post-war insecurity, and catastrophic political, social, and economic events. In particular, the economic strategy and policies advocated by the United States for rebuilding the economy on a free market basis had mainly the same basis of the following economic reviews, analysis, and assessments.<sup>[1]</sup> However, since the implemented policies were based on little understanding of Iraq's economic conditions, potential for growth, and structural problems, they failed to improve the deteriorating economic situation in spite of spending abundant available financial resources.

Economic theory may be defined generally as a systematic logical analysis of reasons and generalization of economic knowledge that is based on empirical observations, realities, and speculations. Ideas of the ideal (unchanging) economic theories (and policies) lead to repressive views of fixed political system which empower the dominant political elitism as well as restrict social progress. Theoretical discussion among different schools of economic thought and their policy implications have been focused on assumptions and behaviors of investment and savings, interest rates and investment, wages and profits, and maintaining equilibrium in order to maximize economic growth and employment of resources in free market conditions. Economic theories have been evolving in response to the events and outcome resulting from economic growth, rapid technological progress, social development, and changes in consumer behavior in the leading developed countries.

However, although the pioneer economists have exposed the hidden crisis of oil-rentier economies during the 1950s to 1970s,<sup>[2]</sup> the theories have not formally observed the dynamics and policy implications in the case where aggregate demand depends heavily on the economic-rent generating from the extraction of crude oil; a scarce natural resource in the developing oil exporting countries. Since the strategic importance of crude oil, as the world's main energy

source, will remain for a long time, it is justifiable to highlight the unique significance of using oil revenues by the state policy and criteria, and question the economic efficiency criteria of a free market in the oil-producing countries.

Specifically, the applied economic policies in a rentier-state of Iraq that were established on mixed ideological and pragmatic assumptions play a key, but inadequate role in developing the economy on free market basis.[3] The long experience showed that increasing oil production and maximizing oil revenues should be considered as an integrated part of the required expansion of non-oil production capacities; i.e., the implemented policies have failed to achieve this objective.

In Iraq, the post-war U.S. economic strategy and policies that are based on the doctrines of neo-classical economics, as well as the policies applied during the period (1953-1979) which were based on a mixed of Keynesian and post-Keynesian assumptions, were insufficient in utilizing oil revenues for achieving sustainable growth and employment. Thus, the experience raised a fundamental question with regard to the role of economic-rent which is owned by the state as a major driving factor of economic growth and distribution in a free market system.

This paper analyzes Iraq's economic policies by examining indirectly the relevancy of basic assumptions of neo-classical, Keynesian, and post-Keynesian economics. A classical economic growth and distribution model for Iraq is suggested to explore the implications of different policy assumptions and develop the argument in three scenarios; the 1970s oil boom experience, the economic collapse during 1990-2003, and an alternative strategy and policy path for the desired economic situation where free market conditions prevail and the economy depends on non-oil and private sector activities.[4]

There are two specific aims for this attempt; first, to highlight that the current economic deterioration in Iraq was due to rigid application of the policies that were based on the doctrines of neo-classical economics, and there is urgent need for a radical change to these policies. In particular, the paper tackles the importance of relating two concepts; i.e., the *economic-rent* and *efficiency price of crude oil to the (unnecessary) excess of oil production* in a liberal oil-rentier economy. Indeed, if these policies continue, the acute economic, social, political, and security crises will prevail despite of spending huge financial resources. Secondly, to further support the general call for broadening the scope of economics.[5] Iraq's experience shows that oil, socio-economic development and democracy are interrelated and constitutes the three main elements of its political economy[6] and thus successful economic experience would lead to social progress and improve the political system.

Iraq's long experience confirms the great influence of the state's oil power in domestic politics. However, no attempt is made in this paper to show the dynamics of oil revenue allocations in empowering the state (governments) to enforce a certain political and ideological agenda. Also, no attempt is made to underline the commercial interests of foreign companies in utilizing Iraq's oil wealth. The economic destruction of terrorist attacks is also out of the scope of this paper.

## **Iraq's Experience of Oil Wealth Power**

Against the current miserable state of shambles, Iraq, as it is well known, enjoys an abundance of human and natural resources and occupies a strategic geopolitical position in the Middle East region. The availability of crude oil and gas, water, agriculture land, as well as people's interest and will for hard work, support the promise of realizing an outstanding economic success in the country. For many centuries, as a route to the Indian continent, Iraq maintained its commercial strategic position between Western powers and the Eastern world.

Distinguished from the region's oil-rich countries, Iraq also had a central constructive position in the Arab and Islamic Empire as well as having had deep civilization roots as the land of the first

human civilization of Sumer, south of the Mesopotamian fertile valley, where the first human being efforts made a food (economic) surplus which was then distributed by the justice criteria of pagan Gods, governors and servants of Temples. Because of the then-surplus, settlements were developed into cities, religious and public buildings were built, laws were made, and writing evolved.[7]

The modern state of Iraq was established in 1921 under the British mandate and gained its independence in 1932. The availability of crude oil in the country added an important strategic factor to its geopolitical position that led the victorious great powers of the First World War to compete for controlling its oil wealth. Domestically, since early the 1950s, oil revenues played a significant role in the economic and social development of the country.[8] During the period from 1953 to 1979, Iraq utilized its oil revenues for financing the state's normal functions as well as achieving economic growth, accelerating social development, building the physical public infrastructure, the expansion of production capacities in different sectors, increasing employment, and the provision of public education, health and social services. However, a general assessment of past experience shows that such progress did not match with the opportunities provided by the abundant availability of oil revenues as a main source of public finance and foreign currency earnings that were essential for imports. Indeed, since the establishment of modern Iraq, the governments have failed, though in different degrees, in utilizing oil wealth for expanding sufficiently non-oil production capacities and enhancing the role of the private sector in order to sustain economic growth and employment, alleviate poverty, increase public services and utilities, and complete the economic infrastructure. Many factors have contributed to this failure; among them was the lack of proper economic strategy and policies.

After Iraq's occupation, it was apparent that the implemented policies were also unsuccessful in reviving the economy on a free market bases as well as rebuilding the infrastructure. As a matter of fact, since the fall of the former dictatorial regime on April 9, 2003 and after difficult experiences with the immense human, material, and financial costs and the moral burden, the occupation authority, the national governments, and the political parties have failed not only in realizing the required radical economic changes, but also in maintaining security and political and social stability. The misuse of oil revenues (wealth) has been at the center of the present dilemma, at a level even worse than practiced before.

Politically, it is widely argued that various causes have contributed to this decline: among them, the collapse of government and public institutions, weak liberal and democratic forces, the terrorist attacks, hostile foreign interventions, and the incompetence of the occupation authority, governments and dominant political parties. Iraq's reality today also shows that oil revenues were misused and mainly utilized as the engine powering the existing political mess. A glance at the financial sources of the activities of all government institutions, indigenous political parties, the civil non-governmental organizations, and the foreign companies (contractors), traders, private security firms, armament and advisory consultants, including economic advisors, reveals the strategic role of oil revenues in running the daily domestic politics. The unnecessary rush for the approval of the "Oil and Gas Law 2007" amid political disarray and security chaos is an outstanding example of the selfish interests of foreign concerns and greedy politicians in the country's oil. Unfortunately, the post-war spending of huge amounts of oil revenues produced nothing but more sluggish economic growth, increase unemployment, widespread of poverty, lack of economic and social infrastructure, and basic public services and utilities, and corruption.

The applied economic policies and financial measures were no more than a collection of non-substantive and unjustified official promises, shortsighted ideas of business culture, incorrect explanations of free market conditions, misconceptions of the role of public and private sector, and little understanding of the reasons for structural economic reforms. In addition, the prevailing policies also ignored the social and environmental implications of economic development. The envisaged alternative, however, is to consider the salient features of the national economy, especially the strategic role of oil wealth, the weak private sector, and narrow social base of the

middle class, as well as the political, social, and environmental elements required for identifying the objectives priorities of a national economic strategy.

## Relevance of Neo-Classical and Post- Keynesian Economics

Two crucial issues are at the centre of the theoretical argument. First, in contrast to laissez-faire neo-classical economics, the mere dominance of economic-rent generating from the world's scarcity of crude oil means that those economic efficiency criteria, i.e. production, allocation of resources, and products distribution efficiency, are far from the practice seen in the crude oil-rentier states. Also, there is no economic logic behind the producers' decisions to increase crude oil production as long as demand and prices of oil exports are increasing in the longer-term. Indeed, it is a rational investment decision to postpone production for the future. In neo-classical free market theory, there is no economic justification for having excess oil production (revenues) that stimulate more government spending while the absorptive capacity of the economy is limited. Moreover, production of non-renewable natural resources has long-term environment costs, and it should be strictly perceived to protect the rights of future generations.

Secondly, different from post-Keynesian suggestions, increasing aggregate demand in order to increase growth and employment through government fiscal policy is not enough to diversify the economy and lessen its high dependence on oil-rent (revenues). In addition, oil revenues were used to ease the inflation pressures through financing increasing imports and maintaining the foreign exchange regime that predetermined the exchange rate of the national currency vis-à-vis the U.S. dollar, and consequently unnecessarily constrained the indigenous monetary policy by the U.S. interest rate. Economic stability in terms of constant official exchange rate of ID/US\$ during the 1970s and 1980s, as well as the proclaimed economic stability as a prime success of post-war policy, have been artificially manipulated only by the misuse of oil revenues. Furthermore, the ability for financing increasing imports has nothing to do with the government's fiscal policy and the artificial independence of the monetary policy of the Central Bank of Iraq or as a result from free flow of foreign trade and capital.<sup>[9]</sup>

Examining these two issues, we need to recall the relevant theoretical assumptions. The central concern of neo-classical economics is the behavior of the individual firms and the consumers with their marginal rational decisions that determine the static equilibrium and growth at full employment. The decisions were assumed to be based on optimizing the profits of individual firms and consumers' utility. It is also assumed that prices, output, and income distribution are determined in the market through supply (aggregate of individual firm decisions) and demand (aggregate individual utility consumers). Such rational decisions in a free market will achieve maximum growth and optimum use of resources. The theory also assumed that economic matters at the macro-level are the results of aggregation of the relationships between individual firms. These assumptions are in contrast to Keynes' general theory which was mainly concerned with the role of macroeconomic circumstances in terms of aggregate demand and employment of resources. For the Keynesian economics, aggregate demand plays a decisive role in determining output while the behavior of individual firms is dominated by macroeconomic events. In this theory, the level of savings, not the rate of interest, determines investment and there is no automatic tendency for the level of savings and investments to be equal. It acknowledges the importance of the individual firms, but it emphasizes more the essential role of the state in regulating the macroeconomy and utilizing available labor and resources, especially in case of depression.

Accordingly, the government can influence aggregate demand to cut unemployment through public finance policy.

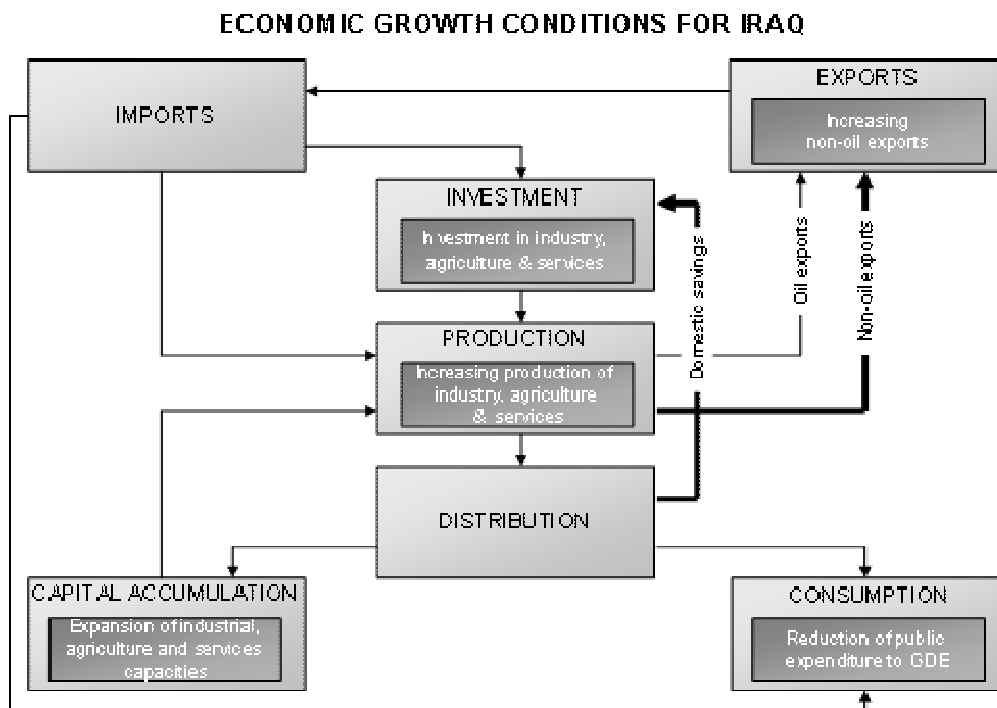
In response, neo-classical economics is based on the macroeconomical assumptions, and emphasizes that growth can only be enhanced by influencing supply through the government

demand management, and assumes decisions of individual firms and consumers are rational. However, the impact of government intervention would be ensured only when their policies are unanticipated.

New Keynesian economics tries to combine microeconomic foundations with the rational expectation and the role of government in macroeconomic demand management. It stresses the existence of institutions which may rationally lead to sticky prices and wages despite the change of economic events which would result in change of output and employment. Money is not neutral and the business cycle can be partially explained by changes in aggregate demand. The central banks, as government agents, can improve the economic efficiency under imperfect market conditions. In contrast to the neo-classical economics, it showed that wages and prices do not adjust instantly to allow the economy to attain full employment of resources. I.e., unemployed resources and non-clearing markets can exist and persist even when rational expectations apply.

Iraq's experience showed that government consumption and investment expenditures are the determinants of output and employment, whereas domestic private and public savings generated from the non-oil activities were extremely insignificant. In other words, oil economic-rent, but not normal domestic savings or interest rate, determine national investment. Oil revenues constitute the large share of aggregate demand. In addition, Iraq lacks the economic and social conditions and infrastructure for an active indigenous private sector and entrepreneurship, as well as for foreign corporations in indigenizing non-oil industrial activities.

In general, it has been established that there are three main conditions for increasing economic growth and employment in Iraq: Increasing domestic private savings for increasing national investment, especially in non-oil industries, and increasing non-oil exports.[\[10\]](#)



Source: Sabri Zire Al-Saadi, "Liberalization of Iraq's Oil-Hostage Economy: Alternative to Oil Power Dominance and Neo-Liberal Subordinate Economic Policy," part 1 & 2, MEES 49, nos. 42 & 43, October 16 and 23, 2007.

Given these conditions, the following strategy is crucial for liberalizing and diversifying the economy as well as for the establishment of free market foundations:

*A gradual transformation of the economy can be achieved by implementing a strategy and macroeconomic policies that encourage and influence the indigenous private sector for increasing its contribution to GDP to at least 80 percent, increasing the share of non-oil value added to GDP to at least 80 percent, non-oil revenues contribution to the government annual budget should be at least 80 percent, and increasing non-oil exports to 70 percent of total exports.*[\[11\]](#)

For the monetary policy, a new foreign exchange regime (FXR) must be established so as to reflect more adequately the efficiency price of oil production which would minimize the value difference between the economic-rent (world market prices) and efficiency price (shadow price) of crude oil. The efficiency price is determined by the required oil revenues (production) for economic and social development. If gradually put into practice, this conceptual proposition, i.e. to adjust the FXR in accordance with the excess level of oil production, would also serve the mutual interests of both the consumers of crude oil and Iraq in the long-run.[\[12\]](#) Obviously, this suggestion contradicts the well-known policy of the IMF and the World Bank that advise the oil producing developing countries to maximize their public spending of their excess oil revenues even on unnecessary imports of consumer products and financing the construction of *white elephant* type of projects. For the IMF and World Bank, equilibrium of demand and supply at the world's level is superior to the economic efficiency and requirements of sustainable economic growth in the oil-rentier countries.

So, while neo-classical economics puts the cart before the horse, the post-Keynesian policies failed to appreciate the prevailing imperfect market conditions and structural economic problems in oil-rentier countries.

Moreover, in a free market economy, the distribution pattern of rewards of production factors is determined through the free price system. In practice, however, it is difficult to envisage an efficient economic mechanism that simultaneously performs efficient production and socially acceptable (justice) distribution of income and public oil wealth without the state intervention at the macro-level, and accompanied by proper regulations applied at firm level. Implicitly, such intervention would reduce the economic efficiency of the market system in terms of optimal economic growth, i.e. full mobilization and optimal allocation of resources. Nevertheless, in reality, the political, social and culture activities (decisions) have to make acceptable compromise between achieving higher economic growth and employment on one hand, and just income distribution and maintaining effective social security and welfare system on the other. In Iraq, where oil wealth is abundant and owned by the state, the chances are available for achieving such compromise.

## **Classical Economic Growth and Distribution Model**[\[13\]](#)

### **Definitions:**

#### ***Endogenous variables;***

- The national product (income),  $Y_t$ : is made of oil and non-oil national product at year  $t$ .
- The national wages,  $W_t$ : is made up of total paid wages at year  $t$ .
- The national profit,  $F_t$ : is made up of total profits generated from non-oil economic activities at year  $t$ .
- $C_t$ : is national consumption at year  $t$ .
- $M_t$ : is national import at year  $t$ .

### **Exogenous and policy variables;**

- The national export,  $E_t$ : is made up of oil and non-oil exports at year  $t$ .
- $E_{o,t}$ : is oil export at year  $t$ .
- $E_{n,t}$ : is a non-oil export at year  $t$ .
- $I_t$ , is national investment at year  $t$ .
- $Y_{t-1}$ , is national product in year  $t-1$

### **Parameters;**

- The income distribution pattern,  $v$ : is equal to the sum of  $((ps-gs) a + gs)$ .
- The ratio of profit to value added generated by private sector from non-oil activities,  $a$ .
- The propensity to save of the private sector is  $ps$ .
- The propensity to save of the public sector is  $gs$ .
- The ratio of public oil revenues allocated for investment national product,  $B1$ .
- The ratio of public oil revenues allocated for consumption to national product,  $B2$ .
- The ratio of total public oil revenues to national product is  $B$ .
- The marginal capital-output ratio is  $k$ .
- The ratio of intermediate import commodities to national product is  $m1$ .
- The ratio of consumer goods and commodities to national product is  $m2$ .
- The ratio of capital commodities to national product is  $m3$ .

### **Accounting Equations**

Assuming that national income (product) is distributed by wages and profits only and there are three sources of saving; oil export revenues, public enterprises, and private sector. When saving is equal investment, then we have the following accounting equations;

$$C_t = W_t + (1-v) F_t + B2Y_t \dots (1)$$

- $Y_t = I_t/k + Y_{t-1} \dots (2)$
- $M_t = m1 Y_t + m2 C_t + m3 I_t \dots (3)$
- $Y_t = C_t + I_t + E_t - M_t \dots (4)$  [\[14\]](#)

where;

$$E_t = E_{o,t} + E_{n,t}$$

$$E_{o,t} = (B1 + B2) Y_t$$

### **Investment Equation**

When the saving is equal to investment and since income is distributed by wages and profit, i.e.:

$$Y_t = W_t + F_t + BY_t$$

$$S_t = PSt + GSt + SSt$$

And by assuming the ratio of saving from wages is zero, and:

$S_t$ , is total savings in year  $t$ ,

$PSt$ , is total savings of the private sector at year  $t$  which is equal to;  $ps a Ft$ ,

$GSt$ , is total savings of public enterprises at year  $t$  which is equal to;  $gs (1-a) Ft$ ,

$SSt$ , is total savings of the state allocated for investment and finance by oil revenues, which is equal to  $B1Y_t$ ,

then;

$$S_t = ps a Ft + gs (1-a) Ft + B1Y_t$$

$$\text{or } S_t = ((ps - gs) a + gs) Ft + B1Y_t$$

$$\text{therefore, } I_t = v Ft + B1Y_t \dots (5)$$

From equation no. 5, we conclude that;

$$B1 + Ft v/Y_t = I_t/Y_t$$

or

$$Ft/Y_t = B1/v - I_t/Y_t v \dots (6)$$

## Scenario One: Oil Boom Experience

*During the 1970s, the government centralized economic and social development planning of the country and monopolized most of the economy in terms of the public sector share of national production and investment, and the government consumption share of national consumption. The activities of private sector were subordinate to public sector dominance. The economy and government enjoyed unlimited financial resources from oil-rent.*[\[15\]](#)

Assuming given values of the ( $v$ ) and ( $B1$ ) coefficients, then equation (6) expresses that the ratio of profit generated from non-oil economic activities is determined by investment. Since (most of) national investment is an independent variable, i.e., mainly public infrastructure projects financed by oil-rent, and because their returns were very low, indirect, and only materialized in the long-run, then any new big increase of investment would lead to an increase in aggregate demand which creates the following impacts; successive increase of prices, employment, profit, and saving. These trends lead in turn to national consumption reduction if we limit our analysis to one short-term period of a one flow of investment increase. If investment decreases, then unemployment will increase, profit rates and prices decrease which will relatively increase national consumption. During that period, the situation of semi-full employment of labor must be considered as a result of the continuous increase of government expenditures (investment and consumption) that was coupled with the government socialist employment policy. Thus, any attempt to increase more economic growth at equilibrium by increasing national investment requires one or two of the following conditions:

1. Increasing the propensity to save in both public and private sector.
2. Increasing public investment financed by oil revenues.



In both cases, equilibrium will be moved to a new level represented by equation no. (6). In this situation, the following possibilities exist; the change of (ps) and (gs) as well as the change in the share of private sector to non-oil value added (a) to the extent that lead to the change of (v). The increase value of (a) was a deviation from the then-socialist policies of the government; i.e., giving more role to the expansion of private sector and increasing its contribution to GDP. Also, an attempt to increase the propensity to save of the private sector (ps), even if realized, would not be enough to increase national investment without similar increase in (a). Therefore, while the possibility for increasing the value of (v) diminished, it was possible to increase substantially the propensity to save in the public sector (gs) in order to exceed the value of both (a) and (ps). *Here lays the first main economic problem facing the centrally planned oil-rentier economy.* For in order to maintain a balanced distribution between national profit and national investment on the one hand, and between investment and growth on the other, the economic and financial efficiency of the public enterprises should be improved to increase (gs) to match the required increase of investment. If such a condition was not satisfied, then the economic situation has two contradictory possibilities:

1. First, the state continues to expand the economic activities of the public sector and consequently reduce the activities of the private sector regardless of the demand to increase its profit needed for investment. In this situation, national profit will be decreased or at least remain the same.
2. Secondly, the state takes a neutral policy in regard to increasing (a) and (ps); i.e., enabling a bigger role to the private sector. In this situation, the gap between the desired level of investment and savings will be reduced in proportion to the increase in values of (a) and (ps); i.e., the economy will be nearer to equilibrium position. However, such a possibility was a clear deviation from the social, economic, and political framework of the state's policies.

Since the second possibility contradicts the centralized economic planning of the state and the dominance of public sector, it was thus necessary to ensure one or both of the following options:

1. Increasing the propensity to save in the public sector which was difficult to realize in the short-term;
2. Increasing public investment in mega-projects characterized by high technology; i.e., projects with higher value of capital/output (k) in order to increase production and productivity.

However, in pursuing the second option, new practical requirements were needed to absorb the new modern technology while maintaining the economic efficiency of these costly projects. *Here lays the second main economic problem resulting from the state's big investment in mega-production and infrastructure projects.* The capacity of the state economic planning institutions was lacking in preparing an adequate economic and technical evaluation of those capital intensive projects. Indigenizing advanced technology may not improve the economies of those projects unless their operational requirements are provided and the quality and quantity of their products are marketable at competitive prices. Without these requirements, increasing (k) means nothing but incurring high costs, higher prices of products, and relative decreases in the rate of output growth. Indeed, since the state adopted this option, it failed to achieve the planned economic targets or efficiently utilize the available production capacities; i.e., it led to decreasing the economic efficiency of public enterprises. Hence, at the first stage of successive increase of public investment, the contribution of oil revenues to national investment has increased; i.e., increasing (B1) which means the change of (B) that also depends on the change of (B2). Since the factors that change (B2) and (B1) are the same; i.e., the expansion of public services, supporting the public enterprises, and financing the state's defense and internal security and

other normal activities, then by increasing (B1), the value of (B) would be increased if assuming (B2) will remain the same. *This change closes the vicious circle between the increase of investment and the single source of finance, oil revenues.*

In addition to the successive effects of investment, increasing national consumption as a result of output increases that raising the average rate of profit and wages and because of continuous government consumption expenditures financed by oil revenues, the need for higher growth rate became essential; i.e., more investment was required and therefore more oil revenues were needed. Therefore, the second flow of output and income necessitates the increase of (B) in order to maintain short-term economic equilibrium. Otherwise, equilibrium will be settled at a new higher level of prices.

Parallel to the financial flows, investment in public capital intensive projects highlights the heavy dependence on imported capital goods; i.e., it sustains the long-run high dependence of the economy on imports.

In practice, the mere increase of (B) does not mean instant realization of equilibrium. Therefore, maintaining the short-term economic equilibrium requires another assumption which leads to an increase of the investment multiplier effects; i.e., the flow of commodities needs to cope with the financial flows. This demands flexible and efficient government institutions and public enterprises which are responsible for production, execution of public projects, and the implementation of imports programs. The direct impact of successive investment on prices hinges on public institutions capacities that should be in proportion with the finance procedures as well as match the increasing rate of public consumption. Such flexibility was lacking and therefore the increase of public investment and consumption raised the prices to a higher level that strengthened the demand for more government investment and consumption expenditures, i.e., increasing (B). If we consider the mechanism from different angles relating to the possibility of decreasing (B), as a result of unforeseen external (foreign) factors, the result would be the reduction of investment and consumption that either lead to lower rates of growth, employment, profit, and wages; or, the decrease of (B1) necessitates the raising of profit and saving rates by improving productivity and increasing financial surplus of the public enterprises. It was necessary for public enterprises to employ high technology and operate their production activities efficiently and be able to market their products at competitive prices. This position can be sustained by the reduction of oil revenues allocated to government consumption (B2) and maintains the balance by the required political change of the role of public and private sectors in generating the value-added from non-oil activities (a) and increase the propensity to save of the private sector (ps). Implicitly, this means an increase of unemployment and the reduction of wage rates.

The suitable government policy and public investment criteria for increasing economic growth must be judged by their influence on the rate of propensity to save (investment) for both public and private sectors, which determine the share of oil revenues in national income, i.e., (B). It is also clear that by increasing investment financed by non-oil revenues means increasing the coefficient value of (v). In fact, the relations between (a) and (gs) and (ps) and their changes in determining the value of (v) reveal the usual competitive tendency between the public and private sectors. By examining these relations, the extent to which their positive change could bring about the required economic effects can be assessed.

However, it is not easy to exactly follow the many combinations that can be derived from different values of (a), (gs), and (ps). But it is clear that by increasing (gs) in case of (a) decreases is more important than increasing (ps), and increasing (ps) is more important in case the value of (a) increased. In case that the value of (a) remains constant, it is urgent to change the status of ownership rights of property and means of production, work, trade, and competition in favor of the private sector. The stability of (v), (gs), and (ps) at certain level while the increase of (B1) continues over longer periods means the deepening of the prevailing hidden and apparent economic crises. In the long-term, the situation makes the income distribution pattern even

worse. At the same time, the need for increasing imports can not be sustained by having a constant value of (B1) without increasing non-oil exports.

In fact, the value of (B1Y) is almost the same value of total exports, and imports are entirely financed by oil revenues. Therefore, the investment criterion required to maintain the external economic balance is to give priority for export-oriented public and private projects. Increasing and diversifying non-oil exports are much more important than the then-import substitution policies of the government.

### **Scenario Two: The Economic Collapse;**

*Theoretical analysis of the situation, where a huge and sudden reduction in oil export revenues shows extreme and fast devaluation of the shadow prices of oil resources; i.e., the foreign exchange of national currency.[16] Financial resources, especially foreign currency constitutes a very heavy constraint on government expenditures and imports required for consumption, investment, and raw materials for production. In reality, the severe negative impact of UN economic and trade sanctions on Iraq (1990-2003) proves this theoretical suggestion. The catastrophic social, economic, and political consequences of the oil export embargo were beyond the sensible anticipations of economists and politicians.[17]*

In this case, the value of (B1) is zero, and thus the whole system underwent serious changes; i.e., an extremely sharp drop in national consumption, the value of investment was zero, a huge reduction in production, imports were limited to staple foodstuffs and products, a substantial increase of unemployment of manpower, under-utilization of production capacities and resources, and continuous damage to the infrastructure. All normal assumptions regarding the values and behavior of economic variables and parameters were not valid. Socially, actual events led to widespread of poverty, acute social disturbances, and political instability. The economic hidden crisis; i.e., high dependence on oil production becomes apparent, and showed the gravity of the misuse of oil revenues for government spending without undertaking the required policies and reforms to increase production of non-oil sectors, non-oil exports, and non-oil financial sources of public finance.

### **Scenario Three: The Alternative Policies;**

*Iraq has bright economic prospects. Under normal political, social, and security conditions, the country could embark on a huge reconstruction program of physical, social, and environmental infrastructure coupled with the application of a well-defined economic strategy and policies guided by optimistic national vision. Oil revenues will continue to play a strategic economic role in implementing the required economic strategy and policies in the short and medium-term that should lead to full economic liberalization and a greater role of the private sector in generating GDP, maintaining public finance, and financing increasing exports.*

Contrary to past experience, the new economic strategy and policies are based on a future national vision that considers the public economic and social objectives as well as recognizing world economic developments.[18] The vision assumes that individual economic freedom, property ownership, work, trade, and competition in the market must be guaranteed. Hence, private entrepreneurial and corporate initiatives would be flourishing. The role of the state therefore should be limited to its traditional functions: maintaining security, defense, the provision of basic education, health, and social public services, regulating macroeconomic events, and financing the investment in infrastructure projects and public utilities.

The new model formula is different from the previous one in assuming that the value of (B2) is equal to zero; i.e., all oil revenues will be allocated to public investment (B1) in infrastructure. In

other words, (B1) defines the total value of oil revenues; i.e., (B) and it is equal to public (government) investment.

By assuming that national income is distributed between wages and profits only, and the main sources of saving are: oil export earnings, public enterprises, and the private sector. Then, when saving is equal to investment, the following equations adequately reflect the case:

$$C_t = W_t + (1-v) F_t + Y_t \dots (1)$$

$$Y_t = I_t/k + Y_{t-1} \dots (2)$$

$$M_t = m_1 Y_t + m_2 C_t + m_3 I_t \dots (3)$$

$$Y_t = C_t + I_t + E_t - M_t \dots (4)$$

$$I_t = v F_t + B Y_t \dots (5)$$

where;

$$E_t = E_{o,t} + E_{n,t}$$

$$E_{o,t} = B Y_t$$

From equation no. 5, we conclude that;

$$B + F_t v/Y_t = I_t/Y_t$$

or

$$F_t/Y_t = B/v - I_t/Y_t v \dots (6)$$

Given the change of policy in regard to the economic role of the private sector in terms of increasing value of (a), then increasing economic growth and employment needs enough increase of investment, especially by the private sector; i.e., an increase of (ps). Public enterprises are no longer dominating production and investment activities and therefore the value of (gs) will be relatively decreasing. This means that the value of (v) will be increased by the expected increase of (a) and (ps). *Here is the remedy for increasing economic growth and employment.*

In practice, a flexible economic policy should aim for the following targets: maintaining macroeconomic stability and promoting economic growth, especially for non-oil industries and agriculture, gradual liberalization of the foreign exchange regime, gradual and firm implementation of integrated structural economic reforms, limited and temporary import protection measures as well as export promotion incentives to support the competitive capacities of infant indigenous industries and low-productivity agriculture, and provision of investment incentives for the indigenous private sector and foreign corporations.

## Conclusions

Many factors have contributed to the prevailing acute and multiple crises in Iraq:

- The faulty economic policies and the deep rooted misuse of oil revenues by the state were among them; and,
- The U.S.-advocated rigid interpretation and the widely prescribed neo-classical and post-Keynesian policies that had little ground in Iraq's reality.

Therefore, a radical change in economic strategy and policies is as essential as maintaining security and the political and social stability for Iraq's survival.

Theoretically, the doctrines of neo-classical and post-Keynesian economics afford no reasoning to the unique and substantial influence of economic-rent on growth, employment, and distribution. The applied policies based on these theories have also failed to justify the excess production of crude oil (public financial surplus) more than the absorptive capacity of the economy. In particular, they have no explanation to support the economic efficiency of the predetermined fixed exchange of national currency vis-à-vis the U.S. dollar and the use of oil revenues to control inflation resulting from excessive government expenditures instead of activating monetary policy instruments.

In reality, the economic role of the state at this stage must be recognized as necessary, though not sufficient, for increasing growth and employment of available resources by optimal utilization of oil-rent through effective macroeconomic policies, public investment, and gradual implementation of structural economic reforms.

In Iraq, the expansion of indigenous non-oil production capacities, increasing the role of private sector, and improving the competitive capability of industries, agriculture, and services demand economic policies that ensure efficient use of oil-rent by the state. At this stage, the state's tasks should include building the physical, social, and environmental infrastructure and financing public basic services and utilities, as well as pursuing effective macroeconomic policies, including a flexible foreign exchange regime, and structural reforms to liberalize the economy from its high dependence on oil-rent and unburden the inefficiency of public enterprises.

Technically, given normal political and social stability and security in Iraq, the proposed economic strategy and policies could be put into practice by utilizing the art of modern economic planning approaches and techniques, and the state's macroeconomic policies, as well as the rigorous role of indigenous and multinational corporations that are guided by inspiring political future vision.

Politically, since the prospect for the dominant Islamic parties to cope successfully with the ever-changing economic realities, technological progress, and globalization thrust is limited, then *the liberal and social-democrat* groups may succeed to have the wide social base of the majority of citizens that desperately need to improve their living standards by adopting the proposed new economic strategy and policies, and therefore be able to lead the political control of Iraq in the near future.

Finally, since this special theory that brings about the concept of relative economic efficiency and justify a wider state's macroeconomic role is essential for sustaining economic growth and optimizing the distribution of economic-rent in Iraq, it is reasonable to examine the given stipulations and analysis to the experience of other oil-rentier developing countries such as Saudi Arabia, Iran, Nigeria, Libya and Kuwait. If such a test proves to be viable and consistent, the general theory of oil-rentier economies will emerge. Such an endeavor would not only help to rationalize the economic and oil policies in the oil-exporting developing countries, but also to improve the world's energy security in the long run.

## About the Author

Sabri Zire Al-Saadi is an economic adviser who has worked in a number of Arab countries as chief technical advisor, macroeconomist, and investment programmer, and has held senior economic planning and policy posts in Iraq. All given views are the sole responsibility of the author, and do not necessarily represent his employer's opinion or that of any Iraqi political entity. He may be reached by e-mail at: [sabri\\_saadi@hotmail.com](mailto:sabri_saadi@hotmail.com).

## References

1. Immediately after the occupation of Iraq, the Coalition Provisional Authority (CPA), also officially named the Occupation Authority, issued a coordinated set of Laws (orders) to implement a new economic strategy for rebuilding the economy on free market bases. On June 7, 2003, it issued the order No. 12 titled "Trade Liberalization Policy" that suspended all tariffs, custom duties, import taxes, licensing fees and similar surcharges for goods entering or leaving Iraq, and all other trade restrictions that may apply to such goods, until December 31, 2003. On September 19, 2003, the CPA issued orders No. 37, 38 and 39 to free foreign investment, foreign trade and defined the tax strategy. Also at the same date, it issued order No. 40 to establish a new banking system. On 19 February 2004, the CPA issued order No. 49 titled "Tax Strategy of 2004," in which four income tax brackets (3 percent, 5 percent, 10 percent and 15 percent) and various allowances on individuals were introduced. See [www.cpa-iraq.org](http://www.cpa-iraq.org). As the applied strategy failed to achieve its goals, attempts were made by U.S. advocates to find an alternative that did not contradict the basic principles of the ideal free-market strategy and policies; e.g., Robert Looney, "[A Plan for Revitalizing the Iraqi Economy](#)," *Strategic Insights* IV, no. 8 (August 2005) and "[The Economics of Iraqi Reconstruction](#)," *Strategic Insights* 5, no. 5 (May 2006). Carl Conetta, "[Radical Departure Towards a Practical Peace in Iraq](#)," *Project on Defense Alternatives, Briefing Report No. 16*, Commonwealth Institute, July 7 2004; Republic of Iraq, "National Development Strategy 2005-2007," *Iraq Strategic Review Board*, Ministry of Planning and Development Cooperation, June 30, 2005; U.S. National Security Council, "[National Strategy for Victory in Iraq](#)," November 2005; USAID-Iraq, [Transition Strategy Plan \(2006-2008\)](#), March 2006. James Baker and Lee Hamilton, [The Iraq Study Group Report: The Way Forward – A New Approach](#), U.S. Institute of Peace, December 6, 2006.

2. See for example, Hossein Mahdavi, "The Pattern and Problems of Economic Development in Rentier States: The Case of Iran," in Cook, M., ed., *Studies in the Economic History of the Middle East* (Oxford University Press, London, 1970). Also, Edith T. Penrose and Ernest F. Penrose, *Iraq: International Relations and National Development* (London: Ernest Benn, 1978).

3. The oil rentier-state may be generally defined as "a state that heavily relies (more than 50 percent) on economic rent (revenues) of oil and gas natural resources to finance high level of government consumption and investment expenditures despite of low level of domestic saving. While oil and gas sector contributes more than 50 percent of total contribution of the industries, agriculture, and services sectors to GDP and exports, government expenditures dominate the aggregate demand."

4. Economic assessment of the Iraq's post-war experience and remedy proposals were suggested in Sabri Zire Al-Saadi, "[The Economic Revival of Iraq](#)," MEEES 46, no. 21 (September 1, 2003).

5. See for example, the document entitled "a brief history of post-autistic economics movement" in which economists raised the need for expanding the dimensions of economics. ([www.paecon.net](http://www.paecon.net)).

6. See, for example, Sabri Zire Al-Saadi, "The Iraqi Economic Crisis and Proposition for Change: An Introduction to the Political Economy Features; Oil, Development and Democracy," (in Arabic). Published in the *Iraqi File*, a monthly political and documentary review issued by the Iraqi Centre of Iraqi Studies, London, no. 107 (November 2000). Republished in *Al-Thakafa Al-Jadida*, the Iraqi Culture Journal, no. 297 (December 2000).

7. The first human civilization on earth was founded in Sumer, south of Mesopotamia, during 3500-3000 B.C. See: J.M. Roberts, *The Penguin History of the World*, Third Edition (London: Penguin Books, 1997.)

8. An earlier assessment of the strategic role of the oil sector in Iraq was given in Sabri Zire Al-Saadi, "[Economic Liberalization and Oil Policy in Iraq: Vision and Priorities](#)," *MEES* 49 no. 29 (July 21, 2003). The impact of economic policies implemented by the occupation authorities was given in Sabri Zire Al-Saadi, "[Iraq's Post-War Economy: A Critical Review](#)," *MEES* 47, no. 14 (April 5, 2004). Alternative economic strategy and policies were given in Sabri Zire Al-Saadi, "[Liberalization of Iraq's Oil-Hostage Economy: Alternative to Oil Power Dominance and Neo-Liberal Subordinate Economic Policy](#)," part 1&2, *MEES* 49, no. 42 (October 16, 2006) and 43 (October 23, 2006).

9. An assessment of Iraq's post-war economy and policy prospects by U.S. advocate Robert Looney brought interest comparison with the Ba'athists' economic model which was described as "provided the government bureaucracy with a pragmatic, albeit doctrinaire framework for setting prices for many goods, controlling the country's vast oil resources, running nearly two hundred state-owned enterprises, and dominating most aspects of the economy. The country experienced impressive rates of growth, but perhaps given the buoyant oil revenues at the time, the economy grew in spite of the Ba'athist programs." He also predicted that "[v]ersions of either the neo-Ba'athist or the Neoliberal economic programs face a daunting task." Robert Looney, "[A Return to Ba'athist Economics? Escaping Vicious Circles in Iraq](#)," *Strategic Insights* 3, no. 7 (July 2004). Questioning the efficiency of FXR was raised by the author in his article, "[Oil Revenues and Foreign Exchange Regime in Iraq](#)," *MEES* 47, no. 36 (September 6, 2004).

10. See, Al-Saadi, "[Liberalization Strategy For Iraq's Oil-Hostage Economy: Alternative To Oil Power Dominance And Neo-Liberal Subordinate Economic Policy](#)," Op. Cit.

11. [Ibid.](#)

12. The idea was first presented and examined by mathematical analysis in Sabri Zire Al-Saadi, "Foreign Exchange Rates and Optimal Crude Oil Production in Developing Oil-Exporting Countries," *OPEC Review* XII, no.2 (Summer 1988): 123-127. Iraq's economic collapse during 1991-2003 provided solid evidence of the then given theoretical propositions.

13. Although the proposed model has similarities in analyzing equation no. 6, and to that given by the Kaldor model, the basic assumption in our analysis that is related to the role of investment as an independent variable in addition to our analysis of exports' role are basically different from Kaldor model where investment was assumed as a variable dependent on interest rate and expectations. As for the general equilibrium, the model is very similar to Harrod-Domar and Kalacki growth models, especially in dealing with the case of the decreasing growth rate more than the increase of investment and the role of technology and change of prices in changing the two sides of the equilibrium relations. In the case of Iraq, the equilibrium adjustments and general economic stability have different economic social and political implications that are different from those given by similar theoretical models. See Nicholas Kaldor, "Model of Distribution," in Nicholas Kaldor, *Essays on Value and Distribution* (London: Duckworth, 1960), 227-236. Republished in Amartya Sen, ed., *Growth Economics*, Penguin Modern Economics Readings (Middlesex, England: Penguin Books Ltd., 1970), 81-91. Michael Kalacki, "Determination of the

Rate of Growth of a Socialist Economy Under Conditions of Limited Supply of Labour," *Essays on Planning and Economic Development* 3, Warsaw, 1968, 19-34; E. Domar, "Capital Expansion, Rate of Growth and Development," *Econometrica* 14 (1946): 134-147, republished in Amartya Sen, ed., *Growth Economics*, Penguin Modern Economics Readings (Middlesex, England: Penguin Books Ltd., 1970), 65-77; R.F. Harrod, "An Essay in Dynamic Theory," *Economic Journal* 49, 1939, 14-33, republished in Amartya Sen, ed., *Growth Economics*, Penguin Modern Economics Readings (Middlesex, England: Penguin Books Ltd., 1970), 43-64.

14. When analyzing the impact of a big deficit in the balance of payment due to sharp decrease in oil revenues, this equation should include the value of net transfer to/from abroad. However, this formula is sufficient for our limited purpose.

15. On the main economic features of the period, see my "[Economic Liberalization and Oil Policy in Iraq: Vision and Priorities](#)," Op. Cit.

16. See footnote 12 above.

17. A general assessment of economic deterioration in terms of GDP per capita was given in Sabri Zire Al-Saadi, "[Oil Wealth and Poverty in Iraq: Statistical Adjustments of Government GDP Estimates \(1980-2002\)](#)," *MEES* 48, no. 16 (April 18, 2005).

18. See Sabri Zire Al-Saadi, "[Iraq's National Vision, Economic Strategy and Policies](#)," *Strategic Insights* 5, no. 3 (March 2006). Also see Sabri Zire Al-Saadi, "Iraq Needs a Radical Change in Economic Strategy and a Political Criteria for Oil Wealth Utilization," *Strategic Insights* 6, no. 1 (January 2007).