

Economics of Iraqi Security (Part III): Financing Reconstruction

by [Patrick Clawson \(/experts/patrick-clawson\)](/experts/patrick-clawson)

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ABOUT THE AUTHORS



[Patrick Clawson \(/experts/patrick-clawson\)](/experts/patrick-clawson)

Patrick Clawson is Morningstar senior fellow and director of research at the Washington Institute for Near East Policy.



Brief Analysis

This PolicyWatch is the third in a three-part series written to coincide with the Madrid Donors Conference on Iraq, which begins on October 24, 2003. [Read Part I \(templateC05.php?CID=1673\)](#) and [Part II \(templateC05.php?CID=1674\)](#) (both by Michael Knights).

Although economics is not the driving force behind Iraqi resistance to the U.S.-led coalition, restoring vital public services and improving the standard of living will improve security. The key question asked about the economy has been reconstruction costs: how high they will be and who will pay them. The good news is that these costs can be met without large additional injections of U.S. funds. The bad news is that economic recovery will take years, and the Iraqi public may become disenchanted about the gap between their high hopes and the reality of slow progress.

How Much?

Calculating the amount of money Iraq needs for reconstruction is not easy. This amount will depend to a large extent on the expected outcome of reconstruction; for instance, bringing Iraq up to U.S. standards in all areas would require as much as \$1 trillion in investment over the next decade. It is unlikely that the international community would take on the task of making Iraq as wealthy as the United States. Other estimates of Iraqi needs argue that hundreds of billions of dollars must be spent in Iraq within a few years an argument that holds true only if the goal is to transform Iraq into a fully developed country within that timeframe, which would be a herculean task. After all, according to the UNWorld Bank Needs Assessment (hereinafter Assessment), Iraq's prewar income levels were \$600700 per person per year only two-thirds the average income in the West Bank and Gaza at the height of the intifada. Indeed, the Assessment seems to point to a more modest goal of making Iraq's annual per capita income levels on par with those of some of Iraq's neighbors: somewhere between Turkey (about \$3,000) and Jordan or Iran (both at slightly more than \$1,500), and certainly better than Syria (about \$1,000).

There are several different estimates of Iraqi needs, each covering a variety of time periods and sectors. The Assessment estimates Iraqi needs at \$36 billion for 20042007. Yet, the UNWorld Bank looked at only a limited set of sectors (e.g., electricity, water, transport, education, health, housing, agriculture, employment creation). This set did not include certain sectors for which the Coalition Provisional Authority (CPA) has provided needs estimates (e.g.,

oil, foreign affairs, religious affairs, environmental issues). The Assessment does, however, include estimates of required commitments in many of the areas covered by the U.S. supplemental budget request (which calls for \$20 billion for 2004). For instance, the Assessment estimates needs of \$12.1 billion for electricity generation, transmission, and distribution, whereas the U.S. budget supplemental commits \$5.7 billion to this same sector. In general, there is much overlap between the UNWorld Bank Assessment and the U.S. budget supplemental.

It would seem, then, that the best way to estimate Iraq's overall needs is to combine the Assessments estimates for the sectors it looked at (again, \$36 billion for 2004-2007) with the CPAs estimates for the sectors it looked at (\$19.4 billion for the same period). This results in a total estimate of \$55.4 billion for 2004-2007. Indeed, according to the October 21 New York Times, \$55 billion is what senior Defense Department officials are using as a rough estimate of the amount required to rebuild Iraq through 2007. For 2004, the combined Assessment/CPA estimate is \$17.5 billion: \$9.3 billion for the Assessments sectors plus \$8.2 billion for the CPAs (including \$5 billion for security and \$2 billion for oil).

The above figures represent the amount that needs to be committed in 2004-2007 that is, how much money must be pledged over four years. That is by no means the same as amount disbursed, or actual cash spent. As the Assessment explains, [World] Bank experience with projects in post-conflict and other emergency environments would indicate that if donors make commitments against all the needs identified in the Assessment, i.e., US\$36 billion, disbursement in the first year might be in the range of US\$5 billion. In some of the sectors for which the CPA made estimates, disbursements may be more rapid (e.g., funds for imported refined oil to meet demand that local refineries cannot supply). Nevertheless, disbursements in 2004 would still be far below commitments.

Some confusion may arise in light of the fact that the Assessment is not entirely consistent in its estimates. In certain sectors, the Assessment does not include needs for which financing has already been promised, even though such needs are included in other areas. In particular, the Assessment does not include \$1.5 billion of electricity investment (including \$1 billion in 2004) in its \$36 billion total because the former amount has been pledged by the UN oil-for-food program and other unspecified identified donors. And in the health sector, the Assessment leaves out \$1 billion in 2004 needs for which it was assumed funding had already been secured (no such estimate is provided regarding already-secured funding for later years). The justification for this procedure is unclear. Nevertheless, it does not pose a big problem for those looking to estimate Iraq's needs; although it requires an adjustment in focus, it does not change the overall picture.

Where From?

The UNWorld Banks peculiar procedure regarding electricity and health highlights the manner in which needed funding can come from a wide variety of sources, not just the pledges made at Madrid. A significant amount of the money could come from Iraqi resources or from private funding. As the Assessment puts it, Not all of the identified reconstruction needs will need to be financed externally. It is expected over time [that] an increasing share of these expenditures could be covered by [Iraqi] government revenues or private sector financing, thus diminishing the need for external financial support. Indeed, the CPA budget provides \$11.3 billion in capital financing for 2004-2006 (of which \$700 million is for 2004). Assuming that the level of CPA capital financing in 2007 would be the same as in 2006 (\$5.4 billion), the total funding provided by the Iraqi government from 2004-2007 could be as high as \$16.7 billion. This would constitute 30 percent of the previously described total needs assessment of \$55.4 billion over the same period, leaving \$38.7 billion to be raised from other sources.

The U.S. budget supplemental would provide \$18-20 billion, depending on final congressional action. There is good reason to expect that the remaining half of the \$38.7 billion could be readily secured without any additional U.S. funding required, even on the conservative assumption of no private financing for oil reconstruction, electricity generation, or other potentially profitable activities. Possible sources for the remaining \$19-21 billion include:

- The World Bank is considering a \$5 billion loan program over 2004–2007.
- Japan is considering a \$5 billion program of loans and grants for 2004–2007, though at Madrid it may only make a firm commitment of \$1.5 billion for the first year.
- European Union members are on track to commit as much as \$1 billion for 2004, led by Britain, Spain, and the union as an institution. That could translate into \$4 billion over 2004–2007, although the amount might be higher if more is committed as the U.S. role shrinks and Iraq assumes a greater degree of self-governance.
- The UN oil-for-food programs September 17, 2003, report lists \$2.6 billion in unencumbered funds. The program is due to shut down on November 21; in light of the withdrawal of most UN personnel from Iraq, the plan is to hand over responsibility to the CPA. The reports opaque language also seems to indicate that an additional \$7.8 billion was committed but not yet disbursed: \$5.6 billion prioritized for shipment (much of which had not yet been delivered) and another \$2.3 billion whose priority had not yet been reviewed.
- Other contributions can be expected from countries such as Canada (which is considering \$260 million) and members of the Gulf Cooperation Council, led by Saudi Arabia and Kuwait.

How Quickly?

If the good news is that considerable funding should be readily available, the bad news is that reconstruction projects will be seriously constrained by implementation problems. To quote the Assessment, "Experience by the [World] Bank in other post-conflict countries shows that constraints to reconstruction are often due not to a lack of funds, but rather to difficulties in developing and implementing time-bound investment programs according to established international procedures."

Dedicating even more money to Iraq would not make much difference in how quickly reconstruction takes place. A rule of thumb in the development business is that a country can efficiently handle foreign aid only up to about 20 percent of its national income. The Assessment estimates Iraq's gross domestic product in 2002 and 2004 at \$15–20 billion, which translates to a maximum efficient aid level of \$34 billion per year. In this light, the projected aid levels detailed above are already so high that some funds may be not be well used. Moreover, additional aid money could drive wages up to an unsustainable level and divert resources from productive activities into aid-financed boondoggles.

It would be very difficult to speed up the implementation of reconstruction projects. One way to do so is to award contracts more quickly, but that requires short-circuiting established procedures, which could create the perception of cronyism (as has already been seen in charges that Halliburton unfairly benefited from good political connections). Another way to accelerate projects would be to charge ahead in the absence of personnel trained in the usual reporting and accounting procedures (skills in which few Iraqis are qualified); however, this could lead to charges of fraud and abuse. Another method, much used in the Persian Gulf states, is to bring an entire team from abroad to implement the project in question (e.g., using South Asian laborers and American supervisors); yet, this could raise costs and create resentment among Iraqis at how few jobs are being created for them. Another approach is to make decisions quickly by having a narrow group of experts decide what to build; yet, that could create ill will among Iraqis who expect their local politicians to have an important voice in decisionmaking.

The most likely scenario is that reconstruction will proceed at a measured pace. That means the standard of living for most Iraqis will improve only slowly. That could be a problem in the battle for hearts and minds, especially if Iraqis have been given the impression that their lots would be improved quickly.

Conclusion

To date, much of the focus on the reconstruction problem has been about how to secure sufficient funding to meet

Iraq only needs. In fact, the available funding may be well in excess of what can be spent in the short term—indeed, the effective constraint on the pace of reconstruction may be the country's absorptive capacity rather than the amount of money pledged. Despite the fact that funding will not be as much of a problem as is often thought, the standard of living in Iraq may be slow to improve, which could become a real political problem.

◆ Patrick Clawson is deputy director of The Washington Institute.

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