Budgetary Predictions Cast Doubt on Rapid Iraqi Reconstruction

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ABOUT THE AUTHORS

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Brief Analysis

If Iraq is to rebuild its infrastructure and restore its economy at the pace forecast by the Coalition Provisional Authority (CPA), it will need to bridge a major near-term financing gap by increasing capital inflows from outside the country and simultaneously improving its ability to absorb aid and investment. Oil revenues projected by the CPA budget through 2004 are overly optimistic, and Iraq's capacity to meet the levels of expenditure outlined in the budget are questionable. Without multilateral funding and much improved security and investment environments, Iraqi economic recovery is likely to develop at a slower pace than anticipated.

Revenue

With non-oil revenue projected to reach only $373 million between July and December 2003, oil sales are expected to provide the lion's share of Iraq's $3.8 billion in total projected revenue for this period. The CPA's oil projections are unrealistic, however. Its prediction of $3.4 billion in oil revenue would require exports of around 800,000 barrels per day (b/d). Factoring in a domestic consumption level of approximately 420,000 b/d, Iraq would need to maintain an average production level of 1.2 million b/d in order to meet this export rate. Although current production levels are difficult to judge, they are unlikely to exceed 1 million b/d. Moreover, according to a Senate Foreign Relations Committee report, Iraqi oil exports would have to reach 1.5 million b/d by December in order to meet CPA revenue targets, requiring production levels of at least 1.9 million b/d. Raising production to this level and maintaining it would be extremely challenging. Key export fields in southern Iraq may lack the technical capacity to sustain their current level of production, let alone expand it. Analysts are also concerned that periodic and possibly lengthy pauses in extraction may be required later this year to allow oil field pressure to return and to complete above-ground repairs.

Even if production levels were to increase beyond 1 million b/d, there are many other limitations on export capacity. For example, oil from the southern fields is exported via the Persian Gulf terminal of Mina al-Bakr, which may have difficulty expanding and therefore presents a potential bottleneck. Oil from the northern oil fields has typically been used for the domestic market; redirecting this oil to the export market would require improved pipeline security.

The Syrian pipeline, which is capable of transporting 180,000 b/d, remains closed for technical as well as political reasons.

In order to finance the budget deficit for July-December 2003, the CPA can count on central government reserves of around $5.4 billion, including $1.7 billion of vested funds currently frozen by the United States, $795 million of funds recovered in Iraq, and approximately $1.2 billion in oil revenues deposited in the Development Funds for Iraq account established under UN Security Council Resolution 1483. As for 2004 and 2005, the CPA has announced that it will seek to develop oil exports of 2 million b/d (requiring production of at least 2.5 million b/d) by December 2004, and exports of 3.5 million b/d (requiring production of 4 million b/d) by December 2005. These production levels would necessitate an estimated $1.6 to 2.5 billion of investment in 2004 and a further $2.5 to 4.5 billion by December 2005. Foreign direct investment in the Iraqi oil industry is unlikely to approach these levels so long as the country lacks a new constitution and investment laws. Until then, Iraq will have to self-finance most of its reconstruction. Securitizing future oil production -- that is, borrowing now against the value of future oil sales -- is the only real option.

Iraqi Expenditures

Iraq's expenditures for July-December 2003 are budgeted at $6 billion. In addition, $1.2 billion worth of expenses were incurred between the end of Operation Iraqi Freedom and the budget's commencement in June 2003, and $2.1 billion have been allocated to the central bank as reserves for currency support. Key expenditures include:

Government organizational expenditures of $2.61 billion, including $1.47 billion for operating costs and $1.14 billion for salaries and pensions. With $190 million per month and assuming an average monthly wage of $100 for civil servants, there may be as many as 1.9 million Iraqis still on the government payroll. At $165 million, defense expenditures in the current budget are down by $450 million compared to the previous regime's expenditures. In fact, the current defense budget would have been up to $120 million lower if the CPA had not decided to take on the ongoing expense of building a 40,000-strong Iraqi army. An additional $150 million is allotted to the new Iraqi police force, and $233 million has been budgeted for other security measures, such as the maintenance of local militias and security guards.

Although the budget is unclear on this issue, around $2 billion appears to have been allotted to infrastructure reconstruction. There are reasons to doubt that the CPA can spend this sum in under six months. Following the political furor surrounding the expedited contracting processes used by the U.S. Agency for International Development in the prewar period, it is not clear how much can be done to speed up aid projects. Yet, much needs to be done to restore services to the levels expected by Iraqis, particularly given CPA administrator Paul Bremer's estimate that the eventual cost of reconstruction would range from $50 to 100 billion. For example, the current budget's investment of $347 million in electricity, water, and sanitation constitutes only a small fraction of the estimated $10 to 15 billion needed to restore quality services in these sectors.

The budget also allocates $1.35 billion for social safety-net expenditures.

U.S. Expenditures

In addition to the Iraqi budget, the United States has allotted $3.6 billion for civilian assistance through September 2003, and more funding will presumably be added for the next fiscal year. Moreover, the U.S. military is spending $3.9 billion per month in Iraq. This figure far exceeds the cost of maintaining 147,000 troops in the country; it includes items that will benefit the Iraqi economy (e.g., payments to local civilian service providers and translators; reward payments for information; compensation for damages to people and property from the Brigade Commanders Emergency Fund).

Policy Implications

Given that Resolution 1483 established a moratorium on debt repayments until December 31, 2007, Iraq has a significant window of opportunity in which to kick-start its economic recovery. Yet, the CPA's July-December 2003 budget and early projections for 2004 merely scratch the surface of the capital investment required to revive the Iraqi economy. Moreover, it is unclear whether even this level of funding -- let alone higher levels -- can be rapidly injected into Iraq. CPA estimates of Iraqi oil revenues are probably optimistic, and budget deficits larger than those forecast may be unsustainable. Given the current security, constitutional, and legal environment, major private-sector capital injections are at least two years away. This financing gap explains recent calls to mobilize multilateral aid at the UN donors conference in the fall. Yet, the experience of other recent post-conflict situations (e.g., Kosovo and Afghanistan) suggests that even near-term pledges of aid will be unable to kick-start rapid economic recovery; typically, aid agencies do not disburse funds quickly, especially when the security environment of the recipient nation is poor. Without stability and an improved investment climate, Iraq will not be able to absorb pledged aid or foreign direct investment, nixing the prospects of rapid economic recovery in the near term.

Michael Knights is the Mendelow defense fellow at The Washington Institute.

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