

The Marshall Plan versus the Reconstruction of Iraq

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Introduction

There is a growing literature on the Marshall Plan's applicability to today's reconstruction needs. Several journalistic observers have made unconvincing cases of their incompatibility, citing differences in culture and assuming institutional and legal infrastructure in post-war Europe and Japan that simply was not there at the time (but is now)¹. It is important to look at the broad issues in reconstruction: the organization of the effort; the goals and the funding mandate behind the effort; the ability by the US Government to self-correct; understanding the context the reconstruction effort is taking place in and the similarities and dissimilarities that exist, to name several.

As an example, few people would have said at the time that post-war Japan's imperial structure was anything like the US legal system—least of all McArthur and his legal team who wrote the new laws. In fact several commentators note how foreign the new legal process being developed for Japan was at the time. Fewer still cite any bankruptcy, court proceeding or welfare distribution functions in post-War Germany. Even with entrepreneurialism and public-private cooperation, the task was daunting: trying to rebuild a capital stock of much greater magnitude than what capital needs are today even in Iraq. Thus, while the problems are different, they are all large in their own way, and they all require focus and organization.

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¹ A serious attack on the Marshall Plan application in recent times comes from Barry Eichengreen. He makes an interesting case for the fact that Economic Cooperation Act (ECA) money merely tipped the balance in the economies of Europe, which were at that time starved for capital in an international capital market that was segmented. Today, he claims, with capital markets so free, it is unclear that a Marshall Plan style would have the required impact, and that, in fact, it would represent a waste of tax dollars. Eichengreen's assumption of free capital markets does not apply in war-torn economies or in underdeveloped states such as Sub-Saharan Africa (he notes the latter location). In fact capital markets don't work that well in North Africa either, nor in Iraq, Afghanistan, Kosovo, Bosnia or any other war-torn or fragile state where a Marshall Plan would be considered.

A major thesis we put forward is 1) that the reconstruction effort under the Marshall Plan was more focused, well thought out and planned, 2) was on economic governance issues as much as humanitarian, security, and physical reconstruction programs and 3) lacked a competitive nature with other donors as aid does today. This allowed for the war-torn economy to recover much more rapidly and require less assistance in the out years. Of course, external factors also played a role in rapid recoveries. For example, the start-up of the Korean conflict created considerable demand for Japanese goods and services, and similar increases in world demand helped fuel Europe's post-War growth

An important difference between the Marshall Plan era and more recent reconstruction efforts, in terms of organizational structure, is the way assistance was organized then, all under the auspices of one donor—the US, versus now under joint efforts of many bilateral and multilateral donors. Under the Marshall Plan and in Japan, the U.S. was the final authority and the main and direct source of funds. However as we point out, this was not the main factor in determining success in these early reconstruction efforts. It certainly helped and, we would contend, allowed for faster recovery once problems were addressed, but even under one authority, there were problems. What is of real interest is how the Truman Administration, when faced with division and squabbling between departments, worked to resolve the issues and restore the advantage of a single donor decision-making process.

If we compare the effort of the Marshall Plan with that of Iraq, we note a similar problem at the start of each. Both reconstruction efforts took over a year to get off the ground and were characterized initially more by infighting between the State Department and War Department (Pentagon) than with real economic development. As Michael Hogan has pointed out in his history of the Marshall Plan (written before even the first Iraq conflict occurred):

...previous aid programs had failed and would continue to fail so long as American assistance was used in piecemeal efforts to revitalize national economies. The squabbling between the War and State departments was symptomatic of the drawbacks inherent in uncoordinated aid programs. Worse still, the piecemeal approach seemed to be perpetuating the very order that had hampered economic growth and led to German domination in the prewar period.²

This problem of uncoordinated, unfocused assistance was quickly corrected by President Truman, who admitted mistakes, brought in a prominent leader from another Party (Herbert Hoover!) to assess the situation, gave considerable leeway to junior but very talented staff in the State Department under Dean Acheson and George Kennan, and asked for a new plan to more efficiently use aid³.

² Michael Hogan, 1987 p.35.

³ Quoting from Michael Hogan (1987 p. 33-34): "His [Hoover's] report issued in March 1947 recommended lifting the restrictions imposed by the level-of-industry plan, halting the removal of non-military industrial plants, and allowing the Ruhr and the Rhineland to remain parts of Germany. These revisions in policy, it maintained, would leave Germany with the factories and resources needed to increase production and thus spare American taxpayers the onerous expense of supporting the German population. Together with the proper safeguards against renaissance of German militarism, they would also permit Germany to contribute to the peaceful stabilization of Europe as a whole." (see also Truman letter to

It is of importance that the Marshall Plan had this problem and that it was resolved only after about 18 months. We have seen in Iraq, that in twice the time frame, 33 months, such a solution does not seem imminent. The question that puzzled us as authors is why did this have to occur in Iraq when we already knew it had happened under the Marshall Plan? One answer is that, there will always be start-up problems, and they can last anywhere up to a year or two for very large efforts. The issue is not start-up lags, rather the ability to self-correct. The Marshall Plan, after 18 months, did a review and then availed itself of substantial US Government resources on economic reconstruction and planning. The CPA—as we discuss below—did not use USAID resources as effectively as it could have. This is why the Marshall Plan was able to self correct, and why we believe the Iraq reconstruction effort (in addition to the lack of security) is still beset with problems 18 months after the end of the conflict.

Under the Marshall Plan the US also had been planning for occupation and reconstruction well in advance of the cessation of hostilities. Start up problems did occur, as we discuss in the case studies below, but they were not fatal flaws and were possible to overcome by an Administration in Washington that was willing to consider debate and criticism from several quarters, review its original objectives and quickly organize around a solution.

We believe therefore, that the underlying factor in success of a war-torn reconstruction effort is not the lead and dominating participation of the US, but rather the fact that the development effort is focused through a unified organizational structure and an explicit national development framework. Here, the budget is used as much as possible as a document to guide policy, and that the ruling government—be it a new one or an occupier—relies on the services of those development agencies at its disposal to achieve its collectively agreed goals. What is important is for reconstruction planning and implementation to be well organized and coordinated. While this most easily can take place when one country or agency oversees or clearly leads all reconstruction work (as in the case of the Marshall Plan and Occupation of Japan), there are examples of well organized aid efforts led by several donors (Kosovo, Afghanistan, East Timor), and also an example of a less well organized effort led by one donor (Iraq).

Thus it is tempting to credit the success of these early aid years relative to later years to the singularity of U.S. purpose and to the fact that one government was acting alone as opposed to several donors and aid agencies working together. However, although the primary role played by the U.S. may have had something to do with these early successes in Europe and Japan, a number of later reconstruction efforts beginning with Kosovo in 1999 involved several donors and managed to be successful. And Iraq is an obvious case where we feel it has not gone so well.

Another fundamental difference dominates the two eras in the delivery of reconstruction assistance: a universal approach, characterized by consolidated funds in one administrative pot to be drawn on, in the same way a budget process works, versus

Hoover, January 18, 1947, Hoover letter to Truman, January 19, 1947 and Hoover letter to Truman March 18, 1947 and Herbert Hoover, *An American Epic* 4 vols. (Chicago 1959-64).

today's approach of multiple donors competing with one another (UN, EU, WB, IMF, and bilateral assistance bureaucracies). In many cases donor assistance programs are a diversified patchwork without a consistent theme. In addition, in a number of reconstruction efforts since those immediately after World War II, there has been an apparent lack of strategic interest in the reconstruction effort beyond humanitarian assistance and conflict resolution—as opposed to the Marshall Plan and the Japanese Reconstruction program, which prioritized rebuilding economies and institutions of economic governance. The early efforts of the Marshall Plan and Reconstruction of Japan also had bold, blunt statements about promoting US economic interests globally and ensuring that the largest economy in the world would benefit from its aid in terms of strong economic partners in Europe and Japan. To state these goals explicitly today is seen as anathema, with the consequence that the aid delivery gets watered down to often nominal consequence.

Over the last few decades we have seen a move into attempts at more international cooperation, where responsibilities and tasks are divided up among different types of donors and often long time lags result in aid delivery. Certainly in assistance offered to West Africa and later Kosovo, we see this splitting of responsibilities. Reconstructions in Kosovo, East Timor and Afghanistan have been cooperative efforts of many multinational donors and are rated very highly. In the cases of Kosovo and Afghanistan especially, the planning processes were well coordinated and integrated aid packages were introduced early-on. These reconstruction efforts learned lessons from their predecessors and largely recreated the unity of purpose seen in the Marshall Plan,

The case of Iraq, the most recent major reconstruction effort of those we consider, merits particular attention, when compared with the experiences of the Marshall Plan era. The reconstruction process carried out under the Marshall Plan is now considered to have been a classic example of successful reconstruction carried out by one donor, the USG. The administration of the Marshall Plan after World War II was carried out after the first year by a streamlined, unified State-War-Navy Coordination Committee. The Iraq reconstruction, considered to be principally led by the USG, would lead one to expect a successful outcome in the tradition of the Marshall Plan. However, we find that unified planning under one entity is only a necessary, not a sufficient condition. For example, reconstruction in Iraq has been directed by the CPA, although multiple countries (U.S., Britain and Australia) have participated in the effort. The CPA did not rely on an integrated team, but relied on a team drawn from various organizations across government—Department of Defense, NSC, Department of State, USAID, Treasury, Department of Commerce, USDA, and the NSC— with different operating styles and procedures. There was no streamlined organization within the lead donor (i.e., within the relevant U.S. Government agencies) and little utilization of development specialists in economic reconstruction. Lessons from those efforts highlight the importance of effective coordination in both planning and implementation. Further, as already stated, it has been some 18 months since the start of reconstruction and unlike the Marshall Plan, we see no similar review of aid operations as occurred under Truman with the Hoover report (yet we acknowledge this still may occur in Iraq; it just has not happened yet).

Let's investigate each reconstruction effort in depth

I. The Marshall Plan

Background

The Americans' ultimate goal behind the Marshall Plan was European economic recovery to benefit the long-term interests of the United States. The Truman Administration and Marshall's own conviction was that US economic recovery depended on open trade and increased international investment. Emerging out of the Smoot-Hawley legislative disasters, a deeply ingrained free trade ethic had taken hold. At this time of reconstruction design, American leaders saw the foundation of international order based on the principles of (classical) liberal capitalism, free trade and equal opportunity. These principles, according to Cordell Hall, were associated with democratic forms of government and maintained that autarky was associated with totalitarian governments (such as Stalinist Russia). They assumed that:

“...enemies in the market place could not be friends at the council table. The political line-up followed the economic line-up.”⁴

The emergence of the Cold War at Yalta had fueled the American resolve to rebuild the European economic space on “their own terms”. The agenda was very much constructed around filling the power vacuum left by the defeat of France, the collapse of Germany, and the exhaustion of Britain. Unless the US “assembled the components of a viable balance of power,” a vacuum could be created into which the Soviet Union might expand.⁵ Building economic and political systems strong enough to forestall the rise of Communist Parties was one of the primary tasks of the effort⁶.

However, this was not the only factor. More significant for how we view the Marshall Plan in today's aid environment is that it was seen as an investment, not as a large humanitarian effort. While there was a humanitarian aspect to helping the “Christian people of Europe,”⁷ those who ran it and implemented it, as well as Truman, Clay, Harriman, Hoffman, and even to some degree George Kennan, approached it as an investment that required a rate of return. In so doing they created a management culture around the assistance effort that has not been matched in any post-war reconstruction effort (except Japan). Nor has there been a cheaper (*per capita*) reconstruction effort that achieved so much.

⁴ Cordell Hull, *The Memories of Cordell Hull*, Vol. 1, 1948 p.364.

⁵ Michael Hogan, *The Marshall Plan*, 1987 p.27.

⁶ Michael Leffler, “The American Conception of National Security and the Beginnings of the Cold War, 1945-1948,” *American Historical Review* April 1984 Vol. 89 pp. 346-381 cited in M. Hogan, 1987.

⁷ Correspondence between Ray Moseley and Harry Truman, November 26 - December 1, 1947, Harry S. Truman Library Independence MO, see US National Archives & Records Administration, ARC Identifier: 201510.

It is curious how much the original designs of the Marshall Plan foretold the future European Union that was to come much later in the century. American designs of the Marshall Plan were based on a “grand” design of integration. The US wanted to replace the old European system with a form of American federalism that would create a similar economic “space” to the US:

The strategic assumptions behind this policy held that an integrated economic order, particularly one headed by supranational institutions, would help to control German nationalism, reconcile Germany’s recovery with France’s economic and security concerns, and thus create a balance of power in the West sufficient to contain Soviet Power in the East.⁸

The economic plans were based almost entirely on the Americans’ own experience at home, where a large economy developed that was unencumbered by borders and enhanced by free trade and a single currency, regulated when necessary by national institutions but largely based on free-market forces. A united states of Europe would bring similar benefits and provide the necessary backdrop to de-legitimize the emerging Communist parties and present a stark counter example to the already tired Stalinist state in the East.

As will be shown below, the reason the Marshall Plan had so much success, relative to other aid efforts since, was not because it was applied to “like-minded” Europeans. Nor was it a success as some have said because it was simply a capital market stimulus that pushed Europe over the top (implying that in today’s world as long as a war-torn area has access to capital markets they will be fine). Rather, it was a success because the effort was organized, encompassed economic policy as well as recovery from the beginning, and crucially, treated the entire venture as an investment, rather than as a recovery exercise, or the carrying out of a “moral obligation” to the war-torn states of Europe. As one commentator has properly put it: “our aid to Europe is primarily an investment operation”⁹.

The early years of trial-and-error: 1945-1947

A focused approach was not adopted until late 1947. The unifying concept of building a unified Europe to help the US came about by a series of mistakes from which the US learned. In 1946, the effort was hopelessly piecemeal. While there was a real concern about Soviet aggression through-out the reconstruction era, the means to address this only galvanized after a year of mistakes in which some \$9 billion in a variety of aid programs were expended.¹⁰

⁸ Michael Hogan, 1987.

⁹ Howard Ellis, *The Economics of Freedom*, p. 34 cited in Harry Price, *The Marshall Plan and Its Meaning*, 1955 p. 93.

¹⁰ It is important to note that the \$9 billion spent in one year (1946-1947) approximates about \$100 billion in today’s dollars at a 5% discount rate—roughly the amount spent in Iraq and Afghanistan between 2002-2003. See H. Price, *The Marshall Plan and Its Meaning*, 1955.

The situation in 1946 had gotten so bad that Truman called on former President Hoover to investigate the factors slowing the recovery in Germany. Upon completion of the report in 1947, Truman had become convinced that almost any action would be an improvement on current policy.¹¹

The new approach emerged from their deepening conviction that that previous aid programs had failed and would continue to fail so long as American assistance was used in piecemeal efforts to revitalize national economies. The squabbling between the War and State departments was symptomatic of the drawbacks inherent in uncoordinated aid programs. Worse still, the piecemeal approach seemed to be perpetuating the very order that had hampered economic growth and led to German domination in the prewar period.¹²

The new approach to coordinate the allocation of aid through a supra-national program known as the European Recovery Program (ERP) actually grew out of a renewed concern for what benefit the program would have for Americans, as well as the contribution of newly formed UN agencies specifically tasked with European recovery. The UN Emergency Committee for Europe, the UN European Coal Organization, and the UN European Central Inland Transport Organization had already had considerable success in distributing scarce commodities. Based on this, the UN formed the UN Economic and Social Council (ECOSOC). They concluded and recommended to the US Administration that long-term stabilization in Europe required coordinated economic management on a regional basis and recommended that a long-term permanent economic commission be established to replace the existing emergency organizations. Shortly thereafter in March 1947 the UN General Assembly established the Economic Commission for Europe (UNECE).

At the same time a clique of junior officers at the State Department (including Theodore Geiger, Paul Porter, Thomas Blaisdell Jr., Charles Kindleberger and Walt Rostow as well as Harold Cleveland) all saw the piecemeal approach with alarm and welcomed the UN example of the UNECE. This agenda was then more or less taken over by these individuals, who influenced Dean Acheson (Under Secretary of State) to request a report on the additional aid needs in various countries. This in turn strongly influenced those working closely with George Kennan's Policy Planning Staff, who encouraged the establishment of the special inter-agency entities, the State-War-Navy Coordinating Committee (SWNCC) and the Committee on the Extension of U.S. Aid to Foreign Governments. William Eddy, who headed SWNCC, proceeded to take the entire issue under study and extensively to review the type of aid and its delivery to Europe.

The results of the SWNCC work influenced several junior employees at State to become more aggressive, such as Paul Porter and Charles Bonsteel, who recommended to Kennan the following elements of the future European Recovery Act:

¹¹ John Steelman, undated memorandum for the President, Truman Papers, PSF, General File: Herbert Hoover, cited in Michael Hogan, 1987 p.35.

¹² Michael Hogan, 1987 p.35.

1. Promote currency convertibility
2. Encourage the immediate lowering of tariff barriers
3. Utilize the UNECE as an agency of joint programming
4. Encourage Soviet participation so as to lay the ground for an all European Settlement

This intellectual push from below eventually became watered down slightly in that meaningful Soviet participation was eventually rejected by Dulles, Truman and Marshall, and no significant role was foreseen for the nascent UN. But the point was made that European economic recovery could not be piecemeal, that a single economic space was an ultimate goal, and that institutions that promoted coordinated economic recovery in Europe were the only way to achieve a “proper” ally.

The immediate impact of this dialogue was General Clayton’s request to Acheson and Marshall for \$6-7 billion in new aid each year over a three-year period. As General Clayton recommended:

This amount was required to avert economic, social and political chaos in Europe, contain communism, prevent the collapse of America’s export trade, and achieve the goal of multilateralism. To revive the European productivity, moreover, Clayton thought it imperative that aid be used to reorganize an economy that had become divided into many watertight compartments. Like Kennan, he believed that any recovery plan must encourage a “European economic Federation.”¹³

Truman appointed three teams to clearly investigate the resources available for an aid program and the impact the program would have on the American economy.

The Consequences of Good Planning and Clear Goal Setting: 1948 to 1951

Finally, in July 1947 Marshall made his speech at Harvard and articulated the European Recovery plan that was to become the Economic Cooperation Act – Title I of the Foreign Assistance Act that Congress passed in the spring of 1948, authorizing \$5 billion to support the first twelve months of the European Recovery Program (ERP). Paul Hoffman was appointed to head the ECA (at an annual salary of \$20,000, approximately \$104,000 in today’s wages).

The programs that emerged focused on economic governance and related issues.

Economic governance

A debate emerged as to the program direction between “free traders” and “planners”—a not entirely accurate naming of the groups. The free traders favored replacing the “patchwork” of non-convertible currencies and bi-lateral commercial agreements with a currency-clearing scheme and customs union in Europe. The planners favored increasing production first before any discussion on currency-clearing and customs union. To

¹³ See Clayton Memorandum, May 27, 1947, FRUS, 1947, 3:230-232 and Clayton’s Speech before the UNECE cited in Michael Hogan, 1987 pp. 41-43.

introduce currency clearing and customs mechanisms already in 1948, it was thought, would only exacerbate controversies over internal financial reforms necessary to bring about such reforms. Rather, the planners wanted to concentrate on restoring Europe's existing industries, reducing production bottlenecks and reducing the worst restrictions on intra-European trade and payments. In a sense, the planners were exhibiting good economics since if the real sector is not fixed first then the financial sector will develop along a very thin base and, in the face of any (what would normally be a small) crisis, collapse, leaving questions of its legitimacy. Further, as we will point out later in this report, how the reconstruction program handles domestic debt (even more importantly than international debt) usually dictates the pace of financial reform since the thin banking sectors in these states usually have government debt on their balance sheets as their main asset.

The consequence of the debate was a sort of compromise, with the planners dominating. It was recognized that the payments system would have to be repaired sooner rather than later but that the more sophisticated problems of bank supervision and solvency, as well as currency convertibility, would have to be solved institutionally at the pace of each country's real sector development.

As Hogan states in the final section of his "Paths to Glory" of *The Marshall Plan*:

The former strategy seemed to require supranational controls and economic planning to achieve its goals; the latter would rely on normal market mechanisms. But both converged on the twin concepts of production and integration, and out of this would come a central component of the policy synthesis that would characterize American diplomacy in the years ahead. Although a customs union and clearing scheme would have to wait until production had revived, gains in production were to be accompanied by greater European efforts to stabilize finances and multilateralize intra-European trade.¹⁴

Several interesting papers from Paul Hoffman and interviews with him in Price, *The Marshall Plan and Its Meaning*, reveal the intentions behind the new administrator's policies, largely reflecting the outcome of the planning versus free trader debates. Hoffman makes clear: "It is not to be a relief operation."¹⁵ Very soon in the process Hoffman, as had been predicted by the junior State Department officials, saw that the problems of economic governance had to be addressed. It was not simply a question of operations of emergency reconstruction and food exports. Rather, as Hoffman and even Harriman saw, the emphasis soon began to fall on the analysis of economic conditions and needs, area by area, and on efforts to relate economic assistance to recovery policies in each country. As Price points out after extensive interviews with the major players:

Procurement and production, it was found, could not be isolated and dealt with apart from other basic elements in recovery. The task was not simply increasing production in France, Italy or Greece, and it became clear that the ECA staff must concern itself with

¹⁴ Michael Hogan, 1987 p.87.

¹⁵ Harry Price, 1955 p.73.

the intensive study and coordination of individual country programs as well as with procurement and planning on “some large functional” basis¹⁶.

This observation is crucial to our analysis of the Marshall Plan for lessons learned. Although analysis is sometimes overlooked today in modern aid efforts, it is as important as implementation.

General issues

A further important aspect of the organization was the reliance on local government procurement and public-private cooperation. The ECA did not engage directly in the purchase of aid supplies. Rather, procurement was handled by recipient governments and by private firms and nationals of the participating countries. This delegation of authority away from a large US or (worse) UN procurement agency had two distinct advantages: i) it meant there was no need for a large expensive procurement organization (such as had been created under Lend Lease and UNRRA Administrations), and ii) it made maximum use of private trade channels abroad as well as in the US.¹⁷

As can be seen from the opening paragraphs in every annual report prepared by the *Division of Statistics and Reports and Fiscal and Trade Policy Division* of the Economic Cooperation Administration:

Under the Economic Cooperation Act of 1948, and pursuant to the provision of the agreements entered into between the United States and certain European countries participating in the European Recovery Program, each participant receiving assistance in the form of grants has assumed an obligation to deposit in a Special Account amounts of its local currency commensurate with the amount of the basic dollar grants. In addition, participating countries deposit local currency in the Special Account to match the amount of drawing rights on other participating countries, which they exercise under the Agreement for Intra-European Payments and Compensation of October 16, 1948. There is no requirement for the deposit of local currency against assistance rendered in the form of loans or conditional aid.

These local currency counterpart funds are divided into two portions: not less than 5% is allocated to the uses of the United States within the country [largely for administration costs of the US run ECA], and the remaining 95% is to be utilized within the country as agreed between the government of the country and the Administrator.¹⁸

The primary goals of the Marshall Plan then emerged within the first year and were largely stuck to until 1951. These were:

1. To increase production
2. To expand foreign trade

¹⁶ Harry Price, 1955 p.75.

¹⁷ Ibid., p.78.

¹⁸ *Local Currency Counterpart Funds*, Division of Statistics and Reports and Fiscal and Trade Policy Division, Economic Cooperation Administration, April 30, 1949 p.1.

3. To enhance internal financial stability
4. To develop European Economic Cooperation

This is a slightly revised list from the one originally put forward by Bonsteel (see above) but preserved the essential “investment” nature of the entire program. Each of these was largely met. Production increased by 35% between 1948-51 and agricultural output outstripped 1939 by 16%. Trade with the US rose measurably and was sustainable. There was also a rapid increase in intra-European trade by some 80% between 1948 and 1952, a positive externality of the procurement system introduced by Hoffman at the ECA which even called for a customs union.¹⁹ Inflationary pressure, budget deficits and unemployment were all reduced. As Gardner points out: “The atmosphere of macroeconomic crisis surrounding the recipient economies during 1947-48 had vanished with the expiration of the Marshall Plan funding in 1951.”²⁰ Finally a European payments system was created under the OEEC, currencies became convertible, and the phrase European Union was first used.

Some of the Numbers

The magnitude of the aid effort is important. It is also noteworthy that despite a general sense of success surrounding the Marshall Plan, there was a year of waste. One of the key measures of success, in any aid effort, is the extent to which it recovers from these initial growing pains. In this case, the President, Harry Truman, had the wherewithal to seize the program from its current course, enlist the support of his political enemies, and redirect the effort.

¹⁹ Intra-European Trade data from Harry Price, 1955 p.125.

²⁰ Roy Gardner, “The Marshall Plan Fifty Years Later: Three What-Ifs and a When” in Martin Schain, *The Marshall Plan Fifty Years After*, 2001 p.121.

Table VIII.1

Initial US AID (1946-48) and Marshall Plan AID (1948-51) (\$US billions)

	Factor Adjustment	Initial US Aid		Marshall Plan Aid			Total Pre-Marshall Plan Aid	Total Marshall Plan Aid	Total Aid Effort 1946-52
		1946-47	1947-48	1948-49	1949-50	1950-51			
Amount Current Dollars		\$4.600	\$5.800	\$4.950	\$3.500	\$4.155	\$10.400	\$12.605	\$23.005
Adjusted by GDP growth from 1948-2004	16.00	\$73.600	\$92.800	\$79.200	\$56.000	\$66.480	\$166.400	\$201.680	\$368.080
Adjusted by Av. CPI to 2004	6.65	\$30.590	\$38.570	\$32.918	\$23.275	\$27.631	\$69.160	\$83.823	\$152.983
Adjusted by GDP Deflator 1948-2004	6.45	\$29.670	\$37.410	\$31.928	\$22.575	\$26.800	\$67.080	\$81.302	\$148.382
Adjusted by Av. PCE to 2004	5.36	\$24.656	\$31.088	\$26.532	\$18.760	\$22.271	\$55.744	\$67.563	\$123.307

Sources:

Michael Hogan (1987), Harry Price (1955) Roy Gardner (1999) and Barry Eichengreen (1999), Martin Schain (1999) Paul Christopher Eclipse Capital, James Dobbins (2003)

Notes:

Initial US Aid in 1946-1948 is broken down as follows:

1946-47: \$3.4 billion directly from US sources + \$1.2 billion from the US to the IMF, IBRD (World Bank) and UN
 1947-48: \$4.7 billion directly from US sources plus \$1.1 billion from the US to the IMF, IBRD and UN

The "best" factor adjustment to use is the GDP deflator since we are adjusting a large basket of goods from manufactures to commodities. It is seen here that in two packages the Pre-Marshall Plan Aid was about \$67 billion in today's dollars--a larger package totaling \$87 billion passed Congress for Iraq and Afghanistan. The total Marshall Plan budget today would be \$81.3 billion. Even if we use the over estimate of CPI, with its upward bias, the package was roughly \$83.8 billion—still smaller than similar requests by the current Bush Administration of \$87 billion (for one year!). This is noteworthy since several commentators²¹ have made the case that similar packages could not pass Congress today. Similarly, Eichengreen has noted the dissimilarities in the aid and its magnitude--this clearly is not true unless we use the GDP growth estimate--which is not realistic.

The total aid package, if we look at aid to Europe as both the initial pre-Marshall Plan years and the time after the passage of the European Recovery Program, comes to \$148 billion over six years, covering some 200 million people. Compare this with \$87 billion over one year covering roughly 45 million people, and we see the Marshall Plan effort, while successful, was also very cheap in absolute and in *per capita* terms.

Lessons Learned

A unique reconstruction program was the consequence of this effort and planning—unique in that it has not been replicated since the Occupation of Japan. Its hallmarks are important, as is their absence from later reconstruction efforts after 1960 and introduced again only slowly after 1999. The significant lessons are as follows:

²¹ Gardner, 1999.

- Overall authority rested with the main source of funds—the United States.
- The US admitted flat-out it was an investment program designed to make a return to the main investor--the United States.
- That overall authority was “benevolent” enough to allow 95% of the funding to be committed to projects and investments deemed important by the recipient state.
- All funds worked via existing budgeting processes in the war-torn economies, and in those countries that did not have a budget process (such as post-War Germany), one was quickly set-up, at the same time as humanitarian assistance began.
- The Erhard plan was encouraged and fostered as part of a standard institutional infrastructure program in which fiscal and monetary policy were paramount, essential and initial.
- The focus on institutional reconstruction at the fiscal authority was on budget *execution* more than on budget *preparation*. This recognized the immediacy of establishing the fiscal authority, the relative simplicity of the existing revenue base (making budget preparation a secondary priority), and the need to have a proper future tax base, so as to avoid future inflationary pressure.²²
- The overall authority—the US—was clear in its admission that it had an agenda beyond economic reconstruction. It was to create a clear counter-weight to Soviet Communism in Western Europe. This admission by the Truman Administration early on in the process (i.e., during the debate on the ECA in the Congress over 1947) shaped the context of the economic advice and allowed for very pragmatic discussions on what could and could not be achieved by Marshall Planners in Europe when they went to the US Congress for funds.
- All funds went via one fund’s administration. No bifurcation of multiple funding sources existed to confuse the reconstruction effort; no “pet” capital projects from various donors made to satisfy the donor contractors were permitted. This allowed a proper capital budget to be formed in conjunction with the current budget, providing for responsible fiscal policy planning.
- All participants had to contribute on their own to receive “counterpart funds” from the US.
- There was no complex legal authority assessing the “liability” of funds use (such as the UN Legal Department in New York, which second guesses policy decisions made in field operations).

The consequence was a rational, fiscally consistent, demand-driven reconstruction process influenced by only one bureaucracy rather than many. Its costs in today’s dollars were quite small given the benefits and the number of beneficiaries, and in absolute terms

²² It is interesting to note that the Marshall Planners had not yet heard of rational expectations or the Lucas/Sargent and Wallace critique of fiscal/monetary policy interaction—namely, that monetary policy problems usually are caused by bad fiscal policy, i.e., excessive spending that leads to printing money. It is clear from their planning however, that they understood the problem known today as the “unpleasant monetary arithmetic” and that failure to address a proper tax base would create inflationary expectations. They were no doubt familiar with the worst hyperinflation in history that took place in Weimar Germany between the Wars. Their actions would be seen today by modern macroeconomists as understanding and incorporating into their policy actions the Lucas critique that emerged from the Lucas/Sargent and Wallace debate over the 1970s.

it is still smaller than allocations by Congress made in the last year by several billion dollars.

Iraq

Background

The reconstruction of Iraq is one of the largest war-torn reconstruction efforts the United States has undertaken since the Marshall Plan. The Coalition Provisional Authority (CPA) has put in place several important components of economic governance, including a monetary policy (by introducing and managing a new currency) and a fiscal policy (by building a new, modern budget preparation and execution process). Also, some effort was put into addressing problems in the banking sector. Although the CPA did not give initial priority to implementing a comprehensive economic governance program, the main institutions of economic governance (monetary and fiscal authorities) have been introduced. However, the legal and regulatory regime has lacked adequate local buy-in; the trade regime has not received adequate attention. Oil-for-Food in-kind subsidies have not been monetized; and the privatization program has not been implemented.

Several problems have emerged in Iraq. For example, although there was extensive planning for post-war reconstruction, much of it was not used. USAID and other donor agencies such as DFID all had made detailed preparations for the deployment of economic governance teams, with quite detailed terms of reference. (See Appendix for the comparison of tasks and deliverables under Kosovo, Afghanistan and Iraq by USAID contracts.) While some of these tasks were eventually acted on, allowing the CPA to create a reasonable shell for economic governance, they were not acted on fast enough, and the advice of experienced development professionals was not used at the beginning of the reconstruction process.

A major theme of the lessons learned is that proper economic governance programs need to be developed at the outset of reconstruction, and that economic advisers need to be deployed quickly and systems set up immediately. The main criticism of the way the CPA built the economic governance regime and why it may face so many problems after June 30th is that it did not learn from previous USG experiences and did not deploy experienced development specialists fast enough to start building appropriate institutions. The CPA's focus was short-term (two weeks at a time) initially. In the latter part of 2003 and early 2004, the CPA was able to introduce long-term strategic thinking and, accordingly, it began to utilize more available external expertise—but this turnaround may have come too late to take advantage of the window of opportunity that existed right at the outset of the reconstruction effort.

Iraq has gone through some fairly dramatic changes since 1968. It is of some note that, despite these perturbations (the nationalization of the financial sector and the Iran-Iraq War), Iraq maintained a middle level of income per capita—albeit at a declining rate since 1979. A brief chronology follows:

- Baathists seized power between 1968-1979
 - Nationalized the oil sector (Iraqi National Oil Company)
 - Nationalized the financial sector

- 1979 Iraq reported the highest per capita GDP in the region
- 1980-1988 Iran-Iraq War
- 1989 Year of reconstruction and “nominal” privatization
- 1990-Mid-2003 Gulf War and sanctions
- 1996 Oil-for-Food UN program begins
- 1997 Iraq reports living standards well below pre-Gulf War levels
- March 2003 Coalition Provisional Authority takes over

The erosion of the economy started more or less with the Iran-Iraq War and became more pronounced after the first Gulf War in 1990. At that time sanctions were put in place by the UN, and the Hussein regime began to systematically destroy the capital infrastructure. Shortly after this, in 1996, the UN introduced the Oil-for-Food Program. This program, which has been in essence a subsidy to foreign food producers, has reduced domestic incentives for Iraqi agricultural production. Some 60% of Iraqi families completely rely on food baskets compiled by the UN OFF program, while the remaining 40% rely on them in some way.²³ The enormity of the problem OFF has created for jump-starting a private sector led market economy cannot be overestimated. An important issue, discussed below, for the new Iraqi regime will be to monetize the UN Oil-for-Food Program (OFF).

The overriding issue for Iraqis has been the steady deterioration in their standard of living and the concentration of economic activity in a very capital intensive sector. In 1989 Iraq’s GDP was reasonably well distributed. While oil was the largest sector, at 40% of the economy, services were about 29%, agriculture 17% and manufacturing about 14%²⁴. At about this same time Iraq enjoyed the highest GDP per capita in the region, at some \$US 3,600²⁵. By 2001 per capita income had fallen to about \$US 1200, but this was still on a par with other greater Middle Eastern States such as Jordan (\$US 1700), Syria (\$US 1100) and Iran (\$US 1300).²⁶ At present GDP per capita is only \$US 700-800, and oil dominates the economy (constituting about 97% of budget revenues)²⁷.

Thus, Iraq has had fairly precipitous decline for the last decade. The tragedy of the reconstruction effort that was started after the 2003 invasion is that this was well known to US development economists; they simply were not brought to the table soon enough to present a program for development—although such programs had already been conceived. There was nothing approaching the detail and complexity of the National Development Framework for Afghanistan, nor was there the international buy-in from the major multilateral institutions of the World and the IMF.

²³ Frederick D. Barton and Bathsheba N. Crocker, “A Wiser Peace: An Action Strategy for a Post-Conflict Iraq,” Center for Strategic and International Studies, June 2003, p. 11.

²⁴ CIA Estimate 2004.

²⁵ World Bank, *Iraq: Incentive Framework for a Market Economy*, Concept Note, 2004 p.4.

²⁶ Economist Intelligence Unit (EIU).

²⁷ Stephen Lewarne, *The Role of Investment in Post Conflict Economic Development: Preparing the Investment Regime in Iraq*, Presentation to the World Bank, Trade and Investment Conference, Amman Jordan May 4, 2004.

Economic governance

Iraq, therefore, in the absence of a detailed economic plan and the late entrance onto the scene of development assistance, in any meaningful way has been playing catch-up. The particular problem a new Iraqi regime has in the reconstruction effort is that expectations need to be managed much differently than they had to be in Afghanistan or Kosovo. Most people still remember when Iraq had a per capita income above \$3000 and was the highest in the region. They also remember when it was a diversified economy and thus had a better future.

It is important to show what advantages Iraq is taking into its war-torn reconstruction effort, how some of those matter (such as good human capital) and some of them need to be managed very carefully—such as balanced growth not simply oil sector growth. It will then be necessary to show what the CPA has tried to construct in the last year, mention its strengths and weaknesses and draw some lessons from the effort.

Some of Iraq's Characteristics Relative to other War-Torn Economies

Despite all of these difficulties, Iraq has tremendous advantages over other war-torn regimes, which will help shorten the reconstruction phase considerably. The new Iraqi Regime will need to manage to retain some of the good institutions the CPA introduced very close to their June 30th shutdown date, however, if it is to succeed. Consider the following:

- Iraq is a national entity, with established membership in international organizations (IMF, WB, UN).
- Unlike Kosovo, Bosnia, East Timor, or Afghanistan, Iraq has had a nationwide civil administration that administered an economy roughly on par with the rest of the oil rich Middle East.
- The civil administration needs some rebuilding but not a major reconstruction (as it did in Kosovo, Bosnia, Afghanistan and East Timor).
- Human capital is qualitatively above that of other post-conflict economies and on a par with the rest of the Middle East.
- The humanitarian crisis in Iraq (housing and food shortages) due to its linkages to the UN and other international agencies have largely been avoided—unlike Kosovo's large refugee problem and Afghanistan's inaccessibility issues.

Each of these represent a leg up for Iraq on the reconstruction effort—in particular the human capital component of their civil service is an enormous advantage. This is combined with the oil and gas sector and the potential growth it will foster. On that point it is important to lay out the explicit advantages in this sector—but also note some extreme caution on the large inflow of donor funds.

The oil and gas sector has the following characteristics in Iraq:

- Current production is at 2 million bpd (back to pre-war levels). Pre-1991 production capacity was 3.5 million bpd.
- 112 billion barrels in proven reserves (second to Saudi Arabia) 45-100 billion in potential reserves.
- Very low production costs (when it's safe to go to the oil field).
- 110 trillion cubic feet of gas (which is on a par with Turkmenistan).
- Iraq's upstream and downstream oil and gas infrastructure is outdated and requires a sizable investment in repair, rehabilitation, and upgrading (this will be the main destination of FDI).
- In addition, large-scale investment is required to develop dozens of oil fields that have been identified and appraised, but are as yet undeveloped.
- Oil sales have already established a large reserve at the Central Bank of Iraq and in the Development Fund.

Clearly these matter for helping the reconstruction effort. But these advantages may not produce a stable economic environment and indeed may not stimulate balanced growth.

The current unemployment situation in Iraq stands at about 50%, with some 3.25 million unemployed on a labor force of about 6.5 million, and a population of about 25 million. The rapid rise in unemployment is largely a result of an atrophying GDP after the US-led invasion, as well as an extremely poor growth performance since the Iran-Iraq War in the 1980s—despite large oil wealth. Indeed, it is an important issue going forward that growth is balanced between the oil and non-oil sectors. If there is to be *both* growth and job creation together, private investment will have to be stimulated in the non-oil sector at roughly the same pace as the oil sector. This is so since the oil sector, while already growing at a rapid pace (it has returned to its pre-war levels of 2 million barrels a day), is capital intensive and cannot absorb the large amounts of unemployed in Iraq. Thus while oil can lead growth, the non-oil sector requires an investment environment that will also stimulate growth that is labor absorbing.

A joint goal for the new Iraqi government to achieve by 2010 will be to stimulate growth and increase employment:

1. At least the levels of income it enjoyed in 2001 (\$US1200) or perhaps slightly higher at \$US1400, which are of middle income status.
2. A reasonably well diversified economy where oil and non-oil are split at about a 60/40 ratio such that the non-oil more labor intensive sector can absorb most of the labor force²⁸.

²⁸ A rough scenario of growth to achieve these modest goals will be as follows:

- 10-12% growth in the oil sector to 2010 (with 2010 oil production up to 5 million b/d)
- 7-9% growth in the non-oil sector over the same period
- GDP would grow to \$US 30-40 billion

See World Bank, *Iraq: Incentive Framework for a Market Economy*, Concept Note, 2004.

For these dual goals of growth and lower unemployment to be met, a few things must occur. First, oil production will need to grow from its current rate of 2 million barrels per day to 5 million barrels per day by 2010. It is likely this will occur. Pre-1991 levels were some 3 million barrels a day, and that was under an Iraqi regime subject to strict post-Gulf War I sanctions, and several years of destructive production techniques at wells (such as large water injections into wells). With sanctions lifted, oil production will likely increase substantially fast, leading Iraqi growth.

Second, the non-oil sector must also grow at a similar pace to the oil sector. While oil can produce growth, it will not necessarily create much new employment. What is less certain is that the non-oil sector, particularly agriculture, will attract the necessary private investment for sustainable growth. Thus it is necessary that a proper investment climate backed up by an appropriately liberal trade regime, stable monetary policy and a solid fiscal revenue and expenditure base be put in place to stimulate growth in the non-oil sector such that it can absorb labor.

In order for Iraq to leverage its advantage it must have the proper economic governance institutions in place. The CPA has introduced some basic economic governance institutions—primarily the fiscal and monetary authorities of the Ministry of Finance and the Central Bank of Iraq.

Impact of Oil-for-Food Programs

The Oil-for-Food programs, discussed throughout this text, which were started in the mid-1990s under UN auspices and continued after the conflict under Iraqi government and CPA auspices, have had a profound impact on the economy, albeit one that is hard to assess precisely given the contemporaneous worsening of the security situation and other geopolitical events. According to a group of economists working for the CPA:

“[T]he Oil-for-Food program reduced the incentives for private economic activity. By augmenting the existing rationing system with imported food, the program discouraged the local production and distribution of food and other consumer items. Some agricultural sectors, such as the poultry industry, were helped because they could import feed. But small grain farmers experienced extraordinary declines in incomes, because they could not compete with subsidized grain from abroad. Moreover, because the program allotted virtually the same basket to every family, most households sold part of their rations in secondary markets for cash, because they needed different things or because they preferred better-quality items. The prices that consumers received in secondary markets were generally less than half the purchase cost of these goods, further depressing prices for local producers. Finally, by distributing food through the government’s original food-rationing program, the program maintained the link between each family and their existing food distribution agent, typically a food store or bakery. This discouraged the entry of new retail firms.”²⁹

The CPA economists recommended monetizing the OFF programs—that is, giving the population cash payments rather than in-kind handouts:

²⁹ Christopher Foote, William Block, Keith Crane, and Simon Grey, “Economic Prospects and Policy in Iraq,” *Journal of Economic Perspectives*, vol. 18, no. 3, Summer 2004, p. 53.

“One potential reform would improve Iraq’s microeconomic climate while establishing a precedent for the distribution of oil revenues at the same time. The government’s food ration system, now funded by oil sales, could be turned into a monthly allocation of cash. The funds would then provide a source of demand for Iraq’s private sector, expand the consumption set of Iraqis and establish the crucial precedent that Iraq’s oil wealth belongs to its people and not to the government.”³⁰

Although several proposals for monetization were circulated, unfortunately, they were not implemented, and OFF programs were not monetized, neither during CPA rule, nor during the immediate period after transition to Iraqi self-governance. The reasoning for delaying monetization was that such a reform would be too disruptive and beyond the capacity of the various institutions to achieve given the tough political and security environment. Nonetheless, it is important to recognize that a cost was incurred by not taking the step of monetization (even though perhaps impossible to measure in any precise way) in terms of reduced domestic production and the resulting impact it could have on higher unemployment and increased social tensions.

Monetary and Fiscal Policy

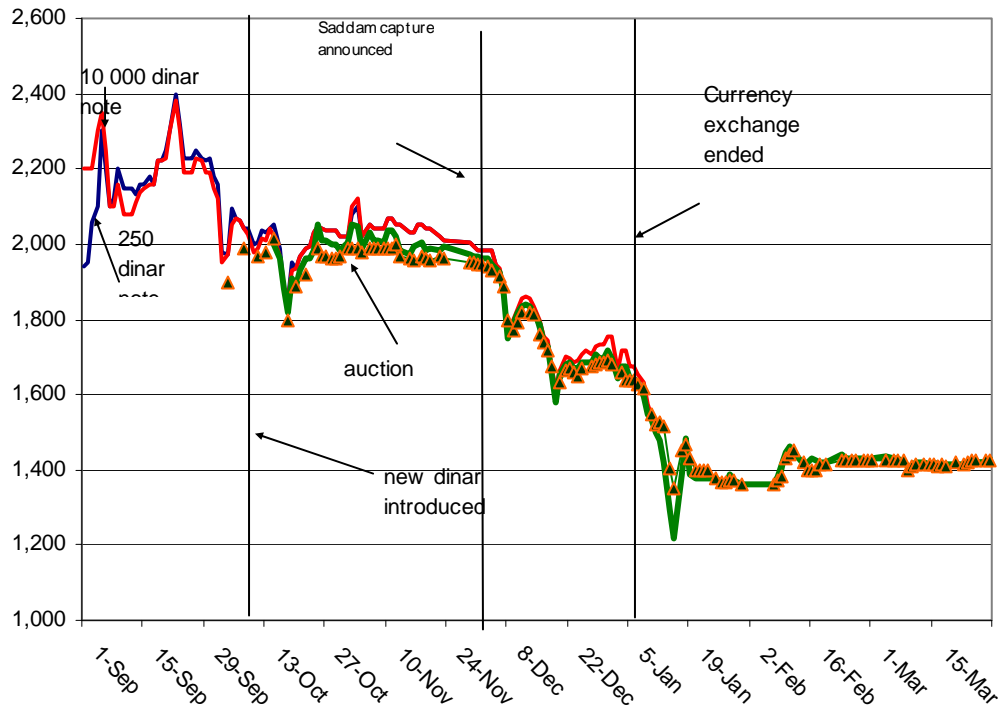
The most success, and where the CPA placed the most emphasis, was on monetary stability. Here it introduced a currency auction to intervene on the markets and stabilize the currency (albeit only after six months after the conflict “ended” and after much convincing by USAID and the Bank of England). It also introduced a new currency, drawing on the IMF’s and USAID’s experience in Afghanistan to both sterilize the new donor flows as well as stabilize the existing currency.

This was done very well and has had the impact of allowing the new Iraqi Dinar to reach an equilibrium of around 1400/\$US. There was a period of appreciation as so many dollars flooded into the economy, but this stabilized shortly after the conversion process ended in January 2004. See chart below:

³⁰ Ibid., p. 67.

Chart VIII.4

September 2003 - March 2004 data (ID/\$US)



The monetary authority now has the ability to intervene and stabilize the currency, which is one of the first and fundamental economic governance reforms.

Next is the fiscal authority. Here there has been a fairly standard budget drawn up by the CPA, and it has paid particular attention to the problems of current and capital spending, as well as recognizing the revenue sources currently available in Iraq. Some of the basic precepts have been established:

- **Budget Planning.** A Budget passed by the CPA announcing both current and capital spending. A program that integrates all public revenues and expenditures has been started.
- **Budget Execution.** A Financial Management Information System (FMIS) has been established.
- **Tax Policy and Administration.** Tax Administration— particularly customs administration—has started, as has capacity building in administration.
- **Intergovernmental Finance.** A municipal, regional and national financial framework established. This is still in process, but a plan has been submitted to the CPA based on international standards.

In addition, the budget document recognized that oil revenues, by constituting nearly 97% of total revenues, is a weakness in the long-run. It further recognized the need to

fund agriculture in addition to funding that would come from petroleum revenues. Some of the more important measures taken were:

- Oil revenue is recognized to be some \$20 billion by 2006 composing about 97% of revenues.
- Reconstruction levy is in place and will be phased out in 2005.
- Personal income tax has been established at a low 15% maximum marginal rate.
- Corporate income tax the same.
- User pay charges have been introduced.
- As have excise taxes, a “hotel” tax, land tax and others.

On the expenditure side the CPA tried not to make the same mistake as in Kosovo and learn from Afghanistan in that they combined the current and capital budget.³¹ On the expenditure side they accomplished the following:

- Capital projects were included in the budget and detailed by Ministerial demands.
- Contingency reserves were set aside (this will cover such things as underestimation of the real size of the subsidy represented by the Oil for Food Program, among other things).
- Foreign Obligations were also recognized. The original budget only has reparations to Kuwait. There are also a host of other domestic and international debt obligations, which when honored, will throw off large expenses.
- However, Paris Club countries working with James Baker have reduced the total debt burden from \$116 billion to \$39 billion.
- Local and regional government finance is built in.
- It has a policy on decreasing support for SOEs which employ over 500,000 people in an employed population of 3.25 million, in a workforce of 6.5 million.
- Special nation-building capital expenses are recognized, as are special economic reconstruction programs.

While many of these steps are positive achievements on the fiscal side of reconstruction, it is not clear that any of these budget “policies” will last or that they will be adopted by a new Iraqi regime. The CPA started the programs too late, and it is unclear the new Iraqi regime will continue with this.

Overall impressions are as follows:

- Monetary policy generally has been perceived as good.
- Fiscal policy on the other hand has some concerns:

³¹ One shortcoming in budgeting was that Oil-for-Food current and capital expenditures only partially were integrated into the state budgeting process during the time when the CPA managed the country’s state finances.

- Need better assurance that the current and capital budget will be run through the Ministry of Finance.
- All donor money has to go through one conduit that is part of the budget construction process
- Iraq, despite its oil wealth, will not have the luxury of a current budget being able to finance large white elephant capital projects
- It is not clear the 15% maximum marginal rate will be kept in place by a new regime
- A full accounting for the unfunded pension liabilities has not been undertaken, and the extent of the all the social safety net requirements in war-torn Iraq is not known? To not have a grasp on this soon will erode confidence in a sound fiscal budget over the long-run.

Legal and Regulatory and Trade

Two other key areas are the legal and regulatory regime and trade. Here the problem is much deeper since these require confidence over time. The regime the CPA has put in place again, as with the fiscal regime, looks reasonable on the surface. The CPA has completed or is completing the full complement of commercial legislation:

- Foreign investment law
- Bankruptcy legislation
- Labor law
- Company law
- Competition law
- Consumer protection law
- Securities law
- Property rights laws

The problem is the existence of the laws themselves, rather the way the laws are being issued. Some are done with appropriate consultation, such as the bankruptcy law³² others are imported model laws (competition policy) that have had no relationship to Iraqi traditions, legal culture or judicial review.

While imported model laws are not bad, they are only a starting point and require substantial domestic buy-in, which is not guaranteed. In addition a law requires

³² The bankruptcy law was gone about in a consultative and thoughtful way for Iraq: A group of Iraqi lawyers and foreign consultants worked on the amendments to the old bankruptcy law and circulated them among domestic and foreign agencies, including Iraqi bankers, judges and the World Bank. One of the most important amendments to the law is a clarification that secured creditors will rank first in the distribution of assets of a bankrupt company. Other amendments include softening punishments for managers of bankrupt companies -- which included imprisonment and prohibition from holding various jobs -- and encouraging negotiated work-outs between a debtor and its creditors. A troubled company will have protection from its creditors while it negotiates a reorganization plan which the creditors can then vote on -- a process generally similar to the U.S. Chapter 11 bankruptcy procedure. Under other amendments, Iraqi courts will be authorized to recognize cross-border bankruptcy procedures, for instance when a multinational company working in Iraq gets into financial trouble.

implementing instructions and precedent—meaning the task of legal and regulatory reform is an iterative process—before investors believe them credible. The legal and regulatory regime requires some very serious review. This is a tougher sell to investors than the establishment of a fiscal and monetary authority, since it relies on long-term enforcement and long-term Iraqi buy-in.

Some of the areas mentioned in May 2004 simply didn't exist in August 2003, such as taxation and tax administration. What is of note is that reservations over customs and trade regulation, labor regulation, business licensing, land registration have all significantly increased since August last year. The good sign is that the macroeconomic environment has improved, as has access to finance (reflecting the liberalization of financial markets by the Central Bank of Iraq in March 2004). Infrastructure issues were either similar to last year or improved (as was the crime index).

The trade regime has been a bit more straightforward. One would expect that to occur anyway since the fall of a dictatorship usually implies an opening up of trading relationships. Some of the more significant things that occurred in trade were:

- 1984 Customs Law is upheld with revisions
- CPA Order No. 54 on Trade Liberalization issued 02/04: Customs, tariffs, duties and import taxes suspended until the new Iraqi Government comes into effect (this extends the original June 03 policy). Updates parts of the 1984 Customs Law—particularly in customs valuation (largely to accommodate the Reconstruction Levy).
- Trade Bank of Iraq set up to facilitate the import and export of goods and services (CPA Order No. 20).
- The Trade Bank of Iraq has issued over \$175 million in letters of credit to international suppliers in order for ministries to import essential goods and equipment. There are over \$120 million more in letters of credit pending issuance. (To put this in perspective \$295 million is roughly half the value of the 2004 budget deficit, or double the needs for housing reconstruction.)
- WTO approved Iraq's request for observer status in February 04.

These are pretty standard reforms for trade. Nothing has been seriously implemented in the form of a trade regime in Iraq since the invasion, other than lowering tariff rates and starting a trade bank. Observer status at the WTO is important, but much lies ahead for this to lead to any fruition.

The problem here is not one of form but of substance. Can the fiscal regime put in place by the CPA for a proper budget management be maintained? Can the legal and regulatory environment the CPA has tried to put in place in the last few months take hold? Will the flat tariff rates and WTO observer status lead to membership? (The major oil producing states of the Middle East are not members, and accession takes a considerable amount of time even under good circumstances: Jordan was one of the fastest, and it still took almost 2 years. Average accession time is 5-7 years).

One answer of course is that the effort is not over. USAID will be introducing large technical assistance programs in economic governance to the new Iraqi regime. It is hoped that, when this assistance is implemented by a cadre of development professionals in cooperation with the Iraqi government, it will focus on *de facto* capacity building (substance) over *de jure* institutional creation (form).

General issues

Dutch Disease and Iraq: Understanding a war-torn economy's major future problems

Several of the donors, in particular the World Bank, have observed the coming problems of unbalanced growth if economic governance is not carried through. This will cause Dutch Disease, and the implications for Iraq will likely be more instability despite greater wealth.³³ The reason is that Iraq must reduce its high level of unemployment from 50%. If this is not done, political problems will emerge for the new Iraqi regime.

Several things are clear now as we view the reconstruction effort in Iraq from the point of view of balanced growth:

Petroleum will dominate GDP for several years and will receive most of the FDI. This means the industry has a steady cash flow to reinvest in its own capital reconstruction needs. Agriculture, on the other hand, requires relatively more assistance for its reconstruction and has to contend with a decade of deterioration due to the Hussein regime's neglect, as well as property displacement among farmers that needs to be legally resolved. More importantly, the presence of the OFF program has ruined domestic production incentives and artificially lowered prices. It is going to take a substantial effort and considerable time to replace depreciated agricultural capital as well as settle land disputes.

Even more difficult for the CPA is that it is taking more time than was originally anticipated by the CPA to monetize the OFF program, converting it first from a subsidy

³³ The Dutch Disease is explained as follows: Huge oil wealth brings with it large foreign exchange earnings and the majority of economic activity in the capital intensive oil sector. This raises the value of the exchange rate making manufactured and agricultural goods for export less competitive with other nations—stifling job creation in the manufacturing and agriculture sectors. This in turn raises imports stifling the creation of jobs in import substituting activities. The non-oil sector then is unable to absorb the excess labor and so we are left with a very wealthy country that is no where near its full employment level. Governments tend to react by overly subsidizing the unemployed making it more difficult to lure them into the workforce which also stifles non-oil business formation. When there is a shock such as a decline in the oil price the pain of adjustment can be severe and for some time high unemployment and high inflation persist together (stagflation), as the lowering of subsidies (because the government has less income) force people into the workforce, and the relative costs of imports (which makes up much of the consumption basket) rises.

to foreign food producers to domestic producers and then eliminating the need for subsidy through agricultural reconstruction.³⁴

The OFF program also covered non-agricultural production and procurement (some 75% was actually non-food), with similar incentive dampening and distortionary effects. The manufacturing and services sectors are equally affected, and like agriculture, but unlike petroleum do not have a large and steady cash flow for their reconstruction. Iraq therefore for the next 5-10 years will be a “one-crop” economy (in petroleum) while it attempts to rebuild the infrastructure in the other sectors.

The level of reconstruction required in Iraq will absorb nearly all of the foreign exchange as they import substantial capital reconstruction materials to replace deteriorated industries and replace war damaged infrastructure. If the reconstruction program is managed properly, the non-oil and gas sector will absorb substantial labor involved in the reconstruction process. At this point in time however, given the tenuousness of the CPA institutional basis, one can be skeptical.

Lessons learned

- A primary lesson out of Iraq is that although the CPA had the benefit of good governance experience in war-torn regimes from Bosnia through Afghanistan, they frequently did not draw on it.
- The CPA professionals did not avail themselves of the vast array of technical assistance available to them in a timely manner (especially from USAID). They waited too long until the security situation deteriorated, and then ushered in reforms that, while looking good, require some serious buy-in from the Iraqis. This should have happened much earlier.
- The CPA budget advisers focused too much on budget preparation rather than execution. One could argue that the security situation in Iraq made this too difficult, but the lack of execution mechanism in place will be a problem in the out years.
- A specific problem in the legal and regulatory regime was the inadequate domestic preparation of the laws. Other than bankruptcy, most of the laws were imported as model laws, and, while this is a useful starting point, it is only the beginning of a long process.
- Even more fundamentally than the above was the lack of a National Development Framework—to be enacted as a working document for the new Iraqi regime to take over. This is particularly disappointing in light of the fact

³⁴ One of the key examples of CPA lack of preparation is its still inability to monetize the OFF Program and indeed its lack of planning in taking over the OFF from the UN in November 2003. This resulted in the CPA requesting the WFP to stay in place and help them administer the program. They still have not devised a full transfer program for its monetization.

that Afghanistan had just gone through the same exercise a year earlier, and has met considerable success (albeit in relative terms).

- The CPA failed to take advantage of the brief political window of opportunity to monetize Oil-for-Food subsidies. Without such reforms, vast amounts of in-kind subsidies in the form of imports will continue to be dumped on the domestic economy, harming domestic production (particularly in agriculture) and reducing employment opportunities.

Conclusions

It is also often stated that the US did a better job in Europe under the Marshall Plan than in more recent reconstruction projects such as Bosnia, West Africa and Iraq, because the country then was more willing to dedicate more resources to the problem in order to, a) assist our war-time allies; b) come to the aid of Christian nations; c) fight communism; d) Provide assistance to our forefathers' nations and historical brethren.

While this did play a major role in the debate in Congress (see the case study on the Marshall Plan), it is important to note that we in fact spent *less* under the Marshall Plan than we do on aid today, per capita (in real dollars), at least in some of the post-conflict situations, in seemingly far-off lands of non-European peoples.

Dobbins, provides a useful comparison in his recent work for The Rand Corporation. Germany received about \$200 per capita (in constant 2001 \$US) during the first two years after the conflict. Kosovo received about \$800 per capita, Bosnia over \$1,400 per capita, and Afghanistan less than \$100. A key conclusion of his is: “Many factors influence the ease of difficulty of nation-building: prior democratic experience, level of economic development, and national homogeneity. However, among the controllable factors, the most important determinant seems to be the level of effort—measured in time, manpower, and money”³⁵. His comparisons measuring aid resources per capita are only partially useful. While it is generally true that, the more one pays, the more one gets, it is also true that many country needs are independent of population size. The cost of achieving many objectives will be the same regardless of how large a country is. For instance, purchasing an expenditure management information system, or training a macroeconomic unit, costs roughly the same in a place of two million (Kosovo) as it does in a place of 30 million (Afghanistan).

There was considerable learning between Bosnia and Afghanistan by all donors. It was only after mistakes in Bosnia on coordination and after USAID's comprehensive umbrella economic governance project in Kosovo that we see more rapid attention paid early-on to establishing economic governance institutions. By the time reconstruction efforts in Afghanistan started, the IMF, the ADB and the UN had learned enough to act immediately after the Bonn Agreement (November 2001) to start economic governance institutions more rapidly. Even then, assistance in this area was slow and came after the standard humanitarian assistance—but it was better than before. To some extent, the

³⁵ Dobbins, 2003 p.xxv.

experience in Iraq, in terms of planning ahead of time, utilization of that planning for implementation, and coordination among government agencies, occurred at pre-Bosnia standards, not taking advantage of the lessons that had been learned in the experiences of Kosovo, Afghanistan, and East Timor.