



## **The political economy of economic policy in Iraq**

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# THE POLITICAL ECONOMY OF ECONOMIC POLICY IN IRAQ

Alexander Hamilton



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# The Political Economy of Economic Policy in Iraq

Alexander Hamilton

## About the Author

**Alexander Hamilton** is an economic adviser for the UK Department for International Development (DFID) based in Baghdad and leading on DFID's economic reform programme in Iraq. He completed his PhD in Political Economy at the University of Oxford and has previously worked for the World Bank. His area of expertise is the economics of fragile states. Specifically, he focuses on the application of political economy tools to better understand and support economic reforms in resource rich fragile state contexts.

## Abstract

Since 2003, despite an abundance of resources and a more pluralistic political settlement, Iraq's economic reform process has failed to take off. This paper explores the link between the evolution and consolidation of Iraq's post-2003 political settlement and the way this has impacted the incentives decision-makers face when implementing economic policy. Paradoxically, the fact that the settlement has accommodated more groups than its repressive predecessor has not resulted in more inclusive, long-term oriented and programmatic economic decision-making. This is because the inclusion of more (elite) groups reflects the fact that more actors can now generate violence if they are not placated with state-generated rents. Consequently, Iraq's political transition has exacerbated incentives for decision-makers to pursue more short-termist policies that have diverted resources away from long-term productive investments and reconstruction, and towards a focus on satisfying ethnic and religious clientelist networks. Transitioning away from this modus operandi will require patient and opportunistic economic reforms that slowly create new pressures on political actors to support the delivery of public goods and a policy environment more conducive to private sector growth.

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## Introduction

Why, despite an abundance of resources and a more pluralistic political settlement, has Iraq's economic reform process failed to take off since 2003? A large literature in political economy posits a curvilinear relationship between political liberalisation and better economic policy; in which a transition away from a highly repressive but stable authoritarian regime does not immediately result in better economic policy; even if this is possible in the future. This paper explores the link between the evolution and consolidation of Iraq's post-2003 political settlement and the way this has impacted on the nature of economic policymaking using the insights of this broader political economics literature. Paradoxically, the fact that the post-2003 political settlement has accommodated more groups than its repressive predecessor has not resulted in more inclusive, long-term oriented and programmatic economic decision-making. This is because the inclusion of more short-term oriented (elite) groups reflects the fact that more actors can now generate violence if they are not placated with state-generated rents. Consequently, Iraq's transition from a highly repressive limited access order (LAO) to a more fragmented, if pluralistic, fragile limited access order (FLAO) has exacerbated incentives for decision-makers to pursue more short-termist policies that have diverted resources away from long-term productive investments and reconstruction towards a focus on satisfying ethnic and religious clientelist networks.

Specifically, the consolidation of the FLAO in Iraq has coincided with a deterioration in the quality of regulation and a shift in the focus of government expenditure towards the expansion of superfluous public sector employment at the expense of long term-oriented public goods generation such as investment and reconstruction. However, while the consolidation of the FLAO has resulted in a formidable self-reinforcing equilibrium in which incentives for sound economic reforms are limited, this does not mean that such reforms cannot be exogenously incentivised. By focusing on reforms that do not directly undermine the short-term ability of the political elite to distribute oil rents but subtly embedding technically-oriented reforms that create incentives to move away from the FLAO in the long run, it is possible for Iraq to slowly move towards a more sustainable political economy.<sup>1</sup>

Viable economic reforms are likely to include: (1) private sector development, such as banking reform and regulatory change; and (2) concessional and conditional reconstruction instruments that foster better policymaking in the long run while also boosting short-term capital expenditure. These reforms may be feasible even though the long-term growth and prosperity of the private sector may undermine the FLAO. This is because

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<sup>1</sup> Although identifying economic reform areas that do not antagonise vested interests is a necessary but insufficient condition for engendering economic reform, any such reforms will still require political will and support.

these reforms do not directly impact the *current* elite's ability to distribute rents and generate growth in the short run, while their long-term political implications are of limited concern to the myopic incumbents. Conversely, any reforms that directly undermine the short-term ability of the elite to redistribute oil rents will be resisted no matter what the economic returns are. Therefore, reforms focused on public financial management, anti-corruption or the rationalisation of the public sector are, despite their potential significant short-term economic and governance dividends, unfeasible.

Thus, understanding the political economy of the political settlement in Iraq can help us identify the specific sectors and tools that can incentivise economic reforms that will not be strenuously resisted and undermined by the political elite. Paradoxically, while long-term political change is essential for sustaining sound economic policies, this can be achieved by focusing on reforms that only affect the political equilibrium in the long-term.

## Literature Review: The Limited Access Order Typology and its Variants

The link between the political settlement and the development outcomes of states (including economic policy) is now well-established.<sup>2</sup> Douglas North and others developed the framework of LAO that has been used to understand the incentives faced by decision-makers in a wide variety of developing countries.<sup>3</sup> The LAO framework postulates an intimate link between the use of the state to generate rents and redistribute these amongst elites capable of generating violence. As this provision of rents keeps the elite members of the ruling coalition from inciting violence, the framework predicts a close link between economic policy (rent-generation and distribution) and the sustainability of the (non-violent) political process – as North and others explain:

[In most societies] No one...has a monopoly on violence. Establishing a society that fosters peace, specialization, and exchange requires the creation of incentives for groups to compete peacefully rather than fight. An LAO reduces violence by forming a dominant coalition containing all individuals and groups with sufficient access to violence that can, if they act unilaterally, create disorder. The dominant coalition creates cooperation and order by limiting access to valuable resources...to elite groups. Restricting support for organizations to elite groups magnifies the rents that elite groups receive... Because violence reduces elites' rents, the existence of the rents can motivate credible commitments among elites that they will not fight each other.<sup>4</sup>

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<sup>2</sup> Jan Pospisil and Alina Rocha Menocal, 'Why political settlements matter: navigating inclusion in processes of institutional transformation', *Journal of International Development* 29 (2017), pp. 551–8.

<sup>3</sup> Douglas North, John Joseph Wallis, Steven Webb and Barry Weingast, 'Limited Access Orders in the developing world: A new approach to the problems of development', *World Bank Policy Research Working Paper* 4359 (Washington, D.C., 2007).

<sup>4</sup> *Ibid.*, p. 41.

North and others have classified Iraq's nascent post-2003 political settlement as a fragile state variant of LAO, a FLAO.<sup>5</sup> The distinction between FLAO and LAO is that in the former each element in the ruling elite coalition has the capacity to unilaterally generate violence that can *existentially threaten the political settlement*, and not just disturb the generation of rents via violence. As a consequence of this fact, members of the political elite cannot credibly commit, *ex ante*, to support long-term cooperation. Therefore, decision-making is inherently unstable and individualistic, and the institutions of the state remain basic and myopic.<sup>6</sup>

An important assumption of the (F)LAO framework is the intricate link between economic and political systems in potentially fostering a transition to a more stable and pro-development political settlement – open access order (OAO). The basic premise of the political settlement literature is that a transition towards a more pro-development trajectory requires the systematisation of both political and economic competition – as both reinforce incentives moving away from the LAO *modus operandi*.<sup>7</sup> If there is a significant gap between the levels of competition in the political and economic spheres, then the incentives to revert towards a LAO or FLAO will increase. Thus, political competition in an economy that is characterised by oligopolistic or monopolistic practises will encourage the transition to a more exclusionary political process; as elites will reconfigure institutions in order to capture economic rents. In the reverse configuration of economic openness but political repression, economic competition will be undermined as rent-seeking and rent-extracting political actors use their insularity from competition to generate and capture rents.

The practical implication of the political settlement framework is that it allows us to link the macro-political environment to the costs of generating publicly funded goods vs. rents. Essentially, the real cost of public goods provisions should rise as we transition from a (non-violent) OAO towards a LAO, and even more so for a FLAO. This is because, as the probability of violence increases in the absence of rents, so does the opportunity cost of using public funds to generate public goods. The political settlement also helps explain another paradox, well established in the literature, that a shift from a relatively stable exclusionary regime to a more pluralistic but fragile one does not always result in better economic and governance outcomes. This is because increased pluralism does not represent the growing ability of groups to make programmatic demands from the state apparatus, but rather the fact that more groups have the power and credible threat of violence to disrupt the peace if they do not receive their share of rents.

The FLAO framework predicts that contexts like post-2003 Iraq will experience: (1) a rapid escalation in violence if a member of the elite settlement is excluded from the sharing of state rents (e.g. the Sunni Arab pre-2003 elite); (2) a reorientation of economic policy towards the short-term satisfaction of clientelist needs (public sector jobs and pensions) over the long-term provision of public goods and reconstruction; and (3) if political

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<sup>5</sup> Ibid.

<sup>6</sup> Ibid, p. 11.

<sup>7</sup> Ibid, pp. 5–6.

and economic reforms are to succeed, their interdependence in the short- and long-run needs to be well understood. More specifically, economic reforms should focus on areas that do not antagonise the elite's ability to generate and distribute rents in the economy, but on generating new growth areas – especially ones, such as private sector development, which might allow for new voices demanding political reforms in an incremental manner to emerge. North and others postulate that the possibility of a LAO moving towards an OAO framework is a long process and requires the elite to gain incentives to generate institutions such as the rule of law to a growing proportion of the population, because this creates economic growth, a proportion of which can be expropriated as rents. Therefore, long-term patient and pro-growth economic reforms, that do not antagonise the elite's short-term rentier objectives, are likely to yield the best results.<sup>8</sup>

The political settlements literature clearly links to a broader literature regarding institutionally-induced incentives of public officials to use public expenditures to generate public goods and/or rents.<sup>9</sup> It is beyond our scope to review this literature in detail. However, the functional implications of the political settlement literature are very much in line with the expectation that different regime types will incentivise different spending patterns. Specifically, a shift from a LAO to a FLAO would shift public expenditure: (1) *quantitatively* away from programmatic expenditures (provision of public goods, public services, etc.) towards rents (excessive pensions, fake jobs, illegal payments) to political actors who, if not placated, can instigate violence; and (2) *qualitatively* towards the most credible type of rent extraction – the generation of public sector jobs and pensions that can quickly be delivered over rents from procurement or more long-term corrupt activities.

It is of course important to note the limitations of the FLAO framework in its ability to explain the entirety of the political economy of policymaking in Iraq. The determinants of economic policymaking are many and complex. We would, therefore, expect other factors to be able to account for some of the variation in economic policymaking. For example, some actors may be able to utilise narratives around nationalism, religion and national capacity to advocate for changes, such as electronic payroll systems, that enhance the capacity of the state (contrary to the expectations of the FLAO). However, we would expect that, controlling for these other factors, the change in incentives created by the post-2003 political settlement would still be able to account for a significant amount of the shift in the nature of economic policymaking. Therefore, our approach remains useful even if it cannot account for all the determinants of economic policymaking.

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<sup>8</sup> Ibid, p. 17.

<sup>9</sup> For example: Timothy Besley, Rohini Pande, Lupin Rahman and Vijayendra Rao, 'The politics of public good provision: Evidence from Indian local governments', *Journal of the European Economic Association* 2/2–3 (2014), pp. 416–26; Timothy Besley, Torsten Persson and Daniel M. Sturm, 'Political competition, policy and growth: Theory and evidence from the US', *Review of Economic Studies* 77 (2010), pp. 1329–52; Bruce Bueno De Mesquita, James D. Morrow, Randolph M. Siverson and Alastair Smith, 'Political institutions, policy choice and the survival of leaders', *British Journal of Political Science* 32/4 (2002), pp. 559–90; David Lake and Matthew Baum, 'The invisible hand of democracy: Political control and the provision of public services', *Comparative Political Studies* 34/6 (2001), pp. 587–621.

## The Development and Institutionalisation of a Fragile Limited Access Order in Iraq Post-2003<sup>10</sup>

Before 2003, Iraq was an exclusionary LAO in which many elements of the population, especially significant subsets of Shi'a and Kurdish groups, were excluded from the political process, often violently. Dissidence and genuine political participation were also severely restricted. The four stages of the emergence and consolidation of Iraq's post-2003 political settlement are summarised in Table 1.

The formation of a new political settlement entrenching the dynamics of a FLAO begun soon after 2003. In the first two years, the fact that economic policy was dominated by the Coalition Provisional Authority (CPA) meant that the political settlement was effectively under the control of agents of a functional OAO. The transition to a politically indigenous political settlement was envisioned via the head of the Coalition Provisional Authority, Paul Bremer's '540-day plan' to draft a new constitution, endorse it by referendum, and hold elections. However, Bremer's attempts to ensure that the design of state institutions were inclusive ran into opposition from the six – subsequently seven – parties represented in the seven-person Leadership Council.<sup>11</sup> These parties, which heavily represented groups excluded by Saddam's regime, had conceptualised a sectarian-based political settlement soon after the first Gulf War. The proposed slow transition and possibility of a more inclusive political settlement galvanised the six political parties to coalesce around demands for a faster transition.<sup>12</sup>

Due to increased violence in the latter half of 2003, as well as the pressure of domestic politics in Coalition countries to accelerate a transition out of Iraq, Bremer accepted the demands of the six parties to introduce the 'Sallahuddin quotas'<sup>13</sup> on the allocation of seats on the 25-person Iraqi Governing Council (IGC)<sup>14</sup> as well as the right of existing members to veto the introduction of new members. This process effectively began to entrench the power of these groups to gain exclusionary political control and, by extension, access economic rents that could be captured by the state. Thus, the creation of the IGC set in motion the establishment of a new FLAO.

<sup>10</sup> The following section, describing the emergence and consolidation of Iraq's new political settlement, is based on Toby Dodge, 'Muhasasa Ta'ifia and its others: Domination and contestation in Iraq's political field', *Religion, Violence, and the State in Iraq*, *POMEPS Studies* 35 (October 2019), pp. 38–45. Available at [https://pomeps.org/wp-content/uploads/2019/10/POMEPS\\_Studies\\_35.1.pdf](https://pomeps.org/wp-content/uploads/2019/10/POMEPS_Studies_35.1.pdf) (accessed 18 February 2020).

<sup>11</sup> Which also included Naseer Kamel al-Chaderchi.

<sup>12</sup> Toby Dodge, 'Elite pacts, political settlements and transition in Iraq', *London School of Economics: London* [forthcoming], p. 10.

<sup>13</sup> These are sectarian quotas dating from the October 1992 conference that formed the opposition Iraqi National Congress.

<sup>14</sup> The distribution included 13 Shi'a, 5 Sunnis, 5 Kurds, 1 Turkoman and 1 Christian.

Table 1: The Emergence and Consolidation of Iraq's Post-2003 FLAO Political Settlement

Time Period	FLAO Elite Actors	Excluded Actors	External Actors
<b>Pre-2003</b>	<b>Conceptualising the sectarian quota system</b> Exiled groups began to articulate a post-Saddam regime that culminated in the first establishment of a sectarian quota system in 1992 shortly after the first Gulf War.	Sunni groups, historically co-opted by Saddam Hussein, were underrepresented at these meetings.	
<b>2003–2007</b>	<b>Elites consolidate and entrench their power</b> By: (1) resisting the US-led Provisional Authority's attempts to include other groups (beyond the original six) <sup>15</sup> in decision-making; and (2) ensuring the draft constitution embedded their preferred sectarian quota system into the subsequent electoral process.	While the speaker of parliament was Sunni, the Sunni population lost its historical privileged access to the political system, and therefore the level of economic rents it had historically received. By 2006, insurgencies in Arab Sunni areas begin to accelerate.	Despite the attempts by Coalition Provisional Authority Head Paul Bremer to (1) involve new stakeholders, (2) the fact that all ministries had a US adviser, and (3) the US was responsible for the bulk of security, the 'original six' were able to use the threat of a boycott to frustrate attempts to move towards a political system that threatened their dominance of the levers of the state.
<b>2007–2011</b>	<b>Consolidation</b> Following the introduction of the new constitution in 2005 and the elections in 2006, the consolidation of power by the new elite took place. Rapid reorientation of economic policy towards (clientelist) public sector job generation begins.	The promise made by the government to provide support for the Sunni tribes that fought against insurgents was an important factor in improving the security situation.	Despite a surge in US troop numbers, the ability (and willingness) of the US-led Coalition to prevent the entrenchment of the new FLAO diminished as the focus was on security and securing an exit from Iraq.
<b>2012–2017</b>	<b>Full institutionalisation</b> Attempts to develop non-sectarian parties thwarted. Short-termism clientelist focus continues unabated.	The failure to accommodate Sunni tribes that fought insurgents results in escalating violence and the rapid expansion of insurgent violence.	Allied surge and support provided the government with the ability to defeat insurgency.
<b>Post-2017</b>	The inclusion of some more Sunni elements facilitates an end to violence, while high oil prices ensure that members of the FLAO elite settlement have sufficient resources to satisfy expanded clientelist needs at least for now.		

<sup>15</sup> The original six are the opposition parties that had coalesced around the idea of sectarian quotas while still in exile.

The power of the new elite settlement to further entrench its ability to control the state apparatus was demonstrated in 2004. The six parties were then able to scupper a plan by UN Special Representative Lakhdar Brahimi aimed at ensuring a transitional government was composed of technocrats rather than representatives of the IGC. This would have deprived the six parties of an incumbent advantage in the upcoming elections. By threatening to withdraw their support of the transition process, the six parties were able to pressure the Coalition into accepting the role of the continued centrality of the IGC in the transition period.

In January 2005, the elite coalition was able to use the reliance on the Sallahuddin quotas during Iraq's first election to entrench its control of the levers of the state. While this election was for a temporary assembly, the role of this assembly was to draft the new Iraqi Constitution, thereby providing the elite with the ability to rig the new 'rules of the game' in its favour. The power of the insider coalition to exclude new entrants into the political process could be seen by the fact that attempts by the Grand Ayatollah Al-Sistani to facilitate the inclusion of independent candidates into the Shi'a electoral lists were resisted by the Shi'a parties in the IGC. The growing power of the parties in the elite coalition to seize economic rents and use these to reward clientelist networks can also be seen by the volte-face of the Iraqi Islamic Party, whose support base is Sunni. Having decided to boycott the January 2005 elections, the party, realising the potential dangers of political isolation, organised a larger electoral coalition and participated in the December 2005 elections (at which turnout increased from 68 to almost 80 percent).

The new Iraqi Constitution realised the entrenchment of the elite settlement, rewarding the insider parties with the tools to perpetuate their ability to distribute ministerial and senior public sector roles along sectarian lines, and use these roles to support clientelist networks. However, the fragility of the new political settlement was soon exposed when Sunni tribes in central Iraq, who had traditionally enjoyed access to political rents, increasingly begun to back insurgent movements. As anticipated by the FLAO model, the failure to provide these actors with sufficient access to economic rents resulted in the rapid escalation of violence and the loss of large parts of territory threatening not just the generation of rents but also the very integrity of the state. The government was only able to reverse this situation through relying on external military support and the better inclusion of these groups in the political settlement by granting them access to public sector jobs. The fact that the exclusion of even a relatively small minority from the political settlement resulted in a rapid deterioration in security underscores the fragility of the regime, which despite vast oil wealth – and therefore rents – lacks the capacity to ensure a monopoly of violence in the face of minority opposition.

## A Simple Formalisation

In order to better understand how the transition from a LAO to a FLAO settlement impacts on incentives for economic policy, it is useful to generate a simple moral hazard principal–agent model.<sup>16</sup> Assume a rent-maximising incumbent ( $i$ ) is randomly installed in power in the first period ( $t_1$ ) of a two-period game. The incumbent has the ability to use an (exogenously fixed) level of taxes ( $\tau$ ), subject to the constraint that tax is less than total national income ( $\tau < Y$ ), to generate: (1) private rents for herself; and/or (2) the provision of public goods ( $\gamma$ ) to all citizens ( $n$ ). In order to capture the effect of the political settlement, we introduce a parameter  $v$  that denotes the proportion of discretionary resources that need to be used to ‘buy the peace’ by elite actors. That is the level of rents that need to be generated in order to avoid violence and therefore (1) the destruction of public goods and (2) the incumbent’s ability to retain office into the second period. Thus, by definition  $0 < v \leq 1$ .<sup>17</sup> As, by assumption, elites can generate more violence in a FLAO than a LAO, we can also assume that  $v(FLAO) > v(LAO)$ .<sup>18</sup> Given the incumbent’s rent-maximising preferences, positive discount factor ( $\delta$ ) and a positive ego rent ( $E$ ) for remaining in office into the second period, the incumbent’s utility function is:

$$U_i = (vr_i + \delta(E + r_i)) - (1 - v)\gamma \quad (1.01)$$

Citizens can credibly commit to acquiescing to the incumbent remaining in office if they receive a certain quantity of public goods ( $\gamma^*$ ). As the generation of public goods requires the forfeiture of rents, the citizen’s utility function can be written as:

$$U_c = (1 - v)\gamma - (vr_i + \delta(r_i)) \quad (1.02)$$

From this utility function it is possible to derive the set of strategies available to citizens at the end of the first period:

$$(U_c) \begin{cases} \text{support incumbent if } \gamma \geq \gamma^* \\ \text{revolt if } \gamma < \gamma^* \end{cases} \quad (1.03)$$

The decision of the incumbent centres on whether it is optimal for her to commit to the supply of the minimum amount of public goods required to stay in office, enjoy residual rents in the first period and the net present value of second period rents; or rent-maximise ( $r^*$ ) in the first period and be removed from office.

<sup>16</sup> The model here is a simple adaptation of the canonical two-period principal–agent model introduced in Tim Besley, *Principled Agents? The Political Economy of Good Government* (Oxford: Oxford University Press, 2008).

<sup>17</sup> For simplicity and given the substantive assumption that rent generation is critical for both LAOs and FLAOs, we assume that  $v > 0$ .

<sup>18</sup> For simplicity we assume no corner solutions.

That is:

$$(U_i) \begin{cases} \text{remain in office if } (vr_i + \delta(E + r_i)) - (1 - v)\gamma \geq r^* \\ \text{leave office if } (vr_i + \delta(E + r_i)) - (1 - v)\gamma < r^* \end{cases} \quad (1.04)$$

The timing of the game is as follows: (1) nature assigns an incumbent into office; (2) citizens credibly commit to the continuation of the incumbent in office if a threshold of public goods is realised at the end of the first period; (3) the incumbent either (a) provides a combination of public goods to citizens and extracts residual rents, or (b) rent maximises in the first period; (4) citizens observe the actions of the incumbent; and (5) either (a) revolt, or (b) acquiesce to the incumbent staying in power; (6) the incumbent is either (a) removed from office, or (b) remains in office for the second period and pursues a policy of maximal rent-extraction.

**Proposition 1a:** If  $(vr_i + \delta(E + r_i)) - (1 - v)\gamma \geq r^*$  and  $\gamma \geq \gamma^*$  there exists a (pure strategy) equilibrium in which an incumbent provides the minimum combination of public goods to remain in office while using any residual resources in order to generate rents. All citizens receive any public goods provided and the incumbent survives into the second period.

**Proposition 1b:** If  $(vr_i + \delta(E + r_i)) - (1 - v)\gamma \leq r^*$  there exists a (pure strategy) equilibrium in which an incumbent pursues maximal rent-seeking, fails to produce a sufficient amount of public goods, and is removed from office at the end of the first period.<sup>19</sup>

Intuitively, the model allows us to begin unpacking the different incentives an incumbent officeholder faces when considering her optimal response to the demands of citizens given a political settlement. Specifically, if we know how a change in the political settlement can affect the relative costs of different choices, we can use this simple model to make predictions about how changes in the political settlement will impact on the relative provision of public goods, rents and by extension the myopia (or lack thereof) of incumbent decision-makers.

## Comparative Statics: A Transition from a LAO to a FLAO

We can use the model above to explore the likelihood of different substantive outcomes (levels of corruption and public goods generation) from shifting from a LAO to a FLAO. Specifically, we can explore how the incentives of an incumbent in a LAO in which the inequality  $(vr_i + \delta(E + r_i)) - (1 - v)\gamma \geq r^*$  and  $\gamma \geq \gamma^*$  is *just* satisfied changes when we shift to a FLAO. Essentially, the shift to a FLAO means that the value of  $v$  has increased. What happens to the incentives of the incumbent as  $v \rightarrow 1$ ? That is  $\frac{du}{dv} v$ ? On the margin,

<sup>19</sup> For our purposes, analysing the effects of shifting from a LAO to a FLAO, the analysis of these two pure strategy equilibria will suffice. There are also other pure strategy equilibria, e.g.  $(vr_i + \delta(E + r_i)) - (1 - v)\gamma \geq r^*$  and  $\gamma \leq \gamma^*$  but these do not add significant value to our illustrative purposes.

an increase in the value of  $v$  would mean that the real return of short-term rent-extraction now becomes greater than limiting rent extraction in the first period and providing public goods. This is because the incumbent is now better-off rent-maximising in the short run than forgoing some rents in the first period. So, the likelihood that incumbents will become more myopic and extract more rents increases as we shift from a LAO to a FLAO (see Annex A).

## Empirical Implications

The transition from an elite settlement with a unified and exclusionary executive LAO to one in which a large number of independent incumbents control their own portfolios with little to no effective cooperation (FLAO) describes the change in decision-making in Iraq. We can use the comparative statics of the above model to generate two predictions of how Iraq's transition to a FLAO will impact the nature of economic policymaking:

**H<sub>1</sub>:** The provision of public goods by (domestic) actors will decline as the political settlement switches from a LAO to a FLAO.

**H<sub>2</sub>:** The aggregate generation of rents will increase as the political settlement switches from a LAO to a FLAO.

We can now review each hypothesis to determine the utility of the FLAO framework.

## Empirical Analysis

The aim of the empirical analysis is to identify whether the theoretical hypotheses generated by our simple formalisation can predict the evolution of decision-making in post-2003 Iraq. There is a large literature linking the movement away from a stable and mature autocratic or liberal democratic regime to worse governance outcomes.<sup>20</sup> The methodological challenge of doing this is that outcomes of interest (pattern of expenditure, regulatory quality and levels of corruption) are not solely determined by the political settlement. In order to identify the possible contribution of the political settlement, we focus on the relative change in variables of interest over time. Specifically, since the political settlement began to emerge after 2003 and had solidified by 2010, it is possible to examine whether there were detectable changes in economic policy outcomes associated with the evolution of the new political settlement.

<sup>20</sup> For example: Gabriella Montinola and Robert Jackman, 'Sources of corruption: A cross-country study', *British Journal of Political Science* 32/1 (2002), pp. 147–70; Patrick M. Regan and Errol A. Henderson, 'Democracy, threats and political repression in developing countries: are democracies internally less violent?', *Third World Quarterly* 23/1 (2002), pp. 119–36; Khusrav Gaibulloev, James A. Piazza and Todd Sandler, 'Regime types and terrorism', *International Organization* 71/3 (2017), pp. 491–522.

## Explanatory Variable of Interest

The development and entrenchment of the current political settlement ( $v \rightarrow 1$ ) in Iraq did not occur instantaneously. Rather it manifested, evolved and consolidated over time. Therefore, we would expect the impact of the post-2003 settlement to become more pronounced over time. Specifically, given the fact that the US-led Coalition was responsible for the administration of much of Iraq immediately after 2003, and control only fully reverted to national political actors in 2011, we would only expect the full impact of the new political settlement to manifest itself post-2010.

## Dependent Variables

Given the consolidation of the political sentiment described above, good independent variables of interest would seek to measure: (1) the overall provision of public goods and/or financed goods and services ( $\gamma$ ); or (2) the level of rents ( $r$ ) generated in the economy. There are several methodological challenges in identifying variables that can effectively measure such dependent variables of interest. In respect to the generation of public goods it can sometimes be difficult to measure the *quality* of outputs (e.g. regulatory quality, quality of public services, etc). In respect to rents, given the sometimes-illegal nature of the transfers and/or their disguise as legitimate public expenditure, it can be difficult to determine their actual size and trajectory.

In order to minimise the risk that the indicators used do not reflect the overall trajectory of public sector outputs and rents we use (1) a combination of different variables measuring regulatory quality and rents; (2) combined with public financial data. The idea is that, if all these indicators are moving in the same expected trajectory, the political settlements theoretical approach has some merit. Specifically, we explore aggregate World Bank indicators of the quality of regulation and political stability ( $\gamma$ ) and corruption ( $r$ ), the comparative performance of Iraq in the Doing Business Index (capturing a mixture of  $(\gamma - r)$  and the evolution of expenditure data in Iraq – especially capital (long-term investment  $\gamma$ ) vs. current (salaries and pensions, some of which may be legitimate, but whose unjustified growth may signal a growth in  $r$ ).

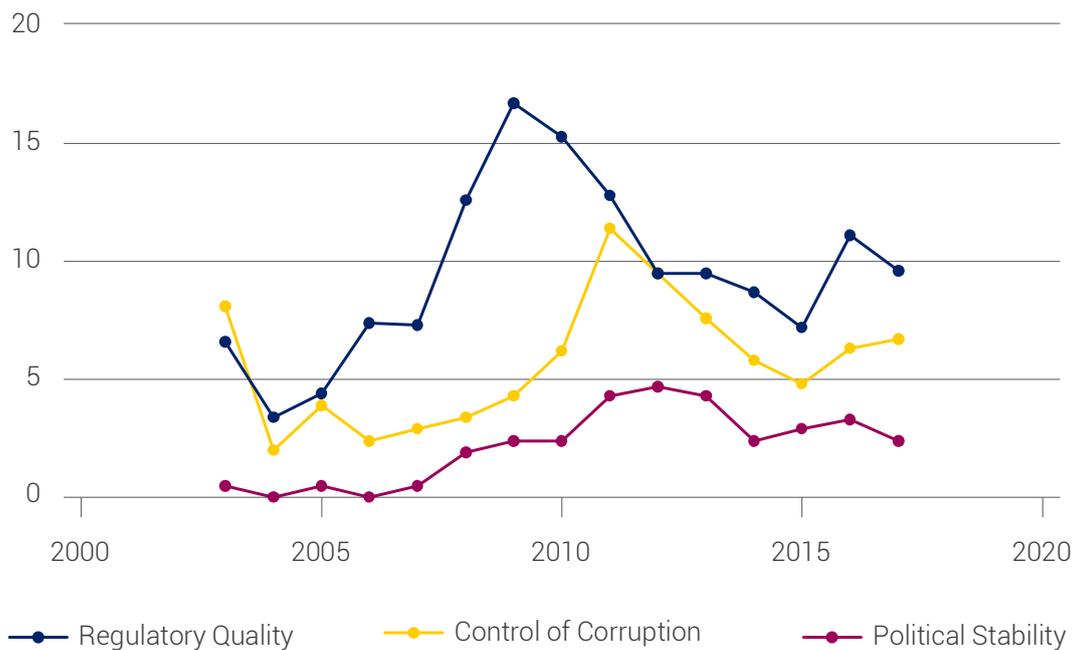
Figure 1 provides an initial overview of the relative evolution of Iraq against three of the World Bank's Good Governance Indicators. These should provide a good, albeit high-level, snapshot of how the evolution of the regime has resulted in qualitative changes in different elements of governance that correspond to  $H_1$ - $H_2$ . This is because these indicators are designed to capture both the provision of public goods (good quality regulation and its implementation) as well as the magnitude of some types of corruption (rents).

The World Bank's 'Regulatory Quality' indicator is designed to 'capture perceptions of the ability of the government to formulate and implement sound policies and regulations that permit and promote private sector development.'<sup>21</sup> It therefore captures a critical

<sup>21</sup> 'Good Governance Indicators', *World Bank* (Washington, D.C., 2019). Available at <https://info.worldbank.org/governance/wgi/#home> (accessed 18 February 2020).

dimension of whether the state can generate public and merit goods ( $H_1$ ). Focusing on the change of regime in 2003, the relatively low ranking of Iraq (tenth percentile) improves as the reconstruction process begins, reaching the high teens in 2009. However, with the consolidation of the new political settlement and the diminished direct Coalition control of governance, the indicator begins a steady decline thereafter. Control of corruption (proxy for  $H_2$ ) follows a similar pattern, starting from a low base, improving until 2011, and then declining. Finally, relative political stability improves until the advent of the insurgency in late 2011 ( $H_1$ ). Thus, despite the huge investment in Iraqi military capabilities, the lack of inclusion of Sunni elites in decision-making regarding the redistribution of rents is a better predictor of political stability. The movement of all these indicators is therefore consistent with the expectations of the model. As the new political settlement consolidates, the quality of decision-making declines, rents and corruption increase, and, despite the inclusion of more elite groups, sectarian violence is exacerbated.

**Figure 1: Good Governance Indicators in Iraq**



Source: World Bank<sup>22</sup>

<sup>22</sup> Ibid.

As Figure 2 illustrates the relative decline of public goods provision ( $H_1$ ) can also be seen from the ‘Ease of Doing Business’ index. While Iraq’s overall business environment started in 2004 above the MENA average and neighbouring Jordan, it has fallen behind since. Therefore, while there has been some absolute improvement in Iraq’s performance since 2009, this has been very slow. As a consequence, in relation to its regional peers, the relative cost and complexity of business registration and operation in Iraq has increased in recent years, as the political settlement has consolidated, even if there has been some improvement in absolute terms.

**Figure 2: Ease of Doing Business in Iraq**



Source: World Bank<sup>23</sup>

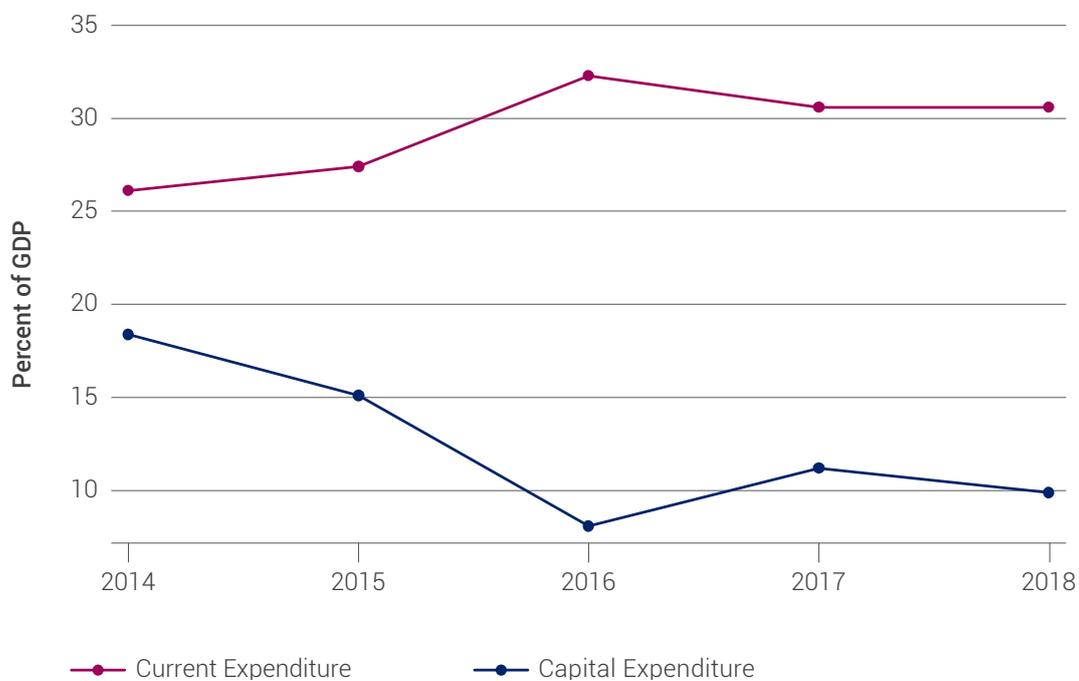
We can further investigate the qualitative decline of decision-making by looking at the nature and trajectory of government expenditure ( $H_1$ - $H_2$ ). If our theoretical model is correct, we would expect a gradual decline in the proportion of public expenditure devoted to long-term investment in favour of short-term recurrent spending that can be used to reward clientelist stakeholders with government jobs and handouts.<sup>24</sup> Of course

<sup>23</sup> ‘Doing Business Index’, *World Bank* (Washington, D.C., 2019). Available at <http://www.doingbusiness.org/en/rankings> (accessed 18 February 2020).

<sup>24</sup> Spending that falls under the more long-term oriented capital account is still likely to be subject to significant corruption and rent-extraction. However, in the absence of total expropriation, this type of spending is less likely to yield ‘privately optimal outcomes’ for corrupt clientelist networks. The delivery of permanent jobs has fewer transaction costs and delivers more long-term benefits for clientelist recipients than trying to extract rents from procurement contracts. Therefore, the relative proportion of state expenditure on capital vs. current budgets is an important, if imperfect, proxy for the emphasis on clientelist expenditures.

the biggest determinant of government expenditure is oil prices, with over 90 percent of public revenue deriving from oil exports. However, as Figure 3 below indicates, the proportion of spending devoted to capital vs. current expenditures has declined as the political settlement has solidified – with capital expenditures almost halving from 18 to 10 percent of GDP, while current expenditures have risen from less than 25 to over 30 percent of GDP in 2014–18. Of course, part of the fall in capital investment can be explained by the fall of oil prices since 2016. However, the fact that current expenditure has increased in both absolute and relative terms since 2014 clearly indicates that the prioritisation of public expenditures, given different oil prices, has become more oriented towards the provision of public sector jobs and pensions.

**Figure 3: Composition of Public Sector Expenditures in Iraq**

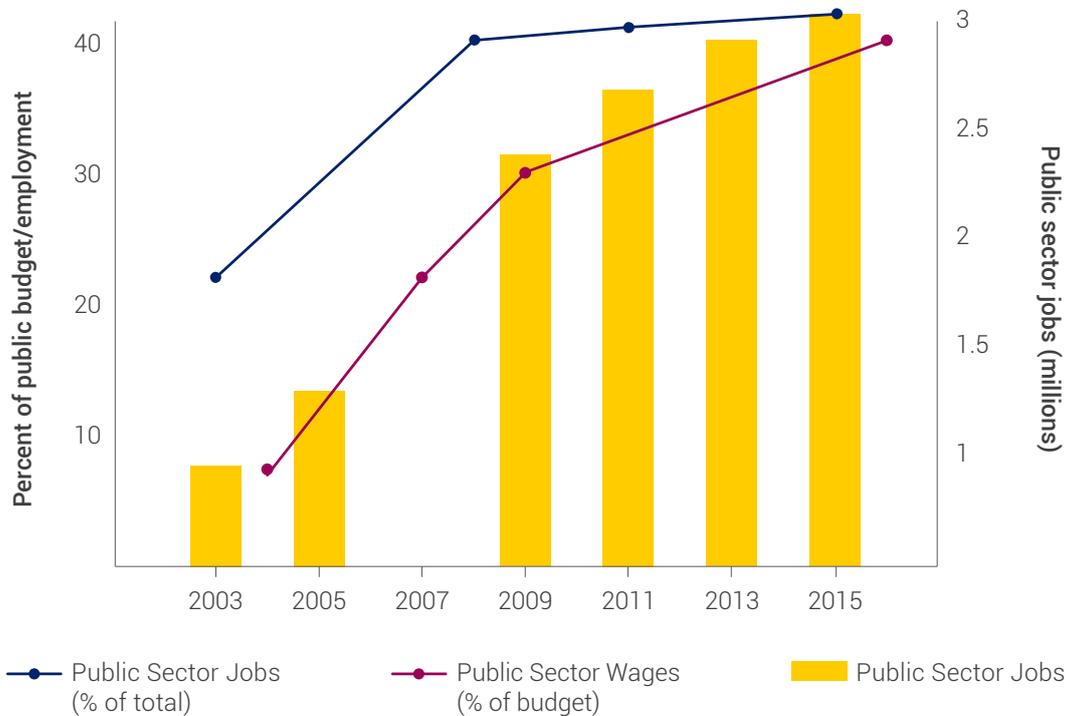


Source: IMF<sup>25</sup>

We can even explore the extent to which expenditure has become more clientelist by examining the explosion of the public sector payroll. It is a well-known fact that government jobs and payments are an important and credible mechanism for clientelist politics. Therefore, despite the worsening of the quality of government outputs (Figure 1) the size of the state has grown exponentially. As Figure 4 shows, the size of the public sector has increased from just over 900,000 in 2003 to over 3 million by 2015. The proportion of the public budget going to pay salaries has increased from 7 to just over 40 percent, while the public sector now accounts for 4 in 10 jobs in the country.

<sup>25</sup> 'World Economic Outlook', *International Monetary Fund* (Washington, D.C., 2019). Available at <https://www.imf.org/external/pubs/ft/weo/2019/01/weodata/index.aspx> (accessed 18 February 2020).

**Figure 4: Growth of Public Sector Payroll in Iraq**



Source: World Bank<sup>26</sup>

## Policy Implications

The self-reinforcing incentives generated by the political settlement in Iraq make it imperative to identify economic reforms that can facilitate both economic growth and political transition in the long run ( $t_2$ ). Like any other political settlement, reforms that have a high short-term ( $t_1$ ) political cost will be difficult to implement. Given that in a FLAO high short-term political costs could result in state disintegration and not just incumbents losing their position, the net impact of certain reforms can be particularly profound. Therefore, while from an economic perspective redirecting resources away from public sector salaries towards human capital investment and infrastructure building could be transformational, it would also likely result in political instability and violence. Partially counterbalancing this tendency is high youth unemployment and a lack of opportunities that are likely to create increased pressures for economic reform, such as the 2019–20 protests.

As Table 2 shows, given the regime's fragility, technically-oriented reforms around public financial management and/or anti-corruption which could threaten the ability of

<sup>26</sup> 'Iraq – Systematic Country Diagnostic', *World Bank* (Washington, D.C., 2017). Available at <http://documents.worldbank.org/curated/en/542811487277729890/pdf/IRAQ-SCD-FINAL-cleared-02132017.pdf> (accessed 18 February 2020).

incumbents to redistribute oil rents are unlikely to enjoy much traction. Conversely, as long as they do not directly disturb the ability of the elite to redistribute these rents, initiatives to support private sector development, even if they diminish the opportunities for petty corruption, may be feasible. This is because the growth of the private sector does not directly disturb oil revenue distribution and may even placate certain powerful groups. Another feasible option might be the use of conditionalities to fund capital expenditures in Iraq. Given the FLAO modus operandi means that the government itself has very limited incentives to invest in long-term reconstruction, providing financial support for reconstruction (that may generate short-term economic stimulus) while attaching requirements focusing on long-term structural reformation might yield both short-term and long-term results. In the short run, reconstruction expenditure could stimulate growth. The slow reform of the government sector, while not disturbing today's incumbent's ability to redistribute rents, could result in the long-term undermining of the FLAO settlement and promote its slow transition towards a more inclusive and productive modus operandi.

**Table 2: Political Settlement and Reform Options in Iraq**

	<b>High short and long-term economic reform impact (<math>t_1</math>)</b>	<b>Limited short-term but high long-term economic reform impact (<math>t_2</math>)</b>
<b>High net political cost (<math>t_1</math>)</b>	<ul style="list-style-type: none"> <li>• Restructuring of state-owned enterprises</li> <li>• Public sector pension reforms</li> </ul>	<ul style="list-style-type: none"> <li>• Public Financial Management</li> <li>• Anti-corruption reforms</li> </ul>
<b>Low net political cost (<math>t_1</math>)</b>	<ul style="list-style-type: none"> <li>• Private sector growth facilitation</li> <li>• Access to finance and banking reforms</li> </ul>	<ul style="list-style-type: none"> <li>• Concessional finance for reconstruction and long-term policy reforms</li> <li>• Support of evidence-based policymaking (e.g. data generation and analysis)</li> </ul>

The dynamic effects of sequencing the focus of reforms, on both economic and political equilibria, can enable over time the movement towards a more inclusive political settlement.<sup>27</sup> This is because, as Table 3 shows, the successful initiation of economic reforms will eventually have a spill-over effect in demands for change in the political settlement, which will in turn result in further incentives for economic reforms. Thus, the initiation of sound economic reforms can result in the multi-causal and self-reinforcing movement towards better economic and political equilibria in the long run.

<sup>27</sup> It is important to note there is considerable debate around the link between economic and political reforms and how they affect each other. However, while no consensus exists, there is a growing acceptance, even amongst sceptics, that there are multi-causal links between the two. See: Staffan I. Lindburg, 'Introduction' in 'Should Modernization Theory Survive?', *The Annals of Comparative Democratization* 16/3 (2018). Therefore, while the descriptions in Table 3 seeks to map out one plausible pathway linking economic and political equilibria, other mechanisms for affecting both are also likely to exist.

**Table 3: The Effect of Economic Reforms on Economic and Political Equilibria**

Time Period	Economic Equilibrium	Political Equilibrium
$T_1$	High-economic impact, low short-term political cost reforms pursued (i.e. concessional finance, private sector reforms).	Largely intact (oil revenues for jobs). Some lower level bureaucrats may resist loss of discretion for petty corruption, but economic boost and prestige of better business environment keeps senior elite placated.
$T_{1+}$	Provision of infrastructure and private sector growth create jobs and economic stimulus.	Expectations of (marginally) better service provision and delivery embedded (concessional finance); and private sector growth create greater political voice.
$T_2$	Diminishing economic growth due to the exhausting of 'low hanging fruit' economic reforms – growth increasingly dependent on governance reforms (e.g. anti-corruption, public financial management and rule of law).	The political benefits of continued economic growth, the relative strength of the private sector and the short-term political gains of maintaining growth may incentivise senior policymakers to pursue some governance reforms that improve efficiency and the rule of law while they still enjoy considerable fiscal discretion (to use oil revenues to create jobs).
$T_{3+}$	Political pressure to change fiscal policy (rent-allocation) builds up due to economic transformation. The social contract based on oil rents begins to change.	Strengthening rule of law, public financial management and anti-corruption make economic misallocation increasingly costly. The long-term effects of a more independent judiciary, anti-corruption efforts, expectations of service delivery, create pressures to make better spending decisions.

## Conclusion

The evolution of Iraq's political settlement since 2003 has had profound implications on the nature of (economic) policymaking. Specifically, a more inclusive, albeit elite, political settlement has increased the incentives for incumbent policymakers to pursue short-termist policies that focus on placating clientelist supporters rather than public goods provision. This is because, as the introduction of a sectarian system for allocating public office has developed and solidified, the relative cost of ensuring survival in office has shifted away from the provision of broadly available public goods towards the satisfaction of clientelist supporters. As such, the state has increasingly focused on the provision of public sector jobs while neglecting capital and long-term expenditures.

This political equilibrium represents a significant obstacle to purely endogenous economic reform. However, the myopia of incumbents can be used to support short- and long-term economic policy reforms that can transform both the economy and the political settlement. As long as they do not antagonise the short-term rentier objectives of incumbents, they have a reasonable chance of success. Specifically, private sector development and concessional capital support that can transform the political and economic space in the long run may be feasible, because neither will significantly impact on the ability of incumbents to redistribute (oil) rents today. Even though the growth of the private sector and the expectation of citizens to maintain investiture may undermine the (highly corrupt) political settlement in the long run, the rational myopia of incumbents, who are only concerned with their short-term survival, may work to entrench such reforms.

## Annex A

### Proof of Proposition 1a

We show how a pure-strategy perfect Bayesian equilibrium exists when incumbents do not play weakly dominated strategies (PSPBEW).

In a situation in which the inequalities  $(vr_i + \delta(E + r_i)) - (1 - v)\gamma \geq r^*$  and  $\gamma \geq \gamma^*$  are satisfied, the incumbent will provide the minimum quantity of public goods required to survive and use any residual resources to generate rents for herself. Deviating from this strategy will not be optimal. Firstly, if the incumbent increases the quantity of public goods ( $\Delta\gamma$ ), she will reduce her welfare (fewer rents  $-\nabla r$ ) without affecting her chance of retaining office  $- [(vr_i + \delta(E + r_i)) - (1 - v)\gamma \geq r^*] > [(v\nabla r_i + \delta(E + r_i)) - (1 - v)\Delta\gamma \geq r^*]$  so she has no incentive to do this.

Conversely, if she reduces public goods generation by even a small quantity, she will lose the support of citizens and lose office, as the in the present period is less than the net present value of retaining office as  $(vr_i + \delta(E + r_i)) - (1 - v)\gamma \geq \Delta r^*$  – therefore she has no incentive to do this. Citizens, who have credibly committed to supporting the incumbent if they obtain  $\gamma^* > 0$ , will have no incentive to deviate from supporting the incumbent as they would get a payoff of zero in the first period instead of  $\gamma^* > 0$ .

### Proof of Proposition 1b

In a situation in which the inequality  $(vr_i + \delta(E + r_i)) - (1 - v)\gamma < r^*$  is satisfied, the incumbent will have an incentive to pursue a rent-maximising strategy in the first period and forgo surviving into the second period. If the incumbent increased public goods production, she would reduce her welfare – even if she did survive in office as  $r^* > (v\nabla r_i + \delta(E + r_i)) - (1 - v)\Delta\gamma, \Delta\gamma \geq \gamma^*$ . So, she has no incentive to do this. As she is already pursuing the maximal amount of rents  $r = \tau < Y$ , then she cannot increase her welfare further by extracting more rents.

Citizens, who can credibly commit to supporting the incumbent only if she generates  $\gamma^* > 0$ , will have no incentive to deviate from this as they will get a payoff of zero instead of  $\gamma^*$ .

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A crane is erected at a construction site in central Baghdad on 5 December 2008. The billboard reads 'Our strength as Iraqis defeated their terrorism and their bombs'.

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