

Beyond the Iraq Study Group: The Elusive Goal of Sustained Growth

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Introduction

Since its release in early December 2006, the Iraq Study Group's (ISG) military, political and diplomatic recommendations have generated wide-spread discussions. Unfortunately, the country's economic recovery has received considerably less attention. Yet the country's economic situation is quite dire. The ISG correctly notes that: (a) instead of meeting a target of 10 percent growth for 2006 only 4 percent was attained, (b) inflation is above 50 percent, (c) estimates of unemployment range from 20 to 60 percent, and (d) foreign investment is less than 1 percent of gross domestic product. In many regards the economic situation today has deteriorated from that under Saddam. In short "Too many Iraqis do not see tangible improvements in their economic situation."^[1]

The importance of reversing the current economic malaise and attaining an acceptable rate of sustained rate of economic growth and improvement in living standards is clear:^[2]

No political and security progress can be sustained in Iraq unless the Iraqi people experience improvement in their daily lives. This will demand substantial progress on simple tasks like clearing garbage; as well as complex tasks like rebuilding a shattered oil industry and establishing law and order. To achieve these goals, Iraq will need assistance from the United States and other countries that want to prevent a further slide towards chaos.

While the Iraq Study Group proposes financial aid to Iraq of around \$5 billion per annum to help rectify the situation, it is silent on the best strategies for putting these funds to effective use. To shed some light on this issue, the sections that follow attempt identify the complex forces at work in Iraq impeding reconstruction, economic recovery, and the eventual goal of sustainable economic growth.

Economic Dynamics of Post-War Iraq

Our working hypothesis is that any efforts to restore the economy will be conditioned by a number of interrelated factors including: (a) the growth and dynamics of the shadow or informal economy, (b) the deterioration in social capital, and (c) the evolving relationship of increasingly overlapping networks of tribes, gangs and the insurgency as conditioned by the dynamic interactions with (a) and (b).

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The Shadow (Informal) Economy

When coalition officials arrived in Iraq after the war, they planned on turning Iraq into a free market economy—a model for capitalism in the Middle East.[3] As part of this plan, they expected private companies, both foreign and domestic, to play a leading role in jump-starting the economy. Free market incentives driven by pent-up demand and a massive aid-financed reconstruction program were thought to be sufficient to induce a massive wave of investment and hiring of Iraqi workers.[4] But violence, crime and uncertainty over the future have undermined investor confidence, preventing market-driven mechanisms from playing their anticipated role. As a result nominal GDP contracted by about 35 percent in 2003. As noted above, it has recovered little since then, despite the U.S.-led reconstruction efforts.

The only part of the economy to have survived both Saddam Hussein and the post-2003 period of instability and insurgency is the country's informal economy. In fact, there is ample evidence that the country's informal economy has expanded considerably since Saddam's overthrow. In this regard, Iraq's informal economy is following a pattern seen in other parts of the world—the informal economy tends to grow during periods of political, economic, and social crisis.

Despite the obvious importance of the informal economy, it is barely mentioned in the many official economic reports. In fact, few systematic attempts have been made to integrate the analysis and quantification of the informal economy into an overall review of economic and military developments in Iraq. This gap in our knowledge has hindered the development of a systematic framework for understanding and planning reconstruction and counterinsurgency strategies in the contemporary Iraqi setting.

Preliminary analysis[5] suggests, a clear pattern exists whereby the relative size of a country's informal economy (as a share of Gross National Product) is related to its progress in opening up to the world economy. Those countries that are relatively closed and inward oriented (like Iraq around the year 2000) tend to have large informal economies, while those countries open to the pressures of globalization have much smaller informal economies. Furthermore, the informal sector becomes significantly smaller as countries increase their control over corruption.

As might have been expected, Iraq under Saddam was in a group of countries with the highest probability of possessing a large informal economy. The profile of these countries is an inward-oriented trade regime with high levels of corruption. On this basis, Iraq's shadow or informal economy probably accounted for around 35 percent of Gross Domestic Product (GDP) in 2000[6] with nearly 70 percent of the labor force employed in informal activities.

Since the fall of Saddam, Iraq's informal economy has been affected by that country's on-going crisis. Clearly conflict and the insurgency have taken a heavy toll on the formal economy. As private firms or public enterprises are downsized or closed due to conflict, retrenched workers often find the informal sector the only source of livelihood. Also, in response to conflict driven inflation or cutbacks in public services, households have often needed to supplement formal sector incomes with informal earnings. In some parts of the country such as al Anbar, the breakdown of law and order has led to an expansion of criminal activity, some of which is carried out in the shadow economy—street vendors selling stolen merchandise etc.

A partial list of factors contributing to the current expansion of Iraq's shadow economy includes:

- Compared with the previous regime, there is considerable political liberalization in Iraq. In transition economies, this normally results in a larger informal economy.
- The demand for services and trade is particularly high due the introduction of free trade soon after the fall of the Hussein regime. Again, this factor would encourage the

development of an informal economy—petty retailing, street vending of imported goods, etc.

- Increased bureaucratic discretion and associated corruption are greatly contributing to the informal economy.
- Because of Iraq's insurgency, institutional enforcements have weakened, thus allowing the incentives for informal activity to become very high.
- The underdevelopment in the rule of law and related institutional enforcement mechanisms have not improved to date. Given the insurgency, the enforcement mechanisms may have even declined.
- In Iraq's case, the present extremely low tax structures should not have been a contributing factor to the informal economy, but many marginal firms do not like to pay any taxes.
- The macroeconomy has been relatively stable, but in the last several years rapidly rising inflation is likely contributing to an expansion of the informal economy.

Of the items noted above, the most critical factor affecting the size of the informal economy is no doubt the inability of the Iraqi government to control corruption. In addition, given the insurgency and uncertainty surrounding political developments, it is safe to say that large segments of the population have reverted to the survival relationships characteristic of the period of sanctions in the 1990s. This is confirmed daily with the news coming out of Iraq describing economic mismanagement,^[7] vast black markets in gasoline^[8], increased crime, and shortages of critical inputs.^[9] These developments do not bode well and suggests that the current size of the informal economy is considerably larger than in the late 1990s. As noted above, another ominous sign^[10] is a recently released index of corruption for 2004. The prestigious Transparency International Corporation ranks Iraq as the most corrupt country in the Middle East. In 2004 the country's ranking was 129th out of 145 nations worldwide. By 2005 it had fallen to 135 out of 158 countries.^[11]

Based on these factors, it is likely that the size of the underground economy has expanded significantly beyond the 35 percent of GNP figure, noted above, for the end of the Hussein regime. A safe estimate, in light of the insurgency and its detrimental impact on investment, electricity, and transport, would put the informal economy at around 65 percent of Gross National Product. This figure is reinforced by the unemployment stemming from the disbanding of the army and the anti-Ba'athist campaign following Saddam's overthrow.

In addition to the factors noted above, the informal economy may be growing simply because of the constraints limiting expansion of formal economic activity. Just as private capital formation is often critical to the development of a thriving modern economy, social capital creation may be just as essential in creating the shift to more formal activities. Again, corruption plays a significant role in structuring the informal—this time through its effect on the country's social capital.

The Deterioration in Social Capital

Social capital refers to networks of relationships that bind people together.^[12] Social capitalists distinguish such relationships from physical capital and, the attributes of individuals, or human capital.^[13] In the context of Iraqi reconstruction and the establishment of a market economy, a key element of social capital centers on a component of social capital, the notion of trust.

A growing literature^[14] on social capital stresses the importance of trust in the institutional infrastructure of a market economy. The focus on trust is inspired by its importance for business formation, which in turn seems to be crucial for explaining the variation in economic performance in a large cross-section of developing and transition economies. Entrepreneurship cannot flourish in an environment of distrust, since many economic opportunities are closed off.

Trust is such a critical factor in the development of modern economies because it motivates contacts with others and opens access for the exchange of goods and services. It facilitates cooperation and cooperation in turn, breeds trust in a two way interaction necessary for the creation of long-term generalized norms for cooperation. Social capital thus represents a set of resources rooted in networks of relationships possessing the power to facilitate economic progress.

One of the main criticisms of U.S. policy in post-war Iraq has been its rejection, not only of social reform, but of the very state-centered approaches that were critical to the reconstruction and subsequent economic growth in post-war Japan and Germany. At the same time, fundamental social reforms were ruled out.^[15] As might be expected, combined with the demise of the state as a safety net, the lack of trust in the buying and selling of goods and services has resulted in the contemporary Iraqi economy being divided into segments of largely non-overlapping networks.

Ascribed Trust Networks

First and by far the largest in number in Iraq are the individual and business networks built on ascribed trust. These are usually confined to the local, informal economy. Most ascribed trust networks involve groups bound together by family, tribal, or ethnicity, which facilitates business organization built on oral contracts. Many of these networks have the potential to expand through selective interaction with outsiders. However, such expansion will take time in Iraq, especially under the current conditions of public corruption and great uncertainty over the enforceability of contracts.

In today's Iraq, many ascribed trust activities fall in what is commonly referred to as the coping economy—numerous economic interactions during armed conflict that provide benefits to the civilian population, particularly the poorest and most vulnerable. These functions are even more important to civilian livelihoods where the formal economy and traditional livelihoods are destroyed or rendered difficult or impossible to sustain. The coping economy includes a wide range of activities including subsistence agriculture, petty trade, and various out of the household businesses—catering, food processing, and the like.

It is reasonable to assume that the coping economy contains a disproportionate share of the country's poverty. Recent data released by the Ministry of Labor and Social Affairs indicate that about 5 million Iraqis are living under the poverty line, compared with 143,000 in 1993.^[16] Significantly, the Ministry noted that more than one million Iraqi women aged 25 to 40 were unmarried, while divorce cases were increasing as was child labor. It is reasonable to assume that this group of women is firmly entrenched in the coping economy.

Process-Based Trust Networks

Second, there are the process-based trust networks reliant on existing ties between the previous members of the Ba'ath government and criminal groups—smugglers, etc.—that thrived during the sanctions period of the 1990s. Today, these activities are largely in the criminal area. The emergence of pervasive criminality was readily apparent soon after the overthrow of Saddam Hussein.

If anything, these problems have become increasingly severe. According to a U.N. report, “The emerging crime problem is subtler and scarier: theft, extortion, and drug- and arms-smuggling operations that have become more sophisticated, more clandestine, and more organized. In Baghdad, one team of thieves recently burned down a warehouse filled with the hot booty of another group. It was one mob sending a message to another.”^[17]

As in the case of the ascribed trust groups, the activities of these networks have been affected by the insurgency. However, process-based networks' activities often directly contribute to prolonging the insurgency through:

- The destruction or circumvention of the formal economy and the growth of informal and black markets, effectively blurring the lines between the formal, informal, and criminal sectors and activities;
- Pillage, predation, extortion, and deliberate violence against civilians, used by extort ransoms, capture trade networks and diaspora remittances, and exploit labor;
- High decentralization, both in the means of coercion and in the means of production and exchange;
- The use of licit or illicit exploitation of trade in lucrative natural resources;
- The reliance on cross border trading networks, regional kin and ethnic groups, arms traffickers, and mercenaries, as well as legally operating commercial entities, each of which may have a vested interest in the continuation of conflict and instability.

Scores of the cross-border relationships cultivated by the various smuggler/criminal groups in the 1990s are still in place and operational at the present time. Goodhand et al. observe that the shadow economy is frequently already widespread before the outbreak of conflict and is a permissive factor for conflict when it contributes to violent state collapse. Or it serves as a source of income to would-be-rebels. Once conflict erupts, shadow economies are easily captured by combatants and thus often become the basis for the combat economy.^[18] This has happened in Iraq, with the current wave of kidnappings and smuggling providing significant financial assistance to the insurgency.^[19]

Extended Trust Networks

While extended trust networks may involve some reliance on kinship and family relationships, they are largely characterized by transactions between largely anonymous individuals. As noted, they are a key element in a modern economic system. Since the focus of the present analysis is on the informal economy, these networks will not be treated in detail other than to note that they are largely undeveloped outside the public sector and the national oil industry. Some banking arrangements are moving in this direction, albeit extremely slowly.^[20]

Clearly, for Iraq, a key challenge facing the economy is developing the conditions conducive to the creation and growth of extended trust networks to encourage the growth and development of this type of networking. Conversely, the lack of supporting institutions has constrained most economic agents and those entering the labor market to informal activities characterized by family/kinship based ascribed trust.

Networks and the Informal Economy

Adding network and labor market conditions to the equation provides additional insights to the factors shaping the overall size and, to some extent, the composition of Iraq's contemporary informal economy. In short the informal economy can be seen as largely a function of fundamental supply and demand factors: (a) a youth population bulge, (b) a long-standing state employment program providing incentives for employment in the public, but not private sector, (c) a workforce of diminished skills following a long period of sanctions, (d) little private sector growth stemming from the instability and the insurgency following the overthrow of Saddam Hussein (e) deficient social capital, especially in the form of trust, thus confining most private sector transactions to the informal market, and (f) openness to trade (neo-liberal reforms) makes many potentially profitable firms unprofitable. In turn, the lack of a sizable private sector reduces the links often found between the informal and formal economy.

Because the informal economy is largely the result of a convergence of powerful long-run demographic and economic forces, it will be a fixture for some time to come. At best, informal activities may evolve over the next several years with some progression from ascribed based networks to process based networks. If this transition is viewed as successful by Iraqi entrepreneurs and the government makes significant strides in the governance area, then the progression to process based networks and extended modern networks is a distinct possibility, particularly if the security situation stabilizes enough to support foreign direct investment.

Unfortunately, a good case can be made that under current conditions, the development and evolution of organized networks may perpetuate and even expand the informal/shadow economies. Many of the organized networks today have evolved out of Ba'ath party efforts to limit traditional centers of tribal authority. In effect the Ba'ath party encouraged the growth and proliferation of informal associational links locally.

Expansion and Evolution of Local Networks[21]

More precisely, local-level kinship affiliation was increasingly encouraged as the effects of the 1980s war with Iran and the sanctions of the 1990s drained the power of the central government. Particularly after the 2001 Gulf War, the central government was weakened to the extent that it was unable to perform many of its traditional military, economic and security functions.[22]

The Ba'thist survival strategy during this period was for the party to serve as a broad tribal unit local associations performing in supporting roles. By 1996 officially sanctioned "tribes" were responsible not only for the maintenance of law and order locally, but also collected taxes on behalf of the government, were appointed judicial powers and extended tribal customary law to the extent of their territorial reach. They received arms and ammunition, vehicles, and logistical support as payment for services rendered to the party.

Local dominance of revived tribal networks was evident in the 1998 crisis involving the United States. At that time, heavily armed and equipped Sunni tribal units were positioned in and around Baghdad to control the restive urban population, a role formerly belonging to the Ba'ath party militia. With time the interests of the central government and local networks began to diverge. Clan based groups controlled the highways around Baghdad. They increasingly turned to criminal activities—looting, smuggling, and hijacking throughout most of al Anbar province. Conditions deteriorated to the extent that convoys were necessary even for basic travel in daylight to avoid raids by tribal guerillas.

By 2000, policeman, judges, and party officials were subject to violent tribal recriminations. Encounters between Iraqi soldiers and tribal irregulars, especially those based in al Anbar province escalated in terms of frequency and scale. In this ever more lawless environment, tribal elements began to take over many of the local, informal street-markets. These markets comprised a sub-stratum of the informal Iraqi economy that, as noted above, began to grow in the

early 1980s as a result of chronic resource scarcities brought on by war, unrest, and a decade of sanctions.

In addition, Saddam Hussein's selective distribution of increasingly scarce resources created some of the underlying group rivalries that exist today. By directing funds, rations, government positions, electricity, clean water, fuel and industrial investment toward specific villages in the western Sunni regions in exchange for service to the regime, and withholding resources to other villages as a punitive mechanism, a local-level competitive calculus developed that was perpetuated by Hussein as an instrument for rule. Because the state-level formal economy was dramatically curtailed by sanctions, this competition for resources further encouraged the growth of informal activities and employment.

The tendency of corrupt party and state institutions to favor key supporters and engage in fraud in the distribution of goods and services encouraged those operating in the informal (and formal) economy to rely on local level mediation by tribal groups. Because informal activity is based in large part on social capital—the trusted familial and kinship ties noted above, local tribal groups played a central role in the expansion of the informal economy. By assessing fees for the settlement of disputes and collecting taxes on local production, local tribal groups also began to establish financial support free of state control.

Tribal groups were also increasingly involved in criminal-type activities, especially in the western border regions. Illicit criminal networks were initially based on the cross-border smuggling of animals, tea, alcohol, and electronics. Later these activities began encompassing the drug trade. Tribal based organized criminal activities increased toward the end of Ba'thist rule with many party members becoming involved due to declining opportunities to acquire official resources. By early 2002, the entire route along the Euphrates River in Al Anbar had essentially developed into a sanctuary for illicit traffickers and criminal entrepreneurs.

Resource scarcity and the stature of sub-tribal groups were both greatly enhanced at the local level following the removal of Saddam Hussein:

- The Coalition Provisional Authority's CPA early adoption of a neo-liberal economic program impeded the growth of regulatory and legal institutions. This institutional vacuum forced businesses and those entering the labor market to rely on the trusted kinship or extended family networks of the informal economy.
- Shortages of critical inputs such as electricity and fuel, and the dangers of transportation further encouraged informal entrepreneurs to rely on tribal and extended family associations for protection and support.
- As noted above, endemic corruption and uncertainty have contributed to a dramatic increase in the informal sector following the 2003 invasion. As a result approximately eighty percent of the labor force is now engaged informally, accounting for nearly two thirds of Iraq's gross domestic product.
- Growth of the informal economy is particularly evident in certain areas west of the capital, where the destruction of the Sunni-oriented military establishment and related industries has contributed to a substantial contraction of formal activities and jobs.
- A principle driver of this growth has been a dramatic rise in criminal activity related to the shadow economy and dominated by local-level tribal elements, including the emerging economies based on the distribution of scarce resources, kidnapping, trafficking in petrol, narcotics, looted weaponry, and the targeting of coalition forces.

- In areas beyond the control of the Iraqi government and lacking a substantial coalition presence, the shadow economy is rapidly displacing any legal or semi-legal structures that may have survived until the present.

The removal of the Hussein regime and the actions of the CPA presented a range of opportunities and constraints that have in part determined the manner in which street-level groups have mobilized and generated new opportunities and constraints for both the original organizations and follow-on groups over time. This evolution has gone through three distinct phases: (1) March 2003-December 2003; (2) December 2003-January 2005; and (3) January 2005 to the present.

March 2003-December 2003

During this initial phase, the persistent lack of security and the policy directives issued by the CPA accounted for the greatest opportunities for armed groups to expand their positions locally. Within this period the most prominent actors at the street-level in term of mobilization potential, organization and stature within the surrounding community were those legacy groups of local/kinship based “tribal” associations reminiscent of the period under sanctions.

These groups are composed of pre-existing social groups (some former regime elements, and perhaps regime opponents) within the tribe that come armed and equipped, and they are activated by conflict, inspired leadership and the prospect of loot.

A second tier of gangs was comprised of those groups engaged in entrepreneurial and organized criminal activities, also a legacy of the sanctions. These gangs are largely based on local associations. While there is some degree of overlap between these two tiers the fact that many tribal groups maintained militias precisely to protect their local economic interests from Ba’ath encroachment prevented an alignment between these two groups—at least in the immediate aftermath of the invasion.

The chaotic lawlessness of this period presented a significant opportunity for groups in both tiers to solidify and extend their presence locally. Hesitation on the part of coalition forces to manage the deteriorating security situation in most urban centers, particularly Baghdad, acted as a catalyst in the very process of institutional devolution that had been occurring under the Hussein regime. The vacuum that developed in the weeks following the invasion increased the scale and intensity of this process as the role of self-protecting mutual assurance groups responded to the precipitous decline in law and order.

In sum, CPA policies of “de-Ba’athification,” disbanding of the Iraqi national army, and the Coalition’s ambivalence toward the rise of militias presented a second opportunity for street level gangs to expand their influence and control of resources. By the closing months of 2003 the die had been cast.

December 2003-January 2005

Hostilities between coalition troops and local populations, the inability of coalition forces to adequately repress insurgent violence, and the return of sovereignty to the Iraqi government provided the most significant opportunities for the various local networks to expand during this second period.

First, the dominant groups at this stage reflected a three tiered structure. The networks corresponding to the two most prominent groups began exhibiting a high degree of overlap:

- The combination of tribally-based former security personnel and criminal groups comprised the first tier.
- The second and third tiers were occupied by indigenous elements motivated by vendetta, and extremist Islamic ideologies, respectively.
- Factors such as the collateral costs of the Fallujah operations and the abuse of detainees at Abu Ghraib, represented a substantial political opportunity by further legitimizing the existence of armed street-level groups.

This environment facilitated the emergence of the second and third tier of violent street level actors. These actors, predominantly foreign in the latter case, were easily absorbed by the expanding networks of street levels groups. These groups provided both the means and an added incentive to engage in anti-coalition targeting by offering generous monetary incentives.

This pattern of network evolution was further stimulated by shifting budgetary patterns after June 2004—the time the CPA transferred control of government portfolios and the national budget to Iraqi ministries. This shift in budgetary authority represented a political opportunity for the street-level groups. Specifically, the allocation of state assets reflected a new budgetary dynamic that tended to favor those interests centered in Baghdad over the remote provincial areas. As a result, the capacity of the coalition to respond to conflict conditions and proceed with reconstruction was seriously weakened.

Second, newly appointed ministers fostered a climate of parochialism by attempting to establish an independent, self-supporting infrastructure within the new institutions under their control. The relationship between the Ministries of Interior and Defense is instructive. Both ministries assumed control of an array of smaller “special” units comprised of thousands of supporters and local affiliates, sustained by diverted funds intended for aid and reconstruction.

January 2005 to the Present

In addition to a continuation of many of the dynamics noted above, this period has been marked by a set of new opportunities created by elite cleavages within the National Assembly, the increased politicization of militias and the continued expansion of the shadow economy.

Changes in the street level dynamic have been consistent with the opportunities for expansion. Again a first-tier of networks exists, possessing a high degree of overlap between entrepreneurial and organized criminal networks. They are comprised largely of Iraqis harboring some form of vendetta or personal grievance against the coalition. A second tier of actors is comprised of foreign and domestic Islamic extremists.

As in the earlier two periods, demand for weapons, stolen goods, and hostages determine the roles and relationships between street-level actors more so than ideological or political convictions. Yet in this phase, engagement in the black market has not merely enabled sustained street-level activity, it has in many cases become the activity itself, dominating collective resources and driving group expansion in terms of capabilities and reach. The shift is evident in certain portions of al-Anbar province where despite frequency of anti-coalition targeting, criminal endeavors are now thought to account for the bulk of street-level activity. Clearly the draw of the shadow economy is a major factor tending to decrease the likelihood that Sunni groups will participate more in the political process in the near term.

Summing up the evolution of local network development in Iraq, a pattern emerges whereby during each phase of the post war period the position of locally-oriented armed groups has been

solidified and expanded in a manner consistent with the type and timing of the political opportunities available. The most significant opportunities have included:

- The slow recognition of security conditions facilitated the establishment of armed groups in the first phase. This first phase also represents the playing out of the structural conditions stemming from the sanctions regime.
- An appreciable shift in the street level dynamic in terms of the relative predominance of certain actors in the second and third phases. This transition has favored the position of indigenous groups radicalized through interaction with the coalition, with a higher degree of overlap between all groups and the shadow economy in the current phase.

State level political openings may lure some elements of resistance into the political process, but in the present phase, the draw of the shadow economy may be sufficiently strong to keep groups engaged in street-level violence.

Assessment

Several years have passed since the removal of Saddam Hussein, yet there are few indications that the degree of Sunni-led violence will decline. On the contrary, violent activity has increased in frequency and scale over this period.

The evolution of local insurgent/criminal networks in Iraq suggests several mechanisms that are consistent with this acceleration of violence. One theory—that associated with the theory of third generation gangs, or the 3G2 model^[23] provides valuable insights as to the manner in which these groups are likely to evolve and the best methods to arrest their development.

Specifically, the 3G2 model suggests that armed groups function within a rationally bounded and organized space that is responsive to forces affecting the calculus and outcomes of group behavior. When modified by state authorities, these forces represent potential opportunities to minimize, deflect, or redirect the activities of the group.

Many of the structural conditions found in Iraq are key constructs of the 3G2 model. In particular, the existence of violent networks in the context of a state that is constrained by minimal capacity, poor economic performance, and significant social and political disparities are key elements of the model. The 3G2 model also assumes that self-protecting solidarity groups are heavily engaged in the informal and criminal economies at the local level. Insurgent/criminal networks in Iraq are analogous to the form and functions performed by street-level gangs—the basic element of the 3G2 concept.

As the 3G2 model would predict, insurgent and criminal groups in Iraq have expanded their economic and political positions vis a vis the state through corruption and intimidation. Further the model posits that 3G2 actors themselves initiate this process for the purpose of establishing lawless areas and criminal enclaves or quasi-states.

The acceleration in violence in Iraq throughout most of 2006 suggests that the informal and shadow sectors will continue to dominate the economic landscape in the near term and will likely grow as the markets associated with insurgent violence expand. The criminal economies based on theft, weapons trading, mercenary kidnappings, black-market smuggling and arbitrage that have become the cornerstone of insurgent mobilization will continue to operate with very few constraints and will likely increase in proportion to increasing levels of violence.

Conclusion—Hope for the Future

The integrated model shows that insurgent-group activity can be viewed as part of the continued effects of the structural forces prevalent in Iraq. The choice to engage in violence is one element of a strategic rationale informed by conditions of scarcity and the functions armed groups perform locally. This rationale also shapes the competitive dynamic that drives the expansion of insurgent groups into the political and economic realms. Therefore the behavior of locally-based groups can be affected by manipulating societal and local-level factors, the most significant of which are the size and composition of the underground/shadow economy and the openness of the legitimate political sphere. These areas comprise the key vulnerabilities of the insurgent/criminal groups in Iraq.

Resolving critical shortages and introducing balanced reforms in the formal sector will slow or reverse the growth of the informal and shadow economies. These measures would significantly undercut street level mobilization structures by co-opting the functions of tribal and sub-tribal groups while diminishing the pull of the shadow economy which fuels insurgent activity. Openness at the political level would similarly undercut or co-opt the rising political stature of armed leaders by channeling them into a legitimate political process.

Clearly, greater emphasis should be placed on limiting the growth of the informal and criminal economies, which are easily captured by criminal/insurgent networks. Iraq's present set of economic policies are legacies of the Coalition Provisional Authority (CPA) period. As in many other developing countries, they were intended to produce a thriving, free market economy. These policies reflect much of the reform agenda commonly known as the Washington Consensus, emphasizing fiscal discipline, re-prioritization of public expenditures, privatization, trade liberalization, deregulation, foreign direct investment, property rights and good governance in general.^[24] Three years later many of these reforms are only partially or haphazardly in place, contributing the expansion of the vibrant informal and shadow economies at the expense of formal sector development. In this environment massive infrastructure projects and high levels of government spending may simply be funneled into the informal economy making the situations worse rather than better.

One course of action is to try and press ahead with the completion of market reforms. However, given the current political atmosphere in Baghdad with so many government officials having a vested interest in preserving their lucrative links to black markets and the underground economy, this is unlikely to occur until major strides are made toward controlling corruption. Even price reforms will take time to begin slowing the growth of the underground markets. For example, while gas prices are gradually rising as part of an International Monetary Fund (IMF) program^[25], the impact on the shadow economy has been somewhat due to the still prevalent oil price differential between Iraq and its neighbors.

Based on the interrelationships noted above, perhaps the best approach and way of utilizing the \$5 billion annual aid package recommended by the ISG is to re-introduce many of the pre-2003 state-based social services with emphasis placed on slowing or reversing the impetus to join the informal and shadow economies. These measures would significantly undercut street-level mobilization structures by co-opting the functions of tribal and sub-tribal groups while diminishing the pull of the shadow economy which fuels insurgent activity.

A variant on this course of action would be the reorientation of economic programs from the post-war centralized top-down orientation toward one that is decentralized and inclusive. This reorientation is likely to erode somewhat the popular or at least passive support for the insurgency—the more people with a stake in the decision making process and economic outcomes, the greater included in the decision making process.

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