Expeditionary Economics

Make Entrepreneurs, Not War

BY ROBERT LOONEY

The hearts and minds of the citizens of impoverished countries, we've been told time and again, can't be won without filling their bellies. Yet nine years after the U.S. invasion of Iraq – and tens of billions in reconstruction aid later – Iraq's GDP barely exceeds the prewar high. Worse, the economy remains almost wholly dependent on oil, which generates 90 percent of tax revenues and more than 80 percent of export revenues.

Now, NATO is rapidly winding down its presence in Afghanistan. And the Afghan economy, which is almost totally dependent on foreign aid and crumbs from the U.S. military's table (along with opium), is likely to go into a tailspin as donor countries recoil from Afghanistan's incompetent governance and failure to contain pervasive corruption. What is the point of spending trillions of dollars and hundreds of thousands of lives (American and Afghan) to secure a hostile country if the economic mess we leave is as bad as the one we inherited?

What, indeed. Hence, the emergence of a new field in economics, dubbed "expeditionary economics" by Carl Schramm, the former head of the Kauffman Foundation. That concept focuses on the development side of the military equation. The gist is straightforward: economic growth is vital for stabilizing post-conflict and post-disaster settings, and the U.S. military, often the dominant player in such environments, must sharpen its ability to encourage indigenous entrepreneurship. It is Schramm's contention (and mine) that the conventional U.S. approach in recent post-conflict recoveries has failed largely because it has failed to focus on precisely this objective.

The expeditionary economics approach is based on a pair of propositions. First, even in highly unstable settings, entrepreneurial activity can flourish and provide employment, essential goods and financial stability for the local populations. Second, successful local entrepreneurs, particularly those involved in new firms, have a vested interest in improved governance – the rule of law and control of corruption. So, once they become established, entrepreneurs will lead efforts to achieve those goals. With these processes in play, Schramm argues that sustained economic growth, and thus stability, can be attained in what were previously considered impossible situations. And at least one case study, of the impact of the coffee industry in post-genocidal Rwanda, suggests he's right.

IRAQ, THE MORNING AFTER

Most of the core propositions of expeditionary economics can be traced to the U.S. experience in Iraq. Since the 2003 invasion, Iraq's economy has floundered badly. Despite vast amounts of assistance along with increasing oil revenues, the country has been plagued by chronic unemployment – the government claimed joblessness had fallen to "only" 16 percent in 2012. Underemployment is harder to measure, but is almost certainly much higher.

Pretty much all job creation in the formal economy has been make-work in the public sector. A shadow economy continues to employ a large segment – perhaps 40 to 45 percent – of the labor force. As in other countries, though, it operates at low productivity because it has little access to capital and cannot enforce contracts through legal means.

In the initial stages, the U.S. strategy for repairing the Iraqi economy after the fall of Saddam Hussein seemed promising. It was drawn up along lines similar to the shock-therapy transition programs successfully implemented in Chile under the Pinochet regime in the 1980s and in Poland after the overthrow of Communism. In devising their strategy, American planners drew heavily on the conventional wisdom in vogue in the early 1990s – neoliberalism as embedded in the standard Washington Consensus formula (macroeconomic stability, fiscal prudence and free markets) – so often prescribed in times of crisis by the International Monetary Fund.

The cornerstone of the strategy was to create an independent central bank charged with maintaining price stability that would be able to resist pressures to finance big government budget deficits. The primary goal (after stabilization) was to unleash the competitive forces suppressed by Saddam, thereby increasing productivity. As in post-Soviet settings, though, a secondary objective was to make the transition irreversible – here, by destroying state-dominated Ba'athist institutions and replacing them with decentralized, market-oriented ones.

The Americans were convinced that a Chile-like, competitive, noninflationary economy would serve as the ideal environment for job creation through private-sector innovation and investment. Accordingly, almost all barri-

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ers to international trade were eliminated. (A 5 percent across-the-board tariff was allowed, though largely as a revenue raiser.) And foreign investment was welcomed, both as a means to supplement anemic Iraqi savings and to obtain modern industrial technology. The only levy, apart from the import tariff, was a Steve Forbes-type 15 percent flat tax on consumption. An $18 billion infrastructure program was focused on lowering private sector production costs. Job One for the Iraqi government was to keep out of the way.

But the strategy was designed without consulting Iraqis who knew anything about the economic culture. And, of course, Iraqi bureaucrats with practical experience in governance – most of whom had lost their jobs because they'd been members of the Ba'athist Party – played no role in the early implementation of the program.

The limitations of this strategy quickly became apparent. It offered nothing to the large numbers of Iraqis lacking either marketable skills – a dismayingly large group, since public education fell into decay under Saddam – or capital for small businesses. The legacy private-banking system, which was stuck holding Saddam's bad debts, was on the verge of collapse. And besides, the banks had little experience in commercial lending. As a result, most Iraqis were left out in the cold, fueling widespread anger that was easily mobilized by extremist sectarian groups.

In this violent, politically uncertain environment, it proved impossible to attract the private investment (domestic or foreign) on which the whole strategy depended. The result was a vicious circle of private sector underperformance and high unemployment – and little hope of change, thanks to widespread, economically disruptive violence.

Note that the strategy was premised on the notion that initial private sector successes would empower the winners to push for further economic reforms and improved governance, so that the growth process would take on a momentum of its own. But there was no Plan B. What's more, the vacuum created by the government's pullback from day-to-day economic activity was filled by organized religious and criminal groups whose interests hardly coincided with the commonweal.

Even after the violence in Iraq was largely suppressed, organized crime abetted by pervasive government corruption (Iraq ranks near the bottom at 175th on Transparency International's 183-country Corruption Perception Index, just behind Haiti) stifled entrepreneurial activity and undermined public trust in government institutions. Such trust in, among other things, the enforceability of contracts and property rights, is critical to efficiency in market systems. Thus today, entrepreneurship succeeds only at the sectarian level, where high levels of trust remain.

Advocates of expeditionary economics have noted the folly of top-down economic planning in countries with little means of implementing it. The Iraq strategy focused on long-term goals with little regard for the task of getting from here to there – in particular, the challenge of giving large numbers of people a stake in its success, early in the process.

Government ministries, excluded from planning, were ill-prepared to assume authority after the withdrawal of U.S. forces. Many projects are simply rusting away because the Iraqi bureaucracy has refused to accept responsibility for ongoing management and maintenance costs. The resulting waste of aid and reconstruction resources has been staggering.

A major lesson here is the wisdom of minimizing conflict with the existing culture. With little social capital to lean on, entrepreneurial activity in Iraq has the greatest chance of thriving at the local level. If a bottom-up strategy stressing community-based development had been adopted and nurtured by the occupying forces, it might have been sustainable, and Iraq's prospects would not have been so grim in the wake of the U.S. withdrawal.

CAN AFGHANISTAN BE SAVED?

Back to the conflict in the forefront of current discussions of expeditionary economics. Over the last decade, the influx of military contracting and development projects has fueled rapid expansion in the Afghan economy. Although still near the bottom on almost all development indicators, GDP (measured in terms of purchasing power) roughly tripled between 2003 and 2011.

This growth, however, does not herald the rise of a viable Afghan economy. The capacity (and maybe the inclination) of the government to deliver basic services remains severely limited, and government presence in remote areas is sketchy at best. Illegal activity continues to thrive, further undermining the central government's tenuous authority and influence. Opium-poppy production remains by far the most dynamic economic activity, generating vast profits that are too often used to finance the Taliban insurgency.

Indeed, 10 years after the overthrow of the Taliban government, the World Bank estimates that the international military presence and donor contributions account for more than 97 percent – that's right, 97 percent – of Afghanistan's legal GDP. Despite attempts to promote manufacturing and other industry, subsistence farming remains the mainstay of the indigenous economy. Adding to Afghanistan's woes, the flood of international aid and military contracts has fueled inflation and created a real estate bubble. Housing prices in suburban Kabul rivaled those of European capitals before air started leaking from the bubble last fall.

The coalition's withdrawal in 2014 will likely trigger a rapid decrease in foreigners' spending, and a commensurate collapse in real estate. Wealthy Afghans are already buying up property in Dubai at a record pace. Even the World Bank, which tends to err on the side of understatement, concedes that economic growth could turn sharply negative. That would destroy a lot of jobs created in the last decade, most significantly for young men employed by private security companies. They might well turn to the Taliban, organized crime or regional militias for income.

Researchers at Tufts University have concluded that much of the blame for this precarious situation lies in the way that Western foreign aid has been managed. Rather than generating good will, development projects are viewed negatively by most Afghans. At the very least, the widespread sense that aid resources are being misused further tarnishes the image of the Afghan government; at worst, it shifts the blame for the utter failure of the Afghan state from Kabul to Western aid agencies.

Aid failure in Afghanistan can be traced to the faulty premise that improved socioeconomic conditions would stabilize and pacify the country. In truth, rapid growth has been destabilizing since it raised the stakes in the competition for power and resources among the country's regional militias and ethnic factions. Lack of coordination on the part of the major donors, combined with the narrow focus of most assistance programs, has further hindered attempts to build the institutions of governance that are prerequisites to sustainable growth.

But what looks hopeless through a conventional lens seems very different from the perspective of Carl Schramm and company. They are convinced that entrepreneurial activity is compatible with ongoing conflict – albeit in somewhat distorted fashion. And field work in Afghanistan sponsored by the Kauffman Foundation suggests that, despite government and donor neglect of Afghanistan's private sector, it has tremendous potential for generating employment.

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Long-held stereotypes about entrepreneurs in conflict settings were found to be dead wrong. Indeed, based on some 130 interviews, Jake Cusack and Erik Malmstrom (U.S. military combat veterans in Iraq and Afghanistan who went on earn graduate degrees at Harvard) concluded that Afghan businesses respond rationally to incentives – and that uncertainty, not physical insecurity, is the fundamental obstacle to growth.

The Afghan government is part of the problem, not the solution. It fails to provide basic services, yet demands fealty and bribes that raise the cost of doing business – in particular, the cost of starting a business with little capital. And both military contracting and foreign aid exacerbate the problem by giving the government more leverage over access to jobs, capital and markets. Businesses survive by focusing on trading rather than long-term market relationships and by purchasing protection from the relevant warlords. But the drag on productivity is daunting.

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The one bright spot in the effort to stimulate indigenous enterprise has been the country's recent bottom-up attempt at improving governance and raising small-business productivity, using aid cash as an incentive. The National Solidarity Program created community development councils in most villages. This allowed community groups to take the lead in planning local infrastructure investments – schools, water pumps, irrigation systems – that are 90 percent funded by aid. (A 10 percent match is required, so locals have some skin in the game.) All told, roughly $1 billion has been spent in 29,000 villages.

But the National Solidarity Program has been the exception to the rule in a country that has pocketed at least $50 billion in economic aid since the Americans arrived, along with countless billions in the form of services purchased by NATO. Corruption is everywhere, undermining critical institutions like those needed to enforce contracts and raising the cost of doing business. It's no wonder, then, that Afghanistan ranks a dismal 160th on the World Bank's Ease of Doing Business Index (down six places in 2012, and behind such exemplars of free enterprise as Equatorial Guinea, Burkina Faso and Ukraine). Simply registering a change in ownership of property takes an average of 250 days.

It's very late in the game to apply an expeditionary-economics-based strategy to Afghanistan. But the United States is committed to providing more aid; at the very least, a consistent policy of bottom-up assistance to entrepreneurs would offer hope to some Afghans as well as provide a donor-learning experience that would be applicable to the next conflict.

THE NEXT TIME

Though one can hope that the United States and its allies will avoid conflicts on the scale and duration of Iraq or Afghanistan, many themes common to those conflicts are likely to re-emerge down the road. Countries will be confronted by the challenge of groups of militants or criminals (or both) that find sanctuary inside failed states. In the absence of strong governments to expel them, these groups often mobilize popular support and extend their control by assuming some of the functions of government, including the delivery of services and suppression of violence.

As a result of their experiences in Iraq and Afghanistan, Western armed forces have come to the realization that this setting does not lend itself to a purely military solution. While ground can be captured, it cannot be secured and stabilized without the support of the local population. Thus, to be successful, operations must include reconstruction as a key component.

Specifically, the U.S. military was able to assist in both countries through the Commander's Emergency Response Program, in which officers designed and implemented local projects like building schools, roads and other essential infrastructure. To jump-start local economies, these programs could be easily extended to support local entrepreneurs, providing them with seed money and security.

Both the Iraqi and Afghan cases demonstrate the vitality of entrepreneurship in situations previously thought to be infertile ground for business start-ups. And they support the conviction that comprehensive economic governance reforms aren't a prerequisite for self-sustaining economic growth.

One major policy failure in both Iraq and Afghanistan was the lack of an effective exit strategy. In both cases, the withdrawal of forces left vacuums in which no significant groups had vested interests in carrying reforms through to completion. To the contrary, those who have inherited power have incentives to derail the reforms.

The analysis of Mancur Olson, a prominent American scholar in the development of what is called public-choice economics, helps in assaying the role of entrepreneurs in this context. Olson distinguished between "distributional" coalitions, whose actions tend to undermine economic growth by protecting their own privileges, and "encompassing" ones, whose interests align with broader societal goals. Clearly, local communities must provide sufficient checks to prevent the emergence of distributional coalitions.

Looking ahead, there are likely to be situations in which countries – think of Pakistan – attempting to stem violence or quell insurgencies, or both, are nonetheless unwilling to accept the presence of foreign military force. Here, expeditionary economics could play a significant role, particularly in areas that are currently out of the effective reach of the central government.

Pakistan has a professional military that (with additional training) could assist in the establishment of new entrepreneurs. Moreover, the government's New Growth Framework, a sophisticated economic plan (aspired to, if not always followed) is entirely consistent with this sort of grass-roots encouragement of enterprise.

Since the Pakistani military is stretched thin and cannot provide adequate security in every arena of conflict, fresh thinking would be needed to implement an expeditionary economic approach. One possibility: the creation of secured reconstruction zones along the lines that were successful in Afghanistan and in Haiti (in the aftermath of the devastating earthquake in 2010).

In extreme situations, a more radical approach, like the establishment of self-supporting, self-governing zones similar to those under consideration in Honduras might be needed. (Honduras plans to create "charter cities" – what amount to greenfield cities – that provide security, infrastructure and financing for new businesses.)

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Entrepreneurial economics as an alternative to traditional aid-based strategies is gaining currency. Recent research by Raymond Gilpin of the U.S. Institute of Peace and Gayle Lemmon of the Council on Foreign Relations has documented the viability of job-creating entrepreneurship in fragile settings. Moreover, "fragile" applies to circumstances short of war, like post-earthquake Haiti or even post-tsunami Japan, where the government has created special tax and regulation zones designed to attract entrepreneurs. The lessons here are well worth another look. M