

## **Entrepreneurship in a Post-Conflict Society: Iraq**

### **Chapter 10 of Political-Economy of Iraq**

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*“Economic attitudes and mentalities of the propertied urban classes in Babylonia [6<sup>th</sup> century BC] can be described in terms of two basic (although necessarily idealized) models: a **rentier** type and an **entrepreneur** type. Rentiers seek to obtain a reliable income from mostly inherited positions and resources with little risk, by exploiting prebends [temple benefices] and landed property. Entrepreneurs tend to engage in highly profitable but also risky venture businesses in a competitive environment.”* Cornelia Wunsch (2010) “Neo-Babylonian Entrepreneurs”

*“One can only note what appears to be a remarkable correlation between the degree to which an economy rewarded productive entrepreneurship and the vigor shown in that economy’s innovation record.”* William J. Baumol (1990)  
“Entrepreneurship: Productive, Unproductive, and Destructive”

#### **Introduction**

Iraq faces a severe unemployment problem because of its rapidly growing population. Any year in which the economy creates less than 240,000 new jobs will lead to further growth in the pool of unemployed young men with the associated political instability. As discussed in the previous chapter, the public sector is limited in its capacity to absorb each year’s addition to the labor force since government service is already severely overmanned with almost 50% of Iraq’s labor force directly or indirectly on the public payroll. And the government is almost entirely funded by earnings from oil exports; therefore its revenues are on a roller coaster driven by world oil prices.

Prior to 2003, with the exception of non-grain agriculture, the private sector was suppressed as part of the Ba’athist Party’s socialist philosophy. Since then, private sector growth has been concentrated in the informal sectors of the economy. The quality of employment data is very low but an estimated 20% of the labor force was employed in the informal economy in 2009. As expected, most firms in the informal economy are very small and in the service sectors.

In economic terms, Iraq is well inside its production possibility frontier and that frontier is moving out at a rapid rate. To reduce unemployment and achieve higher living standards for its people, Iraq needs to expand its non-oil dependent economy. The creation and rapid growth of micro-small-medium enterprises (MSME) has the best potential to create the jobs needed. While the situation is complex, it appears that the binding constraint on the expansion of private-sector MSME is a mismatch between the demand for and supply of entrepreneurs in Iraq combined with very high transaction costs for entrepreneurial acts.

This chapter begins with a basic discussion of the two types of entrepreneurship. Although Kirznerian (arbitrage/speculative) entrepreneurs and Schumpeterian (innovative) entrepreneurs have similar motivations, their impact on the Iraq economy is very different. Next is an examination of the demand for entrepreneurship in Iraq. This demand is a function of the three salient characteristics of post-2003 Iraq: (1) it is a developing country that is (2) transitioning from central planning or state-guided capitalism, (3) during severe conflict. This chapter will then look at determinates of supply including the incentives that might “divert” potential entrepreneurs from productive entrepreneurship into unproductive rent-seeking behavior. (See Desai, Acs, and Weitzel 2010, 1-3; Baumol 1990, 897-8). This will be followed by a discussion of the transaction costs of being an entrepreneur in Iraq. Excessive transaction costs act as a “wedge” between demand and supply that prevents some entrepreneurial acts even when the relative demand and supply are such that these acts, in the absence of transaction costs, would be highly profitable. This analysis of the supply, demand, and transaction costs of entrepreneurship in Iraq will allow the identification of the binding constraints on entrepreneurship growth. The chapter will end with a discussion of possible policy changes that might accelerate economic development in Iraq by facilitating entrepreneurship.

While there has been relatively little empirical research on entrepreneurship in Iraq, the CIPE surveys (2008a and 2008b) and the high quality analysis of Desai et al (20XX) have laid a strong foundation for future work.

### **What do entrepreneurs do?**

*Entrepreneurs are individuals who, in an uncertain environment, recognize opportunities that most fail to see, and create ventures to profit by exploiting these opportunities.*  
(Gunter 2010)

It is widely accepted that entrepreneurs specialize in business related “judgmental decisions” where there is no obviously correct answer *and* information is costly. (Casson 1987, 151; see also Casson et al 2006, 3-4) In other words, entrepreneurs make business decisions based on insight in an uncertain environment. Uncertainty is different from risk. Risk occurs when there are well-defined possible outcomes, a sufficient sample size, and an accepted statistical procedure. (Knight 1921). If one or more of these characteristics is missing then a possible outcome is uncertain. In other words, in cases of risk, decision makers know the true underlying probability distribution of a

possible event while, in cases of uncertainty, the true probability distribution is unknown. (Parker 2009, 33) For example, bringing a dramatically different product to market and attempting to fill an inside straight in poker are both very unlikely. However, while the former involves true Knightian uncertainty, the latter is simply a matter of risk.

The entrepreneur faces a challenge when he or she seeks to profit from his or her judgmental decision or insight. Usually, the entrepreneur's ability to immediately sell the insight is severely limited because the insight is either too simple or it is too complex. If too simple then it is unlikely that it can be protected as intellectual property and the mere description or demonstration of the insight to a prospective purchaser will allow its theft. At the other extreme, since many innovations are based on non-linear thinking or intuition, it is difficult to convince another that the insight will eventually lead to a substantial return on investment. As a result, the most common method for an entrepreneur to benefit from an entrepreneurial act is to establish a new firm.

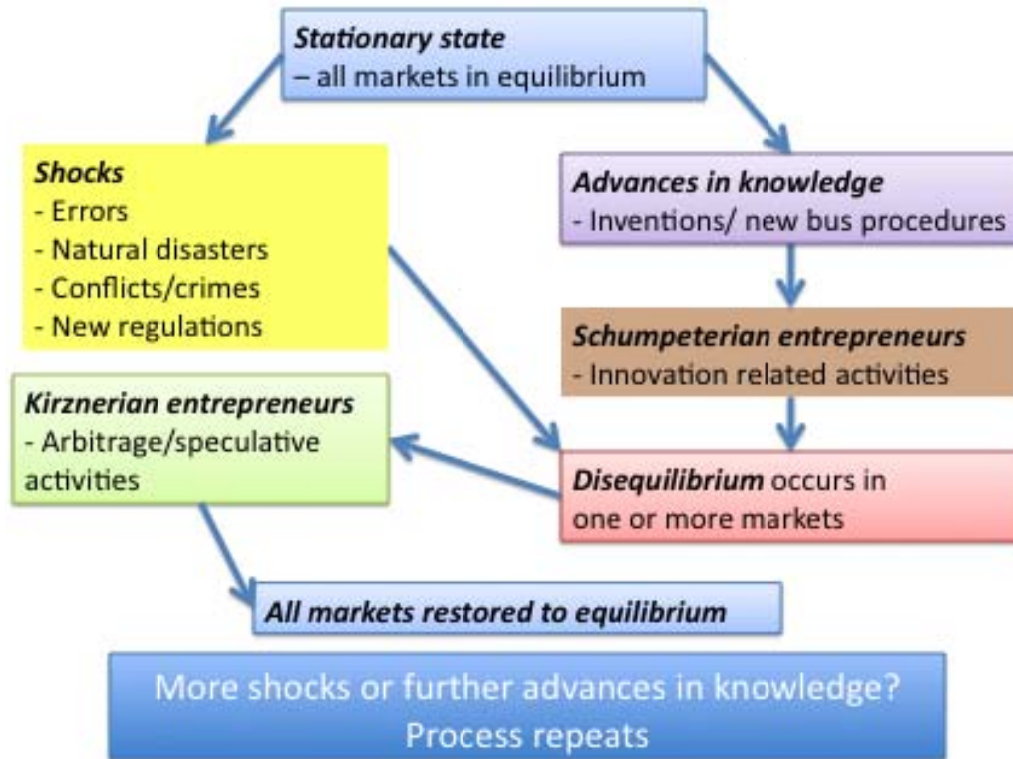
Especially in a developing, transitional economy like Iraq, it is useful to distinguish between Kirznerian and Schumpeterian entrepreneurship. The former primarily involves arbitrage or speculation. Error, conflict, natural disaster, or sharp regulatory changes create disequilibria in one or more markets. The Kirznerian entrepreneur – motivated by profit – gambles on new ways of buying in one existing market and selling in another market. Of course, these entrepreneurial acts of arbitrage or speculation both resolve market disequilibria and reduce profit opportunities for other entrepreneurially oriented individuals seeking to perform the same arbitrage or speculation. (Kirzner 1979, 92) In other words, a successful Kirznerian entrepreneur moves an economy from inside its existing production possibility frontier towards its efficient limit.

The Schumpeterian entrepreneur is also motivated by profit. However, he seeks to earn profit through innovation even in markets that are in equilibria. He or she perceives new possibilities for products, markets, manufacturing processes, etc. that are not apparent to others. If the Schumpeterian entrepreneur is successful then creative-destruction will occur. As new processes, products, or markets are created, old products rapidly lose market share, former manufacturing processes are unexpectedly rendered obsolete, etc. (Schumpeter 1911/1934, 214 & 228) A successful Schumpeterian entrepreneur shifts an economy's production possibility frontier outwards.

Figure 1 illustrates the interrelationship of innovative Schumpeterian and arbitrage/speculative Kirznerian entrepreneurs. The demand for entrepreneurial acts, from which the demand for entrepreneurs is derived, is a function of change. A state that is experiencing no change (no change in consumer preferences, production methods, trade patterns, demographics, etc.) will have little demand for entrepreneurs since uncertainty is low and any profits for filling gaps in this stationary state economy have long since been competed away. (Kuran 2010, 64)

Of course, such a stationary state is hypothetical. Shocks or advances in human knowledge constantly disturb real economies. The former causes disequilibria in multiple

markets that provide arbitrage/speculative profit opportunities for Kirznerian entrepreneurs. Advances in knowledge create innovative profit opportunities for Schumpeterian entrepreneurs that lead to the disruption of existing markets as new markets, new products, or new processes render existing practices obsolete. Thus Schumpeterian entrepreneurship also creates disequilibria and, therefore, opportunities for arbitrage/speculation on the part of Kirznerian entrepreneurs.



Aside from their impacts on market equilibria, Kirznerian and Schumpeterian entrepreneurs also differ in their characteristics. Successful Schumpeterian entrepreneurs tend to have more formal education, create larger entities, and require more finance. Kirznerian entrepreneurs are more likely to establish small – possibly single person – firms, tend to have limited education, and their limited need for finance can often be met from informal sources such as family.

Since Schumpeter's seminal work, there has been an increased interest in the impact of entrepreneurs on economic development. And there has been some progress in determining the characteristics of entrepreneurship in developing countries. Most relevant to a discussion of entrepreneurship in Iraq are:

1. At a low level of economic development, much entrepreneurial activity is invisible to an outsider or an official. Among the reasons for this invisibility is that entrepreneurs

seek to avoid taxation, demands for bribes, or hostile regulations by establishing themselves in the informal economy.

2. Entrepreneurial activity can be either “opportunity driven” or “necessity driven”. In the former case, someone becomes an entrepreneur as a matter of choice while, in the latter case, a person becomes an entrepreneur because he or she has no other options. Acs (2006, X; and also see Estrin et al 2006, 712-4) notes that opportunity driven entrepreneurial activity has a greater impact on economic development. It should be noted that most entrepreneurship in Arab countries is necessity driven. (Noland and Pack 2007, 245)
3. Entrepreneurs in developing countries tend to spread their attention over several related businesses as a form of diversification. (Stevenson 2010, 174; Lingelbach et al 2005, 3) It is almost a cliché that when an Iraqi entrepreneur decides to give you a business card that he has to shuffle through the cards of his multiple businesses in order to give you the correct one.
4. In many developing countries, the personal and professional rewards to unproductive rent seeking are greater than those of productive entrepreneurship. There may be higher profits from persuading the government to award you a monopoly for producing a product developed by someone else than for you to successfully develop and market a product yourself.

### **Demand for entrepreneurs**

Currently, Iraq is experiencing dramatic shocks. The major causes of these shocks are oil-funded economic growth, the transition from a socialist to a market economy, and the recovery from severe domestic and international conflict.

*Natural resource dominance.* First, as is well known, the Iraq economy is dominated by petroleum production and exports. Based on outdated surveys, Iraq possesses the third largest oil reserves in the world and this oil is accompanied by large quantities of natural gas. Petroleum already accounts for over two-thirds of the nation’s GDP and provides the funds to pay about 50% of the labor force. Petroleum export earnings are the source of over 90% of government revenue. The GoI is seeking to increase petroleum output and exports by more than 400% over the next decade. This will require massive foreign and domestic investment in the discovery, exploitation, refining, and transportation of oil and the accompanying natural gas. If the GoI is to succeed in then it will be forced to starve non-oil sectors of government funding. This is expected to disrupt the non-oil economy especially with respect to consumer goods and services as well as employment.

*Transitional economy.* Iraq is also engaged in a transition from centrally planned economic development - which long predates the Baath Party regime – to a more market oriented or capitalistic economy. This transition will require changes in both the macroeconomic environment – exchange rate, inflation, budget expenditures – and the microeconomic environments in Iraq. Based on the Eastern European experience, one would expect a shift: from industry to services, from domestic to international markets, and from intermediate to final goods. (Estrin 2006, 698) As expected, international

organizations such as the International Monetary Fund as well as U.S. Government tended to focus on macroeconomic stabilization, not improving microeconomic efficiency. This is similar to the pattern of business oriented policy advice throughout the MENA. It is thought that macroeconomic stabilization will eventually trickle down to benefits at the individual market or firm. (Stevenson 2010, 171) Unlike many Eastern European transitions, macroeconomic stability was achieved relatively quickly in Iraq. (Estrin 2006, 699) As discussed in Chapter 3, the currency is stable, the central bank has been willing to act aggressively to contain inflation, and the ratio of national debt to GDP is fairly low although the improvement in the last metric is more a result of debt forgiveness than rapid GDP growth.

As a transitional economy, Iraq also faces the problem that existing firms, both SOE and the few large trading firms, are products of the statist period and are, therefore, undergoing substantial change or spending a great deal of management attention attempting to avoid change. Either way, existing firms are more likely to be part of the problem than the solution when it comes to economic liberalization and employment creation. (Estrin et al 2006, 693)

*Post conflict society.* A third source of shocks that contribute to the demand for entrepreneurship is the rebuilding of a sanctions and war devastated economy. The GoI, the United States and the many international organizations that are involved in the post-conflict rebuilding of Iraq have focused on an intellectually simple but in practice extremely difficult challenge of returning the economy to its ante bellum state. In other words, these organizations have concentrated on returning infrastructure, state owned businesses and the general economic environment of Iraq to its condition in some previous, more favorable, period. There is some disagreement over what the proper ante bellum period should be. Should Iraq be restored to its situation in 2003 before the first bomb fell or to 1991 before Hussein's invasion of Kuwait and the international sanctions that followed?

But much of this rebuilding ignores the dramatic social, political, and economic changes in Iraq and the world since Saddam imposed a socialist template on the country. After the constraints of the long war with Iran, UN sanctions following Iraq's invasion of Kuwait, and the long-drawn out insurgency following the U.S. led coalition invasion of Iraq in 2003; there have been substantial changes not only in the product preferences of the Iraqi people but also in the people themselves. They have different skills and knowledge, the social circumstances have changed, and they have different wants. The impact of these changes is further complicated by the rapid rate of recent worldwide technological change since Iraq began its forty-five year experiment with socialism. As a result, Iraqi attempts to return to an ante bellum world are probably doomed. Business along with the rest of Iraqi society must adapt to new demands, new sources of supply and new technologies. This requires entrepreneurship.

In summary, these three ongoing large-scale changes – rapid development of its oil wealth, transition from central planning, and conflict recovery during a period of rapid technological change – mean that the Iraq economy should currently be operating in a

fundamentally different manner than in previous decades. The shape of the production possibilities frontier has shifted significantly.

This rapid change has created multiple unforeseen disequilibria in production and consumption throughout Iraq. Furthermore, markets in Iraq are fragmented geographically and, to an extent, ethnically. Products that are usually sold together are sold separately or on different schedules. Prices and supplies of many food products and utilities are controlled by various government agencies. The breakdown of the SOE has created a very confused situation in many markets. Some continue to produce various products although they are generally high-cost/low-quality producers but their products are heavily subsidized. In addition, about a third of the SOE are not currently producing any products but are attempting to obtain government loans or grants to restart production. This increases the risk to private firms attempting to produce competing products. Demand is currently strong but if the SOE reenter the markets with heavily subsidized products then private firms will find it difficult to compete. All of these structural and institutional changes have greatly enhanced the demand for entrepreneurs. But what kind?

*Iraq needs more Kirznerian entrepreneurs, Schumpeterian entrepreneurs – not so much.*

The three shocks discussed above have resulted in severe fragmentation of markets in Iraq. This follows the pattern of transitional economies in Eastern Europe. With respect to the types of entrepreneurship, Estrin et al posits two phases of demand for entrepreneurs in a transitional economy. In the first phase, the retreat of the planned component of the economy combined with the restoration of larger markets as security improves provides opportunities for Kirznerian (arbitrage/speculative) entrepreneurs. However, a substantial increase in the opportunities for Schumpeterian (innovative) entrepreneurs must wait for the restoration of macroeconomic stability and the acceptance of rule of law. (Estrin et al 2006, 697) Iraq has probably met the first requirement for successful Schumpeterian entrepreneurship but, as was discussed in Chapter 4, it is far from achieving an acceptable level of rule of law.

There is currently a large demand for Kirznerian entrepreneurs in Iraq. And, when rule of law is established, there will be a large demand for Schumpeterian entrepreneurs. But will there be supplies of entrepreneurs to meet this demand?

### **Supply of entrepreneurs**

Baumol (1990, 894), Schumpeter (1911), and others see the supply of entrepreneurs as determined primarily by culture and history and, therefore, exogenously determined. Although, it is important to note that entrepreneurs are not homogeneous. As Desai, Acs and Weitzel point out, entrepreneurs possess differing amounts of skills, discount factors, access to markets and networks (2010, 3) Therefore, the discussion of the supply of entrepreneurs in Iraq will consider not only the impact of history and culture but also the impact of rent-seeking and of two other characteristics that tend to be associated with

successful entrepreneurship – appropriate human capital and the capacity to make credible financial commitments. (Harris 1970, 348-9)

Are the Iraqis an entrepreneurial people? Since entrepreneurship tends to be associated with self-employment, a Gallup Organization survey on preference for self-employment provides some depressing results. Iraq, along with Egypt, Yemen, and Syria, has the lowest self-employment preference among young people in MENA. (Stevenson 2010, 185 GET GALLUP RESULTS) Why don't more young people in Iraq seek to be entrepreneurs? Countries that have recent experience with a market economy tend to have a more favorable entrepreneurial environment. (Stevenson 2010, 174) This is partly caused by the fact that entrepreneurs tend to come from families with previous entrepreneurial traditions. (Estrin 2006, 714) One might contrast the strong reaction to economic liberalization of the People's Republic of China with its roughly 35 years (1949-1982) of exclusive socialism to the more troubled reaction of the USSR/Russia which banished market activities for about 75 years (1914-1989). Iraq had about 45 years of socialism (1958-2003), which means that only the oldest family members remember relatively free markets. Another determinate of the supply of entrepreneurship and entrepreneurs is the general attitudes in a society.

*Cultural environment for entrepreneurship in Iraq.* While there is a continuing debate on which cultural characteristics are actually essential for entrepreneurship to flourish, the following characteristics receive a great deal of attention. Since entrepreneurs tend to be young and youthful societies tend to be more willing to try innovations. (Estrin et al 2006, 707) Iraq's low average age should contribute favorably to its entrepreneurship environment. Entrepreneurship friendly societies or cultures tend to focus more on the individual than the community, have less respect for authority or age, are more focused on financial rewards rather than position and status, and accept that any rewards from accomplishment should accrue primarily to the individual and not be mostly diverted to the members of an extended family, tribe, or the state.

About 97% of the Iraqi people are Muslim and most Iraqis state that their religion is an important influence on their lives. Therefore the supply of entrepreneurs in Iraq is, in part, a function of whether Islam provides a favorable environment for entrepreneurship. Some researchers look for evidence in religious writings or the history of Islam but these are difficult to interpret or often contradictory. (Lewis 2002 and Patai 1983) Kuran (2010, Chapter 3) argues that a more productive approach would be to examine how Islam and other cultural factors have shaped the institutions that affect present day entrepreneurship.

Since Mohamed was a merchant, it is no surprise that Islam was initially very entrepreneurial. In fact, as late as the tenth century, almost three-quarters of all Islamic religious scholars earned a living from business. (Kuran 2010, 66) In outstanding examples of successful entrepreneurship, Moslem traders crossed the world and founded active trading posts in many ports in Africa, India and China. Baghdad became a major world-trading center where merchants bought and sold hundreds of products from the far reaches of three continents. And the city was renowned for manufacturing as well especially textiles and metal products. Cross-national economic comparisons are always

challenging but the limited data available shows that Baghdad may have been the richest, most populous, most economically dynamic city in the world in the first centuries of the second millennium. Supported by an extensive system of irrigation, what is now Iraq supported an estimated population of over two million persons, approximately the same as the United Kingdom during the same period.

Baghdad's golden age of business, scientific and artistic creativity came to an end in 1258 AD when the Mongols sacked Baghdad. Most of the population was slaughtered or enslaved and the city was devastated. Attempts to rebuild were frustrated over the next century and a half by further vicious raids that not only smashed the urban areas in the Tigris and Euphrates valleys but also destroyed the ancient irrigation systems that had formerly fed a large and growing population. It wasn't until over six hundred years later, in the late nineteenth century, that Iraq returned to the population and per capita real income levels that the land had achieved before 1258 AD. (Maddison 2007, 192 and [www.ggd.net/Maddison](http://www.ggd.net/Maddison); Ansary 2009, 87-8)

Whether the destruction of Baghdad combined with later military setbacks in the West (the final "reconquista" of Spain in 1492, the failed Siege of Vienna in 1529, and the defeat at the Battle of Lepanto in 1571) shook the confidence of the Islamic leadership is difficult to determine. After all, the three major Islamic states continued to win battles on their periphery and dominate the social and political life of the core. However, in retrospect, Islam's period of incredible geographic expansion gradually came to an end to be replaced by a period of growing European influence in Islamic states. (Ansary 2009, 217-46)

According to Bernard Lewis, there was a gradual acceptance that the Islamic states were losing power and influence compared to the growing and innovative states in the West. This led to a search for the cause of this reversal of power. One widespread response was that believers had fallen away from the pure Islam of the first half-millennium after Mohamed and the long period of troubles for Islam peoples was the result. And, therefore, the remedy was to throw out any innovations that are not firmly grounded in the Qur'an or Sunnah (the words and practices of Mohammed) which are the sources of Shari'a - Islamic law. (2002, 151-60; Ansary 2009, XXX)

This centuries long movement towards a more conservative, less creative perspective on a variety of issues had an adverse impact on attitudes towards business in general and entrepreneurs in particular. It was necessary to ground business innovations in Islamic precedents. This had two consequences that still influence attitudes towards entrepreneurship in Islamic countries such as Iraq. Business institutions were developed that favored personal over impersonal exchange. In addition, the practice of justifying innovations in centuries' old writings concealed the significant innovations of the period.

Douglass C. North developed a framework for the study of exchange that might be useful. The most restrictive type of exchange has characterized trade through most of history. Such trade is limited to the "...personalized exchange involving small-scale production and local trade." (North 1990, 34-5) In the absence of what most would

recognize as established norms, rules, or laws, trade related agreements are “enforced” by repetitive transactions and shared cultural values among persons who know each other well.

Over time, there arose a second form of exchange that allowed transactions with persons who were not members of the same family, tribe or village. These transactions permit more complex agreements over greater time and distance. However, such exchanges are subject to demanding conditions. They required that the parties to such an exchange have “kinship ties, bonding, exchanging hostages or merchant codes of contract. Frequently, the exchange is set within a context of elaborate rituals and religious precepts to constrain the participants.” (North 1990, 34-5) An individual or firm who fails to live up to such an agreement can not only expect exclusion from future trade opportunities but also this trader will run the risk of being shunned or spurned by his community. These non-formal methods of enforcing exchange agreements are a complicated but effective entrepreneurial response to the lack of formal third party enforcement. (See Estrin 2006, 716-719 for a further discussion of “coping strategies”.) However, the transaction costs of negotiating such non-formal agreements are high.

North’s third form of exchange is impersonal exchange with third-party enforcement. This third party, usually a government, enforces agreements with reasonable predictability, fairness and cost. This allows the possibility of mutually beneficial transactions among domestic or even international strangers. The expenditure of effort to build and maintain the elaborate relationships required by the second form of exchange is unnecessary with effective third-party enforcement.

Islamic business culture is consistent with North’s first and second forms of exchange but is generally inconsistent with the third. The national governments of Islamic states have tended to avoid creating the institutions that would support private business activity with the possible notable exception of the building of grand bazaars in major cities. And the motivation for such bazaars might be more to facilitate the regulation and taxation of commerce rather than encourage it. (Kuran 2010, 77)

However, as long as most non-Islamic trading peoples primarily dealt in North’s first two forms of exchange, Islamic traders felt no disadvantage. But when institutions with reasonably efficient third-party enforcement of contracts appeared in the West, Islamic businessmen increasingly lost the competitive race. (Kuran 2010, 63 & 71) It is not that any modern Middle Eastern government lacks laws to govern sophisticated transactions among strangers. These institutions of a modern economy were established but not as a natural outgrowth of pre-existing domestic business institutions. Rather they were either imposed by colonial powers or adopted in an attempt to prevent the dominance of foreign traders and firms. This reduced their both their effectiveness and perceived legitimacy.

As a result, modern commercial laws in Islamic states operate somewhat in an institutional vacuum that makes contracting and enforcing transactions both more difficult and more expensive than in other cultures. This not only reduces the incentives to engage in many entrepreneurial efforts but also allows foreign entrepreneurs to

compete more effectively. Examples of institutions that complicate the contracting and enforcement of agreements with strangers are seen in the laws of inheritance and corporation.

In the West, a successful businessman could will his business to one or more of his children either directly or by establishing a corporation and ensuring that his preferred heir or heirs have a controlling interest. Shari'a compliant inheritance laws restrict the ability of a wealth holder to distribute his assets by a will. In fact, Islamic inheritance laws generally set out specific shares for each family member. The impact on entrepreneurial activity is significant. Under Islamic inheritance laws, it was very difficult to pass on a family business. If there were multiple children then it was likely that a family business would be broken up. (Kuran 2010, 69)

Nor can this problem be avoided by establishing a corporation, a legal person, to continue the entrepreneur's business. Islamic law only respects flesh and blood persons, corporations (as understood in the West) cannot be established. (Kuran 2010, 69) Since Islamic law only recognizes flesh and blood persons and yet enforces strict inheritance laws, most business entities, however successful, are broken up after the death of the founder.

The adverse impact on entrepreneurship of shari'a laws such as those of concerning inheritance and corporations should not be exaggerated. It is possible to develop shari'a compliant alternatives for incorporating innovations or bid'ahs. A bid'ah is any type of innovation in Islam. If the Qur'an and Sunnah outline a way of life that cannot be improved upon then any bid'ah is suspicious and should be examined carefully before it is considered acceptable. And since the Qur'an provides guidance for an extensive range of government and business activities, judging the acceptability of a business innovation can be both complex and controversial. Among the products whose adoption was delayed because of concerns that the innovations were unacceptable were coffee, the printing press, and, in 1960s Saudi Arabia, television. (Kuran 2010, 72-3)

As a result, entrepreneurs may be forced to spend extensive amounts of time and influence to negotiate an acceptable decision on a business related bid'ah. Or complex procedures may be necessary in order to construct a relatively simple business transaction in a manner that is religiously acceptable. For example, the prohibition against interest may be overcome by the use of murabahah where one party (a bank?) who has at least constructive ownership of an item, announces the actual cost and any mark-up to the buyer. (Schoon 2008, 32-33) Developing, coordinating and executing such acceptable alternatives to otherwise forbidden activities may substantially increase the difficulty of bringing an innovation to market. Kuran compared dealing with bid'ah to the difficulties of dealing with environmental regulations in the United States. (2010, 81) Such regulations rarely explicitly forbid an activity but however worthy their purpose, they tend to make innovations more complex and expensive.

Restrictive inheritance laws, the lack of corporations, and challenges of dealing with bid'ahs made entrepreneurship more difficult in Islamic nations. This adverse impact was

strengthened by the tendency to see new business products and procedures as “discoveries” rather than “innovations.” Only those changes that can be traced back to or discovered in religious writings, the more ancient the better, are considered legitimate. Successful entrepreneurs are careful to deny the existence of genuine innovations in what they do. As a result, the discussion of business in much of society, especially in schools, downplays the role and importance of entrepreneurship. An analogy might be if Bill Gates, the co-founder of Microsoft, or Sam Walton of Walmart felt that it was necessary to not only credit the Federalist Papers as the source of all of their business success but also encourage young potential entrepreneurs to concentrate on intensive study of the Papers if they wished to become successful.

While Islam dominates the religious environment of Iraq, the participation of other religious sects is not insignificant. When over 1,600 small businessmen were asked for their religious affiliation, 6% of those that responded stated that they were either Christian or another non-Shiite, non-Sunni religious affiliation. This 6% response is twice their representation in the population at large. It should be noted, however, that almost 22% of those surveyed refused to answer the question about religious affiliation. (CIPE 2007b, Table 30) Jews are not represented in the sample. As late as 1947, there were an estimated 117,000 Jews in Iraq, 2.6% of the total population, almost half of which lived in Baghdad. The Jewish community of Baghdad was formerly considered to be a fruitful source of entrepreneurs in Iraq and was responsible for significant business initiatives. However, growing hostility towards Iraqi Jews since the late 1940s drove almost all of them into exile. (Tripp 2000, 123-6 and 196)

In summary, the impact of Islam on the supply of entrepreneurs is generally adverse for two reasons. It leads to institutions that increase the transaction cost of entrepreneurial efforts and, therefore, reduce the possible private gain. And it encourages successful entrepreneurs to disguise their innovations. This prevents potential entrepreneurs from discovering the true nature of entrepreneurship.

*Socialism and entrepreneurship.* The changes in Iraq's entrepreneurial environment brought about by the rise to power of the Baathist Party in 1968 are more a matter of degree than kind. Since at least the Hashemite Monarchy (1941-1958), non-agricultural economic activities were dominated by a relatively small number of Iraqis who gained economic power through familial and friendship relations with the national political leadership. These patron-client relationships ensured political power by providing a mechanism to reward loyalty to the regime with status and economic rewards. (Tripp 2000, 197)

Creating and maintaining patron-client relations were one of the motivations for the establishment of State Owned Enterprises (SOE). It was expected that a political leader of any influence would ensure that his followers were taken care of. SOE in Iraq are widely criticized for being high cost producers of low quality products but, to an extent, this criticism is irrelevant since the primary purpose of SOE was not to produce goods and services but rather to provide power, status and economic returns to supporters of the regime and to exclude the opposition from such benefits. Therefore SOE generally

oppose the creation of new firms in their industries especially since new firms may support further economic reform. (McMillan and Woodruff 2002. 153)

In Iraq, this opposition takes the form of harsh regulation of private business (discussed below), harassing private businesses where SOE are important suppliers to or buyers from private firms and, as was discussed in Chapter 4, through massive corruption. As a result, many small firms choose to stay in the informal (underground) economy with all of its associated inefficiencies. These informal firms account for an estimated 20% of Iraq's employment. Since informal firms are unable to access the legal system, they tend to engage in North's first two forms of exchange. Surviving in the informal economy with its lack of formal regulation is inherently an entrepreneurial act. Although, small firms in the informal economy often survive more by their agility at navigating the various layers of governmental authority rather than their ability to recognize purely economic opportunities. (Estrin 2006, 699) If this pool of active entrepreneurs could be freed from the high transaction costs associated with the informal economy then the potential for real economic growth and employment are significant.

*Wage takers, entrepreneurs and rent seekers.* However, as Baumol pointed out, if the supply of entrepreneurs is almost entirely a function of culture and history then it is a "counsel of despair" since nothing can be done to increase the supply of entrepreneurs. (1990, 894) However, he states that it is possible that a potential entrepreneur will engage in unproductive or even destructive entrepreneurship as opposed to the productive type that leads to economic development. Therefore, it might be possible by creating the proper incentives and institutions to persuade potential entrepreneurs to engage in welfare increasing initiatives. (1990, 897-8) Baumol's framework of analysis seems to be appropriate for Iraq.

It is useful in the case of Iraq to divide career possibilities into three categories: wage takers, entrepreneurs and rent seekers. Wage takers are satisfied with jobs with minimum compensation uncertainty. While such employment can exist in both the private and public sectors, in Iraq public sector employment provides the most favorable environment for wage takers. On average, employment with a government ministry or state owned enterprise provides 40%-60% higher wages than equivalent jobs in the small formal private sector. In addition, public sector jobs in Iraq provide stronger job security, better benefits, a pension, and a much more relaxed pace of work. Thus any improvement in the number or relative compensation of public sector employment in Iraq can be expected to reduce the pool of potential entrepreneurs. Even for those potential entrepreneurs who avoid the temptation of a government job, there is still the problem of diversion from entrepreneurship to rent seeking.

Rent seekers are persons who seek to make a living by capturing economic rents rather than by engaging in voluntary trade. (Tullock 1967, X; Krueger 1974, X) For example, a rent seeker could bribe a government official to restrict auto imports to a single port controlled by the rent seeker. This monopoly misallocates resources, reduces aggregate welfare, and redistributes income away from consumers in favor of the monopolist. (See Tullock 1989, 9 and 1993, 11) Rent seeking can also take the form of legal activities such

as lobbying the government to award a contract to a company that is not objectively the high quality/low cost producer.

Rent seeking will impact the pool of Iraqi entrepreneurs in at least two ways. First, if potential entrepreneurs were attempting to maximize their wealth or status then one would expect them to choose to be either entrepreneurs or rent seekers based on whichever one had the greatest potential return. Second, some rent seekers could work at diverting entrepreneurial profits into their own pockets. This would discourage potential entrepreneurs by reducing the possible entrepreneurship profits. The policy implications are clear although difficult to execute. If incentives and institutions can be created that discourage rent-seeking without placing a burden on productive entrepreneurship then an economy would gain in two ways: reduced damage to the economy from unproductive or destructive entrepreneurship and an acceleration of economic development from more persons engaged in productive entrepreneurship. Changing these incentives and institutions will be a much more rapid process than waiting for cultural change. (Baumol 1990, 916-9)

Incentives in Iraq may be shifted in the direction of productive entrepreneurship by increasing the supplies of complementary inputs in the entrepreneurship process. These would include providing the potential entrepreneur with the necessary knowledge or skills, and is able to provide adequate financial guarantees then he or she is likely to fail.

*Education of entrepreneurs.* The smaller businesses of Iraqi entrepreneurs are often simply referred to as Micro Small Medium Enterprises (MSME). At the micro end, enterprises can be expected to have few (or one) employees, negative economies of scale, and require only low-skilled labor in production and management. (El-Gamal et al, 2000, 10) At the medium enterprise level, one could expect up to 500 employees, economies of scale, and the need for skilled and educated workers and management.

The Iraq Household Socio-Economic Survey of 2006-2007 (COSIT 2007, Table 6-22, 330) provides data on firm size based on a survey of employed persons in over 127,000 Iraqi households. Including all forms of employment, this survey showed the following breakdown:

- Less than five employees: 23%
- More than five but less than ten employees: 14%
- More than ten but less than fifty employees: 18%
- More than fifty employees: 45%

But the COSIT survey includes government employment at both the ministries and SOE. One would expect that employment in the private sector to be in smaller entities. And, in fact, this expectation is supported by a 2007 CIPE survey of over 1,600 Iraqi businessmen. This survey shows that private business in Iraq is primarily composed of micro and small firms. According to the survey:

- Five employees or less: 63%
- Between six and twenty employees: 28%

More than twenty employees: 9%

Of these businesses, about 55% were sole proprietorships, 25% family owned, 18% partnerships or domestic corporations, and only 1% foreign owned. (2007b, Tables 2 and 5) Across, the MENA, Countries with Iraq's combination of high self-employment combined with a large informal economy tends to be associated with relatively weak entrepreneurial cultures. (Stevenson 2010, 184)

How much education does a micro or small firm manager (and potential entrepreneur) need? While researchers such as Bauer and Yamey found examples of successful entrepreneurs who couldn't write (1957, 104, f. 1), these entrepreneurs are the exception rather than the rule. A study of entrepreneurs in Egypt found a wide distribution of educated workers among MSME. For example, while 20% of the entrepreneurs in micro enterprises possessed a University degree, 13% were barely literate or illiterate. (El-Gamal et al, 2000, 13) Harris found similar results in Nigeria where most successful entrepreneurs were not at the educational extremes. (1970, 352 and 354) In other words, while the size of an entrepreneur's business, of which the number of employees is a proxy, is positively correlated with the level of education of the entrepreneur, there appear to be limits at both the high and low ends. Using the distinction discussed above, Schumpeterian entrepreneurship in the OECD countries tends to require substantial formal education, this is not true for Kirznerian entrepreneurs in countries at Iraq's stage of economic development. Successful Kirznerian entrepreneurship at the micro-small-medium enterprise level requires relatively low levels of formal schooling.

Without being able to read, write and calculate; the odds are strongly against becoming a successful entrepreneur. Unfortunately, the current state of elementary education in Iraq is grim. According to IMF standards, 34% of the population is illiterate. With respect to school attendance, at the primary level, 14% (about one million) of the nation's children do not attend school. At the intermediate level (12-14 years of age), non-attendance rises to 31%. (COSIT 2009, Table XX) When Iraqi families were surveyed in an attempt to determine the cause of non-attendance at the intermediate level, 48% responded that the family or the individual was not interested in providing that level of education while another 18% stated that there were no schools available. Aside from the social and political benefits of universal primary education, it can be expected that more universal elementary education will lead to more persons attempting entrepreneurship and a greater likelihood of success for those who make the attempt.

Aside from basic general education, research has shown that the best education for potential entrepreneurs is working for or being associated with an independent businessman. (Stevenson 2010, 178) As Lingelbach et al states: "Entrepreneurship is a lonely profession rendered more difficult without the benefit of mentorship and apprenticeship." (2005, 7) Of course, there may be a self-selection bias; potential entrepreneurs may seek out current entrepreneurs to work for. However, the tendency for family members of independent businessmen to become businessmen themselves points to a learning process in addition to self-selection. It is not clear whether the learning involves specific business skills (e.g. how to develop a quality business plan), the

inculcation of a business attitude or both. In contrast, having worked for a government agency or state owned enterprise appears to reduce the likelihood of becoming a successful businessman. Since an estimated 50% of the Iraqi labor force work directly or indirectly for the government, this reduces the learning-by-doing opportunities for potential entrepreneurs.

*Ability to give financial guarantees.* If a potential entrepreneur is unable to provide financial guarantees than his likelihood of success is low. (Harris 1970, 351) Without finance, he must try to convince others to advance resources without a reasonable assurance of payment based on limited information. In other words, he must try to convince others to become entrepreneurs like himself without providing so much information that his prospective partners will steal his innovation. The widespread problems of banking, the bond and stock market were discussed earlier in Chapter 8. However, the difficulty of obtaining finance is a special burden to potential entrepreneurs.

“Getting Credit” and “Protecting Investors” are two of the nine subcategories that are used to estimate the World Bank’s “Ease of Doing Business”. In 2010, Iraq ranked 168<sup>th</sup> in getting credit (out of the 183 countries in the sample) while it ranked 120<sup>th</sup> in protecting investors. The low ranking with respect to getting credit was caused by weak legal rights for creditors and an almost complete absence of either private or public credit information on firms or individuals. As a result, assets of both public and private Iraqi financial institutions are dominated by parking reserves at the central bank and loans to state owned enterprises. Even the small amount of non-SOE loans are primarily to government workers, bank employees, and influential politicians.

The protecting investors ranking is based on three metrics; the extent of disclosure of significant firm transactions, the extent of director liability and the ease of shareholder lawsuits. (World Bank 2010, pp. 28-31) Using this standard, Iraq’s index is 4.3 out of maximum of 10, the same as the United Arab Emirates and Jordan but much less than Saudi Arabia (7.0).

Of course, bank loans and equity sales are not the only sources of finance for an Iraqi entrepreneur. As in the developed nations, many entrepreneurs raise needed finance by borrowing from family members or obtaining credit from suppliers or buyers. But even here, the lack of fundamental protection for creditors has an impact on the amount that can be raised – loans from family members tend to be smaller than bank loans.

A nationwide survey of all Iraqi households showed that the primary source of loans was family members in Iraq or abroad. These family loans accounted for over 81% of all loans. Trade credit from merchants was the second most popular source at about 11%. State owned or private banks supplied about 6% of total loans with moneylenders, employers, and NGO accounting for the rest. (COSIT 2007, Table 10-2, 756) These results are consistent with other studies that show that entrepreneurs in developing countries tend to rely on family or other informal sources of finance. (Lingelbach 2005, 4-6)

The limited access to bank finance was confirmed by the CIPE survey of 1,631 Iraqi businessmen. About 76% of these businesses obtained their financing from the firm's retained earnings while another 7% came from the private savings of the business owner. The remaining financing sources were about evenly divided between private sources (including new partners) and banks with each providing about 7% of financing needs. (2007b, Table 7) The dominance of family members and retained earnings as financing sources has an adverse impact on potential entrepreneurs. Not only is finance for future operations limited by previous business profitability but achieving any significant scale of production will probably be a gradual process as each stage of production must finance succeeding stages. And gradual growth will make the entrepreneur more vulnerable to rent seeking by regulatory authorities.

Just like new borne animals in the wild, a firm is most vulnerable to regulatory predators when it is small. But as noted by Parkinson in one of the less appreciated chapters of his classic work, since bureaucracies tend to operate at a very slow pace, rapid growth will reduce the period of greatest danger of regulatory exploitation. Once a firm becomes large enough, its vulnerability to regulatory predation falls since a large firm can demand (or pay for) political protection from the grasping bureaucracy. (Parkinson 1958, XXX) On the other hand, a slow growing private firm gives regulators an extended opportunity to perceive, evaluate, plan, and execute the successful exploitation of the firm.

*External sources of entrepreneurs.* There are two external sources of entrepreneurs that could help meet the demand. Since the rise of Saddam Hussein, large numbers of Iraqis have fled the country. Over the last thirty years, many of these former Iraqis have either become entrepreneurs by choice or necessity in their new home countries, or have obtained the skills and access to financing essential for successful entrepreneurship. The return of this Iraqi diaspora would be especially valuable since they can be expected to have a realistic perception of the Iraq business environment. (NEED UPDATED REFUGEE DATA BY NATION)

There are also large numbers of foreign businessmen that would be willing to move to Iraq to establish new firms or expand exiting ones. Both of these groups of entrepreneurs or potential entrepreneurs hesitate to return or move to Iraq because of concerns about security and the uncertainty that they will be allowed to retain most of the profits they expect to earn. These concerns appear to be inversely related to the size of the proposed businesses since large foreign investors can obtain support and a degree of protection from one of the ministries. Small firms are more vulnerable.

### **Transaction costs facing entrepreneurs**

Transaction costs are the costs involved in negotiating, executing and enforcing an agreement to trade a good or service other than the costs to the seller of producing the product and to the buyer to consume it.

*Rule of Law.* The scope for entrepreneurship is a function of the size of the market since a larger market allows for increased specialization. And since the days of Adam Smith (1776, 9) it has been recognized that increased specialization facilitates invention and innovation and therefore entrepreneurship. However, the size of a market is determined not only by geography, culture and technology but also by the rule of law.

As discussed above, private sector trade in Iraq is primarily composed of two types of exchange: local personalized exchange and impersonal exchange enforced by non-formal means. The third type of exchange, trade between strangers with third-party enforcement, is limited. The primary cause of this limitation is the lack of a commercial code that provides for predictable, fair and inexpensive resolution of commercial disputes has severely constrained the size of the market for many goods and services. Smaller markets tend to mean lower entrepreneurial profits. Lower expected profits will lead to fewer entrepreneurial acts and fewer entrepreneurs.

The current Iraq commercial code severely limits transactions among private strangers. A complex ubiquitous bureaucracy attempts to manage economic activities with even straight-forward transactions tied up in red-tape. This reflects, in part, the typical situation of transition economies. Business regulations were adopted during a previous planned-economy regime and are inappropriate to a more market oriented economy. (Stevenson 2010, 190-191) Relatively simple business activities required substantial paperwork and the approval of multiple levels of the Iraqi government. Like all bureaucracies, these agencies take a great deal of time to approve routine requests but stall completely when faced with any kind of innovation. If under common law “All is allowed except what is specifically forbidden” then in Iraq “All is forbidden except what is specifically allowed.”

As was discussed in the corruption chapter, the Iraqi economy is structured to not only facilitate rent seeking but to ensure that rent seeking “winners” receive large awards. This occurs because countries with complex business regulations not only make it difficult for an entrepreneur to succeed but also tend to provide large rewards for rent seekers. Table 10.1 shows the results from the World Bank’s annual “Ease of Doing Business” survey for Iraq and, for comparison, the other nations in the Middle East and North Africa.

Of the 183 nations in the 2010 survey, Iraq ranked 166<sup>th</sup> overall, which not only made it one of the most hostile regulatory environments for business in the Middle East and North Africa but in the world. Of the nine subcategories evaluated by the World Bank, Iraq scored particularly poorly in starting a business (174<sup>th</sup>), trading across borders (179<sup>th</sup>) and closing a business (183<sup>rd</sup>, worst in the world!). Not only does Iraq rank in the bottom quintile in most subcategories, its relative standing has deteriorated over the last two years – it has fallen from 153<sup>rd</sup> to 166<sup>th</sup>. In six subcategories, it has fallen by five or more rankings while in the “closing a business” subcategory, the only reason that it can’t drop is that it is already at the bottom of the rankings. The Iraqi regulatory environment for private business is bad and getting worse.

**Table 10.1**

	<b>Iraq</b>	<b>Middle East &amp; North Africa</b>
<b>Overall Ranking (out of 183 nations)</b>	<b>166</b>	<b>11 to 166</b>
1. Starting a Business	174	13 to 177
2. Dealing with Construction Permits	102	14 to 157
3. Registering Property	96	1 to 165
4. Getting Credit	168	4 to 181
5. Protecting Investors	120	5 to 179
6. Paying Taxes	54	2 to 168
7. Trading Across Borders	179	3 to 180
8. Enforcing Contracts	141	35 to 176
9. Closing a Business	183	26 to 183

Particularly damaging to any attempt to encourage entrepreneurship in Iraq are the regulatory barriers to: starting a new business, getting credit and closing a business. The required procedures are complex, difficult and expensive. As a result, these regulations act as a severe “tax” on entrepreneurship that either discourage entrepreneurs from attempting to create a new business or encourage him or her to operate in the informal or underground economy with all of the associated inefficiencies that were so vividly described by de Soto (2000 and 1989).

As an illustration, consider starting a new business in Iraq. The World Bank “starting a new business” ranking is based on a survey to determine the procedures needed to start a small or medium size business legally – without paying bribes. In Iraq, there are eleven separate procedures involving multiple government offices. If the potential entrepreneur knows exactly what to do and is unwilling to pay bribes then it will take seventy-seven days and about 76% of the average Iraqi annual income (about \$2,100) to register a new business. Contrast this to registering a similar business in the state of Delaware in the U.S.A. which can be accomplished online in about one half hour and costs \$139!

Trading across international borders is even more difficult for an Iraqi entrepreneur. Iraq ranked 179<sup>th</sup> out of the 183 nations surveyed when it came to the difficulty of importing or exporting a dry container of ordinary legally manufactured goods to or from a business located on the periphery of the country's largest business city. In other words, what are the costs of shipping a container from dockside in Basra to the suburbs of Baghdad? Not only does it take over 100 days to complete the paperwork and obtain the necessary approvals but the cost per container is an estimated \$3,900! These costs include fees, document preparation charges, terminal handling charges and inland transport. The fees do *not* include tariffs, duties or bribes. For comparison purposes, a similar shipment to or from Saudi Arabia would take only eighteen days to process and cost about \$680. (World Bank 2010, 36-9) Only high value goods that can be ordered with a long-lead time will be internationally traded with Iraqi entities. Other products will either not be traded or smuggled.

Finally, Iraq has the worst ranking in the world with respect to “closing a business” which, considering the competition from other states in the Middle East and North Africa is quite an achievement! For example, in a country in the top-third of surveyed nations such as Saudi Arabia (ranked 65<sup>th</sup>), closing a business takes about a year and a half and stakeholders recover an average of 38%. In Iraq, the average recovery is zero since no firm has successfully completed a legal bankruptcy. (World Bank 2010a, 44-47) The impact of this extremely dysfunctional bankruptcy law on entrepreneurs is two fold. Since there is little chance that a creditor will be able to recover even a fraction of his investment if a business fails, they will hesitate to lend. Also, without a bankruptcy law, it is difficult for an entrepreneur to recover from a failed endeavor. If he attempts to establish a new business then the unsatisfied creditors from previous endeavors can seek to attach the assets of the new firm.

Not only are Iraqi business regulations hostile to private business but also they are difficult for even an educated businessman to understand. When the CIPE survey attempted to discover whether the average Iraqi businessmen found Iraqi trade laws and regulations easy to comprehend, the results were negative. Across the six cities in the sample, only 16% of businessmen thought that that regulations were understandable while 31% responded in the negative. The remainder thought that parts of the commercial code were clear and others obscure. (2007b, Table 18) This creates unnecessary uncertainty that further discourages potential entrepreneurs.

A related issue is whether Iraqi businessmen are confident that, after expending substantial time and money complying with incredibly complex laws and regulations, the authorities will carry out their end of the “bargain”. (Estrin 2006, 795) This confidence is apparently very low in Iraq. Security aside, when Iraqi businessmen were asked to name the top five items that had the most adverse impact on the growth of Iraqi business, the results were surprising. The top five adverse elements were: (1) not applying laws and regulations that was volunteered by 63% of all businesses surveyed, (2) high fees by 59%, (3) lack of respect for property rights by 51%, (4) difficulty in obtaining loans from banks or other financial institutions by 47%, and (5) lack of effective communication

within and outside Iraq by 45%. Both the first and third may be interpreted as revealing a lack of confidence that even if correct procedures are followed, the authorities will do what they said they would do. (CIPE 2007b, Table 19)

The complexity and obscurity of business regulation in Iraq are not unloved artifacts of the previous regime. Rather the expense and time required for a businessman to comply with the regulations increases the incentives to pay bribes to avoid the regulations.

*Corruption.* Whether corruption (the abuse of public power for private benefit) amounts to a significant transaction cost in Iraq is surprisingly controversial. It is argued that corruption is a Western concept that is inaccurately applied to common Middle Eastern business practices. As an Iraqi businessman stated: “In the West, firms pay lawyers to ensure that transactions are legal and executed in the intended manner while, in the Middle East, firms pay bribes for the same purpose.” If, as in Iraq, the legal system is opaque, inefficient, and unpredictable then paying bribes may be not only more efficient than accessing the legal system but cheaper.

This argument that, in view of the ineffectiveness of the Iraqi legal system, businessmen should use a “second best” corruption solution has at least two weaknesses. First, corruption is a very expensive way of facilitating business transactions. In a 2007 survey of business owners in six Iraqi cities, CIPE reported that over half of the businesses reported that corruption accounted for more than 20% of their total costs of doing business. And between 12% (Kirkuk) and 26% (Basra) of firms reported that corruption accounted for 40% or more of total costs! (2007b, Table 27)

In addition, the costs of corruption tend to worsen over time. There are strong incentives for government officials to further increase the complexity and expense of complying with regulations in order to encourage businessmen to pay more substantial bribes.

Iraqi businessmen may not be as accepting of corruption as the rest of Iraqi society. When Iraqi businessmen in six cities were asked about their general attitude towards corruption their answers can be divided into three categories. About 10% thought that corruption was either not a problem or was a problem but they had adapted to it. Another 50% thought that more needed to be done combat corruption. Most discouraging was the response of 38% that corruption was a serious problem but nothing could be done to reduce it in the short-run. (CIPE 2007b, Table 28)

Widespread corruption not only increases the cost of doing business but, as discussed above, it shifts the incentives of potential entrepreneurs. They will favor becoming rent-seekers as opposed to productive entrepreneurs. As with ineffective rule of law, entrepreneurs are more vulnerable to corruption because, since they represent small relatively new entities, they lack bargaining power in negotiations with the bureaucracy. (Estrin et al 2006, 795)

*Transportation costs.* Especially in developing countries, transportation costs can be a substantial contributor to overall transaction costs. Just as the absence of various

institutions can reduce expected entrepreneurial profits by restricting the size of the market in which the entrepreneur can trade, absent or low quality infrastructure can have the same effect. For example, an agribusiness entrepreneur might see an opportunity in producing high quality chickens using modern feed and veterinarian care but is unable to quickly bring his product to market because of the lack of rapid road transport. Much of his stock was dying before it reached the urban market.

Of course, this problem could be seen as another entrepreneurial opportunity – to provide secure cold-chain truck transportation so that a quality product can be provided to the market despite bad roads. However, most infrastructure is non-excludable and, therefore, requires government provision. This topic is discussed at greater length in the chapter on essential services and infrastructure. The take-away is that poor or non-existence infrastructure increases transportation costs and therefore reduces potential entrepreneurial profits.

### **Policy Options**

In summary, there is currently a great need for an increase in private sector employment in Iraq in an environment of rapid change and entrepreneurs can play an important role in facilitating such employment creation. This leads to the critical question of which policy initiatives should be adopted to increase the likelihood of successful entrepreneurship? There is a strong temptation to provide a laundry list of the many initiatives that individually or collectively have facilitated entrepreneurship in other countries. (See, for example, Stevenson 2010, 197-201) In fact, the US Embassy and MNF-I, in the economic annex to their 2009 joint campaign plan were unable to resist this temptation.

However, such a laundry list may do more damage than good unless they are carefully crafted to the specific conditions of Iraq. First, as discussed in Chapter 4, Iraq suffers from corruption at every level of government. Any policy recommendation intended to facilitate entrepreneurship that can possibly be distorted to elicit bribes will be so distorted. For example, the 2009 GoI program to provide microloans to potential entrepreneurs had very little impact since most of the funds were diverted to ministerial clients.

Second, ministerial capacity is limited not only from a general lack of managerial experience but also because of the strict hierarchy in ministerial decision making. Even relatively minor decisions must proceed up the bureaucracy step-by-step with each layer attaching its carefully crafted comments until it arrives at the top of the ministry. As a result, the minister and his few trusted aides struggle to deal with a continual flood of requests for decisions. Routine decisions are long delayed; innovative requests involving new programs often cause the bureaucratic decision process to seize up entirely. As will be discussed in Chapter 13, governmental managerial capacity is even more limited at the provincial and local levels.

Finally, related to the previous issue, cooperation among ministries is more the exception than the rule. As was discussed in Chapters 6, Petroleum, and Chapter 11, Infrastructure,

the ministries of oil and electricity are often unable to coordinate either the supply of fuel to the major electrical generation plants or the supply of electricity to the three largest refineries. As a result, Iraq continues to suffer from shortages of both electricity and refined fuels. The moral is that any pro-entrepreneurship policy that requires inter-ministerial cooperation or even cuts across different ministries areas of responsibilities will be difficult to execute with any efficiency.

Because of corruption, limited managerial capacity, and the difficulties of inter-ministerial coordination; it is best to focus on a few initiatives with a reasonable chance of success rather than spread limited legislative and managerial resources over a large number of policies. If there are too many simultaneous initiatives then the effect is not to speed up execution of these initiatives but rather to stall them all. For these reasons, it would be more useful to specifically identify the few most seriously binding constraints on Iraqi Kirznerian entrepreneurship.

What are the most serious binding constraints on Kirznerian entrepreneurship in modern Iraq? I think that strong arguments can be made that corruption, regulatory hostility, and low levels of education are the most serious problems. The possible causes and cures of corruption are discussed in Chapter 4 so I will focus on the other two constraints.

*Regulatory hostility.* Along with corruption, the greatest barrier to Iraqi entrepreneurship is regulatory hostility towards private business. This hostility is especially evident with respect to: starting a new business, getting credit, and closing a business. Reducing regulatory hostility to business is the most important step in creating the preconditions for entrepreneurial capitalism. (Baumol et al 2007, 153) Since 2004, the World Bank and the U.S. government have strongly encouraged the Government of Iraq to rationalize its Saddam-era business regulations. In particular, the World Bank has extensive experience in regulatory reform. However, while some progress has been made with respect to construction permits and enforcing contracts; the rate of progress has been slow. One issue is that in Iraq, as in the rest of MENA, the government has focused more on encouraging large-scale foreign investment than on efforts to encourage the creation of domestic small businesses. (Stevenson 2010, 173)

The author has argued elsewhere that Iraq doesn't have the time to engage in a possibly decade long re-writing of business regulations. (2009) Since such a re-write would provide massive corruption opportunities, task ministerial managerial capacity to the limit and require extensive inter-ministerial cooperation; the odds are poor that such a re-write could be completed and implemented in less than a decade even with strong support from the Prime Minister's office. Iraq can't afford to wait a decade for the increased employment and market efficiency that greater entrepreneurship is expected to produce. Aside from the economic impact, a substantial rise in the pool of unemployed young men may threaten the nation's new borne democracy. A more radical approach should be considered - the wholesale adoption of an existing set of business regulations of another country.

Adoption of the existing regulations of OECD countries would require difficult and controversial translations into Arabic and Kurdish and are thought to be too non-sectarian for Iraq with its constitution that emphasizes the role of Islam. While Kuwait’s World Bank Ease of Doing Business is ranked 74 (out of 183) compared to Iraq’s ranking of 166<sup>th</sup>, recent history makes Iraqi adoption of Kuwait’s code extremely unlikely. Possibly the best choice for adoption are the business regulations of Saudi Arabia. Saudi Arabia doesn’t have the language or religious issues of the Western nations although borrowing commercial law from Sunni majority Saudi Arabia might make Shi’a majority Iraqis uncomfortable. Saudi Arabia has a fairly business friendly regulatory environment ranking 11<sup>th</sup> internationally in “ease of doing business”.

In the critical category of starting a new business, Saudi Arabia provides a much better environment for entrepreneurs than Iraq’s current regulatory situation. As shown in Table 10.2, there are fewer procedures that require much less time to complete, less than a week in Saudi Arabia compared to almost three months in Iraq. And despite the fact that average per-capita income adjusted for cost of living (PPP) is almost six times greater in Saudi Arabia than in Iraq; the cost of starting a business is higher in Iraq, \$2,700, than in Saudi Arabia, \$1,600.

**Table 10.2**

<b>Starting a Business</b>	<b>Iraq</b>	<b>Saudi Arabia</b>
World Ranking (out of 183)	174	13
Procedures	11	4
Time	77 days	5 days
Cost (% of income per capita)	75.9%	7.7%
Minimum capital required (% of income per capita)	30.3%	0.0%

Source: World Bank 2010 *Ease of Doing Business*

Unless a potential entrepreneur can make credible financial guarantees, his or her ability to actually execute a business plan are very limited. Since the problems of obtaining finance and some proposed solutions are discussed at length in Chapter 8, only a few points will be presented here. Potential entrepreneurs currently obtain most of their finance either from retained earnings or from informal sources such as family members. Banks make few loans to anyone without substantial physical collateral and microfinance institutions tend to make relatively small loans. For small business finance to break out of its current straight jacket one thing is absolutely essential - the rights of creditors have to be strengthened. Unless the creditor can obtain reliable credit information and be confident that any loan agreement will be enforced in a predictable manner in a relatively short period of time and at reasonable cost then potential entrepreneurs will continue to be starved for finance.

Again, a movement towards Saudi Arabia’s regulations and procedures would be very useful. With respect to its “getting credit”, Saudi Arabia ranks 46<sup>th</sup> in the world while

Iraq ranks 167<sup>th</sup>. While Saudi Arabia has stronger legal rights for creditors, the primary reason for its better ranking is the depth and coverage of credit information available through its private sector credit bureaus. Currently, there are no reliable accessible private or public sources of credit information in Iraq.

Of course, debt is not the only option for entrepreneurial finance. An Iraqi stock market has been established but it is not yet an important source of equity finance primarily because of weak legal protection for investors. According to the World Bank's Ease of doing business metric, Iraq ranks 120<sup>th</sup> in the world and its relative position is deteriorating. Iraq provides low levels of corporate transparency, liability for self-dealing by firm management, and overall investor protection. Saudi Arabia ranks 16<sup>th</sup> in the world and is tied or above Iraq in all subcategories. As in the case of starting a new business, and getting credit; Iraq would provide an improved entrepreneurial environment if its regulations were closer to those of Saudi Arabia.

Finally, as late as 2009, there were no cases of an Iraqi business being legally liquidated. Creditors hesitate to lend to a potential entrepreneur if they expect zero recovery in case of business failure. In addition, without an effective bankruptcy law, entrepreneurs can never "escape" a business failure in order to try again in the same or another field. In Saudi Arabia, the average recovery rate is only 37.5% compared to an average of 68.6% in the OECD countries. But combined with the relatively short period of time required to resolve a bankruptcy, one and a half years, this is sufficient to put Saudi Arabia in the top third of all nations with respect to closing a business. The adoption of reasonable bankruptcy regulations is controversial in Iraq but should have a favorable impact on entrepreneurship.

*Primary, intermediate, and secondary education.* Education increases the likelihood that an entrepreneur will be successful. (Baumol 2007, 153) As was discussed above, most Kirznerian entrepreneurship in developing nations does not require high levels of formal education or training. In most cases, a solid primary and intermediate education generally provides an adequate foundation. Unfortunately, in 2008, 14% of Iraqi children were not receiving primary education while almost one-third of children aged 12-14 years were not attending intermediate schools. For secondary education (15-17 years), the rate of non-attendance rose to 45% of males and 62% of females or 54% overall. (COSIT 2009, Table 3.4, 228)

The major reason given by Iraqi parents for not sending their children to primary, intermediate or secondary school is lack of interest. At the primary level, lack of family or individual interest is cited by 41% of those surveyed as the primary reason that their child is not attending school. Other reasons given are lack of nearby school (14%), disability or disease (9%), and expense (5%). (COSIT 2009, Table 3.8, 233) The lack of interest probably reflects a high opportunity cost to the families of having children in school as opposed to helping out in the farm, shop or home compared to the low perceived benefit of education especially for female children. Despite the enthusiasm of foreign governments and NGO to build new schoolhouses in Iraq, the education problem does not appear to be a lack of school buildings. A more serious problem is finding

teachers, especially female teachers, who are willing to work in the countryside. The need for female teachers is cultural. In rural areas, many parents think that it is inappropriate to have male teachers in a classroom with their female children who have reached puberty. And yet, female teachers try to avoid assignment to rural areas because of the social constraints and sometimes hostility towards unmarried adult females.

Not only to increase the likelihood of successful entrepreneurship but also for the other economic and political benefits of an educated population, the GoI over the short-term should engage in educational triage. Its priority should be to achieve 100% attendance at the primary and intermediate level, maintain stable attendance at the Secondary-Votech-Technical level (15-17 years) and accept a decrease in the provision of bachelors and higher degrees. Such educational triage should be close to self-financing since in Iraq the annual expenditure per college student is over \$4,000 while primary/intermediate expenditure per student is \$421. (Author's calculation from data provided by Ministry of Education and Ministry of Higher Education.) Because of the data that was used, this 10 to 1 ratio of education costs is probably a low estimate. Studies of other developing countries put the ratio of college cost to that of primary education at up to 80 to 1. (SOURCE?)

There is widespread corruption in education. For example, teachers assigned to rural districts or far from their homes will often bribe supervisors and inspectors to allow the teachers to receive their pay while remaining in urban areas or at home. As a result, classrooms are overcrowded, taught by uneducated substitutes or lack any teachers at all. This contributes to the families' lack of interest in obtaining primary or intermediate education for their children. One proposal that should make corruption more difficult and partially offset the lack of family interest is for the GoI to add education vouchers to the monthly food basket. Parents would use these vouchers to pay for their children's education. If teachers do not show up to teach then they will not be paid. In larger villages and urban areas where there are more than one school, the vouchers would give parents the ability to choose the school that would be best for their children.

Reducing corruption, regulatory reform, and extending education in the direction discussed above face several challenges. First, asking the ministries to "do less" with respect to regulating private businesses will be difficult since a reduction in ministerial responsibilities will be seen as leading to reduced power, status as well as reduced opportunities to extract bribes. Second, easing the entry of new firms is necessary but the degree of its success in bringing about a substantial entrepreneurial led expansion of the private sector and employment will depend on whether the GoI intentionally or unintentionally decides to offset these regulatory improvements with adverse budget, SOE, or institutional changes. (Stevenson 2010, 172) Finally, if oil prices are "too low" or "too high" over the next decade then regulatory reform will most likely stall. If oil prices are "too low" then – in a repeat of 2006 - the GoI will probably respond to the resulting severe budget constraint by defunding all new initiatives in order to reserve spending on oil production and the compensation of current and former government employees. However, if oil prices are "too high" then there will be little sense of urgency in encouraging entrepreneurship and the accompanying expansion of Iraq's private

sector. The GoI can respond to demands for employment by further increasing the already bloated government payrolls.

While Baumol et al (2007, Chapter 6) and others correctly point out that encouraging entrepreneurship in a developing country has many components from rule of law to better roads. Iraq should concentrate on the three very difficult challenges are the currently binding constraints on domestic Kirznerian entrepreneurship. In my opinion, these are corruption, regulatory hostility to private business, and the low level of primary/intermediate education. There is not need to re-invent the wheel; there are templates for success for all three of these initiatives in the Middle East. What is needed is the political will to push change through a bureaucracy distinguished by its inertia. However, in view of the rapidly growing labor force, there are no good short-term options to encouraging entrepreneurship to create private sector jobs.

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