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Backgrounder
Executive Summary

No. 1633 March 5, 2003

The Road to Economic Prosperity for a Post-Saddam Iraq

Ariel Cohen, Ph.D., and Gerald P. O'Driscoll, Jr., Ph.D.

As the Bush Administration and Iraqi opposition groups plan the future of a post–Saddam Hussein Iraq without its weapons of mass destruction (WMD), economic issues loom large. Iraq's economy has been grossly mismanaged, and its people largely repressed, for 40 years.

Iraq desperately needs an alternative to the failed policies of its dictator. Sound economics are needed to help the Iraqi people rebuild their lives and their country after two decades of wars and four decades of repression under the current regime. The U.S. government, the oil industry, and international financial institutions should provide technical expertise to the future government of Iraq to divest, privatize, and modernize its national economy.

Saddam's Devastation of Iraq's Economy. Saddam's regime has succeeded in bankrupting the country even though Iraq boasts the world's second largest oil reserves after Saudi Arabia, estimated at 112 billion barrels of oil and potentially even higher. The oil sector provides more than 60 percent of the country's gross domestic product (GDP) and 95 percent of its hard currency earnings. Yet GDP for 2001, at the market exchange rate, is estimated to be only about one-third its level in 1989. Iraq also is hobbled by its $140 billion foreign debt. This devastation was wrought by such policies as the nationalization of the country's chief export commodity, oil; extensive central planning of industry and trade; the 1982–1988 war against Iran; and the invasion of Kuwait, which precipitated the 1991 Gulf War.

According to the U.S. General Accounting Office, oil smuggling and illegal surcharges of 25 cents to 50 cents on a barrel of legal oil are providing the funds to bolster Saddam's regime. Saddam's unaccounted revenues are at least $6.6 billion—money that he has been free to spend to develop WMD and support terrorism in spite of economic sanctions imposed by the United Nations after the Persian Gulf War to force him to give up his WMD. And Saddam still stubbornly refuses to meet the terms for lifting the economic sanctions that the United Nations has imposed on his regime.

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The road to economic prosperity in Iraq will not be easy, but the Bush Administration can help the new government achieve fundamental structural reform with massive, orderly, and transparent privatization of various sectors of the economy, including the oil industry.

Building a Post-Saddam Iraq. The new government established by the people of Iraq should represent all the major sub-national groups—the Shiite Arabs, the Sunni Arabs, and the Kurds. The best model is a federal system that includes the various factions. Iraqi opposition leaders will need a commitment, from the United States and international financial institutions, that they will furnish necessary expertise and technical assistance. To gain that commitment, Iraq will need to abandon its statist policies and become fully committed to the principles of a market economy.

Promoting Privatization. Privatization efforts in other countries show that privately held infrastructure, oil, and oil service companies generate greater efficiencies, improved production, and higher revenues than do centrally planned and state-owned industries. The same can be achieved in Iraq, whose oil industry cannot thrive without access to global capital markets. The Administration should work with Iraq's future federal government to develop mechanisms for privatizing these industries, taxing oil sales, and sharing the proceeds equitably with the three major ethnic regions—the Shiite Arabs in the South, the Kurds in the North, and the Sunni Arabs in the central region.

As the end of Saddam's regime will mean the end of the U.N. sanctions, the rationale for the U.N.-administered oil-for-food program will be removed. Absent the threat of an Iraqi program to develop weapons of mass destruction, the Bush Administration should not support leaving the oil-for-food program in place, let alone expanding it. The temporary U.S. administration and the future government of Iraq should also remove Ba'ath cadres loyal to Saddam and his clan in the national oil ministry and the Iraqi National Oil Company.

During the 1990s, Saddam attempted to dismantle the U.N. Security Council sanctions or "encourage" permanent members to veto the use of force against Iraq by allocating lucrative contracts for the development of giant Iraqi oil fields to companies from Russia, France, and China. The power of Saddam's regime to allocate these contracts in view of their corrupt nature is questionable, and the circumstances surrounding the granting of these contracts need to be re-examined.

Needed: Comprehensive Economic Reform. The Bush Administration, its allies, and international organizations should prepare, encourage, and support the future leaders of a post-Saddam Iraqi government to develop a comprehensive economic reform package. Specifically, in addition to the reforms outlined above, a new federal Iraqi government must take steps to create a modern legal environment that recognizes property rights and is conducive to privatization; educate and prepare the people of Iraq for structural economic reform and privatization through a public information campaign; deregulate prices internally, including in the utilities and energy sector; prepare state assets, including industries, utilities, transportation, ports and airports, pipelines, and the energy sector, for privatization; keep the budget balanced and inflation, taxes, and tariffs low; and liberalize and expand trade, and launch an effort for Iraq to join the World Trade Organization.

Conclusion. Economic growth will be an important contribution to the stabilization of Iraq, allowing the United States and other forces stationed there to depart after assuring that Iraq's WMD threat and repressive regime have ended. Structural reform and comprehensive privatization is a winning strategy for the people of Iraq, its future government, the region, and the United States.

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NOTE: Nothing written here is to be construed as necessarily reflecting the views of The Heritage Foundation or as an attempt to aid or hinder the passage of any bill before Congress.

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The Road to Economic Prosperity for a Post-Saddam Iraq

Ariel Cohen, Ph.D., and Gerald P. O'Driscoll, Jr., Ph.D.

As the Bush Administration and Iraqi opposition groups plan the future of a post–Saddam Hussein Iraq without its menacing arsenal of weapons of mass destruction (WMD), economic issues loom large. Iraq's economy has been grossly mismanaged for 40 years, and its people desperately need an alternative strategy to supplant the failed policies of its dictator. Sound economics are needed to help them rebuild their lives and their country after two decades of wars and four decades of repression under the current regime.

Saddam Hussein's regime has succeeded in bankrupting the country even though it boasts 112 billion barrels of oil in reserves—the world's second largest after Saudi Arabia's.[1] According to some experts, Iraqi reserves can be as large as 220 billion barrels—equal to those of Saudi Arabia.[2] Gross domestic product (GDP) for 2001, at the market exchange rate, however, is estimated to be only about one-third the level in 1989.[3] Iraq also is hobbled by its $140 billion foreign debt.[4]

This devastation was wrought by such policies as the nationalization of the country's chief export commodity, oil; extensive central planning of industry and trade; the 1982–1988 war against Iran; and the invasion of Kuwait, which precipitated the 1991 Gulf War. And Saddam still stubbornly refuses to meet the terms for lifting the economic sanctions that the United Nations has imposed on his regime.

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Saddam also has succeeded in diverting at least $6.6 billion—primarily in revenues from smuggled oil and kickbacks—to his program to develop nuclear, chemical, and biological weapons and plat-

1. Carola Hoyos, "Baghdad Re-entry to Market 'Could Have Big Impact'," *Financial Times*, February 21, 2003, p. 6.
2. John Donnelly, "Planning Is Underway to Manage Iraqi Oil," *Boston Globe*, January 26, 2003, quoting James A. Placke of Cambridge Energy Research Associates.
3. U.S. Department of Energy, Energy Information Administration, "Iraq: Country Overview," at *http://www.eia.doe.gov/emeu/cabs/iraq.html*.
4. *Ibid.*

forms for their delivery. He continues to support terrorist organizations, such as Hamas and the Popular Front for the Liberation of Palestine (PFLP), which the U.S. Department of State includes on its list of state sponsors of terrorism.[5] Presumably, a post-war U.S. military presence in Iraq and Iraq's future security forces will ensure that the new Iraqi government does not continue to develop WMD and support terrorism.

The future of Iraq depends not only on the ouster of the country's repressive regime, but also on the ability of the new Iraqi leaders to reverse the damage through policies that will spur real economic growth. The sooner the threat from Saddam's WMD programs ends and the Iraqi economy recovers, the sooner the United States and the other security forces will be able to depart.

A double strategy of ensuring security and enabling economic growth will need international support. The Bush Administration should help Iraqi opposition leaders to develop an economic reform package for their country. The new post-Saddam federal government should develop a modern legal system that recognizes property rights and is conducive to privatization; create a public information campaign that prepares the people for structural reforms and privatization; hire expatriates and Western-educated Arabic speakers with financial, legal, and business expertise for key economic positions; deregulate prices, including prices in the utility and energy sectors; prepare state assets in the utility, transportation, pipeline, energy, and other sectors for privatization; keep the budget balanced and inflation, taxes, and tariffs low; liberalize and expand trade; and launch an effort to join the World Trade Organization (WTO).

THE TOUGH ECONOMIC ROAD AHEAD

Iraq's Lifeblood: Oil. As Chart 1 and Chart 2 show, the Iraqi economy is dominated by the oil sector, which provides more than 60 percent of Iraq's GDP and 95 percent of its hard currency earnings.[6] The economic sanctions imposed by the U.N. in the past decade in an effort to force Saddam to give up his weapons of mass destruction not only have not worked, but also have helped to depress foreign trade.

According to the U.S. General Accounting Office, however, oil smuggling and illegal surcharges of 25 cents to 50 cents a barrel on legal oil purchases under the U.N. oil-for-food program bolster Saddam's regime. These illegal activities from 1996–2002 have provided unaccounted revenues of at least $6.6 billion,[7] which Saddam has been free to spend to develop WMD and support terrorism.[8]

How much Saddam is actually spending on his deadly arsenal is hard to tell. The lack of information is so pervasive that the international financial institutions (IFIs), foreign government agencies, and private businesses that provide country economic analysis and data do not publish any official economic statistics or estimates for Iraq.[9]

This means that no recent data on Iraqi government consumption of GDP are available. In 1993, the most recent year for which data are available, government consumption amounted to 13.9 percent of GDP. According to the Economist Intelligence Unit,

> Oil revenue has been the mainstay of government income since the 1950s. In 1968 the oil-based nature of the economy was reinforced by the introduction of a centralized socialist system, with the

5. U.S. Department of State, Office of the Coordinator for Counterterrorism, "Appendix B: Background Information on Terrorist Groups," in *Patterns of Global Terrorism—2000*, April 30, 2001, at *http://www.state.gov/s/ct/rls/pgtrpt/2000/2450.htm*.
6. Energy Information Administration, "Iraq: Country Overview."
7. U.S. General Accounting Office, *U.S. Confronts Significant Challenges in Implementing Sanctions Against Iraq*, GAO–02–625, May 2002, at *http://www.gao.gov/atext/d02625.txt*.
8. Alix Freedman and Steve Stecklow, "Secret Pipeline: How Iraq Reaps Illegal Oil Profits," *The Wall Street Journal*, May 2, 2002.
9. Gerald P. O'Driscoll, Jr., Edwin J. Feulner, and Mary Anastasia O'Grady, "Iraq," in *2003 Index of Economic Freedom* (Washington, D.C.: The Heritage Foundation and Dow Jones & Company, Inc., 2003).

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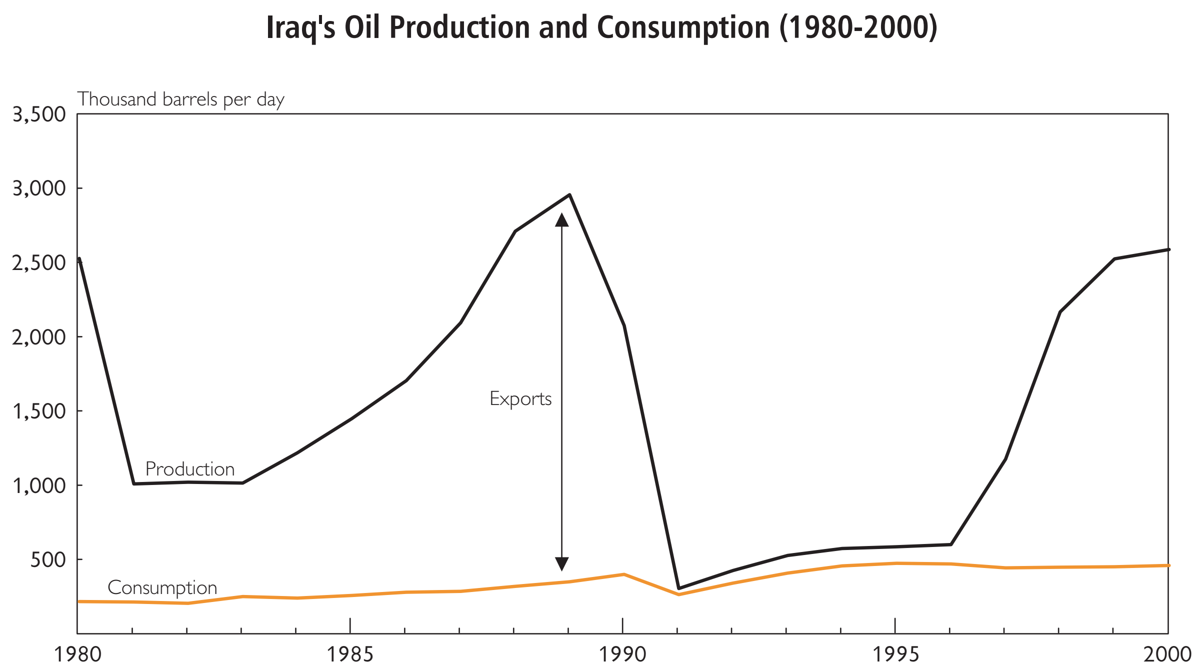
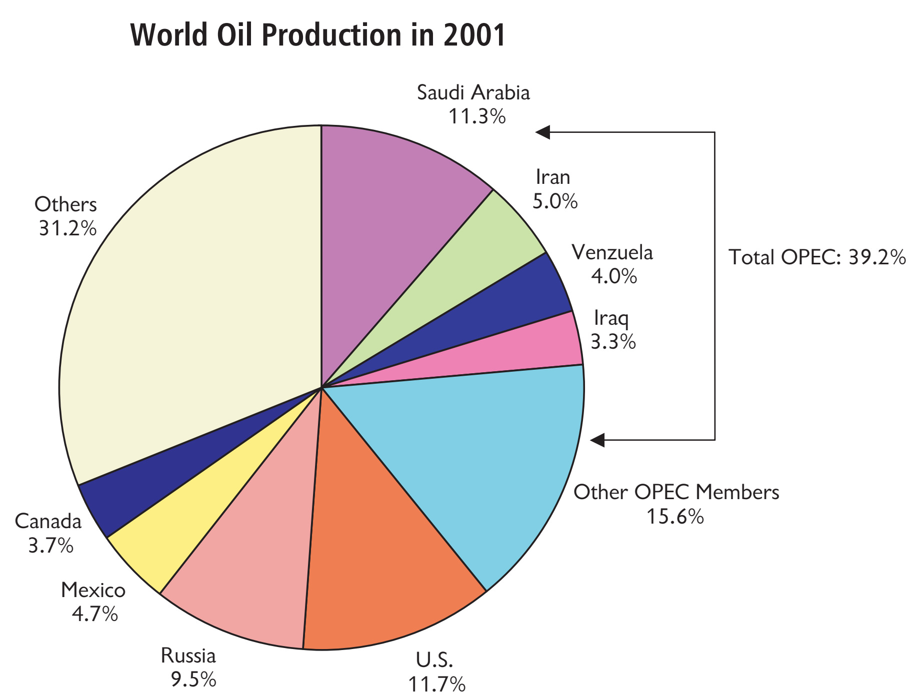
Chart 1 B1633



Note: Production includes crude oil, natural gas plant liquids, other liquids, and refinery processing gain.
Source: International Petroleum Information, U.S. Energy Information Administration, data available at *http://www.eia.doe.gov/emeu/international/petroleu.html#IntlProduction* and *http://www.eia.doe.gov/emeu/international/petroleu.html#IntlConsumption.*

Chart 2 B1633



Source: U.S. Energy Information Administration, available at *http://www.eia.doe.gov/emeu/cabs/nonopec.html#woil* and *http://www.eia.doe.gov/emeu/steo/pub/a3tab.html.*

> government regulating all aspects of economic life other than peripheral agriculture, personal services and trade.... Meanwhile, the state's centrality to the economy has increased because the vast majority of imports and foreign exchange have been controlled by the government.[10]

The socialist Ba'ath government has demonstrated gross mismanagement of the oil sector. During the 1960s, exploration stopped and the sector was nationalized, which bred corruption and mismanagement. Oil production has barely increased since 1980. In 2001, oil production stood at approximately 2.8 million barrels a day. Today, Saddam's regime controls oil exploration, extraction, refining, pipelines, ports, and all utilities, but oil export prices are set by the U.N. sanctions regime.

Taxing Imports, But Not Smugglers. The Economist Intelligence Unit notes that direct taxation has never been a preferred means of raising revenue in Iraq.[11] As the International Monetary Fund (IMF) reports, "imports are restricted by [U.N.] sanctions. All imports subject to import duty are also subject to a customs surcharge.... Imports of commodities are normally handled by the public sector."[12] Although the government of Iraq inspects and regulates all imports, a small private sector is involved in considerable smuggling and black market currency exchange activities.

Tough Investment Environment. Even though Iraq has permitted some foreign investment in its oil industry and private sector, mainly to help it rebuild from the damage of the Gulf War, it discourages most capital inflows. The legal system does not guarantee contracts. Inflation in Iraq remains high. From 1994 to 2001, Iraq's weighted average annual rate of inflation was 80.4 percent; for 2001–2002, the rate ranged from 60 percent to 70 percent.[13]

The government controls almost all prices, and rationing is the norm for items like food. The regime continues to distribute imported goods in what is essentially a highly centralized command economy structure, although it does retain the ability to skew the distribution of food and other items as a way to favor cronies.

There is no application of modern property rights protected by legislation and enforced through the courts. The Revolutionary Command Council (RCC) of Iraq holds all executive, legislative, and judicial authority. The RCC's chairman, Saddam Hussein, appoints a council of ministers who are theoretically vested with executive authority, but in fact they are able only to rubber-stamp the decisions of the RCC and its chairman. The judiciary is not independent; consequently, there is no check on Saddam's power to override any court decision.

AFTER SADDAM: THE OUTLOOK FOR IRAQ AND WORLD ENERGY MARKETS

One thing is clear: Saddam's regime, obsessed with control and coercion, is destroying the wealth of the Iraqi people. After liberation from this regime, it will be important for the Iraqi people to rebuild their economy (especially the oil sector), increase GDP and improve the standard of living, attract foreign investment, and improve government services through privatization.

The Cost of Rebuilding. The cost of rebuilding the country will be high. If Operation Desert Storm reconstruction costs are used as the basis for estimation, the cost of rebuilding Iraq after Saddam's regime falls will be in the $50 billion to $100 billion range.[14] Together with repaying the Iraqi foreign debt (estimated at from $60 billion–$140 billion) and compensation costs to Kuwait and other countries (over $20 billion), the more realistic figure is $200 billion.[15] However, as long as structural economic reforms are undertaken, Iraq's vast oil reserves and rebuilt economy, including the

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10. *Ibid.*
11. Economist Intelligence Unit, "Country Report, July 2002."
12. O'Driscoll *et al.*, "Iraq," in *2003 Index of Economic Freedom*.
13. *Ibid.*
14. Bill Gertz, "Tab to Rebuild Iraq, Kuwait Estimated at $100 Billion," *The Washington Times*, March 4, 1991. More recent estimates confirm this range.

revamped oil sector, are likely to provide the funds needed to rebuild and boost economic growth.

Thus, the United States and the people of Iraq have the same interest at heart: maximize Iraq's economic performance. Without private ownership, however, oil will remain politicized and mismanaged. A group of Iraqi-born oil experts stated in December 2002, after a conference on the future of the Iraqi oil sector sponsored by the U.S. State Department, that

> The aspiration of the group is a rehabilitated, globally connected oil and gas sector.... Oil will remain the primary source of revenue and will play a pivotal role in the country's economic reconstruction. The group recognized the need to establish a favorable investment climate and attract international and inward capital in the reconstruction and growth of the industry. It saw the importance of introducing modern technology, know-how and management skills.[16]

Thus, the exiles fell short of calling for post-Saddam privatization of the Iraqi economy.

Secretary of State Colin Powell has said that "The oil of Iraq belongs to the Iraqi people.... [I]t will be held for and used for the people of Iraq. It will not be exploited for the United States' own purpose...." But this does not preclude the United States from offering its guidance to the future government of Iraq on establishing sound economic and trade policies to stimulate growth and recovery.[17] It would be counterproductive to empower either U.N. bureaucrats or Iraqi officials loyal to the Ba'ath party and Saddam to run the Iraqi oil industry.

The Bush Administration, through its executive directors at such IFIs as the IMF and World Bank, as well as other international governmental and non-governmental organizations, should begin to advise the future leaders of Iraq's next government to establish policies that will lead to a thriving modern economy. These policies should be based on "best practices" developed around the world in the 1990s, when the largest government privatizations in history occurred.

During the Iran–Iraq War and the post–Gulf War sanctions period, Iraqi petroleum production declined significantly. Saudi Arabia filled the void, generating a net profit of $100 billion. The funds it generated represent monies that should have benefited the Iraqi people.[18] (See Chart 3.)

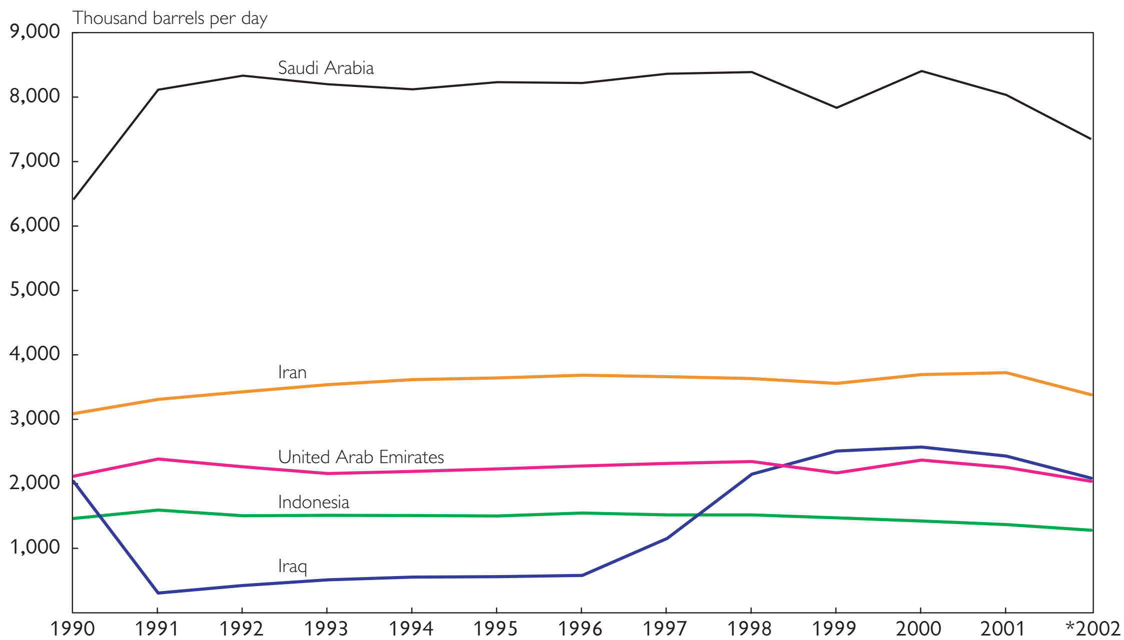
Following the demise of Saddam Hussein, it is unlikely that the Saudi kingdom would transfer a fraction of its production quota under the Organization of Petroleum Exporting Countries (OPEC) regime to Iraq to compensate for those lost profits and facilitate its rebuilding. Iraq will need to ensure cash flow for reconstruction regardless of OPEC supply limitations. Combined with the potential privatization of the oil industry, such measures could provide incentives for Iraq to leave the OPEC cartel down the road, which would have long-term, positive implications for global oil supply.

Potential Benefits of Leaving the OPEC Regime. An Iraq outside of OPEC would find available from its oil trade an ample cash flow for the country's rehabilitation. Its reserves currently stand at 112 billion barrels, but according to the U.S. Energy Information Administration, it may have as much as 200 billion barrels in reserve.[19] Estimates by Iraqi oil officials are even higher: According to Oil Minister Amir Muhammad Rashad[20] and Senior Deputy Oil Minister Taha Hmud, the reserves could

15. Julian Borger, "Post-Saddam Iraq Will Cost You, U.S. Warned," *The Guardian*, August 2, 2002, at *http://www.guardian.co.uk/bush/story/0,7369,767755,00.html*. Lawrence Lindsey, Director of the National Economic Council, is quoted as estimating a cost for the Iraq war of between $100 billion and $200 billion. It is unclear what is included in that figure. See Bob Davis, "Bush Economic Aide Says Cost of Iraq War May Top $100 Billion," *The Wall Street Journal*, September 16, 2002, p. 1.
16. Vicki Silverman, "Iraqi Professionals Discuss the Future of Local Government and Oil," U.S. Department of State, Office of International Information Programs, December 31, 2002, at *http://usinfo.state.gov/regional/nea/iraq/text/1231prof.htm*.
17. Donnelly, "Planning Is Underway to Manage Iraqi Oil."
18. "Round Table on Declining Oil Prices and Its Political Consequences in the Middle East," *Middle East Studies*, Vol. 6, No. 1 (Spring 1999), pp. 5–36, at *http://www.netiran.com/Htdocs/Clippings/Economy/990322XXFE01.html*.
19. Energy Information Administration, "Iraq: Country Overview," p. 14.

Chart 3 B1633

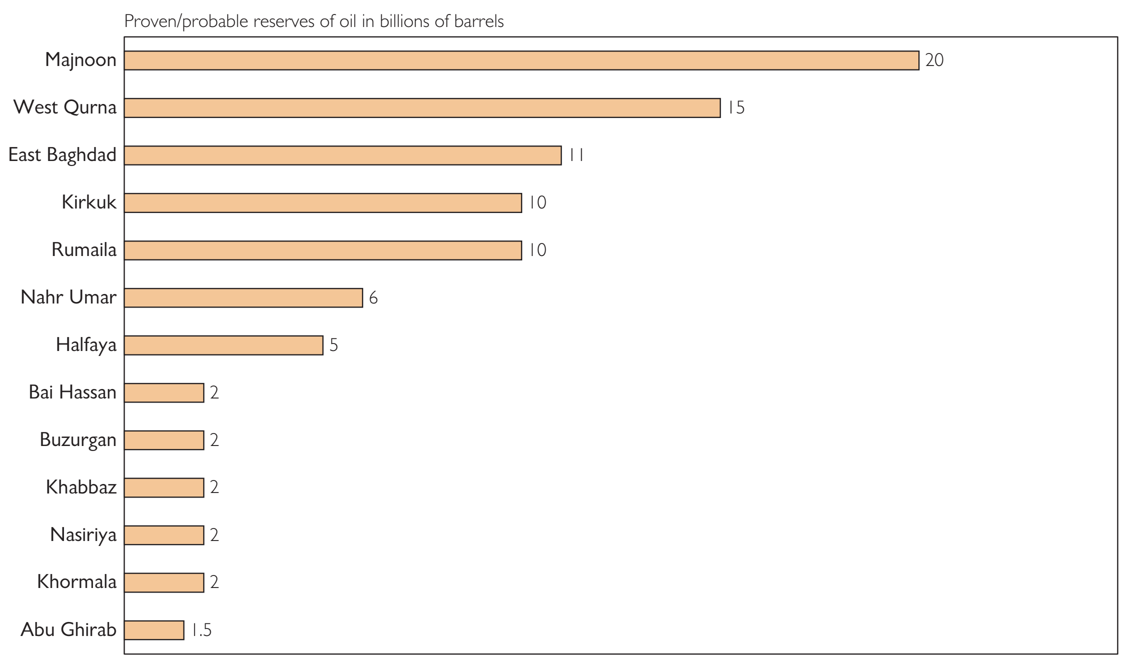
Selected OPEC Member Crude Oil Production, 1990-Present



Note: *2002 Data from January to May.
Source: U.S. Energy Information Administration, available at *http://www.eia.doe.gov/emeu/ipsr/t11a.txt.*

Chart 4 B1633

Iraqi Major Oil Fields



Note: Reserves in East Baghdad, Kirkuk, Rumaila, and Nahr Umar are estimated to be more.
Source: Platts Global Energy, available at *http://www.platts.com/features/Iraq/oilfields.shtm.*

be as high as 270 billion to 300 billion barrels, making them equal to Saudi Arabia's.[21]

Iraq's 1990 output prior to the beginning of the Gulf War stood at 3.5 million barrels a day, while oil discovery rates on a few new projects in the 1990s were among the highest in the world: between 50 percent and 75 percent. Given Iraq's own output projections, it may be capable of pumping as much as 6 million barrels (by 2010) to 7 million barrels (by 2020) a day, more than doubling current production levels.[22] (See Chart 4.)

Such a surge in production may be opposed by OPEC countries, which would like to keep its quota around the current 2.8 million barrels per day, while historic market share is taken by the Kingdom of Saudi Arabia, which currently is pumping close to 8 million barrels per day.[23] Depending on the dynamics of global economic growth and world oil output, Iraq's increase in oil production capacity could bring lower oil prices in the long term.

An unencumbered flow of Iraqi oil would be likely to provide a more constant supply of oil to the global market, which would dampen price fluctuations, ensuring stable oil prices in the world market in a price range lower than the current $25 to $30 a barrel. Eventually, this will be a win—win game: Iraq will emerge with a more viable oil industry, while the world will benefit from a more stable and abundant oil supply.

PRIVATIZATION: LEARNING FROM THE PAST

Boosting oil exports and oil industry privatization by itself still may not be sufficient for growth over the long haul. To rehabilitate and modernize its economy, a post-Saddam government will need to move simultaneously on a number of economic policy fronts, utilizing the experience of privatization campaigns and structural reforms in other countries to develop a comprehensive policy package.

Several lessons from other countries' privatization experiences are particularly relevant to Iraq's situation. Specifically:

LESSON #1: Privatization works everywhere. Between 1988 and 1993, 2,700 state-owned businesses in 95 countries were sold to private investors.[24] In 1991 alone, $48 billion in state assets were privatized worldwide.[25] Privatizations led to higher productivity, faster growth, increased capacity, and cheaper services for consumers.

In one study, the World Bank reviewed 41 firms privatized by public offerings in 15 countries. This review demonstrates that privatization will increase the return on sales, assets, and equity. As privatized firms grow, they often increase their workforces. In another study, the World Bank reviewed 12 privatization efforts in four countries, and its findings again demonstrate why privatization is good for the economy as a whole, no matter where it is implemented.[26]

LESSON #2: Privatization works best when it is part of a larger structural reform program. Privatization needs to be accompanied by reforms to open markets, removal of price and exchange rate distortions, reductions in barriers to entry, and elimination of monopoly powers. In addition to these policies, governments should enact legislation that protects consumer

20. "Iraq's Oil Reserves Bigger than Saudi Arabia, Minister Says," BBC Monitoring, August 6, 2001, Al-Jumhuriyah Web site in Arabic, August 4, 2001.
21. "Iraq's Oil Industry: An Overview," Platts, at *http://www.platts.com/features/Iraq/oiloverview.shtml*.
22. "Iraq Building E&D Project List for Post-U.N. Sanctions Period," *The Oil and Gas Journal*, Vol. 95, No. 15 (April 14, 1997).
23. Hoyos, "Baghdad Re-entry to Market 'Could Have Big Impact'."
24. Energy Information Administration, "Privatization and the Globalization of Energy Markets," Energy Plug, at *http://www.eia.gov/emeu/plugs/plpgem.html*.
25. Madsen Pirie, "Privatization," *Concise Encyclopedia of Economics*, at *http://www.econlib.org/library/encl/privatizaiton.html*.
26. World Bank, "Privatization: Eight Lessons of Experience," Policy Views from the Country Economics Department, July 1992, at *http://www.worldbank.org/html/prddr/outdeach/or3.htm*. For the latest annual update on global privatizations, see Reason Public Policy Institute, "Privatization 2002: Putting the Pieces Together," at *www.rppi.org/apr2002.pdf*.

welfare.[27] Such successful structural reform and privatization programs were implemented in the 1990s in Poland, Hungary, the Czech Republic, and the three Baltic States, particularly Estonia.

LESSON #3: Privatization of large enterprises requires preparation. Successful privatizations of large enterprises may necessitate such advance actions as breaking them into smaller competitive units, recruiting experienced private-sector managers, adopting Generally Accepted Accounting Principles (GAAPs), settling past liabilities, and shedding excess labor.[28]

LESSON #4: Transparency and the rule of law are critical. Opaque privatization and allegations of corruption and cronyism provide political ammunition to the opponents of market-based policies. To eliminate these problems and be successful in its privatization efforts, the government must adopt competitive bidding procedures, objective criteria for selecting bids, and protocols for hiring independent privatization management firms, and establish a privatization authority with minimal bureaucracy to monitor the overall program.[29]

LESSON #5: A minimal safety net is necessary to support laid-off workers and prevent social unrest. Buyouts of the state-owned enterprise's management and labor force, as well as distribution of some of the privatized firm's shares to its management and labor force, can go a long way toward alleviating social tensions that might undermine public support for privatization.

LESSON #6: Privatization is taking place in the Middle East. Privatization is no longer limited to affluent or middle-income countries. From Margaret Thatcher's Great Britain, privatizations of state-owned assets and structural reform policies spread to many countries in Africa, Asia, and Latin America, including the Philippines, Malaysia, Jamaica, and Sri Lanka. An internal study of World Bank managers in the Middle East and North African department found that many were enthusiastic in supporting privatization efforts in their regions.[30] A number of Middle Eastern states, including Iraq's neighbors Turkey[31] and Kuwait,[32] are pursuing privatization of their telecommunications, transportation, utilities, and oil sectors and services, while others, such as Iran and Saudi Arabia, have declared their intentions to privatize assets and are in the policy discussion stage.[33]

LESSONS FROM OIL AND GAS PRIVATIZATIONS

Oil privatization remains a politically painful issue in many countries. Economic nationalists claim oil is a "national patrimony,"[34] whereas socialists and radical Islamists call private and foreign ownership of natural resources "imperialist" and other such pejoratives. Such rhetoric has one goal: to keep a precious and profitable resource in the hands of the ruling elite, be it a communist party politburo, a dictator, or a group of mullahs.

In fact, oil is a commodity and should be managed according to the laws of economics and best business practices. Even a country as fiercely

27. World Bank, "Privatization: Eight Lessons of Experience."

28. *Ibid.*

29. *Ibid.*

30. *Ibid.*

31. See Republic of Turkey, Office of the Prime Minister, Ministry of Privatization Administration, at *http://www.oib.gov.tr/*.

32. Dr. Shafiq Ghabra, "The View from Kuwait," Middle East Forum, March 18, 2000. For more on Kuwait, see U.S. Department of Commerce, "Commercial Overview," at *http://www.arabchamber.com/arab-coutnries/Kuwait/commercial_overview.htm*. See also International Monetary Fund, "IMF Concludes Article IV Consultation with Kuwait," Public Information Notice No. 00/27, April 4, 2000, at *http://www.imf.org/external/np/sec/pn/2000/pn0027.htm*.

33. See Energy Information Administration, "Saudi Arabia," January 2002, at *http://www.eia.doe.gov/emeu/cabs/saudi.html*. On Iran, see "Round Table," Middle East Studies, at *http://www.netiran.com/Htdocs/Clpppings/Feconomy/990322XXFE01.html*.

34. Mary Jordan, "Drilling Stakes at Mexico's Heart," *The Washington Post*, January 25, 2002.

nationalist as Russia recognizes this and is undertaking the largest oil-sector privatization in history. The lessons from past experience in oil privatizations are also positive. Specifically:

ENERGY SECTOR LESSON #1: First "entitize," then privatize. The Conservative government of Margaret Thatcher successfully privatized some British oil assets in the 1980s. In the early 1990s, Russia carved up its state-run oil ministry into regional monopolies. It created joint stock companies, later selling stock to the Russians, first, and then to foreigners. The Ministry of Privatization distributed some stocks to managers and workers in order to smooth the path to privatization. Since privatization, many of these stocks, such as in LUKoil, Tyumen Oil Co. (TNK), and Yukos, have risen in price considerably.

The Russian government did not go all the way, however. For example, it did not privatize Transneft, a company that controls its pipeline infrastructure, or fully privatize some oil companies, such as Slavneft and Zarubezhneft and GAZPROM, the giant natural gas monopoly that boasts the world's largest natural gas reserves and controls a 90,000 km pipeline network.[35] The partial privatization effort has led to friction between state-controlled entities and the privatized–publicly held companies over pipeline access.

ENERGY SECTOR LESSON #2: Oil privatization generates high economic efficiency and market capitalization. The results of Russian oil privatization are fascinating: While the privatized Russian oil companies significantly expanded their production and exports and significantly increased market capitalization, GAZPROM did not. The government-controlled pipeline operator also has had difficulty providing adequate pipeline capacity to the quickly developing oil sector.

Meanwhile, privatized Russian companies not only have attracted Western portfolio investment, but also have been more successful than GAZPROM in attracting capital for foreign direct investment. Several leading Russian publicly traded oil companies also transformed their antiquated, Soviet-era accounting practices to the GAAP standard, hired Western managers, and became centers for dissemination of Western management and accounting skills across Russia's industrial sectors.

Moreover, Russia's largest oil companies, such as LUKoil and Yukos, are fast becoming major global oil players. LUKoil recently purchased 1,300 Getty gas stations in the United States, and LUKoil and Yukos are selling American Depository Receipts (ADRs) on the New York Stock Exchange.

ENERGY SECTOR LESSON #3: Keep it clean, and keep it profitable. The major problem with the Russian oil privatization effort has been its relative opacity, especially in the early 1990s. Scandals included the oil-for-shares debacle in which Boris Yeltsin's government took loans from banks in exchange for shares of the oil companies. The government never repaid the loans, and the companies became the property of politically connected banks.[36] The insider dealing provoked a political row that discredited privatization in the public's eyes.

Other problems in Russia have been privatization through vouchers and the denial of access to foreigners in early privatization stages in order to assuage nationalists in the parliament. These policies resulted in much lower revenues (by as much as a factor of 10) than the government could have received for the privatized assets.

AN ECONOMIC REFORM PLAN FOR POST-SADDAM IRAQ

The Bush Administration should provide leadership and guidance for the future Iraqi government to undertake fundamental structural economic reform. This process should include a massive, orderly, and transparent privatization of state-owned enterprises, especially the restructuring and

35. The Russian government retained 38 percent of GAZPROM shares.

36. Energy Information Administration, "Russia," at *http://www.eia.doe.gov/emeu/pgem/ch4a.html*.

privatization of the oil sector. These steps would greatly enhance needed access to global capital markets.

U.S. political commitment will be needed to motivate international organizations to provide appropriate expertise and technical assistance. *Inter alia*, these organizations could include IFIs such as the International Monetary Fund and the World Bank, and would likely encompass such diverse non-governmental organizations (NGOs) as the National Endowment for Democracy, the Center for International Private Enterprise, the American Bar Association, and the AFL–CIO.

In particular, the Bush Administration should convince the future federal government of Iraq to come to an agreement on how oil revenues are taxed and proceeds are distributed to the country's three distinct ethnic regions—the Shiite Arabs, the Kurds, and the Sunni Arabs. Successfully privatizing the country's oil fields, refining capacity, and pipeline infrastructure will mean higher efficiencies and higher tax revenues in the oil sector.

Absent massive post-war damage, it is likely that Iraq will increase its production capacity from the current 2.5 million–2.8 million barrels per day to 3.5 million–4 million barrels per day in one year and reach 5 million barrels per day by 2005. According to a Deutsche Bank story, Iraq may be able to double production given sufficient investment and technology.[37]

What a New Iraqi Government Must Do. The Administration, the IFIs, and other economic decision-makers should prepare and provide support for a future federal Iraqi government to:

- **Terminate within a reasonable period of time (no longer than six months) the U.N.-run oil-for-food program.**[38] The national oil ministry and the Iraqi National Oil company must be purged of political appointees loyal to the Ba'ath Party, to Saddam Hussein, and his Tikrit clan. The rationale for the U.N.-administered oil-for-food program was to deny Saddam a cash flow from his oil trade. The U.N. partially failed to accomplish that objective as Saddam demanded kickbacks from oil companies that traded in Iraqi oil. After the war is over, there will no longer be any need to administer the oil industry through an international bureaucracy.

  Moreover, when Saddam nationalized the Iraqi oil industry, he appointed numerous political loyalists and members of his clan to run the oil industry. With his regime gone, there will be no need for those individuals, who are likely to oppose the new democratic regime and lack professional qualities, to remain in positions of power.

- **Re-examine contracts allocated to companies from the U.N. Security Council permanent members during the 1990s.** During the period of U.N. sanctions, Saddam attempted to dismantle the U.N. Security Council sanctions regime, or "encourage" permanent members to use their veto against "punishment" of Iraq by the United States. He did this by allocating lucrative contracts for the development of giant Iraqi oil fields to companies from Russia, France and China, such as TotalFinaElf, LUKoil, and others.[39]

- **Develop a modern legal environment that recognizes property rights and is conducive to privatization.** Protection and enforcement of property rights and access to successful alternative dispute resolution mechanisms are vital policies for fostering economic growth and foreign investment. Iraq also will need to build modern and well-functioning regulatory and supervisory frameworks and institutions in the oil and gas, banking, securities, and financial services areas. Such a legal and business environment should be equitable and non-discriminatory, and should not distinguish between Iraqi-Arab nationals and foreigners.

  The U.S. government, its allies, and international organizations should be ready to provide technical assistance in the legal, economic policy, and public administration areas. Working cooperatively with the United States, the Euro-

37. "Majors Eye Iraqi Oil and Gas Reserves as War Looms," *Lloyd's List International*, October 24, 2002.

38. Donnelly, "Planning Is Underway to Manage Iraqi Oil."

39. "Post-War Iraq May Offer Unexpected Challenges for Oil Companies," *The Oil Daily*, October 16, 2002.

pean Union, and the IFIs, the post-Saddam government of Iraq will need to encourage the court system and the rule of law. It will need to provide legislation to allow the use of broad alternative dispute resolution mechanisms outside of Iraq, as the local laws may change too quickly (and the local court system too slowly) for local judges to be able to follow and apply new legislation. Education for judges about the latest legal developments in the economic area will also be important. The courts will have to improve the enforcement of court rulings independent of the executive branch. The central government will need to pay judges and court employees adequate salaries to keep corruption in check.

- **Educate and prepare the Iraqi population for structural reform and privatization through a public information campaign.** Only when the public, including key stakeholders, elites, and the population at large, understand the goals of economic reform will they become more receptive to change and less likely to succumb to the anti-Western demagoguery that undoubtedly will emanate from the remnants of the discredited Ba'ath establishment and Islamic fundamentalists. The new Iraqi government will need to use the media and the educational system to explain the benefits of privatization and the changes to come in order to ensure broad public support.
- **Hire Iraqi expatriates, as well as other Western-educated Arabic speakers with financial, legal, and business backgrounds, for key positions in government.** Examples of this approach in Eastern Europe demonstrate that Western-educated experts can implement economic reforms better than a former socialist bureaucracy can. Younger, well-educated technocrats have an advantage in their ability to communicate effectively with both locals and Westerners, including international providers of technical assistance. In implementing structural reform, the best results are achieved by teams of local and Western experts working together.
- **Deregulate prices in Iraq, including prices in the utilities and energy sector.** Quick price deregulation will be key to ensuring an adequate supply of goods for consumers and ending rationing. It will contribute to increased exports of oil and gas, which in turn will provide additional earnings and tax revenues for the central government to share among the regional and local governments.[40]
- **Prepare to privatize assets in the industrial, utility, telecommunications, banking, transportation, port and airport, and pipeline and energy sectors.** The post-Saddam Iraqi government should prepare to privatize government assets by creating government-held companies instead of ministries, issuing stock for these companies, and implementing guidelines that allow for the introduction of modern management practices and GAAP standards. The central government should hire consulting firms to execute comprehensive assessments of companies it wishes to privatize in order to itemize inventory, to take stock of assets and liabilities, and possibly to settle some of their debts in preparation for privatization.

  In particular, the Oil Ministry and regional oil companies should be restructured to transform them into attractive government-owned oil companies as an intermediary stage before initial public offering (IPO). For example, one company may focus its work in the southern portion of the country, another in the central region (around Baghdad) and the Western desert, and the third around Kirkuk in the North. Three more companies may be created: one to operate the pipelines, the second to operate the refineries, and the third to develop natural gas.

40. John C. Hulsman, Ph.D., and James Phillips, "Forging a Durable Post-War Political Settlement in Iraq," Heritage Foundation *Backgrounder* No. 1632, March 5, 2003.

The stages of preparation for privatization could include:

1. **Taking** inventory of assets and liabilities;
2. **Exercising** necessary efficiency-improvement steps, such as retraining and layoffs (with compensation);
3. **Introducing** GAAP and other modern financial and management practices;
4. **Signing** international conventions against nationalization of foreign investments, such as the Convention on the Settlement of Investment Disputes between States and Nationals of Other States (the Washington Convention), the World Bank's Convention on the Multilateral Investment Guarantee Agency (MIGA), and the New York Convention on Recognition and Enforcement of Foreign Arbitral Awards (1958);
5. **Issuing** company stock;
6. **Running** the companies under new, transparent, and efficient management for at least two years; and
7. **Taking** companies on road shows and completing IPOs in major financial centers such as New York and London, and floating stock in international markets.

Given adequate implementation of each of these stages, the time frame for this privatization effort could be four to five years after the new government is installed by the people of Iraq. During this time, the U.S. government and the IFIs would have to ensure that the political will for privatization remains intact. Management and accounting consultants hired by the new Iraqi government would have to ascertain that the program is transparent and on track.

Moreover, after privatization, Iraq must demonstrate that it is not losing tax revenue and that the government's oil revenue is distributed among the regions equitably and efficiently, allocated to worthy causes, and not wasted, looted, or abused, which could undermine the entire economic reform program.

- **Keep the budget balanced and inflation, taxes, and tariffs low.** International experience demonstrates that lower and flatter taxes (in the range of 20 percent or less), applied uniformly and in a non-discriminatory fashion, are an important investment magnet, especially for a country like Iraq that is rich in natural resources. Moreover, oil revenues will allow Iraq to keep the budget balanced and import tariffs low. Such a stable macroeconomic policy is likely to attract massive investment from a variety of sources, including the Middle East and Asia, not just the West, and boost income and employment.
- **Liberalize and expand trade, and launch an effort to join the World Trade Organization.** A study by the Council on Foreign Relations has demonstrated that a majority of Middle Eastern countries suffer from high import tariffs, red tape, and corruption—problems that depress GDP growth.[41] Elimination of import taxes and tariffs and implementation of trade liberalization would provide an additional economic development engine for Iraq. The Bush Administration should provide technical assistance for trade liberalization and support Iraq's eventual membership in the WTO.

CONCLUSION

For the Iraqi people, structural economic reform and comprehensive privatization of government assets are necessary to stimulate recovery and provide stability after years of disastrous economic policies under Saddam Hussein. The winning strategy of structural reform and privatization also would benefit the industrial world, the United States and its allies, countries of the Middle East, and the developing world.

Iraq's return to global markets would allow for a more abundant and stable energy supply, a higher cash flow for the Iraqi people, and numerous business opportunities for the region and the world. Iraq's restructuring and privatization of its oil and gas sector could become a model for oil industry

41. Bernard Hoekman and Patrick Messerlin, "Harnessing Trade for Development and Growth in the Middle East," Council on Foreign Relations, 2002.

privatizations in other OPEC states as well, weakening the cartel's influence over global energy markets.

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