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WORKING PAPER NO. 1
BUILDING A SUSTAINABLE INVESTMENT CLIMATE IN IRAQ

Executive Summary

One part of an ongoing economic sector work program to provide timely discussion of critical issues facing Iraq, this note seeks to guide and inform the Iraqi authorities, the Bank and the international community in the continuing development of support strategies and, in particular, efforts to nurture a healthy climate for future investment in Iraq. Responding to questions that have arisen in the ongoing dialogue with the Iraqi authorities, the note examines and emphasizes the need for private investment from both Iraqi and foreign services to generate growing and sustained employment. Further, assessing Iraq’s significant institutional and capacity shortcomings in the private sector, the note details a strategy, based on the Bank’s global experience, for laying the necessary institutional foundations for a strong and growing private sector.

Acknowledging the obvious – the paralyzing impact of continuing internal violence on the development of either investor confidence – the note looks ahead to measures that can be undertaken once security is restored and to preparatory steps that can be initiated in the interim. It identifies some areas where immediate support can take place that will encourage job creation, an urgent task of enormous dimensions.

The challenge is huge. Reasonable estimates put employment and underemployment in Iraq as high as 50%. No job-creation program (and no long-term strategy to stimulate private investment) in the world has been able to solve a problem of this magnitude overnight. It is therefore essential to develop a strong package of social safety-net interventions in parallel to work on improving conditions for investors and investments. These interventions, which should be as non-distortionary as possible, could include a strong emphasis on micro-finance and job-creation schemes through public works financed by the reconstruction.

Public Awareness is Critical

There is no debate that Iraq needs a strong and growing private sector if it is to meet the twin challenges of:

- Job generation for now and the future, and
- Economic diversification and sustainability

However, a strongly held view believes that public investment will suffice and sees foreign investment as a major challenge to sovereignty.¹ This philosophy is driven in part by its

¹ A recent survey showed that 90% of Iraqis expected the public sector to generate the necessary jobs
past history as well as its perceptions of neighbors. It is undercut by the reality that the country’s huge reconstruction needs will clearly absorb the majority of public investment funds available. **The first key recommendation, accordingly, is to mount an extensive public awareness campaign on the need for private-led investment with a wide range of stakeholders in Iraq.**

**Institutions are Fundamental**

Investment will drive private-sector growth, but only when investors gain the confidence to invest and the investment climate becomes attractive. Even in the best of circumstances this will take time, and current circumstances in Iraq are particularly challenging:

- The security situation makes it virtually impossible to conceive of any significant private-sector investment taking place now, and
- The large, oil-based economy, because of its impact on internal competitiveness, will make it difficult to follow a traditional export manufacturing approach.

On the positive side huge reconstruction flows present an enormous opportunity to develop the private sector. For the Iraqi private sector to benefit fully from them, however, efforts will be needed to foster business skills, entrepreneurial development, and business associations. Bureaucracies will also need training in administering public investment and conducting regulatory oversight. The greatest possible Iraqi participation in the allocation and use of these reconstruction funds is essential to insure that they not only serve genuine needs but are seen to do so.

Analysis of the investment climate shows the obvious that many critical areas – infrastructure, the financial system and security are very weak. As these issues are being addressed very seriously in other studies, they are not covered here. What is less obvious is that necessary institutional underpinnings for a strong private sector either do not exist or are very weak. Unfortunately recent survey evidence suggests that this situation on the institutional front is deteriorating rather than improving. Indeed the Bank has identified institutions -- along with sound and stable, social and macroeconomic structures -- as the critical success factor for private-sector growth.

Therefore the second key recommendation is the need to focus now on creating—in some cases, strengthening -- some critical institutional building blocks. This priority reflects investors’ various needs. They need to know their property rights will be respected. They need competitive costs of business so they can make a profit. And whether Iraqis believe it now or not, the private sector will benefit from competition. This theme of institutions is important particularly in post-conflict or transition situations. Experience has shown that where perceived risks are high, initial investors may not be particularly professional, a deformity that can be very hard to change later. This is an area where it is possible to work now. As the experience in West Bank Gaza shows, institutional reform can be initiated and continue even in the most hostile of environments.

The building blocks of a competitive investment climate will include the following institutional components:
• The creation of a commercial legal and regulatory structure,
• Building the institutional capacity of the public sector,
• Strengthening the private sector’s institutional capacity,
• Building the capacity to access various markets for trade and investment,
• Developing the framework for regional economic development institutions, and
• Revitalizing the trade facilitation infrastructure by addressing key bottlenecks, e.g. a working customs administration

In virtually every case a multi-phased approach is required initially. The first phase would support specific priority areas with the following type of support: (i) a business plan for the institution which deals with strategy and direction, organizational issues, resource and training needs and sustainability questions; (ii) guidance and training on operating processes; (iii) support for feasibility studies on initiatives; (iv) seed financing for initial initiatives and (v) draft enabling regulations. The priority areas include:

• A self-standing Investment Promotion Agency that will need to bring together a number of disparate investment initiatives.
• Strengthening export promotion capabilities.
• Developing an Alternative Disputes Resolution System. This is a way to provide for property rights uncertainty without waiting for more fundamental reforms of the Commercial Court system
• Creating a local economic development capability in a small number of pilot cities, recognizing that economic development tends to happen at the municipal and sub-regional level where it is often easier to identify opportunities and resolve constraints to doing business, and
• Supporting on a pilot basis public private partnerships that provide financial and technical resources. This should link with the reconstruction flow, export and the services sector.

The second phase would apply the lessons learned from the first phase to a much wider array of institutions, (competition authorities, customs, private sector NGOs industry associations and the like). This follow-on would also provide a second round of support to the first-phase activities.

Opportunities for Growth Exist Now

While this work will lay the foundation for growth in the private sector, it will do little to kick-start activity. Three, somewhat interrelated areas of opportunity, however, offer potential for stimulating job creation and investment:

• Ensuring reconstruction flows that benefit the Iraqi private sector as much as possible
• Encouraging economic zones that can provide enhanced security, good quality infrastructure and protection from regulatory interference
• Supporting the private sector, efforts to obtain access to technology, know-how and markets for, export markets and reconstruction flows.
Given the potential for productive activity in these areas, the third recommendation is to investigate the feasibility of these measures in detail.

A considerable amount of effort already seeks to encourage Iraqi private-sector involvement in reconstruction flows. Nevertheless more could be done, particularly in regards to the flows that the Government itself will be managing. The needed is to build a strong procurement system for both internally developed and internationally provided flows so as to encourages Iraqi private-sector participation.

The economic development zones that are proposed do not rely on any tax or customs advantage for their justification. They are a response to the need to maintain security, control red tape and provide infrastructure. In an environment where these problems are insurmountable from a countrywide perspective development zones will help focused resolution of these issues.

The private sector in Iraq consists of very few large companies, a significant number of SMEs and a very large number of micro enterprises. Any support strategy will, of necessity, have a SME and micro enterprise focus. The immediate challenge is to improve their productivity and find markets for them. Reconstruction programs open one obvious area, with exports as the other. In the latter area Iraq has strong artisanal manufacturing traditions and a number of SMEs that -- while not exporting -- have the capability to do so if provided with missing technology and market know-how. Measures to provide these elements should be strongly encouraged.

**Implementation Capacity is Required**

The three key recommendations proposed will require significant effort to implement, including – as an essential matter -- close attention from the senior leadership of Iraq. Further many of the agenda items will require cross-ministerial coordination. The final recommendation therefore is the establishment of an inter-ministerial working group on the investment climate. This committee should coordinate with other aspects of economic reform and act as a bridge to the infrastructure and financial sectors.

Investment climate reforms are a fundamental ingredient of economic growth. Whether in post –conflict or post-transition situations or in the experience of the OECD countries, such reforms have been crucial. Indeed, “[o]ne of the main lessons of Bosnia and Herzegovnia’s experience is the need to press for investment-related policy reforms as early as feasible. Donors are now fully aware of this, and are supporting rapid reform accordingly. Opinions differ on the extent to which it might have been possible to accelerate reforms at an earlier stage. It might have been difficult politically. However, there is no doubt that earlier reform would have been desirable, and this is one of the most important lessons for other post-conflict environments.”

That lesson is one Iraqis must take to heart. If they shirk the path of reform and the effort needed to make their country attractive to investment by its own citizens and by foreigners, private sector jobs will not be generated at the pace needed, and the public sector will be saddled with an overwhelming burden.

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Executive Summary

Introduction

For the people and economy of Iraq to regain prosperity and a position of leadership in the region, they must lighten and eventually shed the dead weight of state-owned enterprises (SOEs). That reform – a difficult undertaking anywhere, but one that has been successfully accomplished in many countries – represents an essential step in modernizing and rebuilding Iraq’s economic strength.

Many SOEs – employers of an estimated 500,000 of the country’s roughly 4 million current jobholders -- urgently require new investment, up-to-date technology, and improved management, ingredients the hard-pressed Iraqi state cannot provide. The previous ban on non-Arab foreign direct investment and the effects of three wars and a decade of international economic sanctions have meant that something like 90% of Iraq’s industrial capacity – the SOE share – is seriously decapitalized, asset-starved, obsolescent, inefficient, saddled with high production costs, over-staffed, and -- as a result of looting – in a state of physical degradation.

SOEs and their employees are therefore expected to bear the brunt of the necessary economic adjustment. It is clear, however, that many of the 192 enterprises counted so far will simply not be able to compete. With high unemployment --50 percent of the workforce is thought to be either jobless or underemployed -- the transition from state to market will, at least initially, inevitably bring significant job losses. To avoid a social crisis, reform measures will have to be complemented by extensive provisions – a resilient social safety net – for displaced workers and their families. The dismantling and restructuring of the SOEs, moreover, cannot proceed successfully without public approval. To gain that, reformers will need to mount an energetic, sensitive process of consultation and education, a campaign that explains the short-term costs of change and the longer-term benefits it will produce and that wins the consent of the groups and individuals most affected.

Antipathy to private and particularly foreign investment is strong in Iraq, a legacy such a campaign will also have to address, but the issue of SOE privatization is not likely to arise immediately. Indications are that, given their current state, few enterprises are likely to attract much interest from investors. An initial attempt to lease companies has not yet been successful. Furthermore, given that the interim government will not be in a position to dispose of SOE assets, privatization is not an option for the short term, at least not until a representative Government is elected and a legal and regulatory framework for privatization has been put in place.
This paper concentrates on the choices to be made in designing such a framework so that, once the security situation is under control and elected authorities are in office, SOE reforms can proceed effectively and at a pace commensurate with Iraq’s urgent need for such change.

Size, performance and reform needs of SoEs

Although almost all Iraqi SOEs are damaged, technologically obsolescent (with equipment mostly installed in the 1970s) and heirs to years of insufficient re-investment, maintenance, and repair, they have for a long time performed a key role in a wide variety of sectors. They have been the sole providers of essential public utilities and the leading providers of a large number of public goods and services as well as of consumer and industrial products. All have suffered from distorted policies which have undermined their viability, while many have also been damaged and some destroyed by wars.

Grouped under 11 line ministries (Table 1), Iraqi SOES are relatively modest in terms of numbers, but many in fact consist of several separate enterprises. In addition there are believed to be a number of other national and sub-national enterprises as well as 43 mixed-ownership firms, in which private companies, individuals, former Ba’ath party representatives and line ministries hold shares.

Table 1. Summary of SOEs as Per Their Former Affiliation With Line Ministries

<table>
<thead>
<tr>
<th>Ministry/Commission</th>
<th>No.</th>
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<tbody>
<tr>
<td>Agriculture</td>
<td>10</td>
</tr>
<tr>
<td>Electricity</td>
<td>11</td>
</tr>
<tr>
<td>Finance</td>
<td>9</td>
</tr>
<tr>
<td>Health</td>
<td>1</td>
</tr>
<tr>
<td>Housing and Construction</td>
<td>15</td>
</tr>
<tr>
<td>Industry and Minerals (MIM)</td>
<td>48</td>
</tr>
<tr>
<td>Military Industrial Complex (now with MIM)</td>
<td>48</td>
</tr>
<tr>
<td>Irrigation</td>
<td>11</td>
</tr>
<tr>
<td>Oil</td>
<td>19</td>
</tr>
<tr>
<td>Trade</td>
<td>8</td>
</tr>
<tr>
<td>Transport and Communication</td>
<td>12</td>
</tr>
<tr>
<td>Total</td>
<td>192</td>
</tr>
</tbody>
</table>

SOEs can be categorized into two broad groupings:

- Enterprises that deal in tradable goods and services, and
- Enterprises that provide public goods and services

At first sight this distinction seems straightforward. However, individual infrastructure ministries, for example, control construction and manufacturing enterprises that fit comfortably in the first category.

Most SOEs are large. For example, the enterprises under the Ministry of Trade employ on average 4,000 people; those of the Oil Ministry—3,500; those of Mining and Minerals—2,000; while the SOEs of the Ministry of Housing and Construction employ on average 800 people.
Many SOEs are holdings for 5-15 constituent enterprises covering many medium-sized and even small SOE branches, a few of which have less than 100 employees. These SOE branches are located at different sites, quite far from the main headquarters and act as separate entities in carrying out technical functions. The branches do not have commercial autonomy since they are not registered as legal entities. They are not allowed to sign contracts directly with customers or receive credit from banks.\(^3\)

Of course some SOEs are utilities, providing services such as electricity, telecommunications, water and ports. In reforming these enterprises, it will be necessary to address a range of specific sectoral policy and regulatory issues more complex to tackle than those involved with industrial or trading enterprises. Other SOEs form part of the oil sector, and these again will require separate treatment depending on the government’s policy towards the oil sector.

Most Iraqi SOEs were shut down after war damage and looting interrupted normal operations. Many have not restarted, and those that have are, in most cases, operating only partially. Most need some capital to accomplish repairs and secure raw materials before they can restart at all, let alone break even. Most also carry from 30-50 percent more staff than would normally be needed elsewhere for similar production. The overstaffing is complicated by a substantial number of ghost workers listed on the payrolls, whose salaries serve both social-safety-net and rent-seeking purposes.

**Context, constraints and challenges**

It is clear that without further investment Iraqi SOEs cannot survive. The financial weakness of the government does not permit Iraq to continue supporting loss-making enterprises. Even if the government continues to provide such support, it is unlikely that the vast majority of these enterprises could stand full competition from market forces. If nothing is done, many will move toward eventual closure with consequent job losses, social turmoil and avoidable loss to the economy.

Hence, Iraq must attract private investment into its SOEs if they are to survive, modernize and expand. The second critical need of Iraqi SOEs is modern, commercially adept management expertise. Finally, it must be clear that the primary purpose of SOE reform in Iraq should be to build strong, competitive enterprises throughout a market-oriented economy.

To achieve the above, a number of constraints must be overcome and challenges faced. The following list of obstacles reflects the fears of selected Iraqi policy makers:

- Over-employment in the SOEs, giving rise to fears of large-scale layoffs and associated negative social consequences;

- Legislative constraints – laws in force which prevent effective implementation of the program, e.g. labor laws

\(^3\) For example, the State Enterprise for Construction Materials Industry accounts for 12 plants producing bricks, plastic pipes, and several other types of stone.
• Lack of appropriate regulatory frameworks and institutions (particularly in the case of utility and financial sectors);

• Lack of effective institutions to implement the SOE reform program;

• Poor condition of the enterprises;

• Complete lack of financial viability in some enterprises;

• Weakness of the Iraqi capital market and capital market institutions;

• Popular antagonism toward foreign investment;

• Lack of domestic capital to invest in purchasing shares of SOEs;

• Corruption in SOEs, leading to strong self-interested opposition from SOE managers and/or line ministry officials; and

• Danger of concentrating ownership in a single ethnic group or a few families.

Each of the above impediments – including, of course, the security situation -- will need to be tackled resolutely and intelligently if SOE reform is to succeed. If over-employment in the SOEs means that large-scale layoffs and associated negative social consequences are feared, then this concern stands as by far the most significant barrier to reform action and must be addressed. Among employed Iraqis, one of about every eight holds an SOE job; upwards of 3.5 million are employed in the private sector (3.7 million were so registered in 2001). Some working-age Iraqis are not in the labor force: students, homemakers, people with disabilities, etc, but among the estimated 28-60 percent unemployed are also the former military (currently on stipends), former police, workers dislocated by disruptions of war, seasonal agricultural workers as well as unemployed persons in a normal job transition period. Because of this very high rate of joblessness – even without SOE reform – it is a matter of priority to prepare a range of measures to cushion workers from the effects of enterprise reform. These social-safety-net measures will likely include

• Generous redundancy or severance payments;

• Retraining programs to impart or upgrade needed skills;

• A range of programs to assist workers to re-enter the job market – such as the establishment of employment agencies;

• Public works programs.

It will be important to introduce these safety net measures in an integrated fashion so that laid-off employees can benefit from them whenever and wherever necessary and in parallel to the reform of SOEs.

Although Iraq lacks most of the laws, regulations, and associated institutions required to permit the smooth development and implementation of a SOE-reform program, it has time to
rectify this deficiency, given that there are no plans to proceed with rapid privatization. It is, however, important to proceed to design and put in place the necessary laws and institutions as soon as possible. Laws and institutions specific to SOE reform are discussed in section 5 below. Other key laws, regulations, and institutions related to the investment climate will need to be put in place quickly, since without such measures, investors will not muster the confidence to act on SOE privatization or other market opportunities.

Many enterprises are in a poor condition, and the technology in most is considerably out of date. Some of these conditions may be remedied, while for others it will be better to face reality and liquidate them. It will be necessary to complete ongoing surveys of enterprises to determine which are altogether unviable, which require restructuring, and which are clearly viable. In this regard, subsidized input prices need to be considered as well, since enterprises, which rely heavily on subsidized energy inputs and seem currently profitable, may not actually prove viable if those prices are increased.

Foreign investment is a critical contribution to the reconstruction process, both in general and for state enterprises in particular. Nevertheless, misplaced fears about foreign investment among some Iraqis could act as a brake on the enterprise reform program. In fact, the fear is exaggerated. Countries that are part of the global trading system compete with one another to attract foreign investment, valuing foreign investors as a very welcome and useful means of creating new jobs and building the local economy. To insure that Iraq also welcomes foreign investment as a critical contribution to the reconstruction process, an extensive public education program is needed to bring popular apprehensions out into the open, discuss them and lay them to rest.

The Iraqi capital market is certainly weaker than that of many other countries. Nevertheless there are over 100 enterprises listed on the Baghdad Stock Exchange and there is a history of investment in shares. Experience from other countries has shown that citizens usually have more money than expected to trade in shares if the opportunities are attractive and the marketing is effective. The capital market will need to be strengthened as privatization establishes new companies join it. Technical assistance to strengthen the exchange and assist companies to comply with listing requirements will be necessary.

Corruption in SOEs, leading to strong self-interested opposition from SOE managers and or line Ministry officials needs to be addressed. Changes in the governance of state enterprises would make corruption less likely, since a transparent and competitive process would select managers on the basis of merit, and line ministry officials would be less involved in running enterprises.

The SOE reform program should not lead to further concentration of wealth, but should instead be a part of greater democratization of capital ownership in Iraq. Achieving this goal requires designing a clear strategy to use the program to spread wealth rather than concentrate it. Public offers of shares and opportunities for SOE employees to acquire shares are two approaches to be considered.
Finally, the process of seeking public understanding should be as much one of consultation as education. Through seminars, workshops, and by formally inviting responses to consultation papers the views of interested parties should be sought so as to take them into account when designing the program. An excellent opening step is to prepare, circulate, and discuss a policy document that can help

- Create certainty about privatization aims and policy and provide a clear statement of government commitment that helps clear the air and remove doubts about the policy direction;
- Build public awareness and support;
- Reduce opposition;
- Appeal to outsiders -- taxpayers and consumers -- rather than dealing always with insiders -- employees and management;
- Show the longer term, general, dynamic effects of the policy as well as the immediate, static, transaction-related costs; and
- Give the bureaucracy the resolve to tackle difficult issues and in particular backing those individual bureaucrats who are trying to bring about change.

**An institutional and legal framework for enterprise reform**

It is important to construct a very robust institutional and legal framework for enterprise reform. Experience has shown that the effectiveness of and respect for the institutions dedicated to implementing reform and eventual privatization are critical to success. Clear definition of roles and responsibilities must be complemented by transparent, publicized procedures. Conditions currently prevailing in Iraq mean that a solid institutional framework and concentrated authority for the enterprise reform program, preferably underpinned by legislation, is particularly important. Reviews of SOEs in the governorates have highlighted the conflicting interests of various parties (e.g., government ministries, provincial governors, powerful managers, local militias) who may lay claim to current or future SOE value. Such rivalries represent a major barrier to progress and will have to be dealt with up front.

Some countries have relied on line ministries to tackle the reform; others have opted for a centralized agency. Given concern over concentration of power, the model of decision taking by a commission involving a range of interests is more likely to succeed in Iraq. This approach is also normal for privatization agencies generally headed by a commission of ministers and other senior figures. Representatives of labor and the private sector should also be included. This commission or board is usually chaired by the minister of finance, or even by the prime minister or another minister. Other key ministers are often members. It would be useful if the commission were ethnically and politically balanced. Effective staffing of such an entity – the Enterprise Reform Commission (ERC) -- requires special skills and experiences not usually found in the public sector, such as financial, accounting, legal, and communications.

Most institutional frameworks for enterprise reform/privatization involve three levels of decision-making, an arrangement which seems to suit Iraq as well. The levels are cabinet/PM, cabinet subcommittee/privatization commission, and executive/implementation. The executive level needs to be close to key decision-makers to facilitate maximum influence and access.
The SOE reform/privatization process and its institutional framework should be underpinned by primary legislation. The adoption of privatization legislation with public debate gives political legitimacy to enterprise reform and privatization and gives legal authority to act to a specialized unit.

Similarly, a strong executive body is needed, since weakness in that unit would lead to failure in overcoming opposition from vested interests. An effective body needs attributes such as (i) the administrative authority to require state enterprises and government ministries to comply with its requirements, (ii) the necessary professional skills to implement the program – talents and experience not usually found in the public sector, and (iii) adequate resources for implementation. The institutional structure should furthermore provide for a delegation downwards as far as possible and for a high degree of professionalism to ensure that complex matters are handled effectively and quickly.

Finally, a privatization law will be needed if a duly elected sovereign Iraqi government decides on such a policy. A law should establish an institution responsible for privatization together with a supporting executive body, state their powers and duties, ensure that they are kept small enough to remain effective and ensure the right mix of professional, commercial, political and administrative skills. It should state what can be privatized (e.g. all government property, broadly defined to include direct and indirectly owned, managed or controlled).

Pre-privatization interim measures and institutional arrangements for “permanent” SOEs

The Bank’s “Bureaucrats in Business” study (1995) identified the following preconditions for successful SOE management:

- The existence of hard budget constraints
- Factor market disciplines (capital and labor)
- Competition
- Corporate Governance free of political interference, and
- Commitment to eventual privatization

The current ownership arrangements for state enterprises in Iraq, Iraq – owned by line ministries of which they are effectively part – are less than ideal. It would be best practice for all SOEs not already in a corporate form that will either be slated for privatization or remain in the state sector in the medium term to be converted to a corporate form (so-called corporatization) under the commercial law. International best practice would suggest that rather than line ministries (and on occasion various other state enterprises) being the shareholders of an SOE, ownership should be consolidated in the one organization responsible for privatization and for holding state assets. This would mean that the shares of all SOEs should be held by such a body, which would be responsible for exercising the rights, duties and privileges of shareholders conferred by commercial law. It would be the responsibility of this body to:

- Vary the Memorandum and Articles of Association.
- Appoint and remove the directors.
- Approve and receive dividends.
• Approve the amalgamation, winding up, or transfer of the company.

An important corollary of this approach is that serving public officials would be barred from serving on SOE boards. There will also be a need for some form of independent audit function to report on the activities and financial position of SOEs on a regular basis.

The current framework for management and financial oversight of SOEs is in need of radical reform. Implementation of timely, accurate, and consistent financial information (probably in accordance with International Accounting Standards) will be a crucial step in ensuring the accountability of each SOE’s board of directors. All employees of SOEs that remain in the state sector should lose their status as civil servants and sign new employment contracts as employees of the state enterprises. Other steps include devising new, open, and competitive mechanisms for constituting the boards and management of corporatized state enterprises, as well as new personnel management policies.

These reforms could cover areas such as the creation of new posts, recruitment of staff, conditions of service and salaries and other benefits. Reforms should also be considered in the areas of performance evaluation and monitoring as well as rewards for superior performance and penalties for under-performance. The possibility of potential contractual arrangements between line ministries and state enterprises in respect of non-commercial obligations should also be examined. Underpinning these arrangements would be new approaches to financial management of SOEs. Within a hard budget constraint, SOEs need greater freedom to take commercial decisions without first seeking approval from Baghdad. They should have permission to commit funds and make purchases on their own account. Last but not least, environmental issues should also be examined and an approach to dealing with them built into the program.

Choice of method of reform

The choice of program objectives and transaction objectives will affect the methods used. There is a wide range of methods, for example:

• Sale of businesses, assets and shares by tender or auction;
• Sale of shares by public offer;
• Free distribution of shares to the population;
• Management / employee buy-out of enterprises;
• Concessioning of enterprises or leasing of assets;
• Contracts for the management of enterprises; and
• Contracts for the provision of services.

Based on the above, Iraqis will need to select a method and design a master plan to be reviewed on an annual basis. Its objective is to outline a broad strategy, schedule activities and monitor their progress. The plan would take into consideration other support programs such as sector reforms, legislative changes, and Iraq’s privatization experience of the 80s. Since some methods are clearly better at achieving certain objectives than others, it is essential that the condition and needs of the enterprises should strongly influence the method of reform chosen.
Executive Summary

Objectives of this paper

The objective of the study is to understand the functioning of Iraq's food grain market and the relative roles of the public and private sectors. Its tasks are to obtain an analysis of available secondary data on domestic supply and demand of food grain using estimates of production, imports, government distribution and consumption and examine available price data to assess the extent of price variations and the extent to which markets appear to be integrated. This study forms the first phase of a paper on Iraq's food grain markets, which is one of the background papers for the preparation by the World Bank of a policy brief on social protection and options for food security in Iraq.

Introduction

Social protection concerns, in particular those related to providing a food safety net to the population, have had a dominant influence over the food marketing system in Iraq. The safety net, called the Public Distribution System, PDS, provides monthly rations of food (and soap and detergents) to all the Iraqis. PDS, which was started as a response to sanctions after the Gulf War, was further enhanced and supported by the UN Oil-for-Food Programme (OFFP) since 1997. Without the PDS, nutritional welfare of the bulk of the population would have been at stake. Because of the PDS and the general authoritarian role of the state in the economy, domestic production and food marketing system has become state-dependent to a large extent.

Food marketing has to cater to a large population, estimated to be over 27 million in 2003. The consumer base is also largely urban accounting to about 75 percent of the population.

Food grain supply and demand: the big picture

Cereals, dominated by wheat flour, are most important in the Iraqi diet, accounting for about 60 percent of the average energy supply. Cereal (wheat and rice) availability for food use varied between 121 kg/capita/year and 191 kg/capita/year, according to Food Balance Sheets available for several years from 1984 to 2003. Prior to sanctions and after OFFP, cereal imports have accounted for over 70 percent of the availability for food use. Domestic production of all

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4 This paper was jointly sponsored by the World Bank and the U.N. World Food Programme
cereals recorded the highest level in 2003/04 crop year due to favorable weather and a correction for past underestimation of production. Availability of food rations that provide 9 kg of wheat flour and 3 kg of rice per person per month, meeting over 75 percent of cereal needs, have resulted in excess availability of wheat, part of which are exported across the borders to neighboring countries (Turkey, Iran, Syria, Jordan).

A summary of the country’s food grain balance in relation to sources and users indicate that approximately 60 percent of the total grain supply is dependent on imports with domestic production accounting for the balance. Ration consumption that is supported by public sector interventions account for 60 percent of the total grain availability implying that 40 percent of the grain flows is in the domain of the private sector, with the farm-level uses accounting for 10 percent and private trading accounting for 30 percent. In other words, the private sector is already playing a significant role in the food grain market in an environment of state dominance in the sector. This should help minimize any risks of market disruption or destabilization in a grain market liberalization scenario.

Supply of cereals

Domestic wheat production averaged a little over one million tons during the period 1961 to 2003. However, wheat production has been erratic; there is no significant trend observable during this period. Rice production varied between 60,000 and 380,000 tons. Low productivity and lack of growth are problems facing the wheat sector. Given the land constraints, increasing productivity to be in line with the regional yield levels is key to increasing local wheat production. Wheat sector also faced depressed market prices due to availability of large quantities of heavily subsidized ration wheat flour in the market. There were also serious shortages of inputs and spare parts for machinery throughout the sanctions period. The efficacy of the present policy of providing input subsidies needs re-examination vis-à-vis the role of better output prices to increase profitability. A new policy framework that allows the sector’s resource allocation process to be determined by market forces seems necessary to help the sector’s development; such a policy framework has to go hand in hand with policy reforms on the PDS.

Since the early 1960s, Iraq has depended on food imports. Highest imports were seen during the mid 1980s; the lowest during the sanctions until 1997 when imports increased substantially because OFFP allowed food imports using oil export revenues. The annual average of wheat and rice imports during OFFP was 2.78 million tons of wheat and 0.87 million tons of rice. If the PDS were to continue with current levels of entitlements the total requirements of wheat and rice would be 4.5 to 5 million tons in 2004. PDS has purchased about one million tons of wheat from the successful 2003/04 domestic harvest. The balance requirements of 2004 are likely to be met with imports coming from the renegotiated final contracts under the former OFFP. Private imports have been virtually negligible, given the large magnitudes of PDS disbursements to all consumers and also the availability of domestic wheat and rice. Nonetheless, minimal imports have come from neighboring countries like Syria, Jordan and Saudi Arabia especially to meet the demand for high-grade flour for confectionery and special breads.
Consumption demand

Market demand for cereals and some of the major non-cereal consumption items (sugar, oil, pulses) is highly dictated by the PDS; PDS exerts both a supply effect and an income effect with direct consequences for the determination of market prices and trading activities. PDS rations have been made available to all Iraqis and foreign residents in Iraq. Allocations under OFFP for PDS came in six-monthly phases. Under Phase XIII in 2003 the value of the “planned” PDS rations was about $5.19 per person per month. The actual rations in July 2003 had an implicit value of $3.41 under prevailing market prices (which are directly influenced by the ration availability itself). For a family of seven persons (approximately the average household size), this meant an income of about $24 or about 37,000 Iraqi Dinars (ID) at the exchange rate available in mid-2003. An adult beneficiary is allowed 18 kg of ration foods and an additional 0.75 kg of soap and detergents after a nominal payment of 250 ID (0.16). The annual cereal entitlement of 144 kg is about 75 percent of the average per capita cereal availability for consumption during 1984-1991 (pre-sanctions) period or about 80 percent of the availability in the post-1997 period. Sugar, pulses and oil rations were also similarly high in relation to levels of consumption observed in the past.

Since the inception of OFFP attempts have been made to increase the energy and protein content of the entitlements, reaching an average of about 2150 kcals/person/day and 45 g of protein/person/day just prior to the war in 2003. The income effect of subsidies would have been more on non-ration items required for a diversified diet (vegetables, fruits, eggs, milk, cheese) than for further consumption of rationed items. The average open market price of wheat flour in Iraq markets was about $120 per ton, whereas the average import price during the same period may have been $200-$225, according to OFFP figures.

The demand for cereals over and above the ration entitlement (9 kg wheat flour and 3 kg rice per person per month) could be about 3 kg of wheat flour and one kg of rice. In other words, the total average flour and rice requirement is estimated at 16 kg/capita/month. Accordingly, the annual total cereal requirement is about 192 kg giving a total requirement 5.3 million tons of wheat flour and rice for a population of 27.8 million people (approximate mid-2004 population). The additional demand over the rations would be 1.3 million tons. PDS beneficiaries sell a part of the rations or exchange them for bread. The quantities sold or exchanged vary by income class with the middle income and better-off classes engaging more than the poor in this practice. It is estimated that 20 percent to 30 percent of the ration is sold or exchanged. The primary reason for sale/exchange is perceived inferior quality of ration flour, although some may sell purely for earning an income to purchase other foods or necessities.

Food price behavior

Using monthly market prices of food commodities that have been collected by WFP since 1997, average price movements were examined in relation to four regions: the northern region, northern-central region, central region and the southern region. An analysis of 12-month moving averages of wheat flour prices clearly indicated the northern region to have operated quite separately, especially after mid-2002, when the possibility of war was in the air. All the four regions had different price levels although their movements were somewhat similar in the
regions other than the northern region. In the case of imported rice, prices in the northern region were much higher than in the other regions, where the prices and the movement were virtually same in all three regions. The price behavior is about the same in the case of Iraqi rice in the three regions other than the north, where a completely different behavior is observed after about mid-2000. The northern region has a distinct political identification, a fact recognized in the PDS under OFFP, wherein the World Food programme was given responsibility for overseeing food distribution. The region also has a different trading regime that involves cross-border trade with the neighboring countries. These are some of the factors that account for the apparent segmentation of the north regional market.

The coefficients of variations (CV) in different years of annual prices show high fluctuations of wheat flour prices in 1998, 1999 (drought-dominant years) and 2003 (conflict year); for all years, the CV is 25 percent. Imported rice also shows high price variation in 1998 and 2003. Iraqi rice has had relatively high CVs during all years with an average CV of 39 percent. Prices deflated by the Consumer Price Index computed by the Central bank of Iraq indicated a 30 percent increase in the real price of wheat flour between 1998 and 2000 while the nominal price increase was 60 percent. Since then, real price declined by 40 percent while the decline in nominal price was only 12 percent. In the case of imported rice, real prices were in a declining trend since 1998, while nominal prices tended to fluctuate. The volatility of real price of Iraqi rice is lower than that of nominal prices.

The study tested the price series for any evidence of seasonality in wheat flour prices (given the presence of a sizeable domestic wheat sector) using a seasonal price index. This index was derived by expressing the average price for each month as a percentage of a 12-month moving average of prices. The latter helps to isolate the seasonal pattern by removing the influence of cyclical price movements and long-term trends. The seasonal price index for wheat flour indicates the expected decline in prices corresponding to the domestic wheat harvesting season (May-June) with the price decline setting in somewhat prior to the harvesting period. Given the relatively low gap between the peak and trough level prices, it is unlikely that farmers/wholesalers invest to any significant degree on stock holding operations to benefit from seasonal price changes. In the case of Iraqi rice, price fluctuations are less predictable. The special role of Iraqi rice amongst food grains and the relatively small quantities that move in the market may be some of the factors that cause unpredictability in the behavior of Iraqi rice prices.

The high degree of state intervention in grain marketing would have an impact on the development and functioning of the markets. This issue was examined through a simple market price correlation analysis. If there is a strong relationship between the movements of a commodity price in two different markets (reflected in a correlation coefficient close to one), it could be interpreted as a situation where the two markets are integrated. When markets are integrated, supply and demand shocks in one location are transmitted to the other and the observed price differentials between the markets would arise only due to transaction costs. The degree of cereal market integration among eight regions (identified on the basis of proximity and some preliminary cluster analysis) was examined using correlation analysis based on the first differences of monthly cereal prices. Using the difference between two consecutive monthly prices rather than the observed prices themselves helps to eliminate fixed components of errors associated with price movements. Results indicated that the three northern governorates have
been completely separated from the rest of markets with regard to wheat flour and imported rice and showing only minimal degree of association with the rest of the markets in the case of Iraqi rice. In the case of other markets, some pairs of markets show strong correlations in price movements but in some others the correlation coefficients are substantially below one (closer to zero). The overall picture implies that the grain markets have not functioned efficiently, which should not be surprising given the nature of state control over the grain market. Further testing for market integration require more rigorous analysis, such as tests for co-integration of markets but such analyses require longer price series (and under more stable external environment) than what is available at present.

**Market infrastructure**

The current food grain marketing infrastructure has been deeply molded by the long-standing state-sponsored food distribution system, the PDS. PDS is operated by the Ministry of Trade (MOT) with three main companies under it performing the key functions (the State Company for Foodstuff Trading, the State Company for Grain processing and the Grain Board of Iraq). Most imported commodities for PDS arrive at Port Um-Qasir, but significant quantities also arrive over land from Turkey, Syria and Jordan. Independent inspection of commodities imported under OFFP at entry points is carried out (by COTECNA). MOT is responsible for transporting commodities from the points of entry to the programme-allocated facilities in the 15 governorates of the Center/South. There are currently 30 silos, 25 warehouses and more than 140 mills. MOT also assured delivery of commodities to the two transit WFP warehouses for the North located in Mosul and Kirkuk. Wheat grain is delivered to programme-allocated silos in the various governorates of the Center/South. From the silos, wheat grain is allocated to mills in the Center/South which are working under PDS. Milled flour from the mills is collected by the flour agents of PDS for onward distribution to the beneficiaries. Wheat allocated for the North has also been milled in the Center/South and then sent to the warehouses located in the North, from where the local authorities organize dispatch to flour agents. In the fifteen governorates of the Center/South, the secondary transportation and delivery of food to beneficiaries have been arranged through some 33,000 food/flour agents. In the North, WFP has used private transporters to move food from its transit warehouses in Mosul and Kirkuk to WFP-managed warehouses in the three northern governorates.

The transport of grains was done in the past taking full advantage of the rail and river transport network. Where possible, silos have been built with the capability to receive and load cereals from railway wagons and barges. At present, due to insufficient railway capacity and non-existent river transport, the transport from the entry points is done almost exclusively by road. The virtually exclusive use of road transport increases costs, increases losses and resulted in more investments to adapt the layouts to the extensive use of trucks. Close to two important silos (Dora and Taji) new flourmills are being constructed, which will eliminate additional handling and transport demand. MOT has several service agreements with various private sector agents for a total of 4,025 trucks to augment its fleet capacity. About 50 percent of the Company’s own fleet is normally utilized to service transport demand from other state companies and ministries. Within MOT, there are several companies (Grain Board, Food Stuff, Grain Processing and General Automobile) with dedicated fleets for the transportation and distribution of food-related commodities throughout the center/south. Private sector fleets are
comprised of individual operators, who are contracted through agents or are directly registered with the local warehouses and distribution facilities. The bulk of these operators are single-truck owners. The private sector fleets have continued to be the dominant force in the continuum of the various transport and distribution chains. However, the current fleet is aging, averaging over 22 years, and are increasingly becoming unreliable and not capable of undertaking long-distance trips.

Conclusions

The source of a relatively large part of Iraq’s food grain marketing activities has been the public distribution system. Large-scale public sector interventions in food marketing typically lead to inefficiencies and corruption. Re-sale, exchange and to some degree, export of food grain received under the PDS of food grain constitute part of the inefficiencies of the system. Apparently, a state-dominated food grain marketing system has deterred development of food markets, as evidenced in the segmentation of the markets in the North from the rest of the country and the price behavior in other markets that does not reflect adequate integration of regional markets. With the removal of sanctions the justification of public sector distribution of food has lost its relevance. Handing back food marketing to the open market, as has been the case prior to sanctions, will augur well for reducing the inefficiencies associated with the present system.

However, a part of the PDS will have to continue for sometime to come given the economic, social and political imperatives to have a food-based safety net for a population where a substantial section has been impoverished since 1990. Preliminary results of a WFP study indicate the proportion of the population in poverty to be 50 percent and 25 percent of the population is highly dependent on government food rations – hence, highly vulnerable to food insecurity if transfers were to be withdrawn.

There is scope and the need to release a part of the market share that PDS presently holds with its universal subsidy scheme. A targeted PDS will not only increase private sector’s market share in the food markets, it will also increase efficiency of the PDS itself. Instituting a universal food transfer programme was sanctions-driven. Sanctions and authoritarian rule are no more and the country is in dire need to work towards rapid economic growth. Present conditions call for a targeted safety net, whose objective would be to assure minimum nutritional welfare to the population that is most vulnerable to food insecurity. If this objective were to be achieved while having a universal programme (as now), it requires at least 75 percent more expenditures to transfer a given amount of nutrients to the target population, than the expenditures that would be incurred in a targeted programme. Savings from a targeted programme could well be used in pro-poor investments to improve, education, skills and economic infrastructure in poor regions.

The targeted programme itself could be geared to involve the private sector directly to provide the required services including imports, storage, milling and distribution. Cash transfers to targeted beneficiaries, instead of food commodities, will eliminate the need for the state to be involved in commodity marketing and the markets will be able to respond to the demand for food grains which cash incomes will generate. However, the safety net options, such as cash
transfers, need careful evaluation especially in relation to potential loss of nutritional benefits to the most vulnerable groups, such as women and children.

Over 12 years of food market operations coming predominantly under state control and insufficient availability of resources for development of marketing infrastructure have resulted in having only a thin spread of facilities (equipment, machinery, banking, credit). A comprehensive assessment of the current facilities and the investment needs for rehabilitation, expansion and modernization is a pre-requisite for any market development policy formulation.

At present, the private sector is handling about 30 percent of grain marketing. This should give the confidence that the private sector could take over added responsibility, but transferring such responsibility has to be cautiously undertaken, given the dilapidated physical infrastructure and a highly inadequate marketing services facilities (banking, credit, regulatory framework) presently in place. A breakdown in the food transfer-marketing system is the worst thing that could happen in the transitional situation that Iraq is facing now. Comprehensive short term and medium term planning involving complete identification of constraints and bottlenecks and instituting the appropriate legal and regulatory structures (quality controls, consumer protection) is required prior to affecting a transition to liberalized markets, that should ideally be gradual.

Improving marketing efficiency may entail large-scale public sector investments for infrastructure development; for example development of the UMM Qasr port, highways and waterways. Some investments are already in place, for example, for rehabilitation and upgrading of the port.

Policy changes toward market liberalization, safety net provision and infrastructure development have to be accompanied by a strategy for capacity building and results-based monitoring. A coordinated effort by the donors, international agencies and other development partners for capacity building will be a useful initiative in this direction.

Domestic agriculture has had a lackluster performance especially after the initiation of the oil-for-food-programme. Universal provision of subsidized food grains may have been one of the many reasons for this situation. A well-targeted PDS will increase market demand for food grains (cash transfers would do this even more), which should have a salutary effect on cereal prices, and hence on farm profitability. Such a policy change by itself will not maximize domestic agricultural output. There are other policy issues, such liberalization of input and output markets that need attention. There is a strong need for better coordination of food policy formulation and implementation, which has to be supported by an institutional structure at the highest levels of authority.
Executive Summary

Introduction

Despite significant progress towards establishing institutional foundations of a market-based economy made over the last year in Iraq, the transition is far from complete. The challenge remains huge: It concerns the choice of institutional structures that would offer incentives to maximize microeconomic efficiency, assure the allocation of resources to their best use and prevent easy policy reversals. Ultimately, it concerns the choice of policies assuring maximization of national economic welfare rather than of rents for a few privileged. The note proposes leveraging the WTO strategy to design strategy of structural reforms and drawing on the experience of recent entrants to the European Union to design institutional setting for the development and implementation of the strategy.

The WTO accession process appears to be a useful vehicle for providing incentive and guidance to transition to a market-based economy and friendly business/investment environment. It has a proven record of contributing to the shift towards rule-based, transparent and relatively stable foreign trade regimes in countries that have become WTO members after the completion of the Uruguay Round of multilateral trade negotiations in 1994. The broad reach of the Uruguay Round Agreements embracing now behind the border measures and services combined with general proclivity among WTO members to make sure that new members remove barriers to market access to an even larger extent than current members has compelled recent ‘entrants’ to introduce far reaching institutional reforms. In all, the accession process offers unique possibilities of designing a rule-based trade regime, together with mechanisms protecting against capture of trade policies by private interest groups. Indeed, international commitments associated with WTO membership may act as a ‘lock-in mechanism,’ whereas obligations stipulated by a network of WTO Agreements may provide guidance to domestic economic reforms.

But the WTO compatibility of domestic regulations and policies alone does not amount “to the construction of a high-quality institutional environment at home.” Neither does it ensure the disappearance of rents or the reduction of the potential for corruption, as the process does not automatically guarantee the emergence of a trade regime maximizing national economic welfare for two reasons. First, the major preoccupation of WTO Agreements is with market access not with national economic welfare. The two often overlap, but not always. Second, accession involves bargaining with the WTO members over conditions of opening to competition from imports. Since the exchange of “concessions” may be piecemeal, the outcome is not necessarily the best trade regime.
For these reasons, leveraging domestic reforms with the WTO commitments and development of a strategy designed to integrate Iraq’s economy into global markets may be effective only insofar as the two intertwined conditions are met. First, government is genuinely committed to multilateral liberalization. The accession process expands then opportunities of using WTO membership as a shield and driver of reforms. Second, WTO accession has to become part of a broader strategy of structural economic reforms, whose primary measure of success is not WTO-compatibility but creation of a high-quality institutional environment assuring macroeconomic stability and friendly business climate.

The note only outlines the issues that might be addressed in the development of such a strategy. The major ingredients of a strategy include:

**Tariff regime.** While a preferred option on economic and governance grounds is a duty free regime, reconstruction surcharge\(^5\) is still a better option than a uniform MFN tariff rate for one major reason. Iraq pursued the track of bilateral liberalization in 2000-02 and signed free trade agreements (FTAs) with 11 Arab countries. FTAs with the U.S. and EU cannot be excluded. Once Iraq does so, around 60-80 percent of Iraqi imports will not be subject to MFN tariffs. A reconstruction surcharge is a way around FTAs, as it could be justified to preferential partners as a temporary measure to address Iraq’s reconstruction problems. Reconstruction surcharge, introduced for a limited, specified time period, would apply to all imports including those from preferential trading partners.

**Technical standard.** The development of organizational capacities (e.g., the State Standardization and Metrology Agency, accredited unit certified to issue certificates of meeting ISO 9000 standards on quality or IS 14000 series) to encourage improvements in the quality of domestically produced goods through issuance of local “quality markings,” certificates of meeting international standards and organizing contests for the best manufactured products would be a good investment. Iraq should not invest too much effort in developing its own standards. The best policy option is to follow international practice and accept standards and certificates issued by recognized international and national bodies. Iraq should also make first step towards establishing a modern, market-based, system of technical regulations, product standards and certification by creating a legal framework assuring organizationally splitting the function of accreditation and certification and privatizing laboratories.

**Services.** The WTO accession can be used to promote regulatory reforms in services. Since regulatory reforms are technically difficult and often drain the political capital of government, it may be necessary to make choices as to where resources should be concentrated. The answer is relatively straightforward: the focus should be initially on services directly related to logistics and trade in goods. These include so-called backbone services, that is, transport, telecommunications, financial services, distribution, and business services. Backbone services facilitate resource flows and economic transactions between countries and are critical to attracting ‘production blocs’ from abroad, i.e., taking advantage of production fragmentation. The lack of high quality services in these areas hinders both domestic and foreign investments and, thereby, impedes trade.

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\(^5\) The term: surcharge rather than levy is in line with the language used in both multilateral and bilateral trade agreements. It implies (a) emergency and (b) transitional character of this arrangement.
Going beyond WTO requirements. The General Agreement in Trade in Services (GATS) cannot be used, for instance, to leverage reforms in aviation and management of ports and airports, simply because WTO-disciplines do not cover them. Both are crucial components of transaction costs of conducting foreign trade operations in MENA and many other developing countries.6

Organizational setting. For the reasons of efficiency and expediency, the development and implementation of the WTO-leveraged integrated strategy of economic reforms geared towards Iraq’s economic diversification calls for innovative approach to strategy development and subsequent implementation. Lessons that can be derived from accession of Central European countries (CEEC) to the EU are relevant, although the two accessions are different in terms of incentives and the depth of envisaged integration. Strong public support for the EU accession combined with the carrot of assistance and future access to EU funds has helped CEEC governments overcome resistance of interest groups and facilitated the process of institutional harmonization, i.e., structural economic reforms. Admittedly, however, harmonizing institutions, regulations and policies with the *acquis communautaire* is a much more demanding task and requiring more resources than meeting WTO-membership requirements.

Yet, these reservations notwithstanding, WTO accession may be a good vehicle for focusing reform efforts and, in this context, former centrally planned economies’ experience from their EU accession offer two useful insights. First, the process has to cut across various ministries and be placed at highest levels of government. CEECs had special Offices of European Integration whose heads were Cabinet members. Their primary function was to assure compatibility of laws and organizational arrangements with the *acquis*. Similar arrangements could be envisaged in Iraq, although the emphasis would be on creating a WTO-compatible high-quality institutional environment. As a minimum, one should seek an institutional setting that would allow dealing with a full WTO and regional agenda within one coordinating unit.

Second, with the benefit of hindsight, the EU accession might have gone smoother and faster, had governments sought a “fast track authority” allowing presenting the legislations with a whole bundle of laws either to be accepted or rejected in their entirety. Limited administrative capacity appears to have been a barrier. This may make this approach impossible to follow, although some intermediate solutions (e.g., basic versus developed package) may be developed in Iraq. The point to bear in mind is that too long a process of developing laws and institutions may result in the loss of a window of opportunity that the current institutional vacuum seems to offer.

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6 The World Bank study estimated that transport deficiencies have increased the cost of fruit and vegetables exported to Europe from Syria by 20 percent. See *Syria—A Preliminary Assessment of Transport Costs for Export Development*, mimeo, World Bank, Washington, D.C. 2000.