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**LEVERAGING WTO ACCESSION TO DESIGN STRATEGY
OF ECONOMIC REFORMS FOR NEW IRAQ**

by

Bartłomiej Kaminski

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Middle East and North Africa Region

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Leveraging WTO Accession to Design Strategy of Economic Reforms for New Iraq

Executive Summary

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 surcharge¹ 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 standards: 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.

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.²

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

¹ 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.

² 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.

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.

“Trade theory is about identifying whose hand is in whose pocket. Trade policy is about who should take it out” (Finger 1981)

“The yardstick that matters is the degree to which trade reform contributes to the construction of a *high-quality institutional environment* at home” (Rodrik, 2002)

Introduction

Despite significant progress towards establishing institutional foundations of a market-based economy made over the last year in Iraq, the task—even assuming that the Coalition Provisional-issued economic legislation is not overturned—is far from complete. Weaknesses are in a number of regulatory areas including enforcement of contracts and property rights, judiciary, dispute resolution, etc.

The adoption of best international practice tailored to political and economic circumstances peculiar to Iraq is one of the challenges faced by the government. The challenge is 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. It concerns the choice of policies assuring maximization of national economic welfare rather than of rents for a few privileged. This in turn may entail full-fledged rejection of former structures and push for arrangements that might be resisted by those who already—to paraphrase above-quoted Michael Finger—have their hands deeply in public pockets. But this is not a significant price if the reward is a ‘high-quality institutional environment’ at home.

While the goal of establishing a high-quality domestic business climate can be achieved in many different ways, the WTO accession process appears to be a useful vehicle for change. For once, 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 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 fact, more have been expected from countries seeking accession in the post-Uruguay environment. They have had to meet more stringent requirements than many current members do not meet. These requirements have considerably increased not only because of the wider and deeper reach of the Uruguay Round’s Agreements but also members’ willingness to exploit their power to encourage acceding governments to adopt more market-oriented approaches in their economic policies.³

³ In consequence, there is a tendency among WTO members to seek commitments from acceding governments going beyond the letter of WTO laws. For instance, “... a number of transition economies have been asked to make commitments and report progress on privatization of state-owned

It appears that they have been quite successful in encouraging positive change in acceding countries, as a recent study demonstrates.⁴ Having had examined in great detail the effects of the WTO accession process on transition economies, the authors draw among others the following conclusions: First, accession has played an important role, albeit not exclusive one, in their extraordinary effort to liberalize trade and investment policies. For some countries (e.g., China), it has been critical. Second, it has helped reduce corruption, improve the quality of governance and strengthen domestic policies to address balance-of-payments crisis. Last but not least, while the WTO membership *per se* may not open new markets and the adjustment costs may be substantial, these "...should be more than offset by efficiency gains, growth of trade and inflow of foreign capital."⁵

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 may be effective only insofar as 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.

Outlining of a detailed strategy with sequencing of reform measures would go beyond the format of this note. It requires detailed knowledge of political economy circumstances of a country and a precise assessment of its organizational and institutional capabilities. In brief, this is the matter for a government. Instead, the note only outlines in a general fashion the issues that might be addressed in the development of such a

enterprises—matters on which the WTO is silent." (Bernard Hoekman and Michael Kostecki. 2001. *The Political Economy of the World Trading System*, Oxford University Press, New York, p. 67).

⁴ See Zdenek Drabek and Marc Bacchetta. 2004. "Tracing the Effects of WTO Accession on Policy-making in Sovereign States: Preliminary Experience from the Recent Experience of Transition Countries." *The World Economy*, Vol. 27, Issue 7, July, pp. 1083—1125.

⁵ Drabek and Bacchetta, loc. cit., p. 1122.

strategy. It seeks to show how the WTO accession could be used as an external policy anchor designed to provide discipline and guidelines to implement trade liberalization and domestic policy reforms.

The remainder of this note is organized as follows. It begins with spelling out arguments in favor of an activist approach to WTO accession. Section 3 assesses Iraq's past and present trade regime and seeks to trace implications that it may have for the desired characteristics of a reformed trade regime. Section 4 identifies areas that should receive priority in the design of a WTO-compatible trade regime and provides suggestions on the best practice. Section 5 discusses where and how to avoid WTO disciplines and where to go beyond WTO rules to lock-in regulations and policies that would provide foundations for sustainable economic development and diversification of Iraq's industrial base. Section 6 outlines organizational issues related to the development and implementation of a strategy.

Benefits of meeting the WTO rules: the importance of accession mode

Accession to the WTO may contribute to improved economic performance and growth through four major channels. The first two are domestic in nature and the remaining two are external:

1. *Accession provides an economically sound framework for structuring trade policy and helps lock the country into liberal reforms.* Regulatory requirements on trade policy institutions including technical standards, customs valuation, transparency of regulations, etc., are in national economic interest.
2. *Membership in the WTO reduces the potential for capture of some foreign trade decisions by narrow interest groups.* WTO membership provides a government with a basis to resist domestic protectionist pressures. Taming the rent-seekers is the greatest challenge in designing the process of foreign trade policy making. Iraq does not face various constraints by virtue of its membership in the WTO. It has freedom of action to raise tariffs.⁶ It is not bound by the GATT disciplines on areas of domestic regulatory regimes that involve trade, that is, food and animal safety, industrial product standards, import licensing, customs procedures, investment measures, etc. Neither is Iraq required to liberalize trade in services. While protectionists may regard this freedom of action as advantageous, this is clearly not so. Although many WTO-related reforms are regulation-intensive requiring implementation of the practices that already exist in highly developed countries and require expending significant resources,⁷ the international experience suggests huge benefits in terms of efficiency and growth performance from locking-in a liberal and transparent foreign trade regime.

⁶ For some, this may be a cost, but to most trade economists this is a benefit, as WTO membership reduces the freedom to engage in harmful protectionist, self-defeating, trade policies.

⁷ For an extensive discussion of these costs to a developing country, see J. Michael Finger and Philip Schuler. 2002. "Implementation of WTO Commitments. The Development Challenge," in B. Hoekman, A. Mattoo, and P. English, eds., *Development, Trade, and the WTO. A Handbook*, The World Bank, Washington, D.C.

3. *Membership in the WTO will offer automatically at least an MFN (Most Favored Nation) status among all WTO members significantly increasing predictability, security and transparency of market access.*⁸ It may open new markets to products and services offered by Iraqi firms. In terms of its position in international markets, Iraq is a relatively small country with too weak a bargaining power to negotiate trade concessions effectively on a bilateral basis. While access to external markets may be now of secondary importance, as Iraq exports mainly oil accounting for the dominant share of its exports (usually subject to zero tariff rates in importing countries), it may become a barrier once exports become more diversified in terms of their composition.
4. *Membership in the WTO would offer protection to Iraq exporters against undertakings by other countries to restrain access to their markets and offer the government seat at the negotiation table.* It will give Iraq access to the WTO dispute settlements procedures, which as a rule tend to shield the weak against the powerful. This in turn reduces the costs associated with other WTO member country undertaking actions adversely affecting other member's exports. Participation in multilateral trade negotiations offers the possibility of influencing the evolution of the WTO system.

The first two 'domestic' channels have the potential of generating significant gains in terms of the quality of institutions and policies. Preparations designed to bring Iraq's institutions and policies in line with WTO requirements may provide an extra guidance to 'second-generation' economic reforms and become a catalyst for external sector reforms that comply with the Uruguay Round agreements. WTO accession offers the government a window of opportunity to influence not only foreign trade policies but also the broader framework for economic policymaking.

Benefits from the WTO membership depend on the mode of joining the organization, i.e., on national tariff and service opening commitments and other regulations determining contestability of domestic markets.⁹ In other words, they depend on the changes a country makes in order to become eligible for membership. But the WTO accession alone does not guarantee an efficiency-enhancing foreign trade regime. It creates, however, possibilities for a prospective member to overcome political opposition to adopting unilateral liberal policies and institutional design aimed at increasing national welfare.

But whether these possibilities become realities depends entirely on the reforms undertaken before accession. What guarantees such a regime are the kinds and extent of the unilateral commitments made during the accession process. Some recommend

⁸ This, among others, has been one of the major reasons for China's active pursuit of WTO membership (see Drabek and Bocchetta, loc. cit., and Aaditya Mattoo. 2003. "China's Accession to the WTO: The Services Dimension." *Journal of International Economic Law*. Vol. 6, No. 2. 299-339, p. 299).

⁹ Although acceding countries have to sign on all WTO Agreements, detailed conditions of entry vary from one country to another depending on respective domestic circumstances that might prevent immediate implementation of all WTO disciplines. Maximization of efficiency gains calls for using the negotiating power to focus on the agreements and commitments that would serve this purpose rather than domestic protectionist interests.

increasing tariffs prior to accession negotiations, binding tariffs at high rates, developing and enacting comprehensive antidumping legislation, and negotiate long transitional periods. According to this view these measures improve a country's bargaining power during accession negotiations.

But this is a wrong-headed approach. It carries with it the danger that a country will lock itself into a bad policy framework for a long time and actually reduce its chances for rapid accession to the WTO. Consider that for instance Algeria has been in the accession pipeline since 1987. The government should work hard to prevent this outcome.

The decision should weigh costs and benefits of membership. Costs may be substantial, as the Uruguay Round (UR) Agreements require that WTO members not only lower trade barriers but also implement reforms in trade procedures (e.g., customs valuation and import-licensing procedures) and business environment (i.e., technical standards, sanitary and phytosanitary standards, and intellectual property rights). As for the former, the costs would be negligible for Iraq, assuming it does not overhaul the present 'border' trade regime discussed in the next Section. As a country will have to purchase equipment, train personnel, and establish systems of checks and balances as well as new administrative capacities, the implementation of WTO Agreements costs money. This in turn begs an answer to "... the question of whether money spent to implement WTO rules (...) would be money productively invested."¹⁰

The answer hinges critically not only on the existing institutional infrastructure that would support implementation of the WTO Agreements but also on the assessment of likely benefits as well as modalities of implementation. While implementation costs may be considerable, efficiency and welfare gains—provided that the government develops a comprehensive strategy of structural reforms leveraged by the WTO accession process—should by far outweigh the costs.

Duality of foreign trade regime: implications for reforms

In order to be effective, reforms have to be 'path-dependent,' i.e., they have to take into account the legacy of the past as well as the current arrangements. Reforms never take place in a social and institutional vacuum. Two factors appear to have filled this vacuum. One is a long shadow from the past, which still shapes the current economic regime. The second is institutions and policies introduced over the last year by the now-defunct Coalition Provisional Authority (CPA). CPA had issued a number of regulations designed to foster the institutional development of a market-based economy.¹¹ But the task is not complete, as the 'new' seems to coexist with the 'old.' This section seeks to

¹⁰ J. Michael Finger and Philip Schuler., loc. cit., p. 493.

¹¹ Over its existence, the CPA issued 100 legal orders, with the last one announced on June 28, 2004, just a day of the formal transfer of power to Iraqi government. Some aimed at establishing market-supporting institutions. These include, among others, CPA Orders Number 37 (taxes), 38 (reconstruction levy on imports), 39 (foreign investment), and 40 (banking). For the whole list, see the Iraq Coalition Provisional Authority website <http://www.cpa-iraq.org/regulations>.

capture defining features of foreign trade arrangements before and after the 2003 invasion of Iraq from the point of view of their relevance for the design of a trade regime.

3.1. Foreign trade regime under Saddam Hussein

Saddam's foreign trade regime was reminiscent of arrangements under orthodox, unreformed central planning, albeit with many caveats. For a start, although the scope of state controls was similarly pervasive, the size of the private sector was much larger. Furthermore, since the imposition of UN economic sanctions in 1990, it had a dual structure—a legal and an illegal one, both under the direct B'athist control. In consequence, smuggling and access to authorities and foreign exchange allocations rather than tariffs and non-tariff measures shaped import flows. This was a deeply corrupt regime creating huge opportunities for well connected. As advisor to a member of Iraq's Governing Council, noted: "These arrangements, which were not weakened by the UN embargo, made possible tenfold return on investment very quickly."¹²

In fact, wars and sanctions had led to an even more direct state involvement in foreign trade micromanagement. Under the UN trade sanctions imposed following the Iraqi invasion of Kuwait in August 1990, Iraq's exports and imports were subject to international controls. In 1991-96 Iraq was allowed to export oil to Jordan and import through Jordan's port of Aqaba where independent Lloyd's inspectors oversaw Iraq-bound shipments. The arrangements under the Oil-for-Food Program (OFP), effectively launched in December 1996, required a detailed administrative planning of import needs by relevant Iraqi government agencies. These were subject to review and final decision by the UN Office for the Iraq Programme (OIP) with the proceeds of oil sales to be paid into a UN-administered escrow account.¹³

As a result, the foreign trade regime had two components: the official one, sanctioned by the UN and organized around and the OFP and the unofficial (mostly illegal in terms of UN trade embargo) one. Within the first component, access to conducting foreign trade activities was essentially limited to Foreign Trade Organizations of the Ministry of Trade. The Ministry was responsible for submitting the list of needed imports to the OIP in charge of distributing shipments coming under the OFP, which accounted for 'all legal' imports. Procedures involved reminded one of administrative arrangements under unreformed central planning. Instead of a central planner making the final decision, the UN Office for Iraq Programme performed this function.

Within the second component, private firms had to obtain licenses for individual transactions. This as a rule implied side-payments to officials often in the form of a guaranteed share in revenues from sales of imported products. Another complicating factor was that access to foreign currency was rationed through a multiple exchange rate regime leading to huge black market premia. In early 2003, for instance, the US\$ black market rate was ID 2,000, while the official rate was at ID 0.311. With the introduction of

¹² See Fareed Yasseen "We don't want Oligarchs in Iraq," *The Wall Street Journal*, September 30, 2003.

¹³ Following the implementation of the OFP in December 1996, exports increased more than five times and import more than doubled in 1997.

convertibility and a new currency in the fall of 2003, this source of distortion has been effectively removed.

The by-product of economic sanctions and OFP was redundancy of customs administration. Its staff could not have been engaged into performing regular customs clearing procedures, as these did not apply to foreign trade transaction either going through the OFP or illegal under the UN sanctions but approved by central authorities. If anything, customs were required to sanction paralegal activities.

3.2. The current foreign trade regime

Despite the formal end of sanctions and the UN-tutelage under the OFP, the current regime remains dual. Duality stems from the coexistence of what has remained of the OFP subject to administrative micromanagement and private sector trade activities under a market-based free trade regime. The CPA Order 38 did not put an end to duality, as it excluded imports under the OFP from reconstruction levy/surcharge of five percent *ad valorem* that went into effect on April 15, 2004.¹⁴ These imports include foods but also materials, equipment, etc. Many of these are among items that have been recently increasingly brought into Iraq by private traders. With the introduction of a reconstruction surcharge, they have to compete with ‘administrative’ imports on an unequal base.

Persistent duality but less distortionary

The coexistence of liberal trade regime and ‘state’s monopoly’ import regime and, on the other hand, of free and controlled prices contributes to the persistence of distortions in the Iraqi economy. Price controls over basic staples and oil have two negative effects: First, the continued rationing under the old FFO preserves the vestiges of the old regime. It enhances political strength of a group, which has strong interest in ‘conserving’ the existing arrangements and recreating old administrative structures.

Second, price controls as a rule require export controls. As long as prices remain administratively controlled the measures banning or curbing exports of these products are necessary. The CPA Order 54 (February 24, 2004) suspending all border charges (tariffs, duties, and import taxes) excluding the reconstruction levy has prohibited exports of a wide range of products unless a trader obtains license from the Ministry of Trade (Table 1).¹⁵ The system of licensing going beyond usual suspects (hazardous materials, weapons, historical artifacts, etc.) suppresses supply of these products and provides incentive to smuggling abroad. While smuggling of oil from Iraq to Kuwait and Saudi Arabia hit the headlines of international media on a number of occasions, it is not clear whether there were ‘licensed’ exports or smuggling of products subject to controls.

¹⁴ The implementation of “Reconstruction Levy” has been postponed several times and it remains unclear whether it went into effect across all border points last April. The CPA Order 38 (September 19, 2003) introducing the concept, stipulated its coming into effect on January 1st, 2004. CPA Order 47 (December 31, 2003) deferred its levying until March 1st, CPA Order 54 (February 24, 2004) until April 1st, and CPA Order 70 until April 15.

¹⁵ Price controls were not the only reason for export restrictions. Prevention of exports of stolen goods was also the reason why the list has been so inclusive.

Table 1: Products subject to export controls in 2004

<p>Foods and feeds: sugar, tea, imported rice, wheat and wheat flour, imported vegetable oil and fats, lentils and chickpeas, dried beans, milk powder and infant formula, and yellow corn of animal feed.</p> <p>Animals: all animals (including fowl), excluding household pets.</p>	<p>Manufactured goods: ferro-concrete, iron, iron reinforcing rods, galvanized iron plates, steel sheets and plates, all kinds of wood, mineral water pipes and their fittings, ceramic and other bathroom furnishings including taps and sinks, plain and colored window glass, metals of all kinds, including scrap.</p> <p>Other articles: bar soap and detergents, date palm seedlings and shoots.</p>
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Source: Coalition Provisional Authority Order Number 54, Trade Liberalization Policy 2004

Different conditions of entry

Another impediment stems from the apparent absence of a common customs border, as customs procedures across Iraq seem to differ depending upon the border point. Reportedly goods entering its customs territory through Kurdish-controlled areas have been subject to charges and duties, despite the provisions of the CPA Orders 38 and 54 suspending all customs tariffs, duties, import duties and other surcharges for goods entering or leaving Iraq.

Ambivalence about the past regulations

Continued ambivalence about the choice of how old laws and regulations should be ultimately approached is not helpful in developing a new trade regime. The CPA seems to have contributed to ambivalence by ignoring laws in some areas of foreign trade and amending them in others.¹⁶ Instead of addressing the fundamental question concerning the approach to be taken, the CPA had in fact deferred them to the sovereign Iraqi government.

Should previous laws and institutions be retained and recreated, albeit in a modified form reflecting the changes triggered by the collapse of Saddam Hussein's regime? Or should they be completely overhauled? Positive answer to the first question would call for a time consuming review of all legal acts—a formidable and a time-consuming task. It would give premium in job markets to those with intimate knowledge of old laws and regulations and slow down the emergence of a rule-based foreign trade regime. In contrast, taking a 'beginning-from-scratch' approach would drastically simplify the task and offer more effective mode of designing an economic regime in line with best international practice. It would allow starting the institutional design from scratch. A strong argument can be made for adopting the radical approach that would allow bypassing the regulatory legacy of the administrative past. But it remains to be seen whether this view prevails within the new government, as many hands—to paraphrase

¹⁶ For instance, CPA Order 54 (02/24/2004) makes a direct reference to the Customs Law of 1985. It has amended or suspended several of its articles (see Section 5.1, 3, 5 through 9). Orders on Central Bank (#56, 03.06. 2004) and Small Businesses (#64, 03.05. 2004) refer explicitly to the laws that they replace. No similar reference was made in the first regulation on foreign trade, that is, the CPA Order 38.

motto from Mike Finger—may be ready to slip into pockets offered by opaque trade arrangements.

Whatever the final decision on the choice of approach is made, the most direct implication is that arrangements that have allowed (and continue allowing) collecting rents should be terminated. The end of sanctions as well as foreign trade measures taken by CPA has not effectively put an end to these opportunities. The challenge ahead is to introduce an open foreign trade regime free of duality.

3.3. Bilateral liberalization: past and future

Iraq actively pursued the bilateral regional liberalization track before the invasion in 2003. According to the Ministry of Trade, the government signed free trade agreements (FTA) with 11 Arab countries. Most of these agreements were signed in 2001-02 as part of Iraq's concerted effort to skirt the UN international trade embargo. The Internet search has identified ten countries rather than 11 countries (Table 2).

Table 2: *FTA Partners, date of agreement and significance in Iraq's trade*

	Free Trade Agreements	Iraqi imports. Average 2001-2002 (in US\$ million)	Share in total imports average 2001-2002
Algeria	Jun-01	50.4	1.0%
Bahrain	Jan-02	0.1	0.0%
Egypt	Jun-01	92.1	1.9%
Jordan	Jul-02	543.0	11.0%
Libya	Jun-01	0.0	0.0%
Lebanon	Apr-02	29.1	0.6%
Qatar	November-02	0.1	0.0%
Syria	January-01	0.0	0.0%
Tunisia	February-01	81.2	1.6%
Yemen, Republic of	2002	4.0	0.1%
Subtotal		800	16.2%
EU		1,696	34.3%
US		39	0.8%

Source: Information on FTAs derived from original official news and other internet sources and on Iraqi trade from partners' foreign trade data as reported to the IMF Direction-of-Trade database.

Ten identified Iraq's FTA partners accounted for 16 percent of Iraq's average imports in 2001-02. This share may be significantly larger. For instance, Syria did not report trade with Iraq to the IMF DOT database, although there are indications that it traded with Iraq, and Egypt might have underreported it, as there seems to be discrepancy between IMF data and statements from Egyptian trade officials. Quotes from official data in both countries suggest that actual trade was significantly larger, although it remains unclear the extent to which it involved re-exports or other operations—as argued earlier—circumventing the UN trade sanction regime. Hence, while it is impossible to give even a rough estimate, it seems that the share of Arab FTA partners was probably twice as high as indicated in the IMF DOT database. This should not suggest, however, they will be able to maintain this share once trade with Iraq is conducted in accordance with market rules and its domestic markets are fully contestable.

The share of trade exempt from tariffs because of preferential agreements, especially is likely to expand if Iraq pursues the path of bilateral liberalization. Consider that Iraq will be under strong pressure to observe the existing FTAs in order not to antagonize its Arab neighbors. For these reasons, the new government may not only want to continue the Arab path of regional trade liberalization but also extend the existing network to members of Cooperation Council for the Arab States of the Gulf (GCC), i.e., Saudi Arabia, Oman, and United Arab Emirates.

These pressures for bilateral liberalization will not only come from regional partners that remain now outside the Iraqi network of FTAs but also from two major trading superpowers—the EU and U.S. Both of them have been actively pursuing the path of bilateral liberalization circumventing WTO multilateral negotiations. The U.S. has declared the establishment of a free trade area with Middle Eastern countries within a decade as one of its political objectives. A Middle East Free Trade Area (MEFTA) initiative launched in 2003 by the Bush administration has already resulted in trade-facilitation agreements with eight Arab countries, from Algeria to Yemen, as a preliminary step toward free trade and negotiations of free trade agreements with several other countries. The US already signed FTAs with Jordan in 2001, and with Bahrain and Morocco in 2004.¹⁷ Since MEFTA would be incomplete without Iraq's participation, the US will be interested in signing the FTA with Iraq. On the other hand, since future participants of MEFTA already have bilateral FTAs with Iraq, the government may find it in national economic interest to sign a FTA with the US. The resulting congruence of interests makes Iraq-US FTA a very likely prospect.

The EU has followed a slightly different track than the US with the “Wider Europe—Neighborhood” initiative negotiating FTA with the GCC while simultaneously pushing under the Euro-Med cooperation framework for free trade area among EU associates—Egypt, Jordan, Morocco and Tunisia. Iraq already has FTAs with all these countries except Morocco. It also borders Turkey, which enjoys EU accession status and

¹⁷ The driver of the MEFTA initiative were estimated benefits of free-trade agreement with Jordan, which allegedly contributed to a 197 percent increase in two-way trade and has drawn FDI to Jordan. The Jordanians estimate that expanded trade has helped to create 35,000 jobs. See Robert Zoellick. 2004. “Free trade can change the Middle East.” *International Herald Tribune*, June 14.

customs union arrangements. Inclusion of Iraq into a free trade area with the EU cannot be dismissed. In fact, it might be viewed as a logical component of neighborhood of wider Europe. Hence, again Iraq may find that staying out of regional arrangements might be much less attractive than moving-in.

If Iraq follows the path of bilateral liberalization, the share of preferential partners in Iraq's imports would be anywhere between 75-95 percent of total imports. In other words, only between 5-25 percent of imports would not be subject to preferential treatment. Even assuming very likely asymmetries in respective schedules of tariff removal in a possible EU and/or US-Iraq free trade agreement, i.e., longer periods for Iraq, the share of duty free imports encompassing initially products not manufactured in Iraq would be quite significant. This has important ramifications for tariff policy (see Section 4.1).

3.4. Implications for reforms

Considering Iraq's unique circumstances including limited administrative capacities of government, the foreign trade regime should have the following characteristics:

- *Simplicity*: Simplicity reduces the demand for skilled administrators and offers a better chance of symmetrical relations between the private and public sectors. The reasons related to simplicity would also favor duty-free regime on a multilateral rather than bilateral basis (see Section 3.1).
- *Transparency*: Transparency combined with simplicity reduces the scope for illegal activities and provides for a healthy interaction between the state administration, on the one hand, and NGOs and private businesses, on the other hand.
- *Stability*: Iraq has been in state of flux for quite some time. Individuals and businesses face huge uncertainties due to an overall instability. The least needed are administrative arrangements increasing uncertainty.
- *Low potential for reverse tariff discrimination*: High differences between MFN and preferential partners tariff rates provide incentive for fraudulent certificates of origin and corruption in the customs administration. The only way to avoid it is to keep MFN tariff rates close to preferential rates.

While these are attributes of any good economic regime, they are of particular relevance in the context of Iraqi reforms for two reasons. First, since its economic regime is in transition away from an administrative, rigid economic regime, the danger of locking-into a bad equilibrium of incomplete, partial reforms is particularly high. Many transition economies had fallen into this trap. The experience of these economies clearly shows that liberal foreign trade and open investment regime are key to establishing competitive markets and preempting the emergence of powerful interest groups blocking liberalization and capturing policy-making process.

Second, considering paucity of highly skilled administrators and the fact that old administrative habits die hard, every effort should be made to simplify regulations, which, in turn, reduces administrative burden and inserts a greater symmetry in state-business interaction. The alleged benefits associated with administratively complex regimes should be cast against the burden levied on the private sector and opportunity costs of shifting skilled labor to these activities. In a nutshell, it seems that a liberal policy-environment based on clearly defined and stable rules is more consistent with administrative capabilities of Iraqi government.

Priority areas: leveraging WTO accession

Following the Uruguay Round Agreements, foreign trade regime is neither limited to border measures nor to trade in goods. As a result of agreements negotiated during the Uruguay Round, which ended in 1994, GATT disciplines were extended to many trade-related domestic policies including among others services, intellectual property rights, technical regulations, and food safety standards. The Uruguay Round Agreements have also expanded previous GATT rules on customs valuation, making them mandatory for all members rather than optional.¹⁸ Whether or not Iraq decides to seek accession to the WTO, its foreign trade regime should be both WTO-compatible and competition enhancing. The two usually overlap, albeit not always.

4.1. Border measures: tariffs and other charges

Border measures pertain to tariff policy and other charges levied at the point of entry. WTO accession serves as a policy anchor for avoiding creation of barriers to trade that would go against the broader interests of national economic welfare. It also greatly improves the predictability of tariff policy, as applied MFN tariff rates will have to be bound. This commitment may help the government resist calls from to use tariff to keep competition from imports at bay. So may WTO membership help resisting administrative temptation to levy various charges on imports, as the latter—in accordance with the WTO rules—should not exceed the value of administrative services rendered and follow the principle of national treatment.

Customs valuation

Iraq will have to observe the WTO Agreement on Customs Valuation, which requires customs inspectors in WTO member countries to rely on the transaction value, i.e., the price paid or payable in the market, when calculating *ad valorem* duties instead of using reference or minimum prices set by the government. This implies the reliance primarily on what traders submit on their invoices.¹⁹ Applying this valuation method requires modernization of customs administration. Otherwise it only opens the door to fraud and reduced collections of tariffs, excises and other taxes collected at the border. To prevent such fraud, one has to allocate resources on increased training in valuation

¹⁸ This means that WTO members who do not implement these new rules can be taken to binding dispute settlement in Geneva.

¹⁹ The rules concerning customs valuation, as specified in the CPA Order 54, Section 4.2. (February 24, 2004), draw directly on procedures set forth in the GATT Agreement on Implementation of Article VII.

methods and enforcement, and share information about product valuation with other customs bureaus in the region.

Valuation is only one dimension of customs procedures, and it is probably not the dimension that most influences international trade flows. The other dimensions relate to streamlining of customs procedures or border controls complemented by administrative cooperation with neighboring countries. This may include joint border controls, an exchange of information between customs authorities, and regulatory cooperation regarding transport equipment. Last but not least, this calls for the introduction of the customs code consistent with international best practices (including WTO rules and the revised Kyoto convention) and setting the legal foundation for licensed customs brokers.

In a nutshell, the legal obligation to comply with WTO rules may be used to leverage comprehensive reform of customs administration, including computerization, and promotion of entry of licensed customs brokers. Starting from scratch offers unique opportunity to set right the rules and procedures.

Structure of tariffs

Governments of some WTO members, especially those with significant interests in market access to an acceding country seek to use the accession negotiations as a vehicle of lowering tariff barriers and extending the scope of WTO-bound tariff rates for their potential exportables.²⁰ The result often is a highly diversified tariff structure, although maximum tariff rates—as the experience of recent entrants indicates—tend to be at ‘reasonable’ levels by standards of ‘old’ WTO members including highly developed countries. So are WTO-bound tariff rates, which as a rule cover most of customs items.

The clear advantage of accession is that it compels the government to bind MFN tariff rates on majority of tariff lines. If they are above WTO bound levels, WTO members affected by a measure may demand compensation in terms of raising tariff rates on country’s imports. Thereby, WTO ‘bounds’ set a threshold on a country’s discretion in raising applied tariff rates above bounds. The caveat is, however, that the capacity of affected WTO members to respond on a country’s export basket: exporters of energy and raw materials are often not vulnerable to tariff sanctions. Yet, the mere possibility alone provides a government committed to liberal policies with a shield against capture of trade policy by vested interests.

There are, however, little, if any pressure from WTO-members to steer an acceding country towards the two best tariff options: zeroing tariff rates across all customs items or adopting a uniform tariff rate. There are strong arguments for tariff uniformity.²¹ First, because of its administrative transparency and simplicity, it reduces the scope for arbitrary actions by Customs officials. Second, the political economy of

²⁰ The tariff schedules of the ‘post-Uruguay Round’ members are almost fully-bound.

²¹ For an extensive discussion, see V. Thomas, J. Nash and Associates, 1991. *Best Practices in Trade Policy Reform*, Oxford University Press, Oxford., pp. 163-169 and D. Tarr. 2002. “Arguments for and against Uniform Tariffs,” in B. Hoekman, A. Mattoo, and Ph. English, eds., *Development, Trade, and the WTO: A Handbook*, The World Bank, Washington, D.C.

trade policy formation suggests that a credible commitment to a uniform tariff, enhanced by a binding commitment at the WTO accession, keeps potential lobbyists at bay. Third, a uniform tariff rate is neutral and minimizes the net welfare cost. Uniform tariff structure equates the marginal distortion cost of protection in production across all industries.

Governance and tariff regime

What tariff policy should the government pursue? The fundamental choice is between adopting a duty-free trade regime on a multilateral basis, i.e., extended to all trading partners, and a tariff schedule with non-zero tariff rates. Leaving aside the standard mainstream economist's argument that free trade extended not only to goods but also to services is the best trade policy option, the advantages of a duty-free trade regime from the view-point of governance stem from the disappearance of several important administrative burdens. First, meeting the requirements of the WTO Agreement on Customs Valuation loses its relevance. Neither Customs nor traders have reasons to bargain over the 'real' value of a shipment. There is no need for setting up administration in charge of solving possible disputes arising over valuation. Neither is there a need for comprehensive reforms of customs administration, as its main task is restricted then to monitoring imports and preventing entry and exit of banned products.

Second, it is less prone to corruption, if at all, as the trader has no incentive to bribe a customs officer to lower the assessment. Classification of imported products loses its significance, as duties do not depend on how customs classifies an item.²² The caveat here is, however, that the uniform tariff structure achieves the same goal, as the same tariff rate applies across all products.

Third, another complex and contentious—in the presence of FTAs—issue that disappears with a duty-free regime relates to the determination of origins of imports. The coexistence of preferential, duty-free access with MFN tariffs always provides incentive to cheat on certificates of origin. The strength of the incentive depends on the extent of reverse discrimination, i.e., magnitudes of preferential margins (difference between an MFN rate and a rate stipulated in FTA). For countries with weak administrative capacities, the scope of fraudulent certificates of origin may be quite substantive.²³ If Iraq does not revoke FTAs signed mostly in 2000-02 (see Section 2.3), an unlikely prospect even if it has MFN duty-free regime, there is no need for customs administration to deal with arcane issues related to the rules of origin. Customs still has to collect information but only for statistical purposes. There is no reason to discriminate against sources of imports, as preferential/discriminatory treatment loses its relevance.

Fourth, the *raison d'être* of various administrative arrangements designed to mitigate anti-foreign trade bias inherent in foreign trade regimes discriminating against

²² Misclassification of products, i.e., classifying them as products subject to lower tariff rates, is often used by Customs throughout the world to extract payments from traders.

²³ Examples abound. BMW automobiles entering Georgia as 'Made in Russia,' (see *Trade Performance and Regional Integration of CIS Countries*, World Bank 2004) or a whole range of products that entered the Province of Kosovo as produced in Macedonia, although the latter had never produced them.

imports in favor of domestic products and services disappears as well. These include export processing and other special economic zones established to avoid cumbersome administrative formalities and customs, and various schemes of tariff rebates (customs drawbacks, etc.) granted to exporters. They are administratively complicated—not to mention that they are usually not very effective in encouraging exports. Moreover, products from local firms located in special economic zones and enjoying access to duty free imports and often tax holidays very often find their ways into local markets creating unfair competition for other domestic firms and depriving the government of tax revenues.

In short, duty-free trade regime applied to all imports creates relatively transparent and simple administrative environment devoid of opportunities for corruption and rent seeking. This in turn substantially lowers the ‘hassle cost’ of conducting business operations in a country.

But whether the current *de facto* ‘reconstruction surcharge’ regime remains in place or not, the *argument can be made in favor of adopting a uniform “WTO-bound” tariff rate set at a relatively low rate upon Iraq’s accession to the WTO.* Domestic constitutional arrangement stipulating the principle of uniform tariff rate unless overridden by a super-majority vote in the parliament may complement the WTO ‘lock-in’ mechanism (see Section 4).

Reconstruction surcharge (levy)

Although the reconstruction levy remained only on paper since the relevant provision of the CPA Order 38—initially suspended until January 1, 2004 and then *ad infinitum*—had not been implemented, an important policy question is whether the government should scrap it altogether or retain it as a policy option. Its shortcoming is that its introduction would mark departure from the current duty-free regime. In consequence, governance issues, although not only, related to the necessity of implementing more complicated customs clearance procedures would re-emerge. Assuming, however, commitment to the principle of uniformity, administrative complexities would be significantly lower than with a dispersed structure of tariffs/levies.

Reconstruction surcharge²⁴ is still a better option than a uniform MFN tariff rate for one major reason. As argued earlier, Iraq pursued the track of bilateral liberalization in 2000-02 and signed FTAs with 11 Arab countries. For the reasons discussed earlier, it may be tempted to sign FTAs with the U.S. and EU—potentially (if not actually) its major trading partners. 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.

²⁴ 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.

4.2. Standards (TBT) and Sanitary and Phytosanitary Measures (SPS)

The importance of standards and technical regulations goes beyond accession to the WTO and observance its disciplines. Product standards are an essential component of any economy seeking integration into global markets. Consider that a large share of exports is subject to health, safety, and related standards.²⁵ Countries may thus need enforcement capacity (i.e., conformity assessment procedures and market surveillance) not only to assure that imports meet prescribed standards but also for exports to countries with which they have mutual recognition agreements. Hence, any attempt to encourage exports should also include issues related to technical standards.

No modern economy can function effectively without product standards, technical regulations and certification systems. Without a modern, market-based standards regime, producers of processed goods have rather limited opportunity to enter international markets. Standards facilitate information exchange, ensure quality, facilitate market transactions through reduction of the costs of uncertainty and comparison of products by consumers and allow tapping economies of scale. While safety concerns are only one among many objectives served by standards, the safety of products for human, animal consumption is the defining feature of sanitary and phytosanitary measures (SPS). Standards are either voluntary, developed by industry or nongovernmental standardization bodies,²⁶ or mandatory, enforced by state authorities, and often developed through international cooperation, with the International Standards Association (ISO) as a key player. But whether a standard becomes mandatory or not depends on the decision of a government. Mandatory, not voluntary standards may be used to restrict imports, which is why they are within the GATT/WTO purview.

Two WTO agreements on Technical Barriers to Trade (TBT) and its *lex specialis* Sanitary and Phytosanitary Measures (SPS) are deemed as having the most significant welfare-enhancing potential for a developing country. What distinguishes them from other policies subject to WTO-rules is that technical regulations are "... generally intended to be welfare enhancing."²⁷ These agreements do not require WTO members to have product standards. They merely require that WTO members apply mandatory regulations transparently and fairly and in ways that minimize their restrictive impact on imports. Mandatory standards approved by such organizations as the International Organization for Standards (ISO), the Underwriters Laboratories, the joint FAO/WHO Codex Alimentarius, International Plant Protection Convention, and a few other institutions are regarded as *de facto* compliant with the provisions of WTO TBT and SPS

²⁵ For instance, according to one estimate, over 60 percent of US exports is subject to certification in destination markets. For 45 percent of US exports to the EU government-issued certificates were required, for 15 percent private, third-party certification was required, and for the rest manufacturers self-certification was sufficient. See J. Wilson. 1998. *Standards and APEC: An Action Agenda*, Institute for International Economics, Washington, D.C.

²⁶ Most notable examples include the American National Standards, the British Standards Institution, the Deutches Institut fur Normung, and the Association Francaise de Normalisation.

²⁷ B.M. Hoekman and M. M. Kostecki. 2001. *The Political Economy of the World Trading System. The WTO and Beyond*. Second Edition. Oxford University Press, Oxford, p.186.

agreements. Governments basing their technical regulations on other sources of standards face the task of demonstrating that theirs are WTO-compliant.

What implications does it have for Iraq? These are different for SPS related measures and other technical standards. As far as the former are concerned, they are of much greater relevance and urgency, as imports of foods from less developed countries may constitute a health hazard. Hence, there is clearly a need to develop technical capacities to test imported foods. There is, however, no urgency for Iraq to develop, or reactivate its own SPS measures. It should accept others' SPS using a slightly modified WTO-rule—instead of demonstrating that they offer the same level of protection of health and environment as Iraqi SPS, they should simply prove the same level of protection as in a country of origin. Government regulations should make use of existing international standards and be limited to essential public health and safety requirements.

As for TBT products, three observations can be made. First, the development of organizational capacities 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. This would include, among others, the establishment of an accredited unit certified to issue certificates of meeting ISO 9000 standards on quality or IS 14000 series on the environment. Furthermore, Iraq should seek membership

Second, 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. In fact, harmonization of national with international standards is essential to participation in international supply chains cutting across national borders, as common standards reinforce linkages between component manufacturers, assembly operations, and distributors in the final product markets. It generates the so-called network externalities. Even though Iraq may not have mutual recognition agreements, it should accept certificates from highly developed countries (e.g., EU, US). Products safe for consumers in these countries are also safe for consumers in Iraq. These products should not be subjected to mandatory testing.

Third, 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. Legal framework would set the development of the standards regime on a right track, with the standards voluntary, developed and enforced by private sector bodies, allowing for manufacturer's self-declaration of conformity assessment, and eliminate duplicate regulations.

Furthermore, the State Standardization and Metrology Agency should be reinstated (or created from scratch), although its mission should not be designing technical regulations but provide information on international standards, raise awareness of the importance of quality management and encourage the development of private-public cooperation in promoting international standards.

4.3. Services: General Agreement on Trade in Services (GATS)

The greatest impact that accession to the WTO can generate as an external policy anchor, however, is on Iraqi regulatory policies rather than on its tariff policies. As a result of agreements negotiated during the Uruguay Round, which ended in 1994, GATT disciplines were extended to many trade-related domestic policies including among others services, intellectual property rights, technical regulations, and food safety standards.

Efficient provision of services has huge welfare-enhancing potential for a developing country. Services account for a significant portion of overall production costs of goods: their availability and low pricing lower the costs of exports and imports alike. Moreover, their supply is decisive for domestic firms to participate in the most rapidly expanding division of labor based on fragmentation of production. The development success of third tier of East Asian countries (Malaysia, Thailand) has been due in large part to their participation in this new division of labor organized around FDI (foreign direct investment) and by MNCs (multinational corporations). Outsourcing, just-in-time production and supply-chain management, which are all critical to transferring abroad a slice of a production process, cannot function efficiently if they are delays and disruptions because of weaknesses in 'service links.' In a nutshell, without high quality 'service links, the prospects for diversification of the Iraqi export basket are dim.

Hence, an important question to be asked in the Iraqi case is: How can the WTO accession be used as a vehicle for regulatory reforms of services in New Iraq? This section reviews major features of the GATS and seeks to answer the above question.

GATS: salient characteristics

Services entered the agenda of the Uruguay Round of multilateral trade negotiations for two reasons. First, with on-going transition from industrial to service economy, trade in services has been one of the most rapidly expanding areas of international trade growing much faster than merchandise trade. Highly developed, increasingly service-based economies sought to extend rule-based regime of international trade to services. Second, electronic revolution has made the links between services and liberalization in their trade and overall economic performance more pertinent. Liberalization of trade in services may improve the quality and availability of services through competition, economies of scale and, last but not least, incentives to policy makers to improve regulatory environment. Benefits of services liberalization are not limited to services sectors themselves: they impact all other economic activities.

WTO membership includes extensive commitments made under the General Agreement on Trade in Services (GATS) to maintain open borders to cross-border trade and foreign investment in services. Trade in services is defined in GATS (General Agreement on Trade in Services) as the supply of a service through any of the four ways, known as "modes of supply": *Mode 1*: services supplied from one country to another (e.g. international telephone calls), officially known as "cross-border supply"; *Mode 2*: consumers from one country making use of a service in another country (e.g. tourism), officially known as "consumption abroad"; *Mode 3*: a company from one country setting

up subsidiaries or branches to provide services in another country (e.g. a bank from one country setting up operations in another country), officially known as "commercial presence"; and *Mode 4*: individuals traveling from their own country to supply services in another (e.g. an actress or construction worker), officially known as "movement of natural persons." Country acceding to the WTO is likely to be required to make commitments concerning conditions of entry and national treatment of foreign providers of services. It also has to offer the same treatment to all suppliers from WTO countries, i.e., the MFN principle.

GATS was deemed a success of the Uruguay Round not because of the progress in liberalization of trade in services but simply because it has locked countries into a standstill against backsliding, i.e., erecting new protectionist measures and to further rounds of progressive liberalization. The GATS has failed to introduce similar disciplines in scope and depth as under the 1994 GATT. First, while it commits WTO members to meet two general obligations: transparency and the most-favored-nation (MFN) principle across-the-board, the Agreement allows for temporary exemptions to MFN. Second, unlike the 1994 GATT, the principle of national treatment (i.e., no less favorable than afforded to domestic one) and market access applies only to sectors specified in national schedules of GATS commitments (see Box 1).

Box 1: Basic principles underlying the GATS

- ⇒ Except for the annex on air transport excluding major aspects of aviation policies from coverage by GATS, all services are covered.
- ⇒ MFN (most-favored-nation) treatment applies to all services except for the provision of the one-off temporary exemptions.
- ⇒ National treatment applies only in the sectors/areas where commitments are made.
- ⇒ Regulations have to be reasonable and objective.
- ⇒ Transparency in regulations and enquiry points is required.
- ⇒ Individual countries' commitments are negotiated and bound.
- ⇒ GATS schedules are divided into horizontal commitments, i.e., applying across sectors and sector-specific commitments.

In consequence, the GATS is weaker than the GATT in meeting the fundamental objectives of multilateral trading environment, that is, the promotion of transparency, stability and liberalization of trade. The 1994 GATT scores higher on liberalization of trade. GATS Article III to notify changes in laws, regulations, and administrative procedures apply to all sectors thus assuring information availability, albeit with a caveat. Namely, since the barriers to market access are not price-based barriers such as tariffs but NTBs taking the form of discriminatory treatment embedded in laws, regulations and administrative acts and procedures, these tend to be less easy to navigate than rules related to trade in goods. In a similar vein, standstill rule assures stability in access, but less so than under the 1994 GATT. The problem is that GATS contains some unfinished rules on emergency safeguard measures and subsidies and with respect to domestic regulations. The extent of liberalization depends on the sector-specific commitments,

which are more limited than that in trade in goods. For this reason alone, ‘rewards’ in terms of preferential access may be larger for trade in services than those for goods, simply because the extent of discrimination against non-preferential suppliers is larger.

Worldwide, the use of GATS by WTO members as a credibility enhancing mechanism has been rather limited, with one important exception—telecommunications sector.²⁸ The Telecommunication ‘Reference Paper’ contains explicit provisions on regulatory principles, though non-binding, that countries should follow. But here as in other cases, WTO membership is not a necessary condition to open markets to competition from foreign suppliers. Consider that Bahrain, neither a WTO member nor observer, has become the first country in the Gulf to fully liberalize external access to provision of local and international fixed voice and data services, internet services and radio-based services.²⁹

What commitments should Iraq make?

Before addressing the question in the title of this subsection, one should ask how high WTO members of the Iraqi WTO accession working party, which will be established once Iraq applies for membership, will put a bar for Iraq? Country acceding to the WTO is required to make commitments concerning conditions of entry and national treatment of foreign providers of services. It appears that there is a link between the date of accession and the extent of commitments made by acceding countries. The requirements placed on new acceding WTO in terms of opening their respective markets for services seems to have been on the increase in terms of WTO members’ demands (Table 3).

Thus, one may expect that Iraq will be under pressure to bind the country’s markets for services to be open to external competition in most, if not all sectors. The empirical evidence from cross-country studies suggesting positive impact of liberalization on availability, and the quality and costs of supplied services. As it was argued earlier, a regulatory environment fostering competition in service sectors is also crucial to trade in goods and tapping opportunities offered by the division of labor based on production fragmentation.

While these WTO-related pressures may indeed improve the quality of services sectors, they will not do so by default. The GATS/WTO commitments alone do not provide automatically for regulatory environment supporting efficient provision of services. To the contrary, the task of creating a regulatory environment that encourages the development of services begins at home, simply because the main restrictions to trade in services are ‘behind-the-border’ laws, regulations and red tape. Liberalization calls for reforms in a wide range of domestic policies concerning, for instance, rules for network

²⁸ See A. Mattoo. 2000. “Shaping Future GATS Rules for Trade in Services,” paper presented at an NBER Conference on Trade in Service, Seoul, June, p. 11.

²⁹ The new regulations allow local and foreign companies, provided the latter are headquartered in Bahrain to apply for an unlimited number of licenses in telecoms services except mobile services that will remain closed at least until 2005. See William McSheehy, “Gulf Liberalisation: Bahrain opens telecoms market.” *Financial Times*, July 2, 2004.

access in telecommunication, licensing regimes, investment rules, rules on temporary movement of workers and competition policies. Except for non-binding rules in Telecommunication “White Paper,” there are no other cases of extending multilateral disciplines to regulatory arrangements.

Table 3: Sectoral commitments of selected countries that acceded to the WTO in 1997-2001

	Mongolia (1997)	Panama (1997)	Kyrgyz Republic (1998)	Latvia (1999)	Estonia (1999)	Jordan (2000)	Georgia (2000)	Oman (2000)	Moldova (2001)	China (2001)
Professional services	x	x	x	x	x	x	x	x	x	X
- Legal services	.	x	x	x	x	x	x	x	x	X
- Accountancy services	X	x	x	x	x	x	x	x	x	X
- Taxation services	.	x	x	x	x	x	x	x	x	X
- Architectural and engineering services	.	x	x	x	x	x	x	x	x	x
- Medical services	.	.	x	x	x	x	x	x	x	x
Computer and related services	.	x	x	x	x	x	x	x	x	x
Research and development services	.	.	x	x	x	x	x	.	x	.
Other business services	x	x	x	x	x	x	x	x	x	X
Postal services	x	.	x	.	.	x	x	.	x	.
Courier services	x	.	x	x	x	x	x	x	x	X
Telecommunications — valued added	.	X	x	x	x	x	x	x	x	X
Telecommunications — basic	.	.	x	x	x	x	x	x	x	X
Audiovisual services	.	X	x	.	.	x	x	x	.	X
Construction services	x	X	x	x	x	x	x	x	X	X
Distribution services	x	X	x	x	x	x	x	x	X	X
Educational services	.	X	x	x	x	x	x	x	X	X
Environmental services	.	X	x	x	x	x	x	x	X	X
Financial — insurance	x	X	x	x	x	x	x	x	X	X
Financial — banking and other financial services	x	X	x	x	x	x	x	x	X	X
Health services	.	.	x	x	x	x	x	x	X	X
Social services	.	.	x	x	x	x	x	.	.	.
Tourism services	x	.	x	x	x	x	x	x	X	X
Recreational services	.	.	x	x	x	x	x	.	x	.
Transport services	.	X	x	x	x	x	x	x	x	x
- Maritime transport	.	.	x	x	x	x	x	x	x	x
- Air transport	.	X	x	x	x	x	x	x	x	x
- Rail transport	.	.	x	.	x	.	x	.	x	x
- Road transport	.	.	x	x	x	.	x	.	x	x
Limitations on National Treatment	x	X	x	x	x	x	x	x	x	x

Note: "x" denotes commitment made by a country to open access

Source: Derived from http://www.wto.org/english/thewto_e/acc_e/tn_4accprocess_d_e_tab4.htm.

Yet, the WTO accession can be used to promote regulatory reforms. It may help in the reform process in several ways provided that government is genuinely committed to establishing an environment fostering competition and trade facilitation. As mentioned earlier, accession can be used as an 'excuse' and, thereby, a shield that would contain domestic vested interests, if such have already emerged. But the real challenge is not in opening to competition of foreign providers of services but in designing regulatory structures that would assure competition. Autonomous regulatory structures—regarded as crucial to assure stability and predictability of regulatory and policy environment—have been established in such areas as telecommunications, banking and securities markets. However, they remain untested.

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.

While the regulatory environment supporting efficient provision of services is far from complete in Iraq, some progress has been made in a number of important policy areas and Iraq appears to be ahead of most MENA economies in terms of liberalization. Consider first that the CPA Order 39 sets the framework for almost unhindered commercial presence (natural resources, primary processing and financial services excluded) of foreign firms;³⁰ it spells out adherence to the principle of national treatment; it does not set any limits on equity held by foreigners; and it allows for repatriation of profits.

Second, the fundamentals—both legal and institutional—of a modern banking system are already in place. Iraq has a two-tiered banking system, with commercial banks and a central bank. It is also open to foreign banks. In fact, the Central Bank has been actively seeking applications for licenses from foreign banks—at least three international banks have either started or are about to start operating in Iraq. A number of commercial banks have been approved to provide remittances and letters of credit. The Trade Bank of Iraq provides trade financing, albeit still on a limited basis.

Thus, it seems that if the government builds upon those achievements and devotes energy and resources to beef-up competition-enhancing regulatory structures, there would be few, if any, restrictions on access to Iraqi markets for services. In most sectors, the key to success is to nurture regulatory independence, that is, the institutional separation between regulators and service providers.

4.4. Concluding comment

The economic benefits of WTO membership are determined not only by the extent of one’s own multilateral trade liberalization but also by the depth of regulatory reforms in services sectors and other measures improving business climate. Opening to external competition alone will not bring all benefits as long as domestic firms are handicapped by high administrative hassle and high transaction costs that make impossible fair competition.

³⁰ The provision that entry into retail services sector requires at least 30 day prior-residence and deposit of US \$100,000 does not strike one as too restrictive.

Going beyond and side-stepping WTO

As argued earlier, not all WTO agreements a member-country has to implement, and they do not cover all areas that enhance competitiveness of domestic firms and economic welfare. Furthermore, the institutional underpinnings of a trade regime are beyond WTO-rules insofar as they do not restrict imports. This section offers suggestions, not yet tested in international practice, as how to lock-in reforms thus assuring their stability and irreversibility. It also identifies areas not covered by the WTO Agreements, but with a significant potential for improving a country's economic performance, and those that are covered but not worth implementing.

5.1. Beyond WTO: institutional lock-ins

While there is no 'private interest-proof' solution, one may seek shielding foreign trade regime from private interests through institutional design of trade-related procedures. Embedding basic principles into a constitution, albeit rarely, if ever, used vehicle, is a possibility. As for the current 'constitutional moment' in Iraq, there are two restrictions. First, the window of opportunity is short—essentially limited to the period during which the government will work on writing a constitution. Second, regrettably there is no international tradition to lock economic rules of the game in a constitution, with the exception of constitutional guarantees concerning the protection of private property rights. Another exception relates to endowing the executive rather than legislative branch of government to make fundamental trade-related decisions. The superiority of this solution over alternatives is that the executive branch, especially at its highest level is more committed to public rather than narrow private interests.

In addition to assigning responsibility for foreign trade decisions to the chief of the executive branch, another idea that might be embedded in constitution relates to MFN tariff rates. The problem is not with their maximum levels, as WTO accession takes care of it through WTO bound tariff rates. Rather the problem is how to preserve the principle of a uniform tariff rate. One possible solution might be assuring inviolability of the principle of a uniform tariff rate through infusing a super-majority requirement for upward changes in its level and a simple majority rule for its downward revisions combined with strict adherence to the principle of national treatment in all relevant domains. For instance, this might involve adopting the rule that *the principle of a uniform tariff structure* can be revoked only by 80 percent super-majority vote in the Parliament, whereas the *change in the level of a uniform tariff rate* would require a simple majority vote.

The advantage of this arrangement is straightforward. Since the increase in a uniform rate affects both final and intermediate products, the gain to a domestic lobbyist for protection is diluted and, therefore, the incentive to lobby is also reduced. If tariff increases are selective (i.e., in the absence of a uniform tariff) benefiting a small selected industry, the potential gains to their beneficiaries are large and so is the incentive to invest in lobbying activity. With a tariff increase affecting all imports, consumers, exporters and the non-trade sector will lobby intensively against it.

5.2. Beyond GATS: aviation services and management of ports and airports

The GATS cannot be used to leverage reforms in aviation and management of ports and airports, simply because WTO-disciplines do not cover them. Although the list of sectors covered by the GATS mentions aviation services, all major aspects of aviation policies have been excluded from coverage by GATS. Similarly, despite general stipulations, the GATS have not gone far to open ports and airports to external providers of services. Both are crucial components of transaction costs of conducting foreign trade operations in MENA and many other developing countries.³¹ It is estimated that worldwide the total economic costs of transport inefficiencies are equivalent to 3-5 percent of the total value of trade. Both are tempting to rent-seekers, as they offer huge opportunities to put ‘hand in a public pocket.’

For these reasons, both aviation and management of ports and airports should be high on the reform agenda. Although Iraq is not a land-locked country, air transportation is key for the development of trade. Consider that although the US has direct access to both Atlantic and Pacific Ocean, more than 40 percent of the value of goods enter or leave its customs territory through air. Given the possibilities offered by differences in seasons for fruits and vegetables in Iraq and the EU, this mode of transport may be crucial to Iraqi agricultural exports to the EU once this sector fully recovers. More generally, air transport provides fuel to the emerging global division of labor based on production fragmentation.

Table 4: *Aviation: premises of ongoing transformation and their impact on regulatory trends*

Before (1960s)	Now
<i>Economic weight and effects</i>	
<p><i>Marginal role in economic development:</i></p> <ul style="list-style-type: none"> • Merely 2 percent of goods in terms of their value transported by air. • Passenger traffic restricted to wealthy individuals. 	<p><i>Key role for economic development:</i></p> <ul style="list-style-type: none"> • Around 40 percent of goods in terms of value transported by air • Mass passenger traffic (1,600 million passengers) thanks to the fall in airfares on average at around 1-2 percent annually.
Importance of employment and other economic effects generated within an airline (national airlines required to buy domestically; source of innovations—navigation technology by PANAM)	With the advances in productivity and the fall in costs due to technological progress outside, outsourcing and specialization in provision of services
<i>Shift in regulatory approach</i>	
<i>Role of State:</i> service provider. For each country one flag carrier.	<i>Role of State:</i> regulator and facilitator. Flag carriers privatized.
Domestic: Highly rigid and detailed Civil Aviation Laws regulating all aspects of air traffic.	Domestic: Since the late 1970s (initially US followed by others) deregulation. Total freedom (s.t. safety and financial tests) in the EU and US. Frame Laws supplemented by (safety) regulations
External: Bilateral agreements protecting national carrier	External: towards multilateral agreements; open skies policies and unilateral liberalization (tourism intensive countries, e.g., Dubai and some Caribbean countries)

³¹ 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.

The recreation of national flagship carrier, although tempting would be step backward vis-à-vis worldwide tendencies. The last decade or so has marked a dramatic shift in regulatory approach, which began with deregulation in the US in the late 1970s and spread to many other countries. Table 4 above summarizes underlying forces and characteristics of the shift. Iraq has a chance to move ahead of the curve by pursuing unilateral liberalization. As the case of Dubai amply illustrates, this does not mean resignation from domestically owned airlines. This only implies that they cannot count on domestic subsidies and would have to survive in a competitive market for air transport services on their own.

As for management of airports and ports, the best practice is separation of operational and commercial functions (the landlord port), privatization of port/airport services, and leasing large container and bulk terminals to private operators. The longer one waits the more difficult it will be to implement the concept of landlord port, with the state acting as landlord rather than manager.

5.3. Sidestepping Anti-Dumping

Although the WTO agreements extensively cover antidumping (AD), this should not suggest that WTO-members must have antidumping legislation. The WTO-rules merely stipulate that WTO-rules be observed only if a country resort to AD actions. The AD legislation is a bad idea for several reasons: First, it alone increases the leverage of protectionist interests over the government; breeds lobbying and corruption; and diverts scarce entrepreneurial talent into the political process.

Second, the standards of antidumping do not make economic sense—they do not guide government to deciding where an import restriction would harm or serve the national economic interest, while allowing for an easy exit from a liberal foreign trade regime once it is in place;

Third, they reduce import competition in domestic markets and raise prices as a mere opening of the investigation causes imports to fall and prices paid by users to increase; and they rarely, if at all, address cases which present a real threat to competition.

Last but not least, they take into account the interests of producers competing with imports at the expense of users of imports including possible exporters.

The absence of AD legislation does not leave the government powerless in face of a sudden increase in imports endangering the survival of whole industries. To the contrary, the WTO-rules provide a much better option—a safeguard option. Namely, in case of serious injury caused by imports, GATT Article XIX allows for safeguard actions. It is better than the AD action because measures reducing imports have to be price-based (i.e., expressed in terms of tariffs), precisely defined, temporary, non-discriminatory and introduced only after appropriate procedures consistent with WTO rules are followed. In contrast to AD undertakings, they tend to take into account not only the gains to protected industries but also the costs to users of imports.

5.4. Concluding observations

The section provides only examples where going beyond or sidestepping WTO-rules make good economic sense. There are clearly other cases.³² Their identification and analyses, together with policy recommendations, should be part of economic reform strategy organized around WTO accession. But the examples discussed have one feature in common: they promise big gains in efficiency of allocation of resources and competitiveness of domestic firms.

Conclusions: approach and organizational underpinnings

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 both its rushing it through legislative (as it should include a number of laws) and organization of its preparation 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.

WTO accession lacks tangible political rewards. It would require skillful political persuasion to use the WTO as a political rallying point around economic reforms. 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

³² Faced with subsidized state-owned enterprises, the Chinese government has focused on meeting WTO-rules on subsidies. These were used as a political shield to reform the state-owned industrial sector.

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.