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Liberal Economic Regime is the Best Option for Iraq: The Foreign Trade Perspective[•]

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1. Introduction

Trade regime facilitating and promoting international transactions is only one of many ingredients that are indispensable to put a country on the path of sustainable economic growth. Without effective political system, fully liberalized prices, environment friendly to private business and investment, macroeconomic stability, even the best trade regime will fail to trigger supply response and accomplish this objective. Yet, this should not suggest that reforming foreign trade regime could wait till other components are in place. To the contrary, unreformed trade institutions could perpetuate or lead to the emergence of huge rent-seeking opportunities and opposition to reforms. These groups blocked reforms in many transition economies. Coalition Provisional Authority (CPA) has partly preempted this possibility. CPA Order 12 suspended tariffs and other border charges until January 1, 2004.

Further measures adopted by CPA in late September 2003 suggest commitment to follow the radical approach to economic reforms, as opposed to gradualism advocated by some. Three most recent acts of the CPA establishing liberal regimes of taxation, banking, foreign investment and foreign trade have closed various loopholes and further exposed the Iraqi economy to competition from imports and foreign investors.[1] This happened despite opposition from some on the Iraqi Governing Council (IGC) as well as within CPA. A commentary published two weeks before CPA issued 'reform orders' by *Oxford Analytica* (October 6, 2003) had a title "IRAQ: Rapid economic opening may be scaled back."

The Iraqi reform package, announced at the annual meeting of the World Bank and International Monetary Fund in Dubai, has come under attack. It has been dubbed neo-conservative, extreme, etc. Jeff Maddrick (2003) observes that by mainstream economist's standards is extreme and "in fact stunning," He writes: "The current plan is supported neither by theory nor experience, only by the wishful ideological thinking of its advocates. Its consequences, as in Russia, could be widespread cruelty." (Maddrick 2003). He misses the point completely, as Russia neither adopted radical shock nor opened its economy to external competition.

Furthermore, CPA's measures are neither as radical as he portrays them nor do they ignore the experience of transition from central planning. Corporate income tax of 15 percent is hardly stunning—in fact, it is 2.5 percentage points higher than in Ireland and 3 percentage points lower than in Hungary. Neither is a 5 percent reconstruction levy, a uniform tariff rate under a different label. Simple average tariff rate for industrial economies was 4 percent in 1999. Estonia, Hong

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[1] See the CPA Orders Number 37 (taxes), 38 (reconstruction levy on imports), 39 (foreign investment), and 40 (banking), all issued last September, available at the Iraq Coalition Provisional Authority website http://www.cpa-iraq.org/regulations.

Kong, Singapore had zero, and Latvia or Uruguay 5 percent.[2] More significantly, he accuses CPA of ignoring fatal Russia's experience with swift liberalization. He appears to be unaware, among others, that exclusion of oil, non-ferrous and other easily marketable raw materials from price liberalization fueled rent seeking and more importantly the emergence of powerful 'newly-rich' group of oligarchs that subsequently blocked measures increasing competition in the Russian economy.

While these criticisms may demonstrate their authors' lack of knowledge of contemporary economics in general and that of economics of transition in particular, they cannot be ignored. They are strongly reminiscent of the debate: *radicalism* versus *gradualism* of the early 1990s. While the field was then open for speculations, now at least we have abundance of empirical evidence. Gradualism in the first-generation reforms (liberalization of prices, foreign trade, business entry, and current account convertibility) enriched few at the expense of general economic welfare and inflicted huge economic costs. Capture of reforms by private interests for their own enrichment has been a trademark in a number of transition economies including Russia and Ukraine.

Hence, directing entrepreneurial talents towards welfare enhancing activities rather exploiting rent opportunities should be one of the major concerns of those responsible for reforms. The design of foreign trade and investment institutions and policies together with price liberalization plays an important role in it. They all should subject domestic actors to competition from outside.

The remainder of this paper is organized as follows. Section 1 outlines major features of foreign trade regime before the 2003 war and illicit trade. Section 2 reviews arguments in favor of protection. Section 3 makes the argument for free trade. Section 4 explains why a free trade regime does not emerge as a result of the domestic reform process. Section 5 concludes.

2. Foreign trade regime and sanctions: implications for reforms

Saddam's foreign trade regime was reminiscent of foreign trade arrangements under orthodox, unreformed central planning, albeit with many caveats. For starters, 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 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 imports. This was a deeply corrupt regime. It had led to enrichment of well-connected with implications for a broad spectrum of reforms ranging from foreign trade, foreign investment and privatization.

Duality of foreign trade regime

Wars and sanctions had led to a more direct state involvement in foreign trade micromanagament. Under the UN trade sanctions adopted 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 with the proceeds of oil sales to be paid into a UN-administered escrow account. Following the implementation of the OFP in December 1996, exports increased more than five times and import more than doubled in 1997.

[2] See Appendix Table 1 in B. Hoekman et al. (2002, 562-64).

The foreign trade regime had two pillars: the official one organized around the OFP and the unofficial (mostly illegal in terms of UN trade embargo) one. Access to conducting foreign trade activities was essentially limited to Foreign Trade Organizations of the Ministry of Trade. The Ministry was (and remains) 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. In order to import, private firms had to obtain licenses for individual transactions. This as a rule implied side-payments to officials often in the form of 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.

The current regime remains dual and transitional. Duality stems from the coexistence 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 duality, as it excluded imports under the OFP from reconstruction levy. These imports include food but also materials, equipment, etc., which are items that have been recently increasingly brought into Iraq by private traders. They will now have to compete on an unequal base. Furthermore, as long as prices remain administratively controlled, measures curbing exports of these products are necessary.[3] In sum, the coexistence of two import regimes and controlled prices, while necessary, contribute to the persistence of distortions in the Iraqi economy.

Trade: where have all trade surpluses gone?

Iraq neither published nor reported its foreign trade data to international organizations. There are two sources of information on its trade activities—mirror statistics, i.e., transactions reported by foreign trade partner to the IMF Direction-of-Trade (DOT) and UN COMTRADE databases, and imports and exports conducted under the OFP. The latter cover only the 1996-2003 period (Table 1). Taken together they offer some glimpses into Iraqi foreign trade performance.

Table1: Average exports and imports in three periods, 1989-90, 1991-96, and 1997-02 (in billion of US dollars and percent)

	1989-90	1991-96	1997-02
Exports (average)	12.5	0.53	9.45
Imports (average)	7.4	0.50	2.95
Index: Exports 1989-90=100	100	4.3	75.6
Index: Imports 1989-90=100	100	6.8	39.9

Source: IMF Direction-of-Trade database.

For comparative and analytical purposes, it is useful to distinguish three phases in Iraq' foreign trade developments: the pre-Gulf war period 1989-90; the embargo period 1991-96; and the OFP period over 1997-2002. As can be seen from data in Table 1 based on mirror statistic, the cutting dates reflect actual developments in the sanctions regime, i.e., almost a total embargo affected trade in 1991-96, and the OFP had an impact beginning in 1997.[4] Trade came to a virtual halt in

[3] This provides one with another argument in favor of a quick dismantling of administrative rationing and full liberalization of prices.

[4] Although the Security Council established the Oil-for-Food Program on 14 April 1995, deliveries began in December 1996.

the 1991-96 period. It is worth noting that exports appear to have been less affected than imports. Reported exports stood on average at 4.3 percent of their average value in 1989-90 and imports at 7 percent. In value terms, they were 25 and 60 percent lower in 1997-02 than before the Gulf War in 1991.

The composition of both exports and imports underwent significant changes (Table 2). On the export side, the reliance on oil increased from 96.8 percent in 1989 to 97.6 percent in 1991-96 and 99.5 percent in 1997-2001. Simultaneously, the share of manufactures dropped almost ten-fold from 2.1 percent in 1989 to 0.23 percent in 1997-2001. The change in imports was much less pointed between 1989 and 1997-2001. Interestingly, the share of manufactured goods increased more than three percentage points.

Table 2: Composition of exports and imports in 1989, 1991-96, 1997-01

	Exports in million of US$			Imports in million of US$		
PRODUCT GROUP	1989	Average 1991-96	Average 1997-01	1989	Average 1993-95	Average 1999-01
All food products (0+1+22+4)	60.1	3.3	14.1	1,840	305	601.2
Agricultural materials (2-22-27-28)	27.7	0.5	1.2	241	1.5	9.1
Textile fibres (26)	7.3	0.2	0.9	89	0.5	0.9
Ores, Minerals and Metals (27+28+68)	45.2	0.8	6.0	154	1.3	11.4
Energy (3)	12,234.6	423	9,589	17	0	2
All Manufactured Goods (5 to 8 - 68)	265.6	5.3	21.9	5,878	128	1,925
Goods (0 to 8)	12,640.5	433.6	9,633.4	8,218,371	437	2,548.9
	(in terms of percent)					
All food products (0+1+22+4)	0.48	0.76	0.15	22.54	69.79	23.59
Agricultural materials (2-22-27-28)	0.22	0.12	0.01	2.43	0.34	0.36
Textile fibres (26)	0.06	0.05	0.01	0.89	0.11	0.04
Ores, Minerals and Metals (27+28+68)	0.36	0.18	0.06	1.65	0.30	0.45
Energy (3)	96.79	97.56	99.54	0.22	0.00	0.08
All Manufactured Goods (5 to 8 - 68)	2.10	1.22	0.23	72.26	29.29	75.52
Goods (0 to 8)	100.00	100.00	100.00	100.00	100.00	100.00

Source: Derived from data in UN COMTRADE database.

Trade embargo significantly impacted not only the level and composition but also the directions of trade. Turkey followed by Jordan emerged as Iraq's major suppliers of foreign goods in 1991-96. These two countries provided Iraq with 60 percent of all its imports in the 1991-96 period. In the OFP period the level of geographical concentration of Iraq's imports has significantly declined. France with the total sales of US$ 2 billion over 1997-2002 tops the list of ten largest suppliers. The EU altogether accounted in this period for 33 percent of total Iraqi imports down from 40 percent in 1989-90. Not surprisingly, the US and the United Kingdom, which together contributed 21 percent of Iraqi imports in 1989-90, has not made to the top-ten list in 1997-2002. The US accounted for a mere 1.7 percent and the UK for 1.9 percent of the total foreign sales to Iraq in this period.

How do trade data reported in mirror statistics match with the data from the UN Office of the Iraqi Program (OIP) in charge of the OFP? On the export side, there appears to be no significant differences with the revenue generated under the OFP of US$ 3.2 billion higher than total exports reported in IMF DOT statistics or 5.3 percent.[5] On the import side, the differences are much more

[5] Since all payments were made not to the government of Iraq but to the UN (or more precisely Bank National de Paris, which was handling financial side of the OFP and issued letters of credit), this suggests that some countries failed to report even legitimate imports from Iraq. Source: UN Office of the Iraq Program (http://www.un.org/Depts/oip).

significant with the value of all OFP "arrived" shipments (US$ 25 billion) 29 percent higher than the value of world exports to Iraq reported in IMF DOT statistics (US$ 18 billion). It appears that buyers of Iraqi goods (almost exclusively oil) appear to have provided more detailed information, whereas countries exporting to Iraq were reluctant (or simply too sloppy) to disclose in their statistics all relevant information. This was so despite the fact that the difference refers to transactions under the OFP, fully conforming to international norms.

Trade with Iraq reported to the DOT database by some countries was surprisingly low despite close geographical proximity and anecdotal evidence suggesting much more significant flows. Syria and Turkey, for instance, reported no trade activity in the OFP period to the IMF DOT statistics—Turkey since 1996 and Syria since 1997.[6] Turkey continued, however, its trade relationship with Iraq in the 19977-02 period even seeking exemption from the UN sanction regime similar to that enjoyed by Jordan. Before the Gulf War Turkey was an important trading partner contributing 4 percent to total Iraqi imports in 1989-90, and it had emerged as the largest exporter over 1991-96. Habur gate, the only legal crossing point between Turkey and Iraq, has remained open since the end of Gulf War. According to Turkish officials,[7] trade between the two countries, mainly under Iraq`s oil-for-food deal with the UN, did not exceed $200 million in 2000, down by 32 percent the level reached in recent years. The average value of Turkish exports to Iraq in 1991-96 was around US$ 160 million, while that of imports amounted to US$ 11 million. Assuming that the ratio of imports to exports remained as reported by Turkey in 1991-96, this would suggest that Turkish exports were probably at around US$ 150—200 million per year over 1997-2002.

Syria entered during the OFP period into several lucrative commercial deals with Saddam Hussein's regime. The value of Syria's reported total exports to Iraq over 1989-2002 was US $28.6 million with practically all these exports taking place in 1997 (US$ 28.3 million). Syria reported imports from Iraq only for 1991-96 to the tune of US$ 0.4 million. Considering improved political ties that began with reopening of their border in 1997 that was closed after Iraqi invasion of Kuwait in 1990, one suspects that there was trade, albeit not reported. According to the official Syrian Tishrin daily, during the first nine months in 2001, Syrian exports to Iraq totaled $1.35 billion, more than double the total for the whole of 2000.[8] Although a huge portion of these exports might have been simply re-exports by Syrian firm skirting the trade embargo, this nonetheless add significantly to the value of Iraqi imports. Together with 'probable' Turkish exports this would raise Iraqi total imports by around US$ 1.5-1.8 billion in 2001 and US$ 1 billion in 2000.

Egypt appears to provide another example of underreporting. Egypt's trade turnover with Iraq was "…an estimated $2 billion in 2002, the second year the Iraq-Egypt FTA was in place, according to trade officials."[9] This contrasts rather dramatically with Egypt's reported imports

[6] While Turkey stopped reporting its trade with Iraq to the IMF DOT database, it continued submitting data on its exports and imports from Iraq until 1998 to the UN COMTRADE database. One has serious doubts, however, as to their accuracy. The value of exports reported in 1997 was US$ 54 million down from US$ 188 million in 1996, and US$ 11 million in 1998. This would suggest dramatically steep contraction, which probably occurred only in statistics.

[7] See the Reuters dispatch: "Iraq and Turkey to significantly boost bilateral trade. Both countries pledge to bring trade to pre-1990 Gulf war levels, according to Iraqi minister." March 1, 2000, 03:12 PM, Baghdad (Reuters)

[8] See http://www.syrialive.net/financial. (January 22, 2002).

[9] "In the program's first four years, France won more than $3 billion in contracts. But this year it was eclipsed by Egypt as Iraq's top trade partner, and now French companies are likely to be getting fewer contracts." See Lederer (2001).

from Iraq of US$ 1 million in both 2001 and 2002 and exports of US$ 91 and 94 million respectively. According to Iraqi Minister of Trade, Mohammed Mahdi Saleh speaking in 2001, Egypt was the third largest trade partner after France and Russia.[10] Neither Russia nor Egypt according to the IMF DOT statistics would qualify as such in any single year over 1997-2002, which would suggest that Russia also failed to disclose publicly its trade activities with Iraq.

According to the DOT statistics in 2000, Russia with exports of US$ 90 million would rank eight and Egypt (US$ 75 million) would rank twelfth. To make things a little more confusing, Iraqi trade officials suggested that Egypt became the largest exporter to Iraq in 2002.[11] It is difficult to estimate how much of this trade went underreported and whether the portion not reported in trade statistics of these countries submitted to international organizations was illicit exports. But if Egyptian and Russian exports were indeed second only to those of France, then they were higher than Australia's (second largest exporter in 2000) exports valued at US$ 342 million.[12] This would add another US$ 500-600 million to Iraqi imports.

In all, a very conservative estimate is that around 30 percent of imports into Iraq were not reported to the DOT database. Had all 'legitimate' exports to Iraq been reported, the actual average value in 1997-2002 was probably higher than the average of US$ 4.1 billion per year as reported by the OFP data. The total estimate of trade flows of Egypt, Russia, Turkey, and Syria that were not reported to the IMF DOT statistics is at least US$ 1.8 billion.[13] Adding the estimated value of these flows to the average annual total world exports to Iraq as reported in the DOT statistics (US$ 2.95 billion) would yield the annual average of Iraqi imports of US$ 4.7 billion, i.e., US$ 562 million higher than OIP data. These calculations would suggest that Iraqi imports circumventing the OFP ran at around at least US$ 562 million per year over 1997-2002.

But there are indications that these imports might have run in billions of dollars, as Iraqi foreign exchange earnings were significantly higher than in OIP data. A US General Accounting Office estimated that Iraq earned about $2.2 billion in illicit revenues in 2001—$1.5 billion in illicit exports and $700 million in surcharges (reportedly paid to Iraq by oil trading companies of 20 to 50 cents per barrel of oil).[14] Other estimates are at a similar range. Iraqi oil smuggling to Jordan, Syria and Turkey and through Iranian waters provided it with "… more than $1 billion a year in cash—which goes directly to Saddam."(Lederer, 2001).

These estimates appear to have solid foundations. Consider first, for instance, that Syrian gateway alone could have generated almost US$ 1 billion in extra exports in 2001. Following the opening of an oil pipeline through Syria, both countries signed a swap agreement under which Syria used Iraqi oil sold at a 50 percent discount and exported an equivalent of its own oil. Reportedly, this line was used to smuggle $2 million worth of oil daily (Recknagel 2001). On an annual basis, this would amount to around US$ 800 million of illicit exportation bypassing the UN OFP, which required that all Iraqi oil revenues be placed in a UN- supervised escrow account for spending only for approved purchases.

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[10] "Egypt third largest trade partner with Iraq after France, Russia." *Iraq-Egypt Economics*, April 18, 2001 at http://www.arabicnews.com/ansub/Daily.

[11] "In the program's first four years, France won more than $3 billion in contracts. But this year it was eclipsed by Egypt as Iraq's top trade partner, and now French companies are likely to be getting fewer contracts." See Lederer (202).

[12] One assumes that both Australia and France have provided accurate trade statistical information.

[13] The total was arrived as follows: Egypt's and Russia's estimated exports were around US$ 550 million each; Syria's around 500 million; and Turkey's 160 million.

[14] Quoted in Katzman (2002).

Second, Turkey appears to have been also heavily involved in imports bypassing the OFP. According to Katzman (2002), the Turkish government regulated and taxed about US$ 400 million of illicit imports of Iraqi energy products per year. It is not clear whether the above estimate includes US$ 400 million worth of oil that was apparently smuggled by trucks into Turkey (Recknagel 2001). This so-called “diesel trade” had become commonplace there until September 2001, when Turkey banned this trade. Thereafter, truckers could bring in only crude oil under the OFP program (Martin 2003).

Thus, it would seem that the estimate of the U.S. Government Accounting Office is close to the mark in terms of Iraqi extra export earnings. In all, it appears that on average annual Iraqi exports during the OFP period were around US$ 2 billion higher than the OIP data. Adding the estimate of illicit exports would increase the total earning by US$ 6-9 billion to US$ 66-69 billion over 1997-2002.

The import side is fuzzier. The difference between data reported in the IMF DOT statistics (US$ 18 billion) and the UN OIP data (US$25 billion) is huge amounting to 29 percent. It appears that even countries whose firms participate in the OFP did not collect and submit relevant statistics on their exports to Iraq totaling US$ 7 billion in 1997-2002. As mentioned earlier, this would raise annual imports to US$ 4.2 billion. We may only guess that revenues from illicit exports were not only stashed in cash by the authorities (or deposited abroad) but also expensed on purchases abroad. It would be impossible to estimate how they were allotted between the two and what services and goods and originating where were imported outside the sanctions regime. One would expect, however, that at least 50 percent of illicit revenues were spent on imports. This would give an initial estimate of *around US$ 5 billion* over 1997-2002.

How close is this estimate to the actual levels of imports into Iraq? One way of testing it would be to estimate the size of cumulative surpluses during the OFP period. This would amount to around US$ 7 billion annually or US$ 42 billion. Out of it, US$ 14.1 billion is in the OFP approved pipeline of purchases that were not delivered before January 1, 2003. The balance of US$ 28 billion appears to be in line with compensation and other payments mandated by the UN Security Council as presented in the November 2002 Report of the Secretary-General. Note, however, that the assumption underlying these estimates is that 50 percent of illicit revenues were spent on imports. This is, however, only an assumption without any empirical evidence.

But whatever the actual levels of imports were, the scope for enrichment to the well connected in both private and state sector had been clearly enormous. Unaccounted expenditures run in hundred of millions, if not billions dollars. On top of illicit transactions, black market operations and smuggling, one should add informal commissions paid often by suppliers under the OFP to Iraqi officials. While some of these fortunes have been responsible for surge in prices of real estate in elegant districts of Amman, much of it is in Iraq. According to one source, Iraq has around 3,000 families each with the net worth estimated in millions of dollars (Yasseen 2003). Intimate association with the regime allowed many, if not most of them to increase their wealth.

Political economy implications for reforms

The most direct implication is that arrangements that allowed collecting rents should be terminated. As Yasseen (2003), advisor to a member of Iraq’s Governing Council, notes: “These arrangements, which were not weakened by the UN embargo, made possible tenfold return on investment very quickly.” The end of sanctions as well as foreign trade measures taken by CPA has effectively put an end to these opportunities. The crux of the matter is to maintain an open foreign trade regime.

Leaving aside a difficult task of vetting out those, who illegitimately made fortune, reforms do have a direct bearing. For starters, exposing the economy to foreign investment will at least put fortunes of Iraqis willing to invest domestically to foreign competition. This also has implications for privatization. Keeping it closed from foreign capital may give ‘illegitimately’ rich opportunity to acquire state assets. Affording protection to privatized firms in the form of tariff and non-tariff barriers will only strengthen groups having a vested interest in blocking further liberalization and opening new areas for rents. Hence, free foreign trade regime and open investment regime are the key to establishing competitive markets in Iraq and preempting the emergence of powerful interest groups blocking liberal reforms.

2. Arguments for Protection

Arguments against free trade regime are twofold: First, trade should be taxed in order to generate revenue to the government. Indeed, historically taxes on trade were the main source of government revenue and in many least developed countries continue to account for their significant share. Countries with duty-free regimes (Estonia, Hong-Kong, Singapore) have well developed tax administrations. Hence as long as there are no other easily taxable sources, border charges make sense but only insofar as they are uniformly applied. Otherwise the authorities infringe upon the private sector in determining what to produce and consume and, ultimately, where resources are to be allocated.

Second, it is argued that in the absence of protection there would be no industrialization and the agricultural sector would be devastated by subsidized exports from highly developed countries. As for industrial protectionism, poverty or unemployment considerations, rather than infant industry argument, tend to form its cornerstone under circumstances peculiar to the Iraqi economy. Liberalization would then lead to the persistence of high levels of unemployment due to the inability of the Iraqi industrial sector to withstand competitive pressure from imports. As Fadhil Mahdi from the UNDP stated: “Iraq’s technological prowess in the civilian sector is worse than Russia’s in the 90’s. Opening up to competition at a mere 5 percent tariff will most probably ruin many producers and exacerbate unemployment.”[15]

The stakes are high, as the state sector has been an important employer in Iraq. Since many assets were looted, most state-owned enterprises do not produce anything at the moment and most employees get paychecks from CPA. It is rather doubtful that a tariff of 15 or 20 percent would save these enterprises from bankruptcy.

However, the question germane in this context is whether trade policy is the most efficient instrument to address the unemployment issue. The answer is emphatically negative. If something has to be done, explicit subsidies are better than tariffs for that purpose. Consider the consequences of using tariffs to protect selected industrial sectors. What level of tariff rates would assure their re-birth and survival? One suspects that they would have to be set at a very high level, simply because historically Iraqi SOEs were not exposed to international competition and their assets had been largely destroyed. Like SOEs in centrally planned economies, political rather than economic considerations were behind their emergence. The industrial structure erected in Iraq under state-run import-substituting strategy reflects neither Iraq’s endowment in factors of production or, consequently, its comparative advantage. Even without surveys taking stock of assets and liabilities of SOEs, one may reach the conclusion that three decades of economic negligence, war economy, sanctions and, more recently, looting has resulted in the total absence of value added that could be generated by SOEs at international prices.

Data on Iraqi exports seem to corroborate this observation, albeit we do not have information on the ownership structure of firms involved in export activities. The value of manufactured exports (Standard International Trade Classification 5 through 8 excluding 68) fell from US$ 267 million in 1989 to the annual average of US$ 22 million over 1997-2001. With the average sales of US$

[15] As quoted in Madrick (2003).

9.5 million, the electrical equipment sector (SITC. 77) was the largest exporter in this period. Exports of other two-digit SITC manufacturing sectors were miniscule with the second largest exporter—telecommunication equipment—reaching US$ 2.3 million on average over 1997-2001 (derived from mirror statistics in COMTRADE database).

But the averages do not tell the full story. Between 1997 and 2000 the value of manufacture exports fell precipitously from US$ 33 million to US$ 12 million. There were only seven two-digit SITC manufacturing sectors in 2001 with values of exports exceeding US$ 1 million. These sectors included telecommunications equipment (US$ 2.5 million), metalworking machinery (US$ 1.9 million), metal manufactures (US$ 1.9 million), perfumes (US$ 1.8 million), industrial equipment (US$ 1.7 million), electrical equipment (US$ 1.5 million down from US$ 28 million in 1997), and photographic equipment and clocks (US$ 1.2 million). The values of exports of four sectors contracted rather dramatically in 2001 as compared with 1999—electrical equipment down 75 percent, photographic equipment and clocks down 44 percent, metalworking machinery down 43 percent and telecom equipment down 34 percent from their respective levels in 1999.

It is unclear whether the contraction in exports also indicates a similar collapse in domestic manufacturing capacities. Export performance may not offer many clues, as it had been volatile and driven by the sales of electrical equipment. The share of electrical equipment in manufactured exports had been on the decline since 1997, when it reached 85 percent with the value of exports of US$ 28 million. Subsequently its share fell to 43 percent (US$ 9 million) in 1998, 27 percent (US$ 6 million) in 1999, 15 percent (US4 2 million) in 2000, and 9 percent (US$ 2 million) in 2001. Simultaneously, exports of other manufacturing sectors increased between 1997 and 1999 more than threefold from US$ 5 million to US$ 17 million, fell in 2000 to US$ 11 million and increased to US$ 16 million in 2001. For a firm this might have been an impressive sales performance. But for an economy with the GDP around US$ 27 billion and a past record of exports at almost US$ 300 million it is an indication of enormous de-industrialization that had taken place in the 1990-2001 period.

Manufacturing sector, which even before the 1991 Gulf War was not integrated into global manufacturing, has remained decoupled from international markets. There has been little two-way trade in the same manufacturing sectors, as shown by the values of the well-known Grubel-Lloyd index.[16] These were in single-digit ranges and fell from 5.6 percent in 1998 to 3.5 percent in 1999, 1.4 percent in 2000, and 1.1 percent in 2001. For comparative purposes, consider that the value of this index for low middle-income economies hovers at around 30-50 percent.

Hence, assuring the survival of SOEs, or for that matter of whatever has been left of manufacturing, would probably require affording very high levels of protection to selective sectors of the economy. The resulting ‘cascade-type’ tariff structure would negatively impact Iraq’s economic performance through higher domestic prices, erosion of competitiveness of non-protected firms and distortions in the choice of future activities. Tariffs are the implicit tax with efficiency (resource cost) and equity (income redistribution) implications. High tariffs on products of SOEs would lead to higher domestic prices. Glancing at a list of SOEs, these would include higher prices for cement, cotton, fertilizers, iron and steel, petrochemicals, paper, etc. Many of these products are used as inputs in other sectors. This would contribute to higher prices in other sectors. If these were significantly above world prices, they would be unable to withstand international competition. Capital would then move from ‘genuinely’ competitive sectors to ‘artificially’ competitive sectors further exacerbating welfare loss.

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[16] The GL index of intra-industry trade between two partners is usually expressed as: $GL = 1 - \sum[\,|X_i - M_i| / \sum (X_i + M_i)]$, where X and M are exports of a country and imports by a partner correspondingly of product *i*. The index suffers from two problems: aggregation and aggregate trade imbalances.

Since the uniform tariff schedule minimizes distortions in production and distribution, would a uniform tariff rate provide a stimulus to the development of domestic industrial production? For the reasons discussed above, it would have to be set at a relatively high level. Neutrality notwithstanding this would lead to a strong anti-foreign trade bias with huge impact on domestic prices.

What about extending protectionist umbrella only to agriculture? Around one-third of Iraqi population live in rural area and this sector enjoys high level of protection in most developed and developing countries including Middle East. Iraq has always been a net importer of agricultural products. As can be seen from data tabulated in Table 3, exports of foods accounted for 3-4 percent of agricultural imports in 1989-90 and 1999-2001 and those of agricultural materials for 16 and 20 percent respectively. In 2001 not a single two-digit SITC agricultural sector generated exports exceeding imports.

Table 3: Trade in agricultural products and exports as percent of imports in 1989-90 and 1999-2001 (in million of US dollars and percent)

SITC. Rev. 2	Trade Balance (in million of US dollars)		Export as percent of imports	
	1989-90	1999-01	1989-90	1999-01
All food products (0+1+22+4)	-1,476	-579.0	3.4	3.7
Agricultural materials (2-22-27-28)	-139	-7.3	15.6	19.9
Textile fibres (26)	-53	0.5	12.9	159.9
All goods (0 to 9)	4,814	10,706	171	520

Source: Derived from data in UN COMTRADE database as reported by Iraqi trading partners.

Furthermore, agricultural exports, which virtually disappeared by 1993, recovered somewhat over 1998-2001, although they were still in value terms at only 45 percent of their 1989 level. Exports of food products registered much stronger recovery than agricultural materials. The latter stood at 4 percent of their exports in 1989 (Figure 2). Since imports of agricultural materials have also significantly declined, this may indicate the increase in production for domestic use.

The protection of this sector is usually justified in terms of national security, social stability, and subsidized exports from highly developed countries. But none of these seems to withstand scrutiny when cast against Iraq's circumstances. Agricultural self-sufficiency is not a feasible option, and market-driven profile of agricultural output, given Iraq's climate, soil and endowment in water, is probably significantly different than subsidized export baskets from countries located in temperate climate and abundant in water. Furthermore, a special argument for protection of the agricultural sector does not seem to apply to a sector devastated by underinvestment and misallocation of resources further exacerbated by subsidies (especially of water).[17] It seems that it would only delay the transition to a market-based agricultural system.

3. Political Economy and 'External' Arguments for Free Trade

By almost any mainstream economist's standards, free trade extended not only to goods but also to services is the best trade policy. Fully liberalized transportation and telecommunication, in particular, followed by financial services assure competition and remove important barriers to trade faced by many developing countries. The theoretical argument, even accounting for strategic trade theory, in favor of free trade is overwhelming.

[17] Since imports are now not subject to duties or any other administrative restrictions, the usual argument for gradualism in removal protection to calibrate to cropping patterns does not apply.

On purely economic grounds, this is the best solution in particular for an oil-rich economy with devastated industrial structure for at least two reasons. First, only competition from imports combined with a friendly business/investment climate can produce industrial restructuring in line with Iraq's endowment in factor of production and comparative advantage.

Second, low foreign trade related transaction cost keeps the prices of tradables low. Since most basic food staples are imported, border and non-border charges would raise prices of these products. This *implicit tax* would have particularly negative impact on the urban poor.

Leaving aside standard arguments, there are also other political economy aspects related to the existing free trade agreements and issues of governance favoring the adoption of a free trade regime. Free trade regime is not only about tariffs on trade in goods. In order to tap its full benefits, non-tariff measures should be kept to the minimum and services should be open to competition. These are briefly discussed in turn below.

3.1. Bilateral regional liberalization

Since Iraq has already been involved in bilateral regional liberalization, some portion of its imports will enter its markets free of duties provided that the new government honors these agreements. According to the Ministry of Trade, the government has 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 (Table 4).[18]

Table 4: 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%
Yeman, 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. As mentioned earlier 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

[18] Oman may be one that had signed FTA with Iraq but no agency or press information was found to confirm it.

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.

On the other hand, however, with the normalization of Iraqi external trade relations, the share of other partners, especially that of the European Union, United States and East Asia (in particular South Korea and Taiwan) is likely to significantly expand. Hence, unusually trade turnovers with some Middle East countries are unlikely to persist in the future.

The share of trade exempt from tariffs because of preferential agreements may expand. 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. Furthermore, these pressures for bilateral liberalization will not only come from regional partners that remain now outside the Iraqi network 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.

As for the global dimension, U.S. has declared the establishment of a free trade area with Middle Eastern countries as one of its political objectives. It launched an initiative to create a US-Middle East Free Trade Area within a decade. To this end, several bilateral free trade negotiations either began (Bahrain) or are to begin in 2004 (Egypt) with some of them either already completed (Syria) or to be completed soon. Iraq would be a likely candidate to begin negotiations with the US for two reasons. First, all these future members of the US-Middle East FTA already have bilateral FTAs with Iraq. Second, the project would be incomplete without Iraq's pariticipation. Since Jordan, also a party to number of regional FTAs including Iraq, has a FTA with the US,

The EU is following a slightly different track with the "Wider Europe—Neighborhood" initiative. It is negotiating FTA with the GCC while simultaneously it has been 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. Inclusion of Iraq into a free trade area with the EU cannot be dismissed.

While it is impossible to predict with any degree of certainty, the share of preferential partners in Iraq's imports in the coming years, the historical data—with all due qualifications concerning their quality (see Section 3 above)—would suggest that around 75-95 percent of Iraqi imports may not be subject to MFN tariffs. Even assuming very likely asymmetries in respective schedules of tariff removal in a possible EU or US-Iraq free trade agreement, i.e., longer periods for Iraq, the share of duty free imports encompassing products not manufactured in Iraq would be quite significant. Furthermore, consider that the US' direct involvement in reconstruction will inevitably lead to much larger US exports than in the past. Assuming the increase in ths share to its pre-Gulf War level of 12 percent, potential preferential imports would account for around two-thirds of the total Iraqi imports. Even without the EU-Iraq FTA, whatever the combined share of Arab and US imports into Iraq might be, it is rather unlikely than it would be lower than one-third of total imports.

But in fact the actual share might be significantly higher, as the possibility of obtaining duty-free access will undoubtedly provide incentive to cheat on certificates of origin. The strength of the incentive will depend on the extent of reverse discrimination, i.e., magnitudes of preferential margins. For countries with weak administrative capacities, the scope of fraudulent certificates of origin may be quite substantive.[19] This takes us to the relationship between free trade and governance.

3.2. Governance and other issues

The inevitable legacy of pre-war foreign trade regime is that Iraq will face serious weaknesses in governance specific to the conduct of international trade. Customs was widely viewed as being an oppressive and corrupt system. It appears, therefore, that both the human resources and the physical infrastructure in Customs are inadequate to facilitate trade. Furthermore, the difficulty in assuring uniform treatment across points-of-entry into Iraqi customs territory, exacerbated by differences between the Northern part and Central and Southern parts, will only increase with the growth in administrative complexity of a foreign trade regime.

The great advantage of free trade regime is that it is simple and almost immune to mis-management. It drastically reduces administrative burden on Customs Administration and other government agencies. By the same token, it also significantly diminishes the potential for corruption, as it removes, albeit not completely, 'money' from daily customs dealings with traders.

In fact, several important administrative burdens disappear when a country adheres to a duty-free regime. For starters, neither Customs nor traders have reasons to bargain over the 'real' value of a shipment. There is no need for administration in charge of solving possible disputes arising over valuation. The trader has no incentive to bribe a customs officer to lower the assessment. In addition, classification of imported products loses its significance, as duties do not depend on how customs classifies an item. (Misclassification of products is often used to extract payments from traders).

Another complex and contentious issue that disappears with a duty-free regime relates to the determination of origins of imports. 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 looses its relevance.

The *raison d'être* of various administrative arrangements designed to mitigate anti-foreign trade bias inherent in foreign trade regimes discriminating against 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 form 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 a number of opportunities for corruption and rent seeking. This in turn substantially lowers the 'hassle cost' of conducting business operations in a country.

In addition, there is a highly pragmatic reason not to have Customs involved in clearance, customs evaluation and collecting duties on shipments into Iraq. Its customs infrastructure is not

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[19] Examples abound. BMW automobiles entering Georgia as 'Made in Russia,' or a whole range of products that entered the Province of Kosovo as produced in Macedonia, although the latter had never produce them.

fully operational as yet. Iraq had inland customs clearance facilities that—except for the Northern region where they remain largely intact—were either destroyed or looted during the war (Kelly et al. 2003).

3.3. Liberal conditions in access: other prerequisites

Tariff rates, even if set at zero rates, may do little for a country to tap benefits offered by free trade as long as there other barriers to trade in place. While there is a whole array of non-tariff tools used by governments to discriminate against foreign suppliers, five policy-areas deserve special attention—the right of establishment, anti-trust regulations, import licensing, cumbersome border procedures, technical barriers to trade, and antidumping. Among 'behind-the-border' measures backbone services, i.e., telecommunications, transport, financial, distribution, and business services are particularly important, as they are crucial to trade in goods and facilitate resource flows between countries. In a nutshell, they call for the establishment of pro-competition environment.

Regulations concerning the *right of establishment* should assure that there is no discrimination against foreign firms seeking to establish a presence in the markets for goods and services. Both foreign firms and domestically owned firms should compete on the same footing, i.e., there should be no discrimination in their treatment in state policies. This requirement appears to have been already met. CPA Orders 39 and 40 (on foreign investment and banking, respectively) recognize the principle of national treatment and open all sectors except those dealing with natural resources. The land can be leased for up to 40 years. As for banking, Order 40 allows foreign banks to establish branches, subsidiaries and joint ventures with local banks with a barrier set at less than 50 percent of ownership. Both these measures go a long way to establishing a competition-enhancing environment.

As for technical barriers to trade, Iraqi national ***mandatory*** standards (excluding phyto-sanitary standards—see below) should be done away without review. For one, conformity assessment procedures are expensive and will significantly increase transaction costs of imports. Further, there is currently no capacity to conduct testing and issue certificates, which are necessary for voluntary or regulatory standards mandated by a government.

This should not suggest that Iraq should not have a functioning system of technical standards. To the contrary, it will be needed for Iraqi industrial development, simply because standards promote economies of scale, protect public health or the environment, facilitate information exchange, comparison of products by consumers and market transactions through reduction of the costs of uncertainty.

Yet, Iraq should start with a modern market-based system driven by private sector. Considering that this requires a functioning rule of law (liability laws, etc.), the process should not be rushed. It should avoid copying the practice of other countries in the Middle East of requiring that relevant testing on all imports be done at their national laboratories. Highly developed countries have simply better testing centers as well as standards adequately protecting public health and environment. Last but not least, it should simply adopt standards used in highly developed economies. This would allow exports to incur costs for national certification.[20]

But there is clearly a legitimate issue of phyto-sanitary standards indispensable to protect public health and the environment. Since facilities are in a short supply, the task should be simplified, transparent and focused on a selected group of products that may pose significant public health risks. The balance should be struck between legitimate public health concerns and costs to traders. The list of agricultural products with highest potential to public health should be

[20] For the discussion of benefits of this approach, see World Bank (2003, p. 179).

identified, and these products should be randomly inspected in border crossing points. As for expired pharmaceuticals, the customs would check for that.

The last potential non-tariff barrier relates to *antidumping*, which—with expansion of WTO disciplines to several non-tariff trade barriers—has become a favorite protectionist weapon used not only by developed but also increasingly by developing countries. One may expect that CPA will be pressurized to assist Ministry of Trade in developing an antidumping legislation designed to prevent imports at a price below the production cost.

This course of action should be resisted for several reasons. International experience and a large body of economic literature show that antidumping actions rarely, if at all, address cases that present real threat to competition. The existence of an antidumping legislation would simply increase the leverage of protectionist interests over the government. It breeds lobbying and corruption, and, in consequence, diverts scarce entrepreneurial talent into the political process. It absorbs scarce administrative and professional resources to activities that are inherently rent seeking. It creates temptation to resort to antidumping to cover whatever sort of import restrictions seems politically necessary.

An alternative superior to anti-dumping arrangements is the competition law enforcement agency with a statutory mandate to determine the net cost, taking into account the interests of both users of imports and producers, to the economy of proposed trade suppressing measures.

While this section focused exclusively on trade in goods, the issue of establishing a liberal regime for services is as, if not more, important. The international evidence suggests that low trade barriers in services create employment, reduce transaction costs and lower prices for both exports and imports. Firms are then more likely to penetrate foreign markets. While this calls for a more detailed analysis, opening of services to foreign competition along the lines covered by the WTO General Agreement on Services should be an integral part of a new trade regime for Iraq. The critical sectors are transportation and telecommunication, followed by financial services. These should be fully liberalized to assure competition and any notion of exclusivity for domestic carriers should be removed.

Conclusion

On top of purely economic considerations, there is a strong political economy argument in favor of a free trade regime, which takes into account unique circumstances of Iraq. It can be summarized as follows: The free trade regime will considerably reduce the administrative burden on state agencies—an important point considering Iraqi weak administrative capacities. It will increase transparency, simplicity and thus lower the potential for corruption. Special attention should be paid, however, to non-tariff barriers, as there will be pressure to introduce them in the absence of tariff protection. Last but not least, it will render irrelevant strive for tariff exemptions, free economic zones, export platforms, etc.

The fact that only few countries have a free trade regime, although an increasing number—including Middle East North African countries—are pursuing it, both unilaterally and in the regional setting, is testimony to the strength of private interest groups—often, entrenched elites benefiting from the status quo. It says nothing about the wisdom of pursuing this policy.

4. Stakeholder dilemma: can a free trade regime survive beyond CPA?

Ownership of a reform is very important. Reforms imposed from outside usually fail, as their implementation is sabotaged. While these observations apply to a number of areas including privatization, foreign trade institutions and policies are an exception. Had it not been for international pressures or economic crises, protectionism would prevail over liberalization in the conditions of market access. This stems from unique characteristics of the fact that foreign trade decisions are classic collective action problems with a huge asymmetry in incentives between beneficiaries and losers (Olson 1965).[21] Gains from foreign trade liberalization spread across wide segments of society, whereas losses affect only inefficient producers from import-competing sectors. Since losses are concentrated and gains dispersed, the potential losers have a much stronger incentive to organize in order to block the measure. The WTO helps countries solve this problem. In its absence, either the country can count on enlightened domestic elite (e.g., Estonia), preferential agreement with a 'natural trading partner' (e.g., Central Europe thanks to European Association Agreements) or other external actor.

CPA has clearly fulfilled this function. Both CPA Orders 12 and 38 establishing a liberal foreign trade regime, probably skirting objections of Iraq's Governing Council, have been the only course to follow. Opening the process to negotiations with local interest groups in Ministry of Trade and local businesses would result in arrangements favoring protectionism.

But there is no guarantee that the Iraqi free foreign trade regime existence will withstand the pressures to which future governments will be subjected, as no institutional framework for foreign trade policy has been established as yet. The problem is that CPA Orders have not established institutional arrangements that would lock-in the present arrangements. The ultimate test of a sound institutional design for foreign trade is the extent to which it insulates the decision making process against capture by narrow interest groups. The importance of a good institutional design for foreign trade lies in its long term impact on policy making; give a country "... the institutions to make sound policy and you affect it for a decade" (Winters 1995, p.1). In other words, a sound economic policy may quickly evaporate unless accompanied by the right institutions containing bad policies. This is the challenge that CPA faces before transferring powers to the Iraqi Governing Council.

4. Concluding comments

Iraq already has the best trade policy, although on a temporary basis and not extended to all imports and service sector facilitating trade (transportation, port management). This offers unique opportunity to put it on a permanent basis. The shock that usually accompanies shifting to a more open trade regime has already occurred. The introduction of tariffs would produce another unnecessary shock in an economy that has undergone a series of shocks over the past three decades.

But avoiding another shock is not the most important argument in favor of free foreign trade regime for goods and services. The elimination of a free trade regime would be counterproductive on several counts. First, it would fall short of saving the state sector, as this would require erecting a very high barrier against foreign competition.

Second, it would fall short of generating customs revenue, as imports exempted from duties either because of preferential agreements, fraudulent certificates or exemptions granted, would narrow trade tax base.

[21] Historically, there have been two generally acceptable explanations of foreign trade policy-making (Ray 1988). The first—the micro view—suggests that foreign trade policy mirror the interaction between preferences of interest groups and politicians. The second—the macro view—accords the state considerable autonomy. It stresses national objectives and international commitments as major determinants of international trade policies. The former derive from values shared by political elite: these may range from commitment to free trade, on the one hand, and providing a trade restriction safety net for weak industries, on the other hand. International commitments refer to obligations under regional or multilateral agreements together with mechanisms for adjudicating trade disputes

Third, the introduction of tariffs would put huge administrative burden on a very weak administration and would create opportunities for corruption. Given the administrative legacy of the Baath regime and limited high skilled human resources, this should be avoided.

Fourth, the introduction of tariffs or any other surcharges requiring payments based on the value of a shipment requires the existence of warehouses and other facilities indispensable to carry out customs clearance. Availability of equipment allowing for non-cash transactions also helps. Both appear not to be readily usable and available.

Last but not least, the introduction of a tariff schedule would tie to some extent the hands of the future Iraqi government in terms of how it wants to design its tariff schedule. Consider that introducing a free trade regime would likely encounter opposition from groups taking advantage of economic rents created by tariffs.

Yet, custom clearance and facility issues notwithstanding, an argument can be made in favor of a foreign trade regime as outlined in CPA Order 39 introducing a five percent flat reconstruction charge. Iraq faces huge reconstruction cost. Collecting taxes at the border is an attractive option in a country without a functioning tax administration. While still a second best option, the advantages of a 'reconstruction surcharge' trade regime are as follows: First, it assures the broadest possible trade tax base, as it will apply to all imports independently of their origin or use. The reconstruction surcharge as an emergency temporary measure falls under safeguard provisions of FTAs. Hence, there is no need to exempt imports from preferential partners. It also removes the administrative temptation to exempt from duties some imports on the grounds of their great importance to economic welfare of Iraq.

Second, it defers the decision concerning free trade agreements signed in the past by Iraq and leaves the future shape of trade institutions and policies in hands of a future government of Iraq.

Third, it not only defers the decision as to what to do with the legacy of FTAs but it also renders certificate of origins irrelevant for duty collection. Certificates of origin are then only relevant for statistical purpose. They do not bear fiscal consequences for traders and thus remove opportunity for corrupt behavior.

Fourth, it retains important advantages of duty free regime, i.e., that is neutrality, uniformity and considerable administrative simplicity. Although it erects an extra administrative burden of customs valuation, it eliminates other 'perverse' incentive such as misclassification of customs items. Furthermore, since this is a temporary measure, bureaucratic temptation to establish free or special economic zones will be tamed.

Last but not least, it increases the probability of survival of a free trade regime, although it does not guarantee it, once surcharge is removed. With the rate low of 5 percent, no large group benefiting from rents is likely to emerge and capture foreign trade policies.

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