AUTHENTICATED
U.S. GOVERNMENT
INFORMATION
GPO

S. Hrg. 108-220

TRANSFORMING IRAQ'S ECONOMY

HEARING

before the

JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

ONE HUNDRED EIGHTH CONGRESS

FIRST SESSION

June 11, 2003

Printed for the use of the Joint Economic Committee

U.S. GOVERNMENT PRINTING OFFICE
WASHINGTON: 2003

★ 90-904 PDF

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512-1800; DC area (202) 512-1800
Fax: (202) 512-2250 Mail: Stop SSOP, Washington, DC 20402-0001

JOINT ECONOMIC COMMITTEE

[Created pursuant to Sec. 5(a) of Public Law 304, 79th Congress]

SENATE
ROBERT F. BENNETT, Utah, *Chairman*
SAM BROWNBACK, Kansas
JEFF SESSIONS, Alabama
JOHN SUNUNU, New Hampshire
LAMAR ALEXANDER, Tennessee
SUSAN COLLINS, Maine
JACK REED, Rhode Island
EDWARD M. KENNEDY, Massachusetts
PAUL S. SARBANES, Maryland
JEFF BINGAMAN, New Mexico

HOUSE OF REPRESENTATIVES
JIM SAXTON, New Jersey, *Vice Chairman*
PAUL RYAN, Wisconsin
JENNIFER DUNN, Washington
PHIL ENGLISH, Pennsylvania
ADAM H. PUTNAM, Florida
RON PAUL, Texas
PETE STARK, California
CAROLYN B. MALONEY, New York
MELVIN L. WATT, North Carolina
BARON P. HILL, Indiana

DONALD B. MARRON, *Executive Director and Chief Economist*
WENDELL PRIMUS, *Minority Staff Director*

CONTENTS

OPENING STATEMENT OF MEMBERS

Senator Robert F. Bennett, Chairman 1
Representative Pete Stark, Ranking Member 3
Representative Carolyn B. Maloney 5
Representative Jim Saxton, Vice Chairman 6

WITNESSES

Statement of Mr. Basil Al-Rahim, Founder and Board Member of the Iraq Foundation, Managing Director of MerchantBridge 9
Statement of Mr. Hernando de Soto, President, Institute for Liberty and Democracy 13
Statement of David P. Ellerman, Ph.D., Author and Former Economist at the World Bank 16
Statement of Rachel Bronson, Ph.D., Olin Senior Fellow and Director, Middle East Programs, Council on Foreign Relations 19

SUBMISSIONS FOR THE RECORD

Prepared Statement of Senator Robert F. Bennett, Chairman 43
Prepared Statement of Representative Pete Stark, Ranking Minority Member 45
New Yorker article entitled Building Nation, Hendrik Hertzberg, submitted by Representative Pete Stark, Ranking Minority Member 46
Prepared Statement of Representative Carolyn B. Maloney 49
Prepared Statement, including H.R. 2338, of Representative Jim Saxton, Vice Chairman 51
Prepared Statement of Mr. Basil Al-Rahim, Founder and Board Member of the Iraq Foundation, Managing Director of MerchantBridge 54
Prepared Statement of Hernando de Soto, President, Institute for Liberty and Democracy 67
Prepared Statement of David P. Ellerman, Ph.D., Author and Former Economist at the World Bank 73
Prepared Statement of Rachel Bronson, Ph.D., Olin Senior Fellow and Director, Middle East Programs, Council on Foreign Relations ... 78

Transforming Iraq's Economy

Wednesday, June 11, 2003

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
WASHINGTON, D.C.

The Committee met, pursuant to notice, at 9:30 p.m., in Room 628, Dirksen Senate Office Building, the Honorable Robert F. Bennett, Chairman of the Committee, presiding.

Present: Senators Bennett, Sununu; Representatives Stark, Saxton, Maloney, English, Paul, Hill.

Staff Present: Donald Marron, Ike Brannon, Jeff Wrase, Chris Frenze, Robert Keleher, Brian Higginbotham, Kurt Schuler, Colleen Healy, Melissa Barnson, Gary Blank, Wendell Primus, Chad Stone, Rachel Klastorin, Nan Gibson.

OPENING STATEMENT OF SENATOR ROBERT F. BENNETT, CHAIRMAN

Senator Bennett. The Committee will come to order.

I have a prepared opening statement which has been distributed, and I don't back away from it. But I am going to deviate from it a little in the actual remarks that I make to kick off the hearing, because I think the best demonstration of the atmosphere in which this hearing is being held comes from this morning's papers.

Here is *The Washington Post* and its cover picture. And it says:

"In Holy City, Things Are Going Right. U.S. Forces and Iraqis Work Together In Shiite Stronghold of Karbala."

The New York Times, however, says: "G.I.s In Iraqi City Are Stalked By Faceless Enemies At Night."

And the lead says: "Since the American command quadrupled in military presence here last week, not a day has gone by without troops weathering an ambush, a rocket-propelled grenade attack, an assault with automatic weapons, or a mine blast."

Reminiscent of the war, when we won it on Fox, but lost it on CNN.

(Laughter.)

There is a constant sense of instant conclusion that goes on in the media. We must know, pre-season, who is going to win the World Series. We must know, pre-season, which two teams are going to go to the Super Bowl and which one is going to win.

We have national rankings of college basketball teams before the first dribble is ever bounced on a hardwood floor.

And we carry that same sense of determination to announce outcomes immediately over into politics.

So everything is going well in one newspaper, everything is a disaster in another newspaper. We're going to triumph. There is no hope.

Pick your paper. Pick your conclusion.

The purpose of this hearing today is to get above that kind of babble of voices one way or the other and recognize that we will not know whether we have succeeded in establishing a democratic, stable regime in Iraq for a year, two, or even longer.

The implications of that quest, the desire to replace a brutal tyranny and harsh dictatorship with a functioning, stable government ready to join the world and participate as a true partner in the world economic structure, has enormous implications for the United States. It has enormous implications for our economy. But it has even bigger implications for the world at large.

The establishment of a peaceful, stable, and economically-viable Iraq will transform the Middle East if it is successful. If it is not, we will pay a price that is almost incalculable at this point.

So I want to say to everyone who is listening -- I don't think I need to say it to our witnesses who are testifying -- that if you have come here to try to get the latest answer for are we making progress in getting the water turned on? Will the electricity be available by next Friday? Where are we in finding the latest artistic treasure? This is not the hearing for you. This is a hearing to be discussing very long-term prospects and very long-term strategies, to help the Congress and we hope through the Congress, the American people.

And yes, if I may be so bold, to help the Administration to understand some of the strategies that might work, some of the strategies that should be avoided, and overall, the opportunity and challenge that we are presented with.

There's never been a time in history where more is riding on a successful post-war engagement.

Now I say that looking back, that's probably not true if you look at the accomplishments that followed the Second World War. But the Second World War kicked off an entirely different international situation. As we followed the Second World War, we went into the Cold War, where there was a polarization of forces, with the United States and the other countries of the West on one side, the Soviet Union and its satellites on the other. And the successes that were achieved in Japan

and South Korea in taking what had not been a democratic society and turning it into a viable, modern state occurred within the framework of the Cold War challenge.

Now we are in a world where there is only one super-power, but there are a multitude of nonstate powers that would seek to destabilize the world through acts of terror. And how things come out in Iraq can have an incredible impact on whether or not we get on top of that new kind of world.

So that's the background against which we meet this morning. Those are the issues that we intend to explore. And we have assembled, I believe, an outstanding panel of experts to help us do that.

Now, with that, we're joined by Mr. Stark, the Ranking Member, and I will yield to him for an opening statement. And I would ask consent of the Committee -- our normal pattern is that we have opening statements only from the Chairman, the Ranking Member, and the Vice Chairman. But I would ask that Ms. Maloney be recognized for a brief opening statement because she has to leave us and wants to be part of this, to the degree that she can.

So if there is no objection, following Mr. Stark, we'll hear from Mr. Saxton and then Ms. Maloney.

[The prepared statement of Senator Bennett appears in the Submissions for the Record on page 43.]

OPENING STATEMENT OF REPRESENTATIVE PETE STARK, RANKING MINORITY MEMBER

Representative Stark. Thank you, Mr. Chairman.

I want to commend you and pay homage to your creativity in holding this hearing at this time. It's an important topic. And it's an important responsibility that the President has put on the shoulders of the American taxpayers -- or should I say, debt-holders, since this Administration doesn't believe in taxes.

As I was pondering my thesis for my doctorate in theology at Bob Jones University, I'm a humanist and therefore, the here-after doesn't mean much to me. I keep looking for heaven on earth.

One of the problems of doing that is that I could never find a place for right-wing Democrats or Republicans, either.

And it came to me as I was reading Hendrik Hertzberg's *New Yorker* article, which I'd like, Mr. Chairman, to put in the record --

Senator Bennett. Without objection.

Representative Stark. -- that describes Iraq. Why it's a supply-sider's dream.

There are no taxes. There are no environmental regulations to get in the way of you free-enterprises. Why, religion is the government. There's no separation of church and state.

I have never seen a place where a free-market economy is running amuck.

Charlton Heston would love to go there. Everybody's got a gun. He could organize the NRA and be there. Why, the Club for Growth ought to build their national headquarters there.

(Laughter.)

I just think, Mr. Chairman, that this is the nirvana for the supply-siders and the right-wing Republicans.

Now I'm afraid that's not what we're going to hear from our witnesses today. The facts are that Iraq's economy and their civilian society is a mess, and I suspect we have a long and expensive reconstruction ahead of us.

I don't think we should be surprised if the Administration put as much time into preparing for the inevitable problems with the reconstruction process, instead of preparing their public relations campaign to get us to invade and preparing the prime-time movie about Private Jessica Lynch.

Why, maybe we'd have had some ideas. But that's not what happened and we have to pick up the pieces.

So we'll hear some creative ideas from our panel. But I hope they won't lull us into thinking that this is going to be easy. I think it's going to be expensive and long-term, and I hope you'll be very honest with us so that we can be honest with the American public for a change, and tell them what the consequences are, because I'm afraid if we don't change our domestic policy soon, that our next hearing will be on restructuring the American economy.

Thank you, Mr. Chairman, and I look forward to the testimony of our witnesses.

[The prepared statement of Representative Stark appears in the Submissions for the Record on page 45. *New Yorker* article entitled Building Nations, Hendrik Hertzberg submitted by Representative Stark appears in Submissions for the Record on page 46.]

Representative Maloney. Thank you, Mr. Chairman, so very, very much.

Senator Bennett. I was going to Mr. Saxton.

Representative Saxton. She can go if she wants. That's okay.

Senator Bennett. All right. Mr. Saxton yields to you. So go ahead.

OPENING STATEMENT OF REPRESENTATIVE CAROLYN B. MALONEY

Representative Maloney. Thank you so much, Mr. Chairman, and Mr. Saxton.

At this point, I'm supposed to be at Financial Services Committee hearing in which I'm Ranking Member, but I feel that this is a tremendously important hearing and I ask permission to revise and extend my remarks and just briefly say that in this hearing, we will hear several approaches for setting the groundwork for reconstruction.

One issue that I believe should be a significant part of the discussion is debt relief.

As we have seen in post-war Germany, debt relief can be an essential tool in rebuilding a nation destroyed by war and humiliated by its leadership.

We have also seen in recent years that debt relief is an effective development tool that releases funds within a nation that can be used to address poverty and meet essential human needs.

The case for some debt cancellation is even more compelling in Iraq, given that much of the debt can be characterized as odious.

Odious debt is internationally recognized as debt that is taken on by a country for the personal benefit of corrupt leaders or for the oppression of a people.

Clearly, much of the Iraqi debt falls in this category.

To address the issue, this week I will introduce legislation in the House calling for debt relief from Iraq's international debts, including funds it owes the World Bank and IMF.

Who should pay debt that Sadaam owes? How can we ask the people of Iraq who lived in fear of Hussein's secret police to pay back the loans that supported these armed assassins?

You don't have to travel far outside of Baghdad to see a sprawling slum called Sadaam City that houses 2 million Shiite Muslims. The slum is overrun with garbage and children climb the mountain of refuse to look for scraps of food or things that could be traded for food or clothes.

In the face of this poverty, the Iraqi regime spent billions of loaned dollars on palaces and other luxuries. What better way to enhance our efforts at reconstruction and empower the people of Iraq than debt relief?

If Iraq is ever truly to be a peaceful and prosperous democracy, its citizens must be allowed to start anew. 50 years ago, 20 nations led by the U.S., England and France agreed to forgive half of Germany's pre- and post-war debt. The so-called London Agreement proved to be the

right course. Debt cancellation for Germany was a very important part of the Marshall Plan, which helped the country become a strong and prosperous democracy post-World War II.

This approach can aid Iraq as well.

In addition to odious and other debt that Iraq owes public and private world creditors, the IMF and World Bank are priority Iraqi creditors. When nations service their external debt, they will pay the IMF and World Bank first.

While estimates of Iraq's debt range from $100 billion to several hundred billion, the combined debt owed the IMF and World Bank is just over $150 million. These institutions have resources to relieve the debt, setting an important precedent for the rest of the world.

For this reason, I will be introducing the Iraqi Freedom From Debt Act, legislation to require the U.S. to negotiate in the IMF, World Bank, and other appropriate multi-lateral development institutions for the IMF and World Bank to relieve the debts owed by Iraq to these institutions.

Furthermore, this legislation includes a "Sense of Congress" that the President should urge France and Russia and all other public and private creditors to relieve the debts owed to them by Iraq.

By taking the lead on debt relief, we have an opportunity to do the right thing for Iraq's economy and to prove to the world that the major reason for war was to benefit the Iraqi people.

And I yield back the balance of my time and I thank you for this consideration and I would hope that you would consider looking at this legislation for the Senate.

[The prepared statement of Representative Maloney appears in the Submissions for the Record on page 49.]

Senator Bennett. Thank you very much. We appreciate your contribution and we will take a look at the legislation when it comes over.

Mr. Saxton?

OPENING STATEMENT OF REPRESENTATIVE JIM SAXTON, VICE CHAIRMAN

Representative Saxton. Thank you. It's a pleasure to join in welcoming the witnesses.

Before Ms. Maloney departs the room, I think her position and mine are fairly close on Iraqi debt. In fact, last week I introduced a bill which is H.R. 2338, which sounds very close to what you have just outlined and I'm going to speak a little bit more about that.

So I look forward to working with you.

Representative Maloney. I wish I could stay, but I must go.

Representative Saxton. That's okay. Mr. Chairman, during your opening statement, you referenced the development of a long-range strategy to promote Iraq's economy, which has been sinking for years under the rule of Sadaam Hussein.

I'd like to talk about at least one important piece of what could become that long-term strategy.

The economy in Iraq has for years been doing very poorly. Extensive ownership control and influence of business by the government, its officials, and political cronies undermined economic growth. Iraq's invasion of Kuwait resulted in economic sanctions and the Oil-For-Food Program.

And although the recent war has resulted in some economic damage, Iraq's economic situation today is quite similar in my opinion to the Eastern European countries after the collapse of the Soviet Union.

New institutions are needed that are compatible with a market economy and improved prospects for economic growth. The prospects for Iraq's economic recovery are clouded by an unsustainable debt burden that Ms. Maloney was just referring to.

One of the major challenges to improve the potential of the Iraqi economy is the heavy burden of foreign debt accumulated under the regime of Sadaam Hussein. The hated regime is gone, but the financial legacy should not continue to oppress the Iraqi people, undermining their economic potential.

Forgiving much of Iraq's foreign debt is the right thing to do. But foreign creditors may be hesitant if they anticipate an opportunity for a bail-out indirectly through the IMF or the World Bank.

A write-down of at least part of Iraq's debt would greatly improve Iraq's economic outlook.

Under legislation that I have recently introduced, Iraq's creditors would be encouraged to forgive much of Iraq's outstanding foreign debt rather than to wait for a potential bail-out from the IMF or the World Bank.

This legislation, of which this is a copy, would mandate that safeguards be in place to ensure that lending by these institutions could not be used to repay Iraq's creditors, thus encouraging a more timely write-down of some of Iraq's debt and protecting taxpayer money.

As I have pointed out many times before, the IMF should not be used as a bail-out agency, as this practice creates a potential for mis-use of IMF funds.

Taxpayer money should not be used to bail-out investors of high-risk ventures. There is a role for the IMF and the World Bank in Iraq, but it should be carefully defined to ensure that past mistakes are not repeated.

With adoption of appropriate institutional reforms and market-oriented economic policy, Iraq's people could look forward to a better future.

The IMF and the World Bank can be useful in this regard, but not if the money is to be just funneled through to Iraq's creditors.

Thank you, Mr. Chairman.

[The prepared statement, including H.R. 2338, of Representative Saxton appears in the Submissions for the Record on page 51.]

Senator Bennett. Thank you very much. We'll now go to our panel of witnesses, and I'm quite excited about the witnesses that have agreed to appear today.

I know you would all like to give us something of a seminar, and we would undoubtedly benefit therefrom. But if each witness takes 15 or 20 minutes, we'll be in some trouble time-wise. And we would hope to have some interaction with the witnesses.

Now our normal pattern is five minutes. Some of you may have a little more to say than that, and I'll be a little generous. But if you start tending towards ten minutes, why, I'll begin to tap the gavel and ask you to summarize if you can, so that we can get the kind of interaction that we would hope for from this panel.

Our panelists today are Mr. Basil Al-Rahim, who is of Iraqi heritage. I believe he was born in Iraq. He's an investment banker, founder of the Iraq Foundation.

Mr. Hernando de Soto of the Institute for Liberty and Democracy, a best-selling author and advisor to a wide range of governments.

Dr. David Ellerman. He is an economist, recently retired from the World Bank.

And Dr. Rachel Bronson, who is director of Middle East Studies from the Council on Foreign Relations.

So I think this gives us a wide spectrum of background and understanding and we look forward to hearing from you all.

Mr. Al-Rahim, we will begin with you.

OPENING STATEMENT OF MR. BASIL AL-RAHIM, FOUNDER AND BOARD MEMBER OF THE IRAQ FOUNDATION, MANAGING DIRECTOR OF MERCHANTBRIDGE

Mr. Al-Rahim. Mr. Chairman, thank you very much.

You asked me to speak on transforming the Iraqi economy. It's a huge subject. I'll try to summarize some salient points in five minutes or so.

I apologize that I will miss a lot of the details, obviously.

First, let me say that there are four points to my presentation.

One is that we need a full economic program and it cannot be a haphazard transformation of the economy. The program has to be well thought out, comprehensive, transparent, and elaborated to the public, both here and in Iraq.

I have called this program the Phoenix Plan because rehabilitating Iraq will be like rehabilitating an Olympic athlete that can compete, not rehabilitating a cripple that can, at best, just walk.

The second point is that oil alone is definitely not a panacea. While Iraq has huge reserves, these are underground and don't do the man on the street much good.

The third point is that the solution to transforming the Iraqi economy is empowering the private sector. There is no escaping this.

The fourth point is that the plan must be implemented by an independent commission of technocrats with the ability to fast-track the regulatory approvals necessary to underpin this plan.

Let us remember that Iraq has four very important resources. First is oil, which we all know about. Second, Iraq has water, two major rivers in an otherwise arid part of the world. Iraq has very fertile land and has achieved self-sufficiency in food production in the past, and can do so again.

Fourth, and most important, Iraq has a large technical professional labor force made up of engineers, doctors, lawyers, teachers, et cetera, and it has experienced a very severe brain drain which needs to be reversed.

The economic blueprint that I'm calling the Phoenix Plan is an economic model for Iraq, the region and the future. It will counter the regression that Iraq has gone into back into the 19th century and bring it back into the 21st.

By empowering the private sector and using oil revenue as a catalyst, I believe that this plan can be implemented.

It should have three phases -- an immediate phase, removing bottlenecks in the economy, a medium-term plan, five years, where we detail planned targets, such as production, industry, banking, health, education, with a target GDP per capita of $10,000. And it should have a long-term ten-year objective of a GDP per capita of $20,000, which is where Iraq should be had it grown normally during the last 20 or 30 years of the Baath regime.

The state should act as a facilitator and enabler. Monetary and fiscal policy have to be pro-active to support the plan.

Debt resolution is very important, as Mr. Saxton has mentioned. Debt has to be recognized in three categories -- bona-fide commercial debt, government debt, and war reparations.

Each one needs to be treated entirely separately and absolutely much of it must be forgiven.

The components of the plan fall into a number of sectors. Of course, the oil sectors is the major one. Big oil expertise and capital are definitely needed. However, the Iraqi private sector must be a partner in this exercise.

Though negotiations are difficult, they are between unequal partners. We must get the state out of the oil sector as the experience of the state in oil has been a bane to nations and never a boon.

There is the issue of whether Iraq should stay in OPEC or not, and that has to be thought through very carefully. Iraq has no interest to create price wars in order to obtain market share. But it cannot be tied to rigid allocations that no longer apply.

The downstream sector is also very important. But that also will require additional capital. The downstream sector is valuable not only in job creation, but also in improving the revenue-added value of exports.

The whole issue of privatization has to be explored. There are dangers and advantages to privatization. But this is the way to get what amounts to the majority of the productive assets of the country back into private hands.

There are many challenges, as to how do you value assets fairly at this time? How do you attract foreign investors? How do you achieve broad distribution? How do you avoid the problems that befell eastern Europe when people started out with a voucher and ended up with a bottle of vodka, and that was the extent of their participation in the economy.

Debt forgiveness and rescheduling, as I said, is critical. We see the three categories.

Commercial debt has to be renegotiated. Government debt has to be forgiven because it was extended to the old regime -- as Mrs. Maloney called it, the odious debt. And war reparations have to be

recognized because somebody did actually suffer at the end of this adventurism by Sadaam Hussein.

The plan proposes trading some of this debt for a point system that can be then used for concessions, licenses, contracts.

The point system itself would start having a market value and be traded between people who want to buy those points for use in Iraq on their own. Therefore, you don't eliminate the value of those points, but you shift them to the free market.

Attracting foreign direct investment, an aspect of the plan, is critical. And there are very many issues on this. One of the important issues is to avoid economic pillage of the country by foreign investment, which will definitely happen if we are not careful.

Restitution of private property has to be a part of that plan. And that has resulted from the 1963 nationalization and just continued through various waves of government.

Currency stabilization is critical. A new Iraqi dinar pegged to the dollar and the Euro has to be introduced.

The banking sector is very rudimentary. The banking sector is made up of two banks, two government-owned large banks and 18 small private banks.

This must be modernized, upgraded. Joint venture banks have to be attracted to help rebuild the banking sector, which is a critical part of any economy.

Finally, the component of the plan that we can look at is the capital markets themselves. There is something called the Baghdad Stock Exchange. It's been around for many decades. That has to be expanded, deepened and broadened. And that can be done by linking privatization with ESOPs, with IPOs, and with other forms of participation in the public market.

There are three other critical issues and I apologize if I am running over on the time.

First and foremost, critical to this plan is the employment and empowerment of the private sector. The private sector has been reduced to poverty subsistence over the past 20 years. The transition to a free market economy and full membership in WTO, which should be the objective of Iraq, cannot happen overnight because we need to protect the population to make sure not to disenfranchise them from the wealth of the nation.

Vocational training centers have to be set up so that 400,000 soldiers decommissioned from the army can be brought back in a productive manner into the labor force.

We have to avoid the problem of oligarches and cronyism that we've seen in other parts of the world. And these are already beginning to cluster around Iraq.

Vulture regional and international investors are looking very closely at Iraq and these have to be prevented.

Finally, while the WTO has to be the objective, the plan has to recognize how we move to that objective, step by step.

There has been much talk in the press about something called the Iraq Development Fund. We don't know what the mandate of that fund is. We don't know what the governance and oversight of that fund are. And I would suggest that the mandate should be synergistic with the overall plan.

The governance and oversight has to be transitioned to full local authority once a legitimate government is in place.

There are models that we can look at. The Alaska Fund has been mentioned as one model and some aspects of that fund are attractive, not all are relevant.

The Oil For Food Program has been a resounding failure, in my opinion, in the last number of years and should not be followed. But there's also something called the Iraqi Development Board which was set up in the 1950s, which has some very clear attractions because it was able to take part of the oil revenues away from the government budgets completely and use them only for development work. And that's a program that needs to be clearly examined.

We need to deregulate infrastructure, some parts of it fast, and get the states out of there. The fast parts can be transportation, telecom and media. Over the medium-term, the government should get out and deregulate power and water. And it should partially deregulate but stay partially involved in health care and education.

In closing, I would like to say, what is the role of the United States and other players in the transformation of the Iraqi economy?

It is critical that the United States does not abandon its leadership role in Iraq. Iraq needs a strong open-markets patron and partner with a shared vision for its transformation. It cannot become a beacon for the region without U.S. help.

G-8 countries do have a role and should be brought in because they can bring diverse values that can help rebuild the country.

The gulf cooperation countries, Iraq's neighbors, should be encouraged to supplement the limited financial and industrial absorption capacity of their own economies by participating in the Iraqi market.

And finally, in conclusion, I would like to say that the Phoenix Plan requires an independent technocratic commission with the ability to fast-track implementation and regulations.

A healthy economy in Iraq is a prerequisite for a stable democracy and both are mutually reinforcing. The domino effect can happen and we have to be careful which way it tips.

Empowering the private sector is the only solution. Albeit, important, oil is only one part of the equation.

The price of losing the peace is not limited to Iraq or even the region, and time is of the essence.

Thank you very much.

Senator Bennett. Thank you, sir. We appreciate that. Mr. de Soto?

[The prepared statement of Mr. Al-Rahim appears in the Submissions for the Record on page 54.]

OPENING STATEMENT OF MR. HERNANDO DE SOTO, PRESIDENT, INSTITUTE FOR LIBERTY AND DEMOCRACY

Mr. de Soto. Thank you very much, Mr. Chairman, first of all, I would like to tell you how much I appreciate your comments on the fact that so much is at stake in Iraq. All the eyes of the world are on Iraq. And, in effect, if there is not a successful transformation there, that will definitely bolster the arguments of all those people who are already marching on the streets against globalization, against the values of a free market society, and the possibility of creating capital.

And if you aren't able to do it in Iraq, the question then will be -- are all countries made for that kind of freedom? If they're not, obviously it can't even work, even if the foremost power of the world is involved.

So a lot is at stake.

And I think a very important comment was also made by Mr. Saxton, which is that the important thing here is not to repeat mistakes.

And that's why it's very useful to look at history and see where mistakes have been made.

One of the interesting things about listening to Mr. Al-Rahim, both in a conversation previous to this meeting and here, is that what he says about Iraq is well known and is absolutely true.

There is a large technical and professional class in Iraq, and there is an elite, like of course there was in Cuba and there was in my country and there was in Venezuela and there was in Egypt.

Now why did we get off the track 40 years ago, and I think that's important to remember?

We got off the track because the people who could actually participate in a capitalist society, were, nevertheless, an elite, a minority. And when there are minorities, when it's only 20 percent of the population, 30 percent or 15 or 5 percent of the population that is in an

elite position to benefit from a capitalist society, it usually becomes what I call mercantilism -- it becomes something that is politically unsustainable.

So if all it is about is restitution, in general, one must be very careful because what it could mean is restituting an elite. And the other people, feeling themselves on the outside, will then go for one of these isms, whether it's called socialism or whatever it is, to go for redistribution because that's the reason that though capitalism has been around for such a long time, it has failed in our countries.

It hasn't redistributed opportunities fast enough.

And that's really the history of the world -- in the United States, Japan, Germany, Switzerland, and France, capitalism came, but with large legal efforts to make sure that everybody could come inside the game.

In countries where there were elites that did not distribute these possibilities, whether it be Russia or any country that was part of the former Soviet Union, the system collapsed, and they will continue to collapse because they're not politically sustainable.

Nobody on the outside, as Marx said, will feel that they're participating. They will feel alienated. And that's how revolutions start, whether there's a Kremlin to organize them, whether Beijing is around to organize them, or whether they're not there.

However, we can learn from not only the bad experiences of history, but also the good experiences of history.

One of them, for example, is your own history in Japan, when the United States won the war against Japan and occupied Japan in 1945. What it did there that was good is useful to remember.

People sometimes forget what state Japan was in during the '30s and the '40s. For us Peruvians, of course, it's relatively easy because we had a president of Japanese origin from the year 1990 to the year 2000, President Fujimori, who was a member of one of the 1-1/2 million Japanese families who migrated to South America in the '30s and the '40s, especially to Peru and Brazil, which were open to Asian migration.

The reason the Fujimoris migrated to Peru, and the reason why the de Sotos did not migrate to Japan, was because our GNP per capita was higher than Japan's -- 20 percent higher in the case of Peru, 40 percent higher in the case of Brazil.

Now that President Fujimori has returned to Japan, he has found a Japan which is now ten times richer than any other Latin American country.

What did Japan do between 1945 and today to become ten times richer than us Latin Americans, who used to receive their migrants because they were poor?

The reply is that they created a capitalist system, but where everybody could participate. That required a plan. And that plan was originally set up by Americans working since 1942 in Honolulu to make sure that the feudal class did not recuperate all its privileges and that property rights were widespread.

As a matter of fact, they were already widespread, but at an extra legal level.

But the legal reforms that took place in Japan between 1946 and 1950 made sure that capitalism was a popular enterprise, the way it is today in the United States, instead of being an oligarchic enterprise, the way it is in most developing countries, and therefore, falters.

The ideas and virtues of your economy and political system have been around for more than 200 years and we've tried to imitate them.

One of the first things I think that should be done is to get the facts. What do you have to do to popularize a capitalist economy to make it democratic?

As you know, some of the work that we're doing in different countries, our think tank which you have so generously supported in the U.S. Congress, includes countries like Egypt, where we've been contracted by the government and the government has made public the numbers I'm going to give, therefore, I'm not breaking anybody's confidence.

Though I know that Egypt is not Iraq, Egypt is not very different from the other Asian and Latin American countries that we've been working in. We have found that in places like Egypt, the extra legal enterprises, small and medium enterprises, run by what are generally poor people, actually represent a large amount of assets.

The problem is their owners don't hold them within the law, and as a result, of course, their assets cannot become fungible or liquid. They cannot become capital.

But what we did find out is that the poor in Egypt own about $245 billion worth of assets only in small enterprises and land and buildings.

How much is $245 billion?

Well, it is 55 times the size of all foreign direct investment. In other words, a lot of the resources that Egypt and Iraq may need to get ahead are already within those countries. Their value is much higher than that of foreign direct investment.

Another interesting fact -- the $245 billion is 50 times greater than all World Bank loans given to Egypt.

So, no matter how much aid you give, public or private, the poor may already be holding their more, albeit, illegally. They can't really get

into the official market, the expanded market, and their assets cannot be traded in a way that they can be leveraged and actually create major wealth.

In the case of Mexico, for example -- and by the way, excuse me. One last point.

All the assets of the poor in Egypt are 30 times bigger than the Cairo Stock Exchange.

So it would be interesting to find out, in Iraq, in spite of all the turmoil and all the problems, already the poor have got a stake, and that stake, instead of being withdrawn, should be enhanced.

In the case of Mexico, which is another oil-producing country, it turns out that what the poor have, also outside the law, is about $315 billion worth of assets. And the interesting aspect of it is that, today, Mexico of course produces more oil than Iraq and has been doing so for over ten years.

These assets that belong to the poor are seven times higher than Mexico's known oil reserves.

So the mistake -- the important thing here that you said in your statement is that property rights are crucial. Who gets the property rights? How does the legal system recognize them or not?

Because, in the end, if people see that the law protects their rights and what they have today in assets, and allows them to leverage them, then, of course, the rule of law can come into place because I will understand the rule of law and the measure that protects whatever assets I have, whatever capital I have, no matter how incipient it is.

And the clue to all of that, of course, Mr. Chairman, is inclusion. There are exclusive capitalist systems, what Mr. Al-Rahim called oligarchies and cronyisms, and there are democratic and popular capitalism. And it's very important to ensure that now that the eyes of the world are on Iraq, that that's the kind of capitalism that you get.

[The prepared statement of Mr. de Soto appears in the Submissions for the Record on page 67.]

Senator Bennett. Thank you very much.

Dr. Ellerman?

OPENING STATEMENT OF DAVID P. ELLERMAN, PH.D., AUTHOR AND FORMER ECONOMIST AT THE WORLD BANK

Dr. Ellerman. Thank you, Mr. Chairman. I'm here to speak about some of the lessons learned from the transition economies of the former Soviet Union, in particular.

I think the short story is that the intervention of the international institutions of the World Bank, the Fund (IMF), western academics, the

economic profession in the former Soviet Union and the nation-building effort there was a disaster. It was a debacle.

The recently appointed head of the Council of Economic Advisers, Greg Mankiw, from Harvard, just published a piece on this and was a bit agnostic about assigning the blame. But he said, if in fact this shock therapy and the voucher privatization was wrong, then it was a blunder of historic proportions -- one of the biggest blunders in world history.

But he was a little soft on assigning responsibility because it involved a lot of his Harvard colleagues.

So the question is, what do we learn from that? What are the lessons that we can take away from that experience?

One has to go back to the sort of mentality of the intervention. It was one where it was after a revolution; socialism had failed. The west came in with sort of a cold warrior self-righteousness of let's wipe the slate clean of everything from the past. Let's try to start over. Let's try to create a new society, a heaven on earth.

This is something that conservatives know doesn't work. You can't do this overnight. The Jacobins tried this in the French Revolution. The Bolsheviks in the original Russian Revolution. And yet, the United States backed the "market Bolsheviks" that tried to do the shock therapy and tried to do the voucher privatization and created basically a form of chaos in these countries.

What people knew how to do was not supported. They felt helpless. They were disempowered. And in this chaos, the oligarchs and the criminal elements flooded in.

So one of the major lessons in this is to look at it from the point of view of the population. Are the population empowered or are they all tarred with the same brush as if all were stained from the past?

Many of the -- in Eastern Europe, particularly -- the exiles that came back, tried to say that everybody in the country should be disqualified from office, that everybody is communist and so forth. And this aggravates the chaos, makes it much worse.

And so one point here is there needs to be a line drawn so that the people above that line are suspect, but the people below that line, the professional class, the technical class, scientific engineers and so forth, are people that often had to join the party, the communist party in the case of Russia and eastern Europe, the Baath party in Iraq, in order to get the jobs.

If they didn't, then the nomenclature would have gotten the jobs.

So it was something that was done pragmatically. They're not ideologues, and they should be treated as technical people, professional people, and not with prejudice.

So that is certainly one of the lessons.

Secondly, because this is a time-consuming effort to try to make this sort of a transformation, the immediate thing is to try to get some sort of working order restored, not to say, well, we have to restart things only under a new premise.

So this means something like going back to what's the last time things worked. What's the last time that the ministries worked, the last time the industries worked, and try to restore some sort of an order, even though it would not be perfect.

And the thing not to do is, as was recommended to us in Russia, don't try to jump over the chasm in one great leap, that it's better to try to build a bridge over the chasm from the old to the new, even though one foot of that bridge always has to be on the old, and which is maybe distasteful.

But the thing to avoid is to aggravate this feeling of being totally disenfranchised, totally disabled, nothing works any more. Things didn't work well before, but at least I could tinker around and I could get things to work in a haphazard way. But now things don't work at all.

And this will feed into much greater chaos and extremism.

So I want to urge a real pragmatism there and getting away from this sort of self-righteousness of a conquering army that's going to disempower everybody there and try to set up a new regime overnight.

Let's be very pragmatic.

And also, we can talk about privatization and some of the lessons learned there. But certainly, this attempt at voucher privatization, to just try to wipe away everything from the past and start anew with equal rights, sort of like a primitive communism almost, didn't work, and that should not be even contemplated in the future.

There should be a large emphasis on restarting the enterprises that people see in everyday life, which is the small and medium-sized businesses, the retail businesses, the things that affect people's ordinary lives so that they get some sense that they're returning back to a state of normalcy.

And the overall mentality here, we're often told by the Russians that you treat us as if we were a conquered people. And the Iraqi people are in that position.

So I think that we have to be doubly careful in the whole projection of the American intervention there that they are not treated as the objects of benevolence, the objects of charity.

In some sense, the way to put this is to say that we should not give them aid in the sense of trying to do things for them, that we should try to put the tools in their hands and then let them rebuild their own

country as much on their own, than us to give out contracts and the like, which would, as it were, do it for them in a great show of American benevolence, which would only preserve them in this position of being powerless and humiliated.

And then one practical point I just wanted to raise which I think is very difficult to judge right now. But the Middle East is the only region of the world that doesn't have a regional development bank. There are development banks for all the other regions of the world.

For obvious political reasons, it's been hard to do that. But if in fact in the future we're looking for some means of extrication, then to have a regional bank that's a cooperative effort of the nations in the region, might as well be something to look at.

And finally, I want to just try to get you to look at the psychology of how this is viewed from the Iraqi people because I think they are in a very ambiguous position right now in their own psychology.

Do they want to make this occupation a success? Or do they not? They all want to rebuild their own country. But they're put in a position where if they cooperate with the occupying power, as in Germany and as in Japan, well, that was 55 years ago and we still have bases in Japan. We still have bases in Germany. And they didn't have oil.

So if you're an Iraqi looking at this situation and say, do I really want this to be a success and still 50 years from now have American bases in the country or not?

And so, the fundamental point has to be to somehow make that political switch so that they're not working to make the American occupation a success, they're working to rebuild their own country for themselves.

And that's very difficult. I can't emphasize enough that that's going to be fundamental to the success of this effort from the point of view of the Iraqi people.

Thank you.

[The prepared statement of Dr. David P. Ellerman appears in the Submissions for the Record on page 73.]

Senator Bennett. Thank you very much. Dr. Bronson?

OPENING STATEMENT OF RACHEL BRONSON, PH.D., OLIN SENIOR FELLOW AND DIRECTOR, MIDDLE EAST PROGRAMS, COUNCIL ON FOREIGN RELATIONS

Dr. Bronson. Mr. Chairman, Mr. Saxton, Mr. Stark, thank you very much for the invitation to speak with you today on transforming Iraq's economy.

I want to make four points. The transition in Iraq towards a successful economy and successful political situation will take time, it will be dangerous and will require our resolve, it will be expensive, but ultimately, it will be worth it.

I want to make sure that we don't leave this hearing thinking that the security situation that, Mr. Chairman, you highlighted by holding up the newspapers, is somehow distinct from the economic transformation of Iraq.

They are indeed linked. It is something that we have learned, case after case, particularly in the Balkans.

We need to focus on the security situation if we want all of our goals for the economic transformation of Iraq to succeed.

We must also remember that this is going to be very time consuming. Secretary of Defense Rumsfeld has pointed out that it took eight years for the United States to move from its period of revolution to a constitution.

In Germany, that experience took four years. And in Germany alone, it required $8 billion, in current dollars, between 1948 and 1952. Germany required a significant American and international security presence to help the Germans rebuild law and order in their society. And it took a lot of attention to the international context to help facilitate that outcome.

So we know from the experience in the United States, we know from the experience in Germany, we know from the experience of the '90s, this takes a long time. It requires international assistance. It requires serious attention to law and order.

I want to focus on law and order because it matters to this Committee, both because it will be very costly to the United States and the lack of attention has already set back Iraq's reconstruction.

Much of the looting and the chaos that we've seen in the streets has largely undone all of the good work military planners who carefully considered what to target and what not to target.

Areas that were originally kept off the target list, have largely been destroyed anyway by the looters and this will make everything more costly.

The lack of law and order also makes it harder for the Iraqis to go back to work. They are afraid to leave their homes because of what might happen to their families and their property.

We have to create a situation where they are more comfortable to go back to work.

Focusing on issues of law and order, goes to the heart of the difference between *The New York Times* and *The Washington Post* stories that the Chairman referred to.

The Washington Post stories are focusing on the slow building back of the basic law and order on the streets, very positive and the Administration can very much take credit for.

But the vacuum that was created in the weeks following the war has allowed Sadaam's security forces, loyalists, those in the Baath Party, to begin reconstituting. They are organized. They do not believe this war is over. And the Iraqi people will find it very difficult to work against them if they are not convinced that Sadaam and his sons are dead or that the security forces do not provide an organized opposition to the United States.

The average Iraqi is waiting to see who is going to win this, and right now for them, the jury is still out.

Law and order will be a very expensive proposition. Before the war, the Council on Foreign Relations, our task force, estimated that, at minimum, 75,000 troops would be needed to secure the peace and cost at least $15 billion a year.

We now know that figure is low. The Administration is on record as saying that 150,000 troops in Iraq are costing about $3 billion a month.

The longer chaos is allowed to reign, the more costly this will be and the more difficult this will be. That is why I want to be sure that we focus on the connection between law and order and economic reconstruction.

But even when we get to reconstruction, even if there had been a seamless transition from our authority back to the Iraqis, this still would have been expensive.

Iraq's reconstruction will not be self-financing. The oil industry is in dire straits.

Before the war, because of sanctions and poor political leadership in Iraq over the last decade plus, Iraq was losing about 100,000 barrels per day annually. We need to staunch the bleeding of Iraq's oil industry before we can even hope to get back to the levels that they were before 1990, 1991, or the heady predictions that were made before the war.

We must remember that before the war, Iraq was bringing in about $10 to $12 billion a year in oil. 70 percent of that was going to the humanitarian needs of the Iraqi people--food and medicine. $3 billion is required to go back into the oil industry just to keep it operating.

We estimated that the reconstruction of the oil facilities to get it back to the 3.2 million barrels per day that it was producing before the war could cost up to $5 billion.

To get its energy sector back up to where it was could cost as much as $20 billion. Iraq was a sophisticated society with a sophisticated infrastructure. It is not like repairing Afghanistan.

There are a number of other things that will be required and some of my fellow panelists, the witnesses here today, have made reference to them, and I will quickly go through them and then leave you.

First, there is a requirement to diversify Iraq's economy. Over 95 percent of its resources come from oil. This was not the case just a few decades ago. But relying on this sole commodity is bad for the Iraqi people and bad for the economy.

It also makes it very difficult to get to any sort of democratic future.

When the leadership owns the major resource, it doesn't depend on the people to participate. And so, we need to think about the transformation of its oil sector and its larger economy if we're trying to reach any different political outcome.

Restructuring Iraq's debt is going to be a massive undertaking and we need to show our own commitment to the process before those around the world are likely to forgive the debt.

And also, we have to support a stable, transparent political order. If we want investment to flow into Iraq or if we want to keep the Iraqi money at home, there has to be something to invest in.

This kind of political order will take time. If we move too quickly, the Balkans show us you get black markets, drug lords, and money-laundering.

The Administration was right to step away from the interim authority and trying to create one too early. But by bringing up the topic of an interim authority so soon after the fall of the Sadaam regime created unnecessary expectations.

The way forward is going to be very difficult in Iraq, but it is well worth doing. Iraq can be a model for the region. I receive calls from those around the region on a regular basis, from our dwindling number of supporters begging us to get this right.

Our supporters out there need a win that they can point to. And right now, their hopes are on Iraq. And I think we should make sure that their hopes are realized.

Thank you very much.

[The prepared statement of Dr. Rachel Bronson appears in the Submissions for the Record on page 78.]

Senator Bennett. Thank you. Thanks to all of you. I think you've given us the provocative insight that we had hoped for.

Now we have some members of the Committee who did not give opening statements. If you would like to stay and question, I will allow members of the Committee who did not give opening statements to question before the others do.

Do you want to take advantage of that?

Representative Hill. I'll take advantage of that.

Senator Bennett. Now, actually, having said that, Mr. Paul was here before you were. So I'd like to go in the order in which they arrived.

Mr. Paul, if you could do the first questioning. Or I'll let you two fight it out.

(Laughter.)

Representative Paul. I'll yield.

Representative Hill. Okay.

Senator Bennett. All right. Mr. Hill?

Representative Hill. Thank you, Mr. Chairman.

I don't know quite what to ask, to be honest with you. This problem -- and it is a problem -- of the state of the Iraqi people and what their future holds is obviously complicated.

I woke up this morning and went jogging with my friends. I knew where my meetings were going to be. I knew where the bathroom was. I knew that I had to go to my ATM machine and get some money.

None of that exists in Iraq.

First of all, when you talk about private property, how does that happen? How do people obtain this property? What mechanism is in place, what system is in place that can create private property rights for the people of Iraq?

Anybody?

Mr. de Soto. Well, I would say that one way of looking at it -- without knowing Iraq but knowing other developing countries and what happens -- is that, probably at this stage, after all the looting, the burning, the squatting that had taken place before the Baathist revolution, the adverse possession stakes, the creation of a large, small and medium enterprise situation, maybe a great popular part of Iraq, is similar to what California was like 150 years ago.

You had 800 mining jurisdictions that are being formed on the basis of squatting. Nobody really knew who owned what or where.

It took you 30 to 40 years to put that all together because most of the property was obtained in an extra legal fashion.

So regardless of what existed before, whatever legal system existed before, you have to think of creating a new legal system to accept all the new stake-holders within the system.

And that's why what I insisted upon before was how important it is to get an inventory of what has actually happened on the ground in Iraq over the last 30 years to find out where there are claims, where there are conflicting claims, to make sure whatever property system is redesigned and put into place, actually serves the majority of people's interests. Otherwise, you won't get the constituency to have a stable economy.

Very different than in the situation, for example, of Germany, because the property rights system or the legal system that defined property rights had already been defined in the 19th century.

So the occupation really didn't involve getting into the thick of that because there was a consensus on property.

In most developing countries, that consensus does not exist. What you will probably find are widespread markets and anarchy regarding the law and therefore, the need to re-adapt whatever law exists to reality.

Representative Hill. Well, I'll go back to something that Dr. Bronson had said, that the people are waiting to see who is going to emerge in leadership positions.

It seems to me that none of that can happen until there is some certainty in Iraq. Is that true or not true? And how long will that take?

What has to be done? What should we be doing?

Mr. de Soto. Well, the first thing that you did in Japan, which was very interesting, or rather, that the Japanese did under Gen. MacArthur's sponsorship, is have an inventory done of what the situation was all about.

It took about two years to put the inventory together.

In other words, underneath the feudal class of Japan there were people who held property, but they were not within the law, or their stakes were not recognized by the law.

It took two years to actually find out who owned what. It's the whole experience you had in all of the west of the United States. There were people that went around and tried to calculate how many trees were felled in Wyoming to create a cabin and then find out those that would be calculated improvements and create a property law that was adequate to it.

Your own Congress passed 32 pre-emption acts, the purpose of which was to violate an existing common law that no longer responded to the situation on the ground.

The first thing you did was an inventory, state by state, and then you put the law together.

Mr. Al-Rahim. Mr. Hill, if I can just jump in.

Iraq today is a lawless country. But this was a country that was well on its way to industrialization in the '50s.

There were extensive land records. There were extensive property-holdings, property rights. And we are not talking about complete breakdown of the system.

Mr. de Soto may be right that we need to take some inventory. But we're not talking about starting from scratch and a complete chaotic situation.

Yes, there has been looting. Yes, there has been squatting. But this comes only in the last couple of months.

The problem of restitution and property rights is really going a little bit further back in terms of what's happened since the nationalization and the waves of socialism that took over.

I don't think it's an insurmountable problem. It's one of the problems and there's a lot of problems that need to be resolved.

Representative Hill. Mr. Chairman, I see that my red light is on. But thank you for the opportunity to ask a few questions.

Senator Bennett. Mr. Paul?

Representative Paul. Thank you, Mr. Chairman.

In the Chairman's opening statement, he mentioned that we could be looking at Iraq either as being half full or half empty.

I tend to think that it probably is half empty, and I sort of identify a lot with Dr. Bronson's concerns about what's going on over there.

The other concern I have is it sounds like we're in the business of nation-building, which is something that a lot of us talked about in the past as not being a very good idea. And it's still very popular for me in my district in Texas to say that we shouldn't be in the business of nation-building, and that usually gets a pretty good response.

So I have a great deal of concern about the cost of this and how well it's going. And I appreciate the testimony of all of you because I think it gives us a lot of insight.

But I do see tremendous problems with this instilling property rights in this country. I think it's so much different than in Japan and Germany. These populations were so much more homogenous compared to what we have in Iraq.

So this tends to make me less pessimistic.

I'm just wondering if any of you have given any consideration to the restoration of private property rights on the original owners and the developers of the oil wells because, in Cuba, we're concerned about that all the time, even though it's been 40 or 50 years. There are still people who have claims about property ownership in Cuba.

And I'm just wondering -- I don't hear much talk about that and it seems like maybe we should give that some consideration.

Also, on the debt elimination, I think it's an academic question. They're not going to pay the debt. And it's always interested me that when we talk about debt repudiation, we always have to talk about an appropriation.

So if they owe us money and we can't pay it, why don't we just write it off the books? It makes me suspect that somebody is going to get paid off that probably really doesn't deserve it, or they should get in line.

So I'm always concerned about appropriating money for debt forgiveness.

But if we did have the restoration or the implementation of private property markets, I think the idea of capital is irrelevant. The money will go there. That's all there is to it. We don't need huge appropriations.

So it is more important that we have the right rules set up, of course, by those who are there.

But my question is a political question in many ways because it seems like it's going to be so difficult. To me it seems like we have three countries over there. Iraq was an artificial country. It was designed by Europeans. It was designed after World War I.

And is it conceivable that even with our occupation and our 150,000 troops, more troops now than we needed to liberate Baghdad. We need more troops and all these billions of dollars.

My question is, how long do you think we can do this? How long will the American people tolerate it? And is it achievable?

Maybe, in reality, if we knew right now it was unachievable because, already, we've had Rumsfeld say that, oh, well, we can't have an outright election because if it goes the wrong way -- and the majority would not vote what we want.

So it may well be that the only solution is going to be probably three different countries there. And maybe we're fighting a losing battle.

And I just wonder if you have some comments, especially how long do you think we can go without having success? I think Mr. de Soto said, we'd better have success and we need to have success.

So I'd like to hear your comments.

Dr. Bronson. Mr. Paul, thank you.

In terms of answering your constituency on nation-building, there's a counter-intuitive aspect to it that makes understandable why everyone is so confused.

The more committed and more present you are up front, the faster we can pull our men and women home. And the reason for that is Iraqis are looking to go back to work. They're looking to go on the streets. They need an authority there and a heavy American presence.

As long as chaos reigns, everything takes longer. Everything is more expensive.

The Administration's recognition that more military police, and more soldiers, were needed is actually a good sign. It bodes well that we may actually be able to pull out earlier because if you allow the sort of chaos because we don't have enough people and commitment there, it makes everything much harder.

Will Iraq break down into three distinct territories?

If we don't stay committed, there is the possibility of it. But I think if you look back to original meetings that the opposition was having in the early 1990s, there was a preference, for instance, in the Kurdish community, their first preference was to have their own independent state. They also recognized that that was unlikely to happen.

The second best alternative is participation in a full and free Iraq.

We need to keep them focused on that, that their first preference is unattainable, but their second preference is truly attainable. And that gets back to some of these economic and political issues we're talking about.

We need to think through how the oil from the north and the south goes back to the central government and then resources go back to the provinces.

As long as you can get that kind of system going where the money goes in and goes back out, you will keep Iraq whole.

But if there is no organization committed to that reality, people will start fighting over keeping that oil in the north and the south and that will be a problem for Iraq.

Representative Paul. You assume that it is crucial that it be kept whole.

Is that correct?

Dr. Bronson. That's right, I do. If it is not kept whole, all of the fears of the critics of this war will come to pass. And that is because if it starts fracturing, you will certainly see Turkey moving in because they will be worried about an independent Kurdistan on its border.

You will see the Iranians much more active than we are seeing now if there is going to be some sort of independent Shia state in the south.

It is crucial to the neighborhood and the United States that Iraq remains whole, but that's good news. There is a shared interest. And it's a second preference of the Iraqis themselves which gives us a good basis for moving forward.

We have to have a centralized authority with some independent autonomy in the provinces that allows them to benefit from that kind of vision.

Representative Paul. Thank you. Other comments?

Mr. de Soto. Yes. The only comment or reference to the issue of property claims, what has happened in many developing countries, practically in all developing countries, and many former Soviet Union countries, over the last 34 years, is that, in some cases, because of natural migrations, in other cases, because dictatorships, also need some kind of legitimacy and they go around redistributing land and redistributing property.

And they've done that and probably, Sadaam Hussein has had to do the whole thing to create legitimacy for his own regime. It is very surprising what you see once the dictator is out.

The first thing that you will have seen is that one person may have owned just one estate. Today, there are 15,000 people living on that estate.

And so, what do you do? Do you just restitute to where you were before? Do you give California back to 15 Mexican families or do you keep the 3 million people with big guns on them?

What do you do?

So what I'm saying that I think is important, and it gives you an idea of the time, is you have to make an inventory of what has happened.

I don't think that even Sadaam Hussein actually knows what was happening underneath his nose. It's a whole social process that's been going into place.

Take Egypt: The logical thing of course would seem restitution. There were rent controls. Property was redistributed at the time of the revolution.

The Egyptians want to welcome investment again. But they find out that it's impossible because the families that will be benefitted are a small minority and those that would be dislodged are the large majority that you need for the rule of law to come into place.

The plan for how you go about this cannot be designed until you have an inventory of who is where, who owns what, and what are the different claims within the land: Then you can start creating the kind of law that peacefully settles those conflicts and allows you to bring in stability.

And that's what you in the U.S. Congress did in your own country 32 times before you created the Homestead Act. There's always people who believe that the Homestead Act started the process whereby a large majority of Americans who had squatted now had a right to property.

It was actually the last of your acts. You had 32 going before, including when President Washington had a third of his farms invaded by what he called the Banditti.

But, first of all, you had to take stock of what had gone on. And in many cases in Iraq, I don't think that anybody really knows what's going on. And the process is going to take time.

Senator Bennett. Mr. English?

Representative English. Thank you very much, Mr. Chairman.

Starting with Mr. De Soto, given the natural potential of Iraq's mineral wealth, what options would you suggest to maximize the potential of the petroleum industry since we've brought it up, in order to spur investment and growth in the overall economy in Iraq?

And at the same time, how do you utilize that asset without leading to an imbalanced economy, such as you have in Venezuela, where petroleum had become pretty much the only driver in the economy.

Recognizing Mr. Al-Rahim's point that there has been an industrial base in Iraq, how do you use petroleum and at the same time, encourage a movement towards a strong mixed economy?

Mr. de Soto. Thank you for your question, but I'm afraid I know very little about the use of petroleum. I know about successful experiments, your own in the United States in Alaska bringing a wide amount of people to participate in the wealth.

I know what, for example, the Bolivians have done in terms of their gas industry and how they've made all citizens stake-holders. But I know very little about the headlines, sir.

Representative English. Mr. Al-Rahim, would you like to take a whack at that?

Mr. Al-Rahim. Mr. English, thank you.

Obviously, the oil sector is very important. But I see it as important only as a catalyst for the economy.

Just to put it in context, Iraq has 113 billion of proven reserves. The last count or assessment of those reserves is 20 years old.

Assume that if a new assessment is made, the reserves may be as high as three times that.

Putting reserves in the ground, proven reserves, 1-1/2 times those of Saudi Arabia and, in fact, the largest in the world.

However, reserves in the ground is something and oil revenues is something else.

As Dr. Bronson said, it takes about $5 billion to rehabilitate the industry and it will take probably another $30 billion to get up to six million barrels a day, which at that time will give about $35 billion of revenue a year.

You have to get the private sector to participate actively. The oil sector is not just about upstream production, of course. It's a whole world by itself as an industry. And it is a sector that will involve not just oil field services, midstream activities and downstream activities.

The way to do it is to invite foreign participation with special protection clauses because for a country the size of Iraq which today has a GDP of $25 to $35 billion, to negotiate with a company like Exxon-Mobil, which an annual turn-over five times that, this is not a level playing field by any stretch of the imagination.

But you need to attract the major players.

You also need to implement things that you will implement in the privatization program, which is local participation, employee share ownership programs, IPOs, so as to really get that broad wealth distribution out into the country.

But there are a number of methods that you can do this.

Representative English. Very good. Dr. Ellerman, I've been interested in the thrust of your remarks. And you have argued, as I understand it, for an incrementalist approach to building the Iraqi economy based on your experience in Eastern Europe.

Can you offer us what you think would be probably the best example of how that incrementalist approach has been successful in eastern and central Europe since the fall of the Berlin Wall?

Dr. Ellerman. Well, the general idea is to try to take what I would call the de facto property rights that people have -- their capabilities, their skills, what they know how to do, how they know to operate industry, how they know to make things, and so forth -- and try to then, as it were, shrinkwrap the ownership and control structure around that.

So the people who have to show up to work every day to make the thing work, they have to cooperate together, so they have the control in their hands to make it work.

It's very practical, don't try to set up great long chains of authority that has taken us decades and a century to work right.

Try to have something more like local ownership. And the ESOP, the employee stock ownership plan that's been mentioned, is an excellent way to do that.

Representative English. And which country in central and eastern Europe do you feel has most successfully undertaken that approach?

Dr. Ellerman. Well, all the countries use very mixed programs. You've got to almost go program by program.

But in Poland, for example, what they call privatization by liquidation program was a type of lease buy-out. And ESOP is like a lease buy-out, where the ownership goes to the management and the workers in it, but they have to pay it off over time.

So it's like a lease purchase arrangement where the company itself pays it off.

Something like that also happened in Hungary which was very successful. The country that I used to live in and worked in was Slovenia, and it was certainly very successful in Slovenia.

So something like that is a way of empowering people, a way of giving them a stake fairly quickly.

And for your question and for the previous question, this idea of us getting into nation-building, what I keep trying to say is we have to get the reconstruction effort conceptualized as their building their own nation, not as us doing nation-building to them.

And something like the ESOP, something like these programs where people can formalize their property rights and feel that they can then know what they can do, they're empowered to do it, and they can go further, that's the key thing to make it their effort and not ours.

Representative English. Thank you. And I need to head to the House floor, so I thank you, Mr. Chairman.

Senator Bennett. Thank you, sir.

Senator Sununu?

Senator Sununu. Thank you, Mr. Chairman.

Mr. Al-Rahim, you mentioned an organization established in the '50s or '60s you mentioned as a good model, a good structure for coordinating and maybe identifying prospective investment.

What is it about that model or that structure that works from an economic perspective or a cultural perspective?

Mr. Al-Rahim. Mr. Sununu, that was a development board set up in the '50s, independent of the government, staffed by technocrats, where, at the time, this was prior to the revolution, the government decided to allocate 70 percent of oil revenues to this board. And the board also had the benefit of a number of prominent international economists invited to it.

The attraction of that is that the revenues that came to this board were kept out of government budgets, so that people couldn't spill over and start using that money. And that money was really earmarked just purely for development work.

I just mentioned it as one example of something that could be interesting and could work.

Senator Sununu. Was the fact that it kept a large portion of the oil revenues out of the hands of government part of the reason for its success?

Mr. Al-Rahim. Yes, I would say that. You didn't have government overspending spilling onto its budgets because they were kept in completely separate boxes, as it were.

Senator Sununu. Mr. de Soto, you mentioned both Alaska and Bolivia. I'm familiar I think with the structure of the Alaskan trust.

What is the structure of the equity or revenue distribution of the Bolivian gas industry and to what degree has it been successful? And to what degree could it be a model for Iraq?

Mr. de Soto. I'm sorry, I wouldn't have a reply to that question.

Senator Sununu. I'm sorry. You did mention it, though, didn't you?

Mr. de Soto. I mentioned that I knew of the successful experiments, but I know no more than that.

Senator Sununu. Okay. Could you talk a little bit more about the experience with the inventory in Egypt? What's the scope of that effort? Is it nation-wide? Is it a pilot program?

How long has it been going on? When is it expected to be completed?

Mr. de Soto. It's a nation-wide exercise that the Egyptian government is carrying out and in which we are the technical support.

It began when there was a consciousness that may be a great part of their economy was an underground economy or an extra-legal economy. And we were brought in to quantify it, to try to find it to categorize it.

And the results were surprising. That's why I was saying that it would be interesting to also carry out that kind of an exercise in Iraq.

So far, we've reached the point in July that there is a plan now to carry out the reforms. There were two stages. One was the inventory, and then once you had the inventory --

Senator Sununu. The inventory is complete?

Mr. de Soto. The inventory is as complete as you can get it now.

And as I repeat, the interesting thing about the inventory that we found to be the extra-legal economy is actually the largest part of the

economy. It is bigger than their oil reserves. It is bigger than all the other industries, as I said before. It's 30 times the size of their own stock exchange and it's about 70 times the size of all the bilateral aid they've received ever.

So these are also like oil resources. They're huge human capital and asset resources that are simply not put within the legal system and therefore, they cannot be mortgaged and therefore they cannot be leveraged and they cannot create the wealth that they can in the United States.

Senator Sununu. Has the package of reforms been proposed and adopted?

Mr. de Soto. The package of reforms is being proposed now. Discussions for adoption will start taking place beginning the month of September.

Senator Sununu. To what extent are you concerned that there may be political forces that work counter to the potential economic benefits here?

We'll leave Egypt out of the discussion. It may or may not fall into this category.

But one might argue that, in some societies, the governing forces have some interest in people holding their land or being allowed to use their land, or being allowed to operate their business to a certain extent at the pleasure of the government.

Property rights that are protected empower individuals, make them less dependent on the whims or the political dispositions of the leadership.

So, to a certain extent, might you be concerned, whether it's an Iraq or anywhere else where these kinds of land reforms are undertaken that the governing forces don't really have an interest in establishing clear, quantifiable and protected individual rights?

Mr. de Soto. Well, sir, in the case of the countries we've been called to, including Egypt, and where we have been paid to carry out these studies, various millions of dollars, I supposed that we've been called in because people have been interested in the reforms.

What always spurs along the reforms is, as I repeat, the inventory.

If as a result of the inventory, for example, in the case of Egypt, as we were talking about, one finds out that 88 percent of businesses function outside the law, and 92 –

Senator Sununu. Leaving Egypt out. In the other case histories that you've looked at, I guess, have you seen this phenomenon or is it just a concern that hasn't been seen in the case studies?

Have you seen the phenomenon where sort of political forces desire to have a system where ownership rights are vague or not easily enforced?

Mr. de Soto. I was coming to that, sir. The thing is that when you are aware, if you're a politician, that in fact you are not governing 88 percent of the people who work in the private sector because they work outside your system, that you really don't know who is living where in 90 percent of your land, you have every political interest for that to change.

I have not found resistance for change coming from somebody saying, well, it's all right. 90 percent can live outside the law. I don't really care if they have property rights or not, because the consequences of not having property rights are not only the fact that you don't get development because credit, investment, is all based on property rights. But it's also that you can't even police these places.

You don't know where Osama bin Laden is hiding because you don't have a system of addresses. You cannot participate in the global economy.

Where the danger comes from, sir, is the following one. It has a lot to do with ideology and with cultural myths.

So let me tell you a little bit just how we work there in two minutes and why we're optimistic about the fact that these changes will be adopted.

For example, Egypt has been trying to pass a mortgage law for many years now and has been unable to because the forces of resistance say, how are you going to have a system whereby people are able to use their homes or their chattel, their goods, their animals, their equipment, to guarantee to secure a credit?

Because credit only functions where people have something to lose. That's what basically creates the trusts and that's what allows you also to enforce noncompliance. And therefore, the idea is you can't impose this on poor people. Therefore, you will not be able to pass a mortgage system.

That has been stopping them for years and years now, if not decades.

What we do is try and look at the dark side of the economy because it actually provides the answers in an unideological form.

So we start asking, for example, how do people in this large extra-legal sector of Egypt, but we could also be talking about Mexico, survive on a day-to-day basis within their small enterprises? Do they get credit?

And the reply is they do.

And the question then is, how is it guaranteed? And it's guaranteed by an instrument which, as a matter of fact, the Arabic culture created 700 years ago, which is the check system. I think it even comes from an Arabic word.

There were Arab checks circulating all the way up to Shanghai 700 years ago.

So the way it would work, sir, is that if you asked me for $12,000, I will say that the guarantee will constitute a check written against your account for that amount.

Excuse me -- not for that amount, but it will be drawn blank.

If you do not pay, I can get you in a month or two in jail because in all these countries, there is debtors jail. And a great amount of the prisoners are people who haven't paid their debts.

So what we do are the statistics, which are the following one:

How many people today of Egyptians actually -- there's no mortgage law, mind you -- but how many people to pay off the debt and not to go to jail, have had to sell their houses?

One point five percent.

How many people have gone to jail and anyhow had to sell their houses?

Another 4.5 percent.

How many people have had to flee the region which they live because they've not been able to pay their debts?

20 percent, and therefore, have had to sell their houses as well.

And then we put it next to, for example, U.S. statistics, that say -- the Fannie Mae statistics that I've got, at least -- only 0.3 percent of Americans lose their homes as a result of the mortgage system.

So then the argument becomes the following one:

Not having a mortgage system violates human rights and property rights much more than having a mortgage system. But the examples that you bring are not the examples from how good this works in the United States because then you get a Samuel Huntington telling you that there's something in the Anglo-Saxon gene that makes it work in the states.

What you do is you compare it to the credit system that already exists for most Egyptians, and in this case, for most Iraqis, show how badly it works, how many more little old ladies actually lose their homes under the lack of the rule of law, and that's how you get your rule of law passed.

Senator Sununu. Thank you. Thank you, Mr. Chairman.

Senator Bennett. Thank you very much.

Let me try to summarize some of this, at least for me.

Mr. Al-Rahim, I'm interested to have you say that, along with oil, Iraq has water and fertile land, as well as a technological and professionally capable labor force.

From the papers, we hear about the oil and we hear about the labor force. But we don't hear that Iraq has fertile land and water.

It would seem to me that that would be an enormously valuable resource in the Middle East, to have fertile land and the water to cultivate it, and that Iraq could not only become self-sufficient in food production for its own population, but begin to export food, if not in the Middle East, down into Africa or other places where food is desperately needed.

What are the chances in your view of that becoming a viable economic opportunity for the Iraqis separate and apart from the oil?

Mr. Al-Rahim. Mr. Bennett, I think it's a very viable opportunity within the context of the plan because Iraq has been self-sufficient in the past.

It doesn't even have to go as far as Africa to export because a lot of the region, for example, the Gulf states, are net importers of food, anyway. So it can just export to its own neighbors.

There are two major rivers in Iraq, the Tigris and the Euphrates. They are large rivers, and provided they don't get subjected to severe damming in the north, in Turkey and Syria, and there's been threats of that, those rivers can support a very large agricultural industry in Iraq.

That industry has not had any modernization brought to it like any other industry for the past 20 years for the reasons we all know.

So I don't think it would be very difficult to reactivate it.

I put in my paper which is now in the record, at some point, we need to re-establish a system of collective co-ops just to have the economies of scale that you need in modern agricultural operations.

But I don't think that that is going to be, again, something that is impossible or every difficult to achieve. I think it's a very viable component of the overall plan.

Senator Bennett. And Mr. de Soto, that clearly would go to the question once again of property rights, of who owns the land that could then be turned into agricultural activity.

Maybe we don't want small farms. Maybe we want more of an agri-business kind of approach. But that means the people who are in the way of an agri-business acquisition of large tracts of land would have to be compensated for moving. They'd have to sell their land the way the

small farmer in America sells his land to Archer-Daniels-Midland or whoever, and takes that money and goes off to the city and becomes an entrepreneur in some other kind of circumstance.

So it seems to me that there's a connection between that opportunity. And we should focus on that because we have become so pre-occupied with oil, we should recognize that there are many other opportunities.

I want to come back to you, Dr. Bronson, and a point which was your fourth one which I think has been lost in some of the specifics that we've gotten tied up with here.

When you say this is timely, dangerous, expensive and worth it. And I think we should focus on the worth it.

This is, after all, the Joint Economic Committee. We want to talk about the impact economically on the United States. And let me just philosophize for a minute and then get your reactions, any of you.

Dr. Ellerman, you're in this field as well.

Looking back at the examples that have been talked about here, Japan and Germany at the end of the Second World War, those were enormously expensive operations on the part of the United States of America.

Japan at least dealt with a very, very different culture. The Germans were used to a western style of entrepreneurial activity, the kind that would be compatible with their neighbors. The Japanese were a feudal empire.

Dr. Ellerman, MacArthur kept a bridge on the other side of the chasm. He did not eliminate the emperor. Indeed, when Japan was being bombed, they did not bomb the Imperial palace.

I remember as a businessman driving through the streets of Tokyo with my manager when I owned a business in Japan and looking at all of the buildings, some of which were modern skyscrapers and some of which looked much more traditional.

And I asked, how many of these buildings were built since the Second World War? And the answer was all of them, because every building in Tokyo, with the exception of the Imperial Palace and the Diechi Insurance Company was destroyed by the American bombs.

So MacArthur very wisely kept at least one toe on the old bridge by keeping the emperor in place, but eliminated the system of slavery.

We don't realize that the Japanese had slaves in the 20th century, in the feudal system that they had. The woman who managed my business in Japan was part of the team -- she was a translator for the American occupation forces and was part of the team that went into those areas and told these people, you're now going to have property rights. Told these people, you are no longer slaves.

How long did it take MacArthur to make that transition? Seven years? Five years? Something along that line.

How much did it cost us? I don't know. But it was huge. Dr. Bronson, it was obviously worth it.

Japan, even with its deflation and problems now, is still the second largest national economy in the world, a major trading partner. Most Americans love Japanese cars, if nothing else.

We have created an island of stability and prosperity in a part of the world that desperately needed it. And we have the opportunity to do the same thing here -- create an island of stability and prosperity, property rights, proper kinds of capitalism -- I remember the Russian ambassador saying to me when we were talking about some of their problems, we've had plenty of shock, but damn little therapy.

And you're right. We did not do the Russian thing right, and we need to learn from that and do the Iraqi thing properly.

Am I just a rosy-glasses idealist here who's looking at the best thing? Or is this in fact an enormously valuable opportunity, how difficult and dangerous and expensive and timely it may be?

Is Dr. Bronson really right, everybody, that this is overwhelmingly worth all of the challenge that we need to put into it, and the advantages -- being very selfish -- the advantages to America, to our children, in terms of what could happen out of this, could be as great as the advantages that came to us because our parents did what they did in Japan and Germany at the end of the Second World War?

That's a philosophical question, but I think that's what we really want to deal with in this hearing as a whole.

Responses? Mr. de Soto?

Mr. de Soto. Well, one reply to your question is, regardless of whether that's the way it should have taken place or not taken place, your occupation of Iraq, the fact is that it's done and you're there.

(Laughter.)

And now that you're there, it is an opportunity, not only because, Senator Bennett, it's an island of stability, but it's because these islands of stability are very contagious.

Senator Bennett. Yes.

Mr. de Soto. In the case of China, you didn't get it at the first throw with Chung Kai Chek. But by leaving behind the Brits two ports, with market economies and freedom, at least economic freedom, Singapore and Hong Kong, by allowing widespread property in all of these places, including Japan, what is today South Korea and what is today Taiwan, after 40 years, now the larger continent is also following.

It's very contagious. If it fails, that's also contagious as well. When, for example, you've done similar things in Latin America, but only for the purposes of just occupation, then withdrawing, that has not been contagious at all.

So I do believe, Senator Bennett, that what happens in Iraq since the eyes of the world are upon you, is going to very much determine the future of the whole Middle East, and will bolster the arguments that markets and freedom are something that transcends cultures or, on the contrary, will strengthen the hands of all of those people who say, we're not all built for those kinds of systems.

Senator Bennett. Dr. Bronson?

Dr. Bronson. For the record, let me say that I think that Dr. Bronson is right.

(Laughter.)

It is very important that we get Iraq right. Iraq is in the heart of the Middle East. With all the troubles and problems that we've had since certainly September 11th, with the region, but even before, getting Iraq right is going to be very important to the security of the United States.

We need to remember that, historically, Iraq has played a major role in Middle Eastern and inter-Arab politics. Economically, it has been an engine for the region. And culturally, we often forget this, the universities and the religious establishments of Iraq have shaped the thinking of hundreds of thousands in the region.

This is why many were nervous about us going into Iraq, but this is why it is so essential that we do get it right, because the eyes of the world are on us.

Think about the challenges we're facing in the Balkans, the black markets, the drug lords, all of the problems. Multiply that for Iraq in the region of the Middle East.

It will be catastrophic.

But getting it wrong, as I said in my statement, I have people calling me, begging for us to get this right. Our supporters need a win in this region and we are there -- one of my colleagues has made the point, we are occupiers. We might as well be good occupiers.

There is a lot to be done, but it is do-able and possible. We have to stay committed to it, though. If we don't, it all falls apart.

Senator Bennett. Yes. Getting it wrong -- go to Haiti and see what happens when we come in. It turned out we replaced a brutal dictator, much beloved of American conservatives, with a brutal dictator, much beloved of American liberals. And left. And the people of Haiti are worse off than they were before.

Mr. Al-Rahim, you had a comment.

Mr. Al-Rahim. Mr. Chairman, I have to tell you that I agree, not just fully with Dr. Bronson, but even more than she imagines because Iraq is so geo-politically important. And I'm not talking just about the benefits to the Iraqis.

This country made such a fuss about going into Iraq. The trumpet of changing the face of the region. There's a serious commitment to the world, not just Iraq, that was made about America's intentions, American abilities, and their visions of the future of this whole planet.

I think to get Iraq wrong, if nothing else, is egg on the face of this nation for the next 20, 30 years.

It's not like eastern Europe. When the wall fell down, everybody looked around and said, we won, turned their back and walked away. The western Europeans had to come in because they had to worry about primarily migration problems.

So they stepped in very quickly.

Today, if America does not get Iraq right and Iraq will start the domino effect. The domino effect will start from Iraq under all circumstances. The real question is which way is that domino going to tip?

And if it tips in the wrong way, don't forget Iraq's neighbors are Iran, Turkey, Saudi Arabia, Syria -- Israel is not very far down the road.

It's a volatile region. And if it tips the wrong way, everybody's going to feel it. We're not just talking about the Middle East any more.

And so, I think that's an added incentive of what you just very clearly and eloquently mentioned, that in Japan, you created an island of stability, of growth, of prosperity, as an example, because the tiger nations that eventually emerged in Southeast Asia really followed the example of Japan. That was closer to them.

And you can see that same thing happening again.

I can tell you, it's no secret -- much of the Middle East is still living in the 14th and 15th century, whether it's politically, whether it's systems of ownership, whether it's a feudal mentality, et cetera, et cetera. And that has to change.

The only question is, will that change happen violently and in the wrong direction, or can it happen peacefully by seeing the right example.

And that's one thing that we should all be concerned about.

Senator Bennett. I don't think there's any question but that we are in it for the long haul. We have to stay in it for the long haul. We have to do everything that we possibly can to get it right.

And at the risk of speaking out of school, but the Democrats have all gone --

(Laughter.)

I was at the White House yesterday. And at least based on the President's attitude and comments and general posture, this President is determined to stay however long it takes, spend whatever amount it costs, to see to it that we get it right.

And he is determined that we will not turn and leave, and we will not abandon that which we have begun. I think he understands, Mr. Al-Rahim, exactly what you're saying, that the domino can fall either way. And if it falls the wrong way, that will be a permanent stain on his presidency that George W. Bush is not willing to accept.

So, based on the conversations that we had at the White House yesterday, I think the President would agree with the consensus that has emerged from this panel.

Mr. Paul, do you have any final comments of your own? You've been very faithful all the way through here.

Representative Paul. I have a very brief question, if I may. I would once again like to direct it towards Dr. Bronson, since she's always right.

(Laughter.)

But we're talking about long and costly. Would you be willing to give us an estimate because we have to do some of the budgeting around here, how many troops will we have in Iraq in five years from now?

Dr. Bronson. I think the level of 150,000, where we are now, will be necessary not just for a matter of weeks, but months.

And then the numbers will start to drop after a year or so. But you're not down to this sort of golden number of 30,000 very quickly. It is going to take time and numbers.

To the extent to which we can work with our partners and allies who have constabulary forces and paramilitary forces, the exact kinds of forces that you need, our numbers can drop, because they will both supplement our numbers, but they also have the exact expertise that is needed.

And so, therefore, you can have fewer.

But to the extent to which we have to do this alone, we will be required to stay in there with those numbers because we don't really have that expertise. We have been resistant to nation-build and therefore, haven't built the kinds of forces and troops, security services, that you need.

I don't know the exact number, but I think the notion that we cannot go down below 75,000 probably for a few years. We don't get to that number of 30,000 three to five years, maybe even longer.

Representative Paul. Thank you.

Senator Bennett. Thank you all very much. This has been a most enlightening panel.

The Committee is adjourned.

(Whereupon, at 11:22 a.m., the hearing was adjourned.)

SUBMISSIONS FOR THE RECORD

PREPARED STATEMENT OF SENATOR ROBERT F. BENNETT, CHAIRMAN

Good morning and welcome to today's hearing. Amidst the cacophony of voices in this town talking about our actions in Iraq, let us humbly add our own. Our intent with today's hearing is to push the focus of the debate away from the short-term management of Baghdad and toward the implementation of policies that can ensure a long and prosperous free-market economy in the cradle of civilization.

To be sure, everyone in this room realizes that the current environment in Iraq is frustrating for many of its citizens and needs to be improved upon soon. However, there is little value in debating here how to get the Baghdad electric grid functioning or the resumption of garbage pickup in the country. Able men and women are dedicating themselves to this problem as we speak, under the careful scrutiny of other congressional committees and the ever-watchful gaze of the press.

However, we should not focus on the present to the exclusion of the future, which I submit we are in danger of doing.

Today we ask a fundamental question: what practices and reforms need to be underway in the next two years to ensure a prosperous Iraq in the future?

The only exception to this myopia has been the debate over how to develop and use Iraq's vast oil reserves, and thus far I am not encouraged by its tenor. Various pundits have suggested that the rebuilding of Iraq is as elementary as making a modest investment in oil industry infrastructure and using the proceeds to "pay" for the reconstruction of the economy. This overly-simplistic notion of "letting the oil wealth pay for it" borders on *naiveté*.

Oil wealth, economists tell us, has been more of a curse than a blessing for countries. I suggest with tongue only partly in cheek that the best thing that could happen for the Iraqi economy might be to suspend the production of oil for the next decade. Failing that, we need to think long and hard about how to ensure that natural resource wealth in Iraq is developed efficiently and invested prudently. I trust that our witnesses will address this issue in their testimonies today.

The plight of dealing with Iraq's oil wealth illustrates the essential conundrum of putting a decrepit economy on the path to

prosperity. There is no one magical formula that we can employ nor one model we can point to in this task. The United States has a mixed record in the endeavor of rebuilding economies. While we succeeded admirably after World War II in transforming the Japanese and German economies into vibrant and productive markets, our efforts in assisting the former Soviet economies were less than successful. A half-hearted attempt to assist Haiti in the 1990s can be called little else other than an abject failure.

From the missteps in the 1990s economists have learned a number of lessons, the first of which being that it is not enough to mouth the words "free markets" upon entering a country and leave it at that. We now know that formal institutions need to be in place so that property rights are recognized. While a government's role in the market needs to be limited to ensure prosperity, a government must also guarantee the rule of law and efficiently collect the revenues necessary to provide the basic services expected of all governments, such as police protection and transportation infrastructure. It is also beneficial to have an entrepreneurial class in place with the knowledge of what it takes to compete in a free market.

The goal should be to reform Iraq as a beacon for market democracy in the Middle East. Every Arab country possesses some version of the corrosive, quasi-socialistic economies that have failed to materially improve living standards for nigh on two generations.

A prosperous Iraq would give lie to the dubious proposition that Western oppression, combined with geographic circumscriptions and cultural idiosyncrasies, make capitalism and its attendant prosperity untenable. History is not yet over in the Middle East; if we want market democracy to vie with radical theocracies for the hearts and minds of its denizens we need to present them with a model that works in their neighborhood.

I am pleased to have a panel of esteemed witnesses to discuss the nuts and bolts of transforming the Iraqi economy. Our panelists today are Mr. Basil al-Rahim, an investment banker and founder of the Iraq Foundation, Mr. Hernando de Soto of the Institute for Liberty and Democracy, Dr. David Ellerman, an economist recently retired from the World Bank, and Dr. Rachel Bronson, Director of Middle-East Studies from the Council on Foreign Relations. To our witnesses today we say welcome; we look forward to hearing your testimony.

PREPARED STATEMENT OF REPRESENTATIVE PETE STARK, RANKING MINORITY MEMBER

Thank you, Chairman Bennett. I would like to commend you for holding this hearing on "Transforming Iraq's Economy." It's an important topic, and an important responsibility that President Bush has put on the shoulders of American taxpayers—or maybe I should say debt-holders, since this Administration doesn't believe in taxes. It is clear, instead, that the Bush Administration prefers the easy route of arguing that taxes are an unnecessary burden rather than accepting that taxes are a necessary means to meeting important responsibilities.

As I was thinking about this hearing, I was reminded of an interesting piece in the latest *New Yorker*. The author, Hendrik Hertzberg, observed that in many ways Iraq right now is a conservative's paradise, with limited government, limited regulation, limited gun control, and so forth. I would say, in addition, that if the theories underlying President Bush's economic policies are correct, Iraq should be poised for a robust economic recovery, since there is no meaningful government and no tax burden.

I suspect that this is not the testimony we will hear from our witnesses today. In fact, Iraq's economy and civil society are a mess. And we have a long and expensive reconstruction ahead of us. Should this outcome have been a surprise? Of course not. Should the Administration have put as much time and effort into preparing for the inevitable problems we would face in postwar Iraq as they did into developing an elaborate P.R. campaign to justify the war? Of course. But that is not what happened, and now we have to pick up the pieces.

I am sure we will hear some creative ideas from the economists at this hearing, but I hope they won't try to lull us into thinking that the transformation of Iraq's economy will be a cakewalk, and that all we need to do is set up the right conditions for the free market to flourish. The American public deserves honest answers about the task that lies before us so that we can make wise choices. The Bush Administration does not have a very good record of looking down the road and telling the public about the future consequences of its policies. If that doesn't change soon, we will be having a hearing on "Reconstructing the American Economy."

Thank you Mr. Chairman and I look forward to the testimony of our witnesses.

The New Yorker
June 9, 2003

SECTION: THE TALK OF THE TOWN; Comment; Pg. 39

LENGTH: 1180 words

HEADLINE: BUILDING NATIONS

BYLINE: Hendrik Hertzberg

BODY:
The other day, the *Times* quoted one of that ever-helpful breed, a "senior administration official," as expressing surprise at the horrendous condition of Iraq's "infrastructure," even before the destruction brought about by the war and its aftermath. "From the outside it looked like Baghdad was a city that works," the senior official said. "It isn't."

The quintessential city that works (or, at least, has a cleverly cultivated reputation for being the city that works) is, of course, Chicago. The ward heelers and aldermen of that city understand (or, at least, are celebrated in song and story for understanding) that political power flows not from the barrel of a gun, and not even, necessarily, from the ballot box (whose contents can change in the counting), but from the ability to fix potholes. Garbage that gets collected, buses and trains that take people places, cops that whack bad guys upside the head, taps that yield water when you turn them, lights that go on when you flip the switch, all lubricated by taxes and a bit of honest graft-these are what keep streets calm, voters pacified, and righteous "reformers" out of City Hall.

By Chicago standards, Baghdad, along with almost all the rest of Iraq, is a catastrophe. For that matter, conditions are disastrous even by the looser standards of places like Beirut, Bogota, and Bombay. Reports from the scene are in general agreement on the essentials. Iraq is well rid of the murderous regime of Saddam Hussein. But the blithe assumptions of the Iraq war's Pentagon architects-that a grateful Iraqi nation, with a little help from American know-how and Iraqi oil cash, would quickly pick itself up, dust itself off, and start all over again-are as shattered as the buildings that used to house Saddam's favorite

restaurants. In Baghdad, and in many other Iraqi cities and towns, civic society has degenerated into a Hobbesian state of nature. Despite the heroic efforts of a scattered minority of midlevel Iraqi civil servants, the services that make urban life viable are functioning, at best, erratically. More often, they do not function at all. "In the most palpable of ways, the American promise of a new Iraq is floundering on the inability of the American occupiers to provide basic services," the *Times's* Neela Banerjee reported a few days ago. (Perhaps with an eye to educating her White House readers, she added that Baghdad is "about the size of metropolitan Houston.") Telephones are dead. Electricity and running water work, if at all, for only a few hours a day. Because the water pumps are hobbled by power outages, raw sewage is pouring into the Tigris River and is leaking into the fresh-water system, spreading disease and making the city stink. Hospitals that are secure enough to remain open overflow with patients, but they are short of food, medical supplies, and personnel. (Only a fifth of prewar health staffs are showing up for work.) Worst of all is the pervasive, well-founded fear of crime. Armed thugs rule the streets, especially in the pitch-black nights. "Amid such privations," Banerjee writes, "one of the few things that thrives now in Baghdad, at least, is a deepening distrust and anger toward the United States."

It's tempting to suggest that the Bush Administration is failing to provide Iraq with functioning, efficient, reliable public services because it doesn't *believe* in functioning, efficient, reliable public services-doesn't believe that they should exist, and doesn't really believe that they can exist. The reigning ideologues in Washington-not only in the White House but also in the Republican congressional leadership, in the faction that dominates the Supreme Court, and in the conservative press and think tanks-believe in free markets, individual initiative, and private schools and private charity as substitutes for public provision. They believe that the armed individual citizen is the ultimate guarantor of public safety. They do not, at bottom, believe that society, through the mechanisms of democratic government, has a moral obligation to provide care for the sick, food for the hungry, shelter for the homeless, and education for all; and to the extent that they tolerate such activities they do so grudgingly, out of political necessity. They believe that the private sector is sovereign, and that taxes are a species of theft. To paraphrase Proudhon, *les impots, c'est le vol*.

In a way, Iraq has become a theme park of conservative policy nostrums. There are no burdensome government regulations. Health

and safety inspectors and environmental busybodies are nowhere to be seen. The Ministry of Finance, Iraq's equivalent of the Internal Revenue Service, is a scorched ruin. Museums and other cultural institutions, having been largely emptied of their contents, no longer have much use for public subsidies. Gun control is being kept within reasonable limits. (Although the occupying authorities are trying to discourage possession of heavy munitions, AK-47s and other assault weapons-guns of the type whose manufacture Tom DeLay and most of the House Republicans plan to re-legalize back home-have been given a pass.) And, in the absence of welfare programs and other free-lunch giveaways, faith-based initiatives are flourishing. The faith in question may be Iranian-style militant Shiism, but at least it's fundamentalist.

The Bush Administration no longer flaunts its contempt for nation-building abroad, but it remains resolutely hostile to nation-building at home. Its domestic policy consists almost solely of a never-ending campaign to reduce the taxes of the very rich. Not all of this largesse will be paid for by loading debt onto future generations. Some of it is being paid for right now, by cuts in public services-cuts that outweigh the spare-change breaks for less affluent families which the Administration, in selling its successive tax elixirs, has had to include in order to suppress the electorate's gag reflex. The pain is especially acute at the state level, where net federal help is in decline. States are cancelling school construction, truncating the academic year, increasing class sizes, and eliminating preschool and after-school programs. Health benefits are being slashed, and a million people will likely lose coverage altogether. In many states, even cops are getting laid off.

As it happens,these are the very kinds of public services that America's proconsuls are promising to bring to Iraq. Of course, being nice to Iraq does not necessarily require the United States to be nice to itself. Nor does denying medicine to kids in Texas require denying it to kids in Baghdad. The connection is more karmic than causal. But it's also political. Whatever one may think of the global democratic-imperial ambitions of the present Administration, they cannot long coexist with the combination of narrow greed and public neglect it thinks sufficient for what it is pleased to call the homeland. At some point-the sooner the better-a critical mass of Americans will notice.

LOAD-DATE: June 9, 2003

PREPARED STATEMENT OF REPRESENTATIVE CAROLYN B. MALONEY

I thank the Chairman and Ranking Member for calling this hearing on the post-war rebuilding of Iraq and its economy. In the aftermath of war, the immediate problems of restoring order and basic infrastructure for the people of Iraq have proven daunting. It seems that every morning the newspapers carry demoralizing stories of the latest attacks on American troops and of growing resentment of U.S. forces by the people. Given this atmosphere in the country it is particularly important for Congress to focus on ways that we can boost the Iraqi economy so the people can see that the U.S. action will have a substantial long-lasting positive impact on their daily lives.

In this hearing, we will hear several approaches for setting the groundwork for reconstruction of the country. One issue that I believe should be a significant part of the discussion is debt relief. As we saw in post-war Germany, debt relief can be an essential tool in rebuilding a nation destroyed by war and humiliated by its leadership. We have also seen in recent years that debt relief is an effective development tool that releases funds within a nation that can be used to address poverty and meet essential human needs.

The case for some debt cancellation is even more compelling in Iraq given that much of the debt can be characterized as odious. Odious debt is internationally recognized as debt that is taken on by a country for the personal benefit of corrupt leaders or for the oppression of a people. Clearly much of the Iraqi debt falls in this category. To address this issue, this week I will introduce legislation in the House calling for debt relief from Iraq's odious debt and relief from the debt Iraq owes the World Bank and IMF.

Who should pay debt that Saddam owes? The dictator who incurred the debts or those he oppressed and brutalized? How can we ask the people of Iraq who lived in fear of Hussein's secret police to pay back the loans that supported these armed assassins?

You don't have to travel far outside of Baghdad to see a sprawling slum called Saddam City that houses two million Shiite Muslims. The slum is over-run with garbage and children climb the mountains of refuse to look for scraps or things that can be traded for food or clothes. In the face of this poverty, the Iraqi regime spent billions of loaned dollars on palaces and other luxuries.

What better way to enhance our efforts at reconstruction and empower the people of Iraq than debt relief? If Iraq is ever truly to be a peaceful and prosperous democracy, its citizens must be allowed to start anew.

Fifty years ago, twenty nations, led by the U.S., England and France, agreed to forgive half of Germany's pre- and post-war debt and to renegotiate the remaining debt at favorable interest rates. The so-called "London Agreement" proved to be the right course, providing a much needed economic and spiritual boost to a country ravaged and humiliated by years of war and defeat. Debt cancellation for Germany was a significant part of the Marshall Plan which helped the country become a strong and prosperous democracy post-World War II. This approach can aid Iraq as well.

In addition to odious and other debt that Iraq owes public and private world creditors, the IMF and World Bank are priority Iraqi creditors. When nations service their external debt they will pay the IMF and the World Bank first- and at any cost. Thus it should be our priority to call on the IMF and the World Bank to relieve Iraq's debt, freeing the people of Iraq from the obligation to pay down debts that we accrued by dictatorial regimes.

While estimates of Iraq's debt range from one hundred billion to several hundred billion, the combined debt owed the IMF and World Bank is just over $150 million. These institutions have the resources to relieve this debt, setting an important precedent for the rest of the world.

For this reason, I am introducing the Iraqi Freedom from Debt Act. This bill will require the U.S. to negotiate in the IMF, World Bank and other appropriate multilateral development institutions for the IMF and World Bank to relieve the debts owed by Iraq to these institutions. Furthermore, this legislation includes a sense of Congress that the President should urge France and Russia and all other public and private creditors to relieve the debts owed to them by Iraq.

By taking the lead on debt relief we have an opportunity to do the right thing for the Iraqi economy and to prove to the world that the major reason for war was to benefit the Iraqi people.

I thank the Chairman and I yield back the balance of my time.

PREPARED STATEMENT OF REPRESENTATIVE JIM SAXTON, VICE CHAIRMAN

It is a pleasure to join in welcoming the witnesses before us today. The economic reconstruction of Iraq poses many policy questions that merit the attention of this Committee.

Iraq's economy had been shrinking for years under the rule of Saddam Hussein. Extensive ownership, control, and influence of business by the government, its officials, and political cronies undermined economic growth. Iraq's invasion of Kuwait resulted in economic sanctions and the oil-for food program. Although the recent war has resulted in some economic damage, Iraq's economic situation today is similar to that of the Eastern European countries after the collapse of the Soviet Union. New institutions are needed that are compatible with a market economy and improved prospects for economic growth.

The prospects for Iraq's economic recovery are clouded by an unsustainable debt burden. One of the major challenges to improving the potential of the Iraqi economy is the heavy burden of foreign debt accumulated under the regime of Saddam Hussein. The hated regime is gone, but its financial legacy should not continue to oppress the Iraqi people, undermining their economic potential.

Forgiving much of Iraq's foreign debt is the right thing to do, but foreign creditors may be hesitant if they anticipate an opportunity for a bailout indirectly through the International Monetary Fund (IMF) or World Bank. A write-down of at least part of Iraq's debt would greatly improve Iraq's economic outlook. Under legislation I have recently introduced, Iraq's creditors would be encouraged to forgive much of Iraq's outstanding foreign debt, rather than wait for a potential bailout from the International Monetary Fund (IMF) or World Bank. This legislation would mandate that safeguards be in place to ensure that lending by these institutions could not be used to repay Iraq's creditors, thus encouraging a more timely write-down of some of Iraq's debt and protecting taxpayer money.

As I have pointed out many times before, the IMF should not be used as a bailout agency, as this practice creates a potential for misuse of IMF funds. Taxpayer money should not be used to bail out investors in high-risk ventures. There is a role for the IMF and World Bank in Iraq, but it should be carefully defined to ensure that past mistakes are not repeated. With adoption of appropriate institutional reforms and market-oriented economic policies, Iraq's people could look forward to a better future.

108TH CONGRESS
1ST SESSION

H. R. 2338

To prevent loans for Iraq from the International Monetary Fund or the International Bank for Reconstruction and Development from being used to pay off Iraq's creditors.

IN THE HOUSE OF REPRESENTATIVES

JUNE 4, 2003

Mr. SAXTON introduced the following bill; which was referred to the Committee on Financial Services

---

A BILL

To prevent loans for Iraq from the International Monetary Fund or the International Bank for Reconstruction and Development from being used to pay off Iraq's creditors.

1 *Be it enacted by the Senate and House of Representa-*
2 *tives of the United States of America in Congress assembled,*

3 **SECTION 1. PREVENTION OF LOANS FROM IRAQ FROM THE**
4 **INTERNATIONAL MONETARY FUND OR THE**
5 **INTERNATIONAL BANK FOR RECONSTRUC-**
6 **TION AND DEVELOPMENT FROM BEING USED**
7 **TO PAY OFF IRAQ'S CREDITORS.**

8 The Bretton Woods Agreements Act (22 U.S.C. 286–
9 286oo) is amended by adding at the end the following:

1 **"SEC. 64. PREVENTION OF INTERNATIONAL MONETARY**
2 **FUND LOANS FOR IRAQ FROM BEING USED**
3 **TO PAY OFF IRAQ'S CREDITORS.**

4 "The Secretary of the Treasury shall instruct the
5 United States Executive Director at the Fund and at the
6 Bank to use the voice, vote, and influence of the United
7 States to oppose the making of a loan by the Fund or
8 the Bank, respectively, to the government of Iraq unless
9 the Secretary of the Treasury determines that there are
10 sufficient safeguards in place to prevent the loan proceeds
11 from being used to reimburse persons or governments
12 holding debt arising from credit extended to the govern-
13 ment of Iraq, and outstanding as of the date of the enact-
14 ment of this section, for any losses with respect to the
15 debt.".

○

PREPARED STATEMENT OF MR. BASIL AL-RAHIM, FOUNDER AND BOARD MEMBER OF THE IRAQ FOUNDATION, MANAGING DIRECTOR OF MERCHANTBRIDGE

I. Intro

Good morning Senators, Congressmen, ladies and gentlemen. First let me thank you for inviting me to speak on this important topic. "Transforming the Iraqi Economy".

The subject is important not only because the fate of a nation and its people located in a supremely geo-strategic and volatile region is at stake, but also because the prestige of this country and its leaders (both administrative and legislative) will be judged in the present and for many years by the outcome and face of the new Iraq.

My career has been spent in commercial and investment banking in the Middle East, the United States and Europe. My sources are publicly available information, what little research that I could get my hands on, interaction with Iraqis both within the country and from the exile community and of course my personal experience and preferences. I have not tried to get the most precise numbers because I do not believe they are available from any definitive source at this time.

While I will attempt to cover a very broad area in my testimony I cannot possibly do it justice in the brief time available. The subject is too large simply because so many things need to be done, but that is also the advantage. We are starting from scratch with a nation anxious to get on with it and in possession of the means. If the program is successful it will be akin to the rehabilitation of an Olympic athlete who can compete again, not a cripple who at best will just walk.

To start with I would like to add two important provisos to this presentation. First, that Transforming the Iraqi Economy requires a pre-requisite of civil security; i.e. an efficient police force to maintain basic law and order, plus eventually an army potentially built on the Swiss model of an effective defence force. Second that the economic transformation will be far more achievable if it is led by an independent body, staffed by qualified technocrats combining certain functions of the ministries of Finance, Economy, Trade and Planning, with ability not just to develop and oversee the various programs but

also and critically, the ability to fast-track approval of the regulatory framework necessary for the success of such programs.

II. **Resources**

There are four major resources available to the country that can be immediately recognized:

a. Oil: The last reliable estimate of proven reserves dates back over 20 years and put such reserves at113 billion barrels. This is from a limited number of fields and wells where exploration work has been carried out. More recent and informed guesstimates put the reserves at three times this number and this does not take into account gas reserves. If this is accurate Iraq's reserves are 1.5 times those of Saudi Arabia and represent a significant portion of world reserves. The other very important fact is that Iraqi oil is one of the cheapest in the world in terms of production costs at about the $1 per barrel.
b. Water: Iraq has two major rivers running through it. Assuming historic water rights are respected and these rivers are not subjected to extensive dams in the north this resource is critical in a generally arid part of the world.
c. Fertile Land: In combination with the water, the country can easily achieve self-sufficiency in agricultural products and livestock. Indeed Iraq can again become a net exporter of farm produce given the right circumstances.
d. People: Lastly and perhaps most important the country possesses a large professional and technically competent labour force (doctors, engineers, lawyers, etc.). While this body of people may have gotten rusted over the past 10 years and has certainly been subject to a severe 'brain drain' these factors can both be quickly rectified. It is worth noting that the country had already started its industrialization program as early as the 1950's but hit the progressive calamities of nationalization, Baathism, two decades of war and sanctions. The professional and mercantile classes within the country are eager to update their skills and many of those abroad, the majority of whom are successful in Western countries, are ready to return to help rebuild the country in the right environment.

One of the most critical issues is the ability to quickly address the problem of high unemployment rendered more severe since the de-commissioning of the army. This is an energetic and skilled young labour force that can become a main engine for growth.

III. Economic Blueprint: The Phoenix Plan

Over the past 23 years Iraq has slipped back into the 19th century while the rest of the world has moved on to the 21st. Examples of this economic regression abound, one needs to only look at per capita GDP, telephone penetration rates, internet access or any other plethora of indicators. It is imperative to develop a well thought out and comprehensive economic model for Iraq in which all the parts fit and work together in a synergistic manner.

We must immediately acknowledge two very important factors; first, that no economic rejuvenation and vitalization can happen without empowering the Iraqi private sector, therefore the role of the State has to be that of a facilitator and enabler to create the framework for a new economy. Second, that oil revenues alone are insufficient to lift the economy; the oil sector itself requiring significant investment, and therefore oil revenues are only a catalyst and not a panacea for the solution

The Plan will be implemented in three phases:

A short-term plan outlining immediate actions that can help to kick-start the economy, remove bottlenecks, clarify the regulatory environment, encourage the return of exile skills and attract foreign direct investment.

A medium-term five-year plan detailing expectations for each sector of the economy has to be clearly spelled out setting forth production levels, capacity, consumption and penetration rates as well as health coverage and education. Target GDP per capita should be about $10,000 (in 1979 it was about $7,140) enabling a phasing-in of open markets.

A long-term ten-year plan with per-capita GDP objectives of about $20,000 must be targeted, with a deregulated economy and full access to WTO.

Fiscal policy and monetary policy have to be designed to act in a supportive manner to achieve the desired objectives of the plan in a pro-active not a re-active manner.

Outstanding debt has to be broken down into its three categories, bona-fide commercial debt, government debt incurred by the Baath regime, and war reparations resulting from Saddam's adventurism. Each category has to be resolved in the corresponding manner.

IV. Components of the Phoenix Plan

A number of sectors have to be specifically addressed in the plan and are set out below. Due to the scope of this testimony only the most critical aspects of each are elaborated. Countless other details are important and their omission is not intended to downplay them but rather an admission of the complexity of each and the need for specialist experts. However, the following are the over-riding issues:

A. The Oil Sector:

The conventional wisdom holds that Iraq's rejuvenation program will be largely taken care of by the country's abundant reserves. While reserves may be plentiful, oil in the ground means nothing in the circumstances. Prior to the recent war Iraq produced 2.8 mbpd, with annual revenues of about $17 billion (about one or two month's turn-over for General Electric or Exxon-Mobil). It is estimated that up to $5 billion will be needed to restore this production capacity in the short term and up to $30 billion will be needed over the next five years to produce 6.0 mbpd. At that production level (in five or so years) and using the Shell Oil long-term projections for prices at $15 per barrel Iraq's revenues could be about $35 billion at the time. Given the overall needs and condition of the country and the size of the population it becomes very quickly clear that oil alone is not the solution.

Evidently Big Oil expertise and capital is necessary. Production Sharing Agreements may be appropriate but how those are structured and worded is critical. Experience has shown that oil in the hands of governments is a bane not a boon; however abdicating ownership to foreign interests under any circumstances is unthinkable. The Iraqi private sector itself must be encouraged to become a player and there are a number of methods of achieving this. Negotiating on a level playing field is not easy given the size of the respective negotiators (i.e. Iraq or Iraqi's vs. the oil majors). It is imperative that any agreements keep majority control in the hands of local ownership and fair and equitable exit clauses (put and call options) are available to keep both sides honest and working in the best long-term interest of the economy. While such clauses may not be standard and are novel in this

context, they are not unusual in other transactions and can be easily adapted for the purpose.

The matter of whether Iraq should stay in OPEC or not has also been debated. It is obviously not in the country's interest to trigger a price war to achieve a pyrrhic victory. By the same token current quota allocations no longer have relevance in light of current needs and circumstances. A new formula has to be agreed that helps maintain market stability for consumers and viability for producers.

Finally Iraq should move quickly into the downstream sector, which in itself will require additional capital. This will not only benefit the economy directly through expansion and employment but also improve the added value of oil sales. In order to do this, agreements need to be put in place with end-user countries that receive some advantage for opening up their markets and removing trade barriers in advance of full WTO entry by Iraq.

B. Privatisation

It should be recognized that the Baath State, through inherited nationalisation and progressive expropriation, owned about 80% of the productive economic assets of the country. This, of course, must be brought back into the private sector. However, it is easier said than done since after all, this not only represents the wealth of the nation but arguably also the forfeited economic value of a population short-changed for the past three decades by the Baath State and reduced to living on rations. An economic programme must therefore be careful not to be accused of handing the economy over or selling assets too cheaply to a handful of oligarchs and foreign investors as the average Iraqi citizen does not have the means to participate in such programmes. The two problems, that of broad distribution of the wealth (assets) and 'fair' valuation must be solved simultaneously and quickly to get the economy firing on all cylinders and in a long-term socially and politically acceptable manner.

First, addressing fair valuation the problem is:

i) The current condition of the assets is seriously degraded, true both for machinery and equipment that is out of date or poorly maintained (i.e. for hard asset companies), as well as market share that has been lost or is weak (i.e. for service companies);

ii) Country risk as assessed by the major rating agencies will be near the bottom of the ratings;

iii) There is significant competition from a number of

countries in the world all vying to attract privatisation money making it very much of a buyers market – witness the failure of both the Egyptian effort over the past six years and the more recent failure of the Saudi gas initiative.

Given the above factors fair valuation means that today 'auctions' will not do the job! Better to develop a programme that values assets progressively over the next few years using a set of pre-agreed benchmarks; e.g. EBITDA, Gross Sales or market share etc. This would give the buyer the assurance of the acquisition through an executed purchase and Sale Agreement, while giving the seller (the government) part of the cash price today and part at a later date when the full value of the asset is more properly measurable. Such Agreements can also incorporate Put and Call options between the parties that further ensure a "fairness" to both sides.

Second, as regards the broad distribution of the assets it is important to learn the lessons of Eastern Europe to avoid the economic disenfranchisement of the lower economic classes (essentially the overwhelming majority of the population in Iraq today) and prevent the emergence of a handful of oligarchs. This can be accomplished both through an extensive system of ESOPs and Trusts. For example, at every privatisation full vesting of any ESOP shares would be gradual, for example start paying dividend but delay conveying ownership (and thus the ability to sell) until full value was better reflected by actual performance and understood by the stakeholder. Alternatively, shares to be distributed to the population may be held by a specially created fund e.g. in the case of capital-intensive industries with small employee numbers. The Fund can then administer the assets until such time as value is realisable and it can find an equitable or attractive distribution strategy not only to the direct employees but also perhaps to a wider base of beneficiaries (e.g. regional or geographic within certain proscribed guidelines).

A. Debt Forgiveness & Re-Scheduling

An important feature of the economic plan is clear and final resolution of the debt issue as it impacts almost all aspects of the program. New lenders need to know what other creditors are owed before extending new facilities. Investors need to understand the solvency status of the country, the local government must properly budget to meet its obligations and individuals must achieve a level of confidence before they start investing or saving.

Bona-fide commercial debt should be re-scheduled in conjunction with the Paris Club. Government debt extended by the old supporters of the Saddam regime must be totally forgiven for obvious reasons. War reparations incurred as a result of Saddam's adventurism must not be allowed to become an albatross around the neck of future generations. Part of such forgiveness can be traded for a points program that the old creditors would receive; these points can then be used (redeemed) to enhance bids for licenses, contracts, concessions or other agreements. As the value of such points becomes recognized a separate market in these points will develop internationally (e.g. amongst the oil companies) thereby creating value to the original holders of these points.

B. Foreign Direct Investment

Funds need to be attracted from a variety of foreign sources, government, private, multi-national and multi-lateral; both commercial profit-motivated and charitable aid-related. If the economic plan is structured correctly the need for aid should be minimal and is better allocated to other countries in serious need. Already foreign investors are lining up at the gates of the Iraqi economy armed with know-how and capital. A proper regulatory framework and a clear path to open markets must be elaborated to encourage the making of such investments in the country. The conventional wisdom is unanimous in its view that if the Iraqi economic experiment is successful, it will result in a major economic boom that can spill over into the whole region.

However by the same token it is critical to avoid economic pillage by foreign investors. It should be recognized that while a lot of emphasis will be placed on the indigenous private sector, it will take some time before the local population is up on its feet and able to participate as an equal partner with foreign players. Here also it is imperative to establish a level playing field that gives breathing room and establishes safeguards for the local population during the first phase (five years) of the Plan.

C. Restitution & Private Property

During the past four decades respect for private property has been virtually non-existent. Starting with the nationalization in the early sixties the situation became progressively worse as the Baath regime could expropriate any property for any value or no value at any time and for any reason. Lack of respect for human life extended indiscriminately to property and ownership.

An independent Property Restitution Authority must be set up to look into all legitimate claims and provide proper compensation or restitution. In this regard the experience of Eastern Europe is valuable and needs to be carefully assessed to provide guidance. In addition to being ethically correct such action will have two added benefits; first, it will go some way towards redistributing assets away from the state and its cronies and second, it will inject a measure of wealth back into the middle class which having been totally dispossessed and decimated, will be able to revive and participate in the economy again. While the work of such an Authority may not be straightforward, nevertheless a concerted and consistent effort has to be made.

F. Currency Stabilization

A stable local currency must be created as an ongoing tool of monetary policy and the creation of credit in the banking sector. The new currency should be pegged to a basket of the US dollar and the Euro reflecting the country's primary import and export position. Such currency stability will not only help the average Iraqi feel secure but also help to allay the concerns of foreign investors. At a later point in time and subject to the building up of adequate reserves the Central Bank may decide on changing the basket mix or free market floatation.

G. The Banking Sector

At present there is no proper banking sector to speak of. There are two large government owned and about twenty minuscule commercial and investment banks. The sector is utterly rudimentary by almost every standard. It is imperative to develop a strong and modern banking infrastructure to support economic growth both at the retail and the corporate level. A vibrant banking sector will accelerate the circulation of money, promote investment and capital expenditure to boost every sector of the economy, encourage consumer spending and saving, and contribute to an active deeper stock market.

Specialized lending such as consumer credit, leasing, mortgage lending, trade finance, agricultural finance and micro lending must be introduced and vigorously promoted. Foreign expertise will also be required in this sector and international banks should be encouraged to participate in a dynamic manner. Here again the participation of the Iraqi private sector must be safeguarded at the initial stage, which can be done by requiring foreign investors to have local partners with a minimum ownership during a pre-agreed initial period. As with other sectors involving large international players, ESOP and/or public listing requirements can be built into the license agreements as a partial means of providing such safeguards.

A. Capital Markets

Underpinning the whole economy a program to re-invigorate the country's stock market is of paramount importance. Such a market already exists but it is small and shallow. An independent regulatory authority is needed to promote and develop this vital aspect of the economy resulting in three main benefits; first, it will allow for a broader participation in economic activity and the resultant distribution of wealth. Second, it will allow for the classic ability of enterprise to raise capital. Third, it can be an efficient tool in the privatisation program, its ESOP features, the listing requirements and put/call options that may be negotiated with large foreign buyers.

The Capital Markets can be brought to a reasonable size fairly quickly if a requirement is imposed on certain large privatisation industries to list within a specific time frame. These industries can include oil, petrochemical, power and telecom as an example. Strict requirements on transparency, disclosure, collusion and insider trading must be put in place to avoid the "oligarch syndrome" experienced in other countries both in the region and internationally.

VIII. Other Critical Issues

In addition to the above a number of other issues have a critical impact on the Phoenix plan, these are:

A. Employment & Empowerment: the Private Sector

The local professional and mercantile segment of the population has been reduced to poverty subsistence over the past 20 years. It is not realistic to expect them to participate in the economic program in any meaningful manner very quickly. This needs to be taken into account during an interim period (the first 5 years) while a reasonable amount of intrinsic wealth, self-confidence and skills are accumulated.

Vocational Training Centres (VTC) need to be established across the country to deliver technical training in a variety of skills with a very heavy emphasis on IT. This will not only help absorb the youth, significantly upgrade the quality of the labour force but also indicate to the population at large the start of new economic horizons. Vocational training will also play a key role in harnessing and re-directing the energy of the recently de-commissioned army, channelling this energy into a productive force in the economy.

Real and effective protections need to be put in place during the first five years of the plan to achieve a proper distribution of wealth to the population at large, limit the emergence of oligarchs and avoid economic pillage by cronies of the old regime and foreign vulture investors. Furthermore, specific provisions and benefits programs need to be introduced that start the process of reversing the "brain drain" and attracting competent professional Iraqi exiles back to the country. One example is that followed in the GCC whereby regulation requires that 51% of any business activity is locally owned.

Furthermore it is not enough to limit control to Iraqi ownership, but in certain cases the identity of the owners must also be vetted. Already dubious characters and vulture investors are beginning to circle. The first category is more dangerous as it comprises many local cronies of the old regime who quietly accumulated large amounts of clandestine wealth in shady deals on their on behalf and on behalf of senior members of the Baath regime. Large and unaccounted for amounts of money held by persons with no discernable business backgrounds or worse still from unsavoury business backgrounds are waiting to transform their liquid assets into legitimate businesses in Iraq. Some of these characters are teaming up with gullible international investors, to gain legitimacy, by selling their supposed access and knowledge of the country. This also must not be allowed to happen. As the international community has cracked down on money laundering activities in other parts of the world, it must remain vigilant that another equally virulent strain of this activity does not happen in Iraq.

B. The Iraq Development Fund

There has been talk in the press of plans to set up an Iraq Development Fund that would receive all the oil revenues and be responsible in a transparent manner for reconstruction expenditure. While this sounds acceptable in theory there are two major questions that have to be answered.

First, what is the mandate of the Fund? If the Fund is just an accounting body, albeit transparent, then that is of very limited use. The Fund if it is to be set up must become a synergistic organ of the overall economic plan. It must work within the parameters and guidelines of the economic blueprint and must have some authority to make decisions not just take instructions to write checks and pay bills.

Second, what is the governance and oversight of the Fund? The Fund must have an un-conflicted and qualified Board with local participation. Such governance should have a phased transition to full local authority over a specific period of time. It is intelligent not to

repeat the problems and inefficiencies that plagued the Oil For Food Program partially resulting from the governance of that program.

Finally thought should be given to The Iraq Development Board that was set up in the country in the 1950's, whereby 70% of oil revenues were allocated exclusively, outside of government budgets, to the fund to be expended towards economic development. Such a model or a variation thereof may be very relevant in the present circumstances.

B. Infrastructure De-Regulation

There are certain infrastructure sectors that would benefit from phased de-regulation and expedite the economic revival of the country. These include; power, water, transportation and telecommunications initially, to be followed by other sectors such as education and healthcare. The objective is to either get the state completely out of these sectors, fast (e.g. telecom & transportation), or over the medium term (e.g. power & water), or at least to run in parallel with the private sector (e.g. education & healthcare).

There are a number of well-documented examples one can learn from such as the successful British experience with extensive infrastructure privatisation under Margaret Thatcher; the minimal role of the state from the healthcare system in the USA which is one of the best in the world; and the recent mixed experience with de-regulating the power sector again in the USA.

In the context of de-regulation a separate note must be made of the role of the Media, which in the past was dominated by the Baath state and used solely to serve their purposes. A number of different media outlets have already started springing up, however all controlled by the different political parties. It is important to encourage independent and non-political outlets in radio, television, newspapers and the Internet not just for education and information but also for entertainment and especially for the young.

IX. Role of the USA & other International Players

The US must continue in its leadership role in the reconstruction of Iraq; it is critical not to abdicate it to any other single or multinational authority. This leadership role is important for Iraq but also for the US. From the US perspective what was started must be successfully completed and should not be left half-baked. As the vision for the new Iraq was explained to Iraqis, the region and indeed the world only the US can bring it about. It is no secret that many

countries, some overtly and some covertly are looking for the United States to stumble and be ultimately humiliated in the bold and noble initiative it has undertaken to remove tyranny and bring freedom and stability to the "cradle of civilization" and ultimately to the whole region. Only the close and continued involvement of the US can shoulder the burden and transform this vision into reality.

For Iraq this relationship is equally if not more critical. Devastated by a pathological tyrant, war and sanctions; surrounded by hostile and sceptical neighbours, the country must and can rebuild itself into a vibrant free market peaceful economy in record time. For this it needs not only a strong patron, but also one who shares its vision. From a practical perspective this translates to a number working arrangements including assistance in drafting a new constitution to using a number of the regulatory models in transportation, telecommunications, banking, securities and anti-trust laws amongst others. At another level assistance will be required in re-negotiating debt, free trade agreements where applicable, providing loan guarantees in the short term, technology transfer and other tools that will enable the country to leapfrog into the 21st century.

Iraq can be the beacon that transforms the region but will need US help to do so.

Other international countries can and should be given a role in the reconstruction of the country. Most notably other members of the G8 countries can make an important contribution and should be encouraged to come forward. In a similar manner these countries can provide financial resources, technical skills and know-how in areas as diverse as banking to education and oil-field services to water and sanitation.

Members of the Gulf Co-operation Council who share a destiny with Iraq want and should also be encouraged, to participate in the reconstruction effort. Many of the GCC countries have limited absorption capacity in their own economies relative to their wealth and are in a state of both excess financial liquidity and excess capacity in industry and services. A dynamic Iraqi economy will represent an interesting new market and can act as an economic spark to the regional insipid economic environment.

X. Conclusion

1. The Phoenix Plan must be managed by an independent "Commission" combining certain functions of various ministries as Finance, Economy, Planning and Commerce & Trade. The "Commission must be staffed by technocrats and

have the authority to draft regulations that can be fast-tracked for approval.

2. Any acceptable political system (let alone a vibrant democracy as a beacon to the region) will fail if it is not quickly underpinned by a healthy economy; these two are interlinked and mutually reinforcing in both directions.
3. Oil alone is not enough given the scale of the problem. While it is a big help it is definitely not a 'cure-all'. Empowering the private sector in a comprehensive, transparent and publicly elaborated manner is the only solution.
4. The price of 'losing the peace' is not limited to Iraq or even the region. It will stab at the heart of America's leadership in the 21st century and certainly there are a lot of parties, alone and in collusion, waiting to push and twist the dagger. The "Domino Effect" can start in Iraq; better make sure it tips in the right direction.

There is not much time. At most the honeymoon in Iraq (if one could call it that) will last three to six months. Already other suitors (some unsavoury) are making 'courting' noises. A population, long oppressed, having recently found freedom will turn desperate without productive occupation and basic means of earning a livelihood. Immediate gainful employment is of the highest priority.

The Phoenix Plan is a way to get people off the streets and to work, fill their time, minds, stomachs and pockets in a constructive manner and start the "virtuous cycle" of economic growth.

PREPARED STATEMENT OF MR. HERNANDO DE SOTO, PRESIDENT, INSTITUTE FOR LIBERTY AND DEMOCRACY

The Property Challenge in Iraq

After 20 years of experience analyzing the world's property systems, the ILD has found that the property recording organizations in most developing and former communist nations tend to be in decent working order. Like their counterparts in the West, they have departments specializing in surveying, mapping, and digitalization of real estate and business registries. The odds are that up until Operation Desert Storm in 1991 Iraq's property records were also in good condition (at least for Baghdad). Since then, however, these records have probably degraded. And many or most of them, it is now feared, may have been looted and torched after the fall of the Iraqi regime. If so, they will have to be reconstructed —and fast— to help settle real property claims and provide space for displaced persons and returning refugees.

The real problem, however, is that even if that Humpty-Dumpty can be put together again, Iraq's records are still unlikely to reflect the reality of Iraqi property, much less provide authorities with the legal tools to build an inclusive market economy. History has shown us, again and again over the past two centuries, that once an existing authoritarian legal and administrative system breaks down, it is impossible to reconstitute the previous order. What automatically followed the collapse of the age-old patrimonial system, of feudalism, and, more recently, of communism was not a market economy but anarchy and widespread black markets, or another form of authoritarianism to rein in unruly behavior.

In the Ukraine today, for instance, 14 years after the end of communism, 60% of the people operate in the underground economy. Unable to adapt to burgeoning markets and emerging new practices, the Ukrainian system cannot provide affordable and thus enforceable rules, leaving people no alternative but to make their living in the extralegal sector. And while the Egyptians may have invented surveying and mapping 3,000 years ago to calculate and virtually represent boundaries after the Nile overflow, today 90% of Egyptians operate their businesses and hold their assets outside the law. The same kind of underground economic activity is bound to thrive in Iraq, including the transactions taking place in a vast extralegal micro and small enterprise sector that is probably now one of the largest absorbers of unemployed Iraqis, particularly young people.

The consequences for a genuine property system and the future of capital formation in Iraq are profound. A spanking new computerized property database, neat maps, and property claims commissions do no good if the records they contain do not reflect real possessory rights on the ground. And even if Iraq's legal system could be jump-started tomorrow, it is doomed to failure because its laws will not connect to the reality of how most people do business when freed from authoritarianism and will thus be unenforceable.

Throughout the developing and post-communist world, from Russia to Brazil —and now in Iraq— the real challenge of creating a property system is to design it in such a way that the poor and middle class citizens holding extralegal assets will voluntarily register those assets and transactions and bring them under the rule of law of a market economy —not because they are forced to but because they recognize that it is easier and more profitable to comply with the law than to work outside it. Law will have to be redesigned and adapted to the changing needs and expectations of common people no longer controlled by a dictatorship. That is the only way a property system can work in a non-authoritarian country.

Why Property is so Important for Creating the Rule of Law in Iraq

Creating a property system is more than just building a system to record ownership; it is the cornerstone of the rule of law and the market economy. We believe that a property system has to be designed so that it can integrate *all* of a nation's assets and provides the framework of rules that organize the market, the titles and records that identify economic agents, and the contractual mechanisms that allow people to exchange goods and services in the expanded market. It is property law that provides the means to enforce rules and contracts along with the procedures that allow citizens to transform their assets into leverageable capital. Therefore, if the property system is not designed to enable owners to enter into the market economy, property will be reduced to its ownership protection function and the poor, even with titles in hand, will be excluded from the market economy.

That is also why the ILD program to create an inclusive property system is more than just about land. We want everything that people use and possess to come under the rule of law so that everyone is not partly "legal" and partly in the shadows but fully governed by the rule of law. A property system should be able to represent all kinds of assets —not only land, but also businesses, chattel, and whatever other things people own— in standardized and universally accepted

records that allow owners to use their belongings and track records to guarantee credit and contracts. We make sure that beneficiaries of property programs are also in a position to access the instruments that store and transfer the value of their assets, such as shares of corporate stock, patent rights, promissory notes, bills of exchange, and bonds. We design the property system so that addresses can be systematically verified, so that assets can be described according to standard business practices, so that people can be made to pay their debts, and so that authors of fraud and losses can be easily identified in a expanded market.

That is how the rule of law begins —with property law that protects what poor people cherish the most and leads them quickly to understand the value of a system of rules that applies to everyone.

What needs to be done before implementing an Inclusive Property System for Iraq

The ILD program rests on a strategy whose objective is not just to consolidate the legal rights of those who had property under the Baath regime or its predecessor but to give all Iraqis the right to have property rights. Bestowing such "meta rights," emancipating people from bad law, and creating an inclusive property system is not about drafting elegant statutes, interconnecting shiny computers, or printing multicolored maps. Iraqis know all about that. What Iraqis need is a property program supported by a well-thought-out political strategy that motivates Iraqi leaders to be deeply committed to putting property and capital in the hands of the whole nation, thus giving citizens the incentives to create the institutions of a democratic and free society which they can use to safeguard and advance their objective interests.

That is exactly what the Western nations did – create legal property systems supported by well-thought-out political strategies. That is, for example, what Thomas Jefferson did in Virginia at the end of the eighteenth century, when he increased the fungibility of property by abolishing, among other things, the practice of entail. Similarly, when Stein and Hardenberg set the stage for universal property rights in Germany at the beginning of the nineteenth century, when Eugen Huber in Switzerland at the beginning of the twentieth century and the Japanese reformers after World War II began to integrating the dispersed property systems of their countries, they too employed carefully planned strategies to storm the barricades of the status quo. They also made sure they were armed with astutely aimed legislation that permitted government to create popularly supported, bloodless revolutions that could not be halted.

That is why the program we propose for Iraq takes the form of a transformation strategy that is based not only on our experience in the field but on the lessons that the ILD has learned from the successful transitions to market systems in the USA, Europe, and Japan during the 19th and 20th centuries.

Before creating a new property system for Iraqi authorities, it is important to get the facts: all extralegal and legal assets must be identified, located, quantified and classified according to the different rules —formal and informal—that govern the right to possession and exchange.

The rule of law can be established only if the new property law: reflects the extralegal customs and practices of the poor and middle classes; and gives them more easily enforceable rights than they can obtain through bribes and protection provided by extralegal organizations.

The program will begin by identifying, locating and classifying extralegal rights over assets, whether they are created by feudal, tribal, refugee, or black market organizations. Such information is an essential prerequisite for writing modern law and shaping recording procedures that will be enforceable and respected in practice.

Simultaneously, we will investigate the current laws and regulations that thwart Iraqis who try to gain legal title to assets they are holding, forcing even honest people to operate in the extralegal sector and continue to conduct business in a corrupt environment. The ILD has found that in most developing countries such obstacles to playing by the rules can be truly Sisyphean. Today, in Egypt, for example, which helped set up the Iraqi civil code of 1953, titling a bakery can take up to 540 days of moving from one bureaucracy to another at a cost of 84 times the average wage. In Mexico, even after 15 years of structural adjustment, foreclosing a mortgage takes no less than 43 months.

With the information obtained above, we will acquire the material and criteria needed to create an official property law that is more efficient at protecting rights and creating capital than the fragmented extralegal rules and bribes that characterize the shadow economy. In this manner, records and maps can be transformed from quickly outdated snapshots into “living” cadastres. Instead of slipping back into the corrupt practices of the extralegal economy, owners will have the incentive to keep registering their subsequent transactions, thus maintaining current official property records (and the legitimacy of the market economy law).

We would be very surprised if the information obtained would not confirm that a substantial amount of the poor and middle classes of Iraq are already working within a market economy, albeit an extralegal one and constitute a wide-based constituency for market reforms. This diagnosis would debunk any myth about a market system being incompatible with the local culture.

In our experience, presenting proof to a government that the extralegal sector of its nation is enormous and composed of private firms run by ordinary people loaded with potential capital motivates the leadership to move quickly towards reform. For instance, the ILD diagnosis in Egypt found that 90% of the population holds their assets and does business outside the law. We also estimated that these assets were worth about $245 billion —55 times larger than all foreign direct investment in Egypt and 30 times the value of the nation's existing legal business. Egyptian leaders were astounded. They were no less amazed by another ILD discovery: that the cost of legalizing those assets was prohibitive for most Egyptians: typically, it took 2 years to license a business and 17 years to title a home that could work as collateral, thus depriving the poor of access to their capital. The ILD diagnosis demonstrated that the reason most Egyptians worked outside the law and refused to enter a legal market economy was not due to an Islamic or Arabic cultural trait but to bad law. We are now helping the Egyptians reform their legal property system.

Faced with evidence of such vast potential wealth held by ordinary people, leaders in Iraq will have to recognize, sooner or later, that: The poor are not the problem, but the solution. That they are the most important constituency to create a market economy based on a rule of law compatible with their needs. The poor are vibrant, creative entrepreneurs. The poor already hold the assets required to create capital.

The lack of liquidity for entrepreneurial purposes is the result of a bad legal structure that can be reformed to create an acceptable rule of law. Property reform will allow their macroeconomic policies to work because legal incentives become meaningful and assets and transactions can be taxed.

Reform will defeat terrorism rather than incite it. If the new property law emphasizes the protection of the assets and transactions of the poor, given the fact that they are the majority, this will create a solid constituency for the rule of law in a market economy. (This is in contrast with other countries where market reforms are driven by —and mostly beneficial to— small elites and therefore do not have widespread support.)The best way to win elections and stay in power is by creating an inclusive market economy.

The goal would be to produce a common bedrock law for all citizens. The current extralegal rules that govern most Iraqis should be deconstructed in order to identify the principles that underlie them and see how they can be integrated into a new property law that can be trusted by everyone. One can then proceed to design and help enact a legal property system that consolidates the meaningful aspects of the disparate and dispersed extralegal arrangements (including procedural regulations for refugees and displaced persons) into one modern, codified system that Iraqis will freely choose to abide by and that will meet with a minimum of resistance from official bureaucracies and the formal sector.

In this way, the new government can begin to catch the wave of rising expectations instead of being engulfed by it.

Lawlessness is terrible, but the whole notion of security is far more complex than what would be achieved by putting a cop on every corner. The rule of law is not the iron fist imposed from above, it is a consensus about people's respect for one another's person and property. It is a social contract that people agree to keep because it protects the sources of their lively hood, their assets, and the customs that they respect and obey.

PREPARED STATEMENT OF DAVID P. ELLERMAN, PH.D., AUTHOR AND FORMER ECONOMIST AT THE WORLD BANK

Mr. Chairman, members of the Committee, I am David Ellerman, recently retired from the World Bank[1] where I was an economic advisor to the Chief Economist. Prior to joining the World Bank ten years ago, I started and ran for two years a consulting firm in East Europe to assist in the transition. While in the World Bank, most of my work was on the post-socialist transition with only a small part on the Middle East and North Africa region. The bulk of my remarks today will be based on the many hard lessons learned in trying to help the post-socialist countries make the transition to a private property market economy. While I am not an expert on Iraq, I imagine that many of these lessons would also apply to the post-Baath-socialism transition in that country.

1. The Case for Humility, Caution, and Incrementalism. Western economic advice to the former Soviet Union was partly responsible for the debacle in that region. Professor N. Gregory Mankiw of Harvard, the newly appointed head of the Council of Economic Advisors, noted in a recent book review that the book's author blamed much of the debacle in Russian on the shock therapy advice which came from some of the best and brightest of the economics profession (mostly from Harvard in this case). While Mankiw was more agnostic about the blame, he noted that if the advice "was a mistake…, its enormity makes it one of the greatest blunders in world history."[2] After a debacle of such historic proportions, surely we should have some humility about "nation-building" and be skeptical of those academic economists, brimming with self-confidence from building castles in the air, who now think they can socially engineer a new "shock therapy" program for a quick economic transformation in Iraq.

2. Pragmatism about Party Affiliation. The disastrous advice for institutional shock therapy in the FSU arose partly out of very understandable concerns that most of the people in positions of any power were in the Communist Party. Hence much of the western

---

[1] My remarks are solely in personal capacity.

[2] Mankiw, N. Gregory 2003. Review of: Reinventing the Bazaar (book by John McMillan). *Journal of Economic Literature.* XLI(March): p. 257.

policy advice was wrapped in a cloak of Cold War self-righteousness: "Let's wipe the slate clean of the evil from the past to make a fresh new beginning." But we might recall the results of the Jacobins in the French Revolution or of the Bolsheviks in the Russian Revolution. For whatever reason, the U.S. supported the slate-cleaning "market Bolsheviks" in Russia to use the same methods for the reverse transition from Communism to the Market—with predictable results. Yet many of the professional, scientific, technical, and otherwise educated people were in the Party because it was the only way to get the jobs. If the qualified people hadn't join the Party, then the jobs would have gone to complete Party hacks. In Iraq, an organizational line should be clearly drawn so that above that line are the people who have to go. Below that line are the people whose professional knowledge and best energies will be needed for the reconstruction. They should not be thrown out along with the "dirty Baath water."

3. New Leaders Should Come from Within. It is important to understand the "returning-exiles" dynamics that played itself out in Eastern Europe and the FSU. When the old system collapsed, many who had been in exile (including various types of internal exile) returned to try to take over. They lead the chorus to demonize everyone who was a Party member, even those who had stayed in the country and worked for decades for reforms from within. Only those who were outside were presented as being sufficiently "clean" and untainted by involvement in the old system. By disqualifying those in the country who had any capabilities, the returning exiles tried to fill the power vacuum. But it did not work. Those in the country, in effect, said: "We who stayed suffered under the old system and tried to get along as best we could with passive resistance and active reforms. You got out and had a wonderful life in the West. Now that the system has finally collapsed, you want to come back in and take power." In all the post-socialist countries (with a few minor exceptions that were quickly discredited), the new governments were run by leaders who had grown up from within.

4. Avoid Symbolic Cargo-Cult Reforms. During WWII in the Pacific, the natives on many of the islands saw wonderful cargo being disgorged by the huge silver birds that came from the sky. After the war ended and the refueling stations were gone, the natives started cargo cults to "go through the motions" to get the cargo. They ran crude model airplanes up and down runways and talked into leftover orange crates with vines attached to "radio" to the birds to come back—but all to no avail. After the post-socialist revolutions, many

aid agencies promoted similar Hollywood-storefront "stock markets" along with voucher privatization so people could "go through the motions" of trading vouchers and shares—and thus "get the cargo" like in the West. What better photo-op for aid officials than cutting the ribbon in front of the Great Totem of the Stock Market? Never mind that after a century of perfecting the watchdog institutions, the U.S. still has its ENRONs. Aid officials should not have been surprised when their voucher privatization schemes and ersatz stock markets quickly degenerated into wall-to-wall ENRONs. People who lost their national patrimony in voucher ripoffs and lost their savings in Ponzi schemes expressed their despair with black humor: "Everything the Communists told us about communism was false, but everything they told us about capitalism was true."

5. Reverse the Disenfranchisement of War/Revolution/Shock-Therapy. The revolutions in the socialist countries and the shock therapy that followed in many of them quickly destroyed the "old way of doing things" but then found that it would take years or decades to construct new working institutions. A type of chaos ensued and a variety of economic and political thugs took over. The old system had never worked well but people got along in a twilight system held together "with chewing gum and baling wire." They knew that if they did X and Y, they could get something like Z. But after the old way was destroyed, they were disenfranchised and discombobulated. Things that never worked right, now didn't work at all. The helplessness and despair that followed in many countries lead to extremism and the election of neo-communist governments. Instead of going down this road again by naively trying to socially engineer new institutions overnight, it is better to start by seeing what worked before in some tinkered way and to see how it could be revivified in some more legitimate retinkered way—which can then evolve. Instead of trying to jump over the chasm between the old and new institutions in one great leap forward (only to fall into a chasm of chaos), it is better to incrementally build a bridge—even though one foot of the bridge must always rest on the old ground.

6. Promote Small and Medium-sized Enterprises. In the current situation, the Iraqi people feel helpless. The first aim of economic transformation should be to promote and stabilize small and medium-sized businesses where people can regain some measure of control over their lives. Small business support organizations such as chambers of commerce can give businesses an organized voice, incubators can help new firms get going, domestic franchising can

rapidly multiply successes in the retail businesses, and business education can give hope to a new generation. Instead of setting up cargo-cult stock markets, what is required is quiet and patient work with the banking system so that it can serve small businesses. Where businesses are informal and property rights are *de facto*, they should be formalized and protected as urged by Hernando de Soto so that people can use these "erector sets" to build more. In the small business and family farm, ownership is closely tied to control. There is no long hard-to-police and ripoff-prone chain of authority from shareholders to boards of directors to managers to middle managers and finally to workers. People feel they are empowered and responsible. For larger firms or organizations to be restarted and privatized, the same principle applies. Try to find pragmatic arrangements so that the formal structures of ownership and responsibility are "shrink-wrapped" around the set of stakeholders who have to co-operate in order for the firms to function again. On that basis, they can build a better economy.

7. Don't give aid to the Iraqi people; give them the tools to help themselves. Lincoln said he would like to be neither a slave nor a master. In like manner, just as Americans would not like to receive charity from others, so we should not aspire to bestow charity upon others. Instead we should aspire to get the tools into the hands of the Iraqi people so they can sow and reap on their own—so they can help themselves. Aid recipients in the former Soviet Union sometimes complained that they were being treated like a conquered people. Since the Iraqi people are in that unfortunate position, we must be doubly careful to show respect rather than benevolence. Charity corrupts, and long-term charity corrupts long term. For instance, there is the short-term rush to supply aid in commodity form (e.g., food and supplies) but that will tend in the longer term to undercut the markets that might provide those goods. Phasing in something like a food stamp program would help to restart the Iraqi supply chain of businesses that used to supply those goods. Or, for another example, there will be the temptation to demonstrate American goodwill and know-how by paying U.S. firms to do the reconstruction work. But the Iraqis will see this as adding the insult of presumed helplessness to their injuries. Instead the contracts should go to the Iraqi organizations and firms that can reconstruct local infrastructure perhaps with some additional learning as the work goes along.

8. A Regional Bank for Reconstruction and Development. One of the strokes of genius in the Marshall Plan was that the resources for European reconstruction were channeled through the Organization for

European Economic Cooperation where the European countries had seats but not the United States. The Europeans had to come to a *modus vivendi* and justify to each other how the scarce resources would be allocated. The U.S. role was indirect. If we look at the Middle East and North Africa (MENA) region today, it is the only region in the world without a regional development bank. The idea is an old one but there have been a few problems with "regional cooperation." Perhaps the time for this idea has finally come. Reconstruction efforts will be more successful if they come from within the region as part of regional self-help rather than from Washington. I suspect that the direct strategy: "We'll stay here until we have finished the job" is not viable for Americans and is not welcomed by Iraqis. Perhaps the U.S. Government should adopt an indirect strategy: help the countries of the region work out a *modus vivendi* in the concrete form of a regional development bank so that those countries can better help themselves.

PREPARED STATEMENT OF RACHEL BRONSON, PH.D., OLIN SENIOR FELLOW AND DIRECTOR, MIDDLE EAST PROGRAMS, COUNCIL ON FOREIGN RELATIONS

Mr. Chairman, thank you for the invitation to speak before the Joint Economic Committee about the challenges confronting Iraq's economic transformation. As you may know, I co-directed "Guiding Principles for U.S. Post-Conflict Policy in Iraq," a December 2002 report co-sponsored by the Council on Foreign Relations and the James A. Baker III Institute for Public Policy. Ambassadors Edward P. Djerejian and Frank G. Wisner co-chaired the report. In addition, during "Operation Iraqi Freedom," and the weeks prior to it, I traveled twice to the Persian Gulf to discuss the war and its aftermath with those in the region. Although the Council on Foreign Relations makes my research possible, it bears no responsibility for these remarks.

MAGNITUDE OF THE CHALLENGE

The task we confront in Iraq is enormous. Iraq sits in the strategic heartland of the Middle East. Historically, Baghdad has been a major player in Middle Eastern affairs and has been at the center of inter-Arab politics since its independence in 1932. Economically, Iraq has the second largest proven oil reserves in the world, estimated at 112 billion barrels, with as many as 220 billion barrels of oil resources deemed probable. Culturally, Iraq's universities and religious seminaries have shaped the thinking of large sectors of the region's citizenship. In short, what happens in Iraq matters immensely to millions of people in the region and beyond, as it does, of course, to the Iraqis themselves.

We have set high expectations for ourselves and the Iraqis. But even establishing a basic level of stability, security and economic recovery will be time-consuming and expensive. As Secretary of Defense Donald Rumsfeld has pointed out, after the American Revolution "it took eight years of contentious debate before [the United States] finally adopted a Constitution and inaugurated our first president." In Germany, it took four years to move from the end of the war to a constitution. The German experience, of course, also benefitted from approximately $8 billion of Marshall Aid money (in current dollars), a robust American and international security presence, and an international political context that America organized around Europe's recovery. Time, money and security were required in Germany. In Iraq, there is no reason to expect it will take anything

less. If anything, it could take more.

The challenge confronting the United States is to initiate a process that creates a reasonable level of security, maximizes international political and economic support, addresses the aspirations and needs of Iraq's various ethnic and religious groups and allows as many Iraqis as possible to participate in the positive political and economic transformation of their country. Such an Iraq could provide the region with a new political and economic model. It would supply a win for America's dwindling base of support throughout the Muslim world. But it will require a strong and serious American commitment. Failure to stay committed, politically, militarily and financially would have pernicious effects throughout the Middle East, North Africa, South Asia and beyond. The costs of getting Iraq right will be exceedingly high, second only, perhaps, to the costs of getting it wrong.

THE COMPONENTS OF ECONOMIC RECOVERY

Unfortunately, hard economic data or statistics for what is needed in Iraq are few and disputed. Still, the obstacles confronting recovery are many and include:

Re-establishing law and order. Iraq's recovery is challenged primarily by a lack of law and order. The looting and violence that has occurred, and is still occurring, has all but undone the hard work of military planners who largely tried to avoid targeting sites necessary to Iraq's reconstruction. Destroyed infrastructure along with missing documents and equipment are delaying reconstruction projects and attempts to get Iraq's oil flowing.

Iraq's economic recovery depends on its workforce returning to productive economic activity. But today a large portion of Iraq's workforce remains sequestered in their homes, fearful that leaving would risk the safety of family and property. Others simply can not go back to their jobs because of the damage done by the war, the civil disorder that followed, or both. Unless this situation is reversed, the time-table for Iraq's recovery will continue to slip.

Worse, the breakdown of law and order and the resulting power vacuum is providing Saddam's loyalists from the Ba'ath party, the military and other armed groups the opportunity to reconstitute. Knowledgeable Iraqis suggest that Saddam's security forces, that melted away during the fighting and that have not been disarmed, are trying to hasten an American withdrawal by inflicting a steady stream

of low-level casualties. The use of guerilla tactics that is beginning to emerge in western Iraq is an ominous warning of things to come. Unless America and its partners deal firmly with such opposition, and make clear their commitment to provide for a better future for all Iraqis, all other goals for Iraq will be illusory.

A heavy security presence will be necessary to fill the power vacuum left in Iraq. Prior to the war, a Council on Foreign Relations task force estimated that a stability force of 75,000 American troops would cost no less than $15 billion per year. This estimate did not include reconstruction and humanitarian costs. U.S. administration officials now estimate that the current force levels of about 150,000 (and expected to remain steady for the near future) are costing in excess of $3 billion per month. The original hope of reducing American presence to 30,000 by this fall is no longer viable given the chaotic reality on the ground.

The Administration deserves credit for the growing evidence that law and order is slowly being restored. Maintaining large number of soldiers in the country, supplemented by military police and Special Forces, is helping to stabilize the situation. However, the looting and violence that occurred unchecked during the first weeks of the post-conflict phase has set back Iraq's reconstruction.

Recovering Iraq's oil potential. Even if law and order had seamlessly transitioned from occupational authority to local control, Iraq would still require considerable outside assistance.

Iraq's reconstruction will not be self-financing. Oil is its major source of government revenue. Iraq's oil infrastructure is in decline. After years of sanctions and poor political rule, Iraq's production capacity is decreasing at an annual rate of 100,000 barrels per day. Prior to the war, Iraq generated $10-12 billion in oil revenue per year. Over 70% was spent on basic humanitarian assistance such as food and medicine that still is required today. While official assessments have yet to be concluded, repairing and restoring Iraq's previously used oil facilities may cost $5 billion, in addition to the $3 billion needed for annual operating costs. Up to $20 billion may be required to restore Iraq to its pre-1990 electricity capacity.

Before the war, questionable assumptions were made about the cost of the conflict, and the likely speed of reconstruction. Despite heady predictions for Iraq's recovery, there are limited short-term resources available for repairing Iraq's oil industry and decaying infrastructure. Considerable American and international support is required. It is unlikely that the Administration's one time request of $1.7 billion will produce the stable promising Iraq that many advocated before the war.

Diversifying the economy. To get Iraq back on its feet economically, greater attention must be given to diversifying Iraq's economy. Over 90% of its export earning comes from oil. In 1980, Iraq relied on oil for only 39% of its gross domestic product. Reliance on a single source of revenue makes Iraq vulnerable to the chronic corruption, monopolistic behavior, under-development, and under-employment that have afflicted other energy-reliant economies in the region, while leaving Iraq hostage to the whims of the market. Throughout the twentieth century, the value of economic output for those working with raw materials, in this case energy has declined by 50%, relative to skilled labor.

Re-structuring Iraq's debt. Iraq shoulders a massive debt load. While the exact debt amount is unclear, it is generally agreed to be between $100 and 200 billion. Iraq's debt is largely a result of the Iran-Iraq war of the 1980s, reparations from Desert Storm of 1991, and payments for pending contracts with foreign companies.

UN resolution 1483 "welcomes the readiness of creditors, including those of the Paris Club, to seek a solution to Iraq's sovereign debt problems." When possible, incentives will be required to encourage debt forgiveness. Unfortunately, even if they wanted to forgive Iraq's debt, some of Iraq's creditors are by law unable to do so. In such cases, generous refinancing conditions should be encouraged.

Supporting a stable, transparent political order. The Middle East has been woefully unable to attract foreign direct investment. Opaque authoritarian leadership has chased away such funds. To successfully attract capital and keep local capital at home, Iraq will require a transparent, stable, rule-based political system. While a transfer of power from the occupiers to local leaders is necessary, it will not happen quickly. America must plan to remain actively involved until local political experiments in places such as Mosul and Kirkuk can be replicated at the national level. A speedy transition will either return to power the scions of the old system, as happened in many former communist societies, or result in the assumption of power of a regime viewed as an illegitimate puppet of the occupiers. Neither alternative is attractive to foreign capital. For this reason, the Administration's decision to delay the selection of an Iraqi Interim Authority was a correct one. Initially raising the possibility of an early transfer unnecessarily increased expectations and distracted Iraq's potential leadership from the difficult tasks of recovery.

MANAGING EXPECTATIONS

We must remember that the pre-Saddam Iraq that many hold in their memories is not the Iraq of today, nor will it be the Iraq of tomorrow, even under the best of circumstances. With high unemployment and 42% of its population below the age of 15, Iraq's economic base is considerably worse off than it was before Saddam took office and during the first few years of his rule. At all times, America must make clear to the Iraqi people the reason for our actions and seek to include them in the implementation of policies to the greatest degree possible. Inflated expectations will only lead to discontent and instability.

THE WAY FORWARD

If done well, the reconstruction of Iraq holds the promise of a better and more enduring security situation for the entire region. Successful reconstruction is a hope that many around the globe share with the United States. To the greatest extent possible, the United States should harness the capabilities of those who are able to contribute to the Herculean task we have set before us. The road to Iraq's reconstruction will be long, difficult, dangerous and costly. We can travel it alone, or we can travel it with others. It is our choice.