Panel 3: The Development of a Market Democracy

Moderator: Dr. Robert D. Gatewood*
Panelists: Timothy Mills**
Keith Crane***
O. Lee Reed****

Dr. Gatewood: Terry College is very happy to be one of the cosponsors for today's conference. As recent events have indicated, setting up democracies in Iraq and Afghanistan will be very difficult, but we in the College, and I hope our panelists today, think that one of the underpinnings for setting up a democracy in both of these countries will be the establishment of a private market system. We believe that private markets are essential for the economic development and prosperity of each of these countries and that economic prosperity is a key foundation for democratic stability.

Our first speaker will be Tim Mills. Tim is from the Washington, D.C. office of the law firm Patton Boggs. With more than twenty years' experience representing businesses in national and international matters, he has recently led his firm's Iraq Reconstruction practice group, which helps companies grasp the challenges of competing for U.S. government contracts for reconstruction projects in Iraq. His repeated trips to that country, including one completed within the past week, give him unique insights into the formation of a democratic private market in post-war Iraq and Afghanistan. Among many other things of interest about Tim is that for the past twenty-five years he has served in the U.S. Army, both on active duty and in the Army Reserves.

Timothy Mills: Thank you very much. I want to say what a pleasure it is to be here. I left Baghdad on the eleventh of this month and I will be going back to

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Baghdad on the twenty-second. So this is just a brief respite from the travails of doing business in Iraq. I want to particularly thank the *Journal* and the University of Georgia for giving us an opportunity to share perspectives that few have, because few are there and even fewer are staying, given the current developments in the last ten days.

First, before proceeding into the substance, I want to share with you some of the perspectives I have on the state of market democracy in Iraq, particularly in comparison with the development of market democracy in Afghanistan. I ask you to consider my analytical perspective. First, I adopt the methodologies of both the comparative historian and the lawyer. I look at the evidence of what has been and what is, with a view toward the potential positive and negative in states of what is likely to be. I consider what could be both positive and negative, and most importantly, what should be, particularly in the view of the nationals, in this case Iraqis and Afghans, who must live with whatever actions the United States and international community take and leave behind, whatever those circumstances are.

Second, I am not an academic; I am a lawyer. I do not believe in basing decisions, policies, or business actions on an assessment of what is presumed to be. Rather, I look at the state of what currently is and make critical assessments informed by the skeptical methodology of a trial lawyer. These assessments are based on all the available facts and the inferences that can be drawn from the facts. In the case of Iraq, my understanding of the facts and the informed analysis that I give to you is based on thirteen long visits to Iraq since July. During this time I have examined over 220 Iraqi businesses in various parts of the country, of various sizes, from the largest businesses in the country, headed by the traditional families of Iraq, to the midsize and the much smaller businesses. I have examined emerging businesses, long-established businesses, businesses that are bankrupt, and businesses that are robust. I have met with the most senior Iraqi business leaders, political leaders, business executives, budding entrepreneurs, the ministers, director-generals of state-owned enterprises, and politicians from political parties that have been excluded by the United States from the political decision-making process—which I submit to you was a mistake.

In addition, I have had the opportunity to meet with several provincial governors and with the Americans within the provisional authority who are making the policies and decisions that drive the expenditure of $18.6 billion, along with some donor money as well, totaling tens of millions of dollars. They believe they are advancing market democracy through unilateral acts that are made largely without the consultation of the Iraqi stakeholder communities.
Therefore, there is some question as to whether those policies are either widely supported or widely understood by the stakeholder communities that are most interested and most affected.

In the case of Afghanistan, my understanding is based on extensive surveys of what is happening on the ground, but to nowhere near the depth of some of the others who have spoken today who have been there much longer and much more frequently and are thus more aware. I must thank Mariam Nawabi, who you heard this morning. She is bright and informed; I want to thank her for sharing her insights.

Moving into the substance, we must ask: What is market democracy? My answer is simple. Based on Iraq, based on Afghanistan, and based on other places, market democracy is the opportunity, for those who wish to do so, to conduct business and to reap the benefits of achievement in business through merit on a level playing field free of obstruction and free of the effects of favoritism, from regimes and otherwise, in the marketplace; favoritisms that flow from class, family, position, and, of course, corruption.

As a second step of addressing the substance, we also must ask: What are the essential elements, the tools in the entrepreneurs’ and the policy makers’ toolboxes, in creating and sustaining market democracy, how these dynamics of market democracy are created if they do not exist, and how they are established and expanded to the point of being truly effective in post-socialist states such as Iraq and Afghanistan? In my view, there are essentially four tools. Each one must exist or you will never achieve a market democracy. The four tools are as follows:

1. The rule of law: The criminal, civil, and commercial law that creates a fair and equitable environment that, in substance and application, can be forcibly applied, even by businesses against other businesses, to protect and foment a competitive but fair environment and particularly precludes those who formerly were advantaged and are predatory in nature, because their businesses are essentially monopolies, from continuing to exploit their dominant positions in the marketplace.

2. The availability of capital and other financial facilities that provide the needed working capital to begin operating and expanding business. This is something well-known in the West and in Asia, but the availability of capital is not well-
known in Iraq. It is certainly less well-known in Afghanistan than it is in Iraq.

3. Access to markets unimpeded by those who have typically and traditionally exercised near-monopoly or actual monopoly powers in the days of prior regimes.

4. The availability of modern business management systems and capabilities combined with business partnerships between capable firms from outside those particular countries. This tool, based on my observations in Iraq, can create and give the strongest competitive advantages to emerging businesses, to those mid- and small-level businesses that in the days of the old regimes, in Afghanistan and particularly in Iraq, could not grow above a certain level and did not want to grow above a certain level out of fear for being brought to the attention of the regimes to be slapped down or taken over. There are myriad stories about such businesses and I tell you that now, with that cap gone, they do want to grow. Let me give you one example of what I mean by the competitive advantage of partnership. I was in Iraq in September when the Finance Minister of Iraq went to Dubai and, at the Finance Minister’s Conference, announced the new foreign direct investment law that had been written by the Coalition Provisional Authority.¹ It provided the most favorable foreign investment law in all of the Arab world. One hundred percent foreign direct investment-owned companies could exist in Iraq! This is true nowhere outside of Iraq in the Arab world; those companies could exist without needing a local Iraqi agent or any local representation. The outcry from the large Iraqi firms was immense.

I was asked by the Australian Broadcasting Company to comment on this. I looked at what the heads of these Iraqi businesses were saying and I talked to them about what they were saying. They were saying, “This country is going to be swamped, we are going to be out of business, all of our advantage is going to be gone.” I told them, “Well, you know, this is very interesting, because you have to understand that if you really perceived what your

opportunities were here in this country, you not only would be able to take advantage of these opportunities, which are not what they were before, but you would be able to partner, you would be able to do other things that would put you in an even more dominant position than you are now.” And they asked me, “Well, how do you see us?” I was very candid with them—Iraqis appreciate American candor as long as it is over a cup of Iraqi tea—I said, “The way I see you guys is this: you are wearing glasses with blinders on and you have lenses in the glasses that are mirrors and all you can do is look backward in a very narrow perspective.” The entrepreneurs that emerged in Iraq outside of these businesses are not wearing those glasses. With partnerships with Western businesses, non-Iraqi businesses, European businesses, and Asian businesses, all of which desire to come to Iraq and partner, the entrepreneurs can become dominant in their own particular marketplaces.

Where does the progression of market democracy stand now in Iraq as compared to Afghanistan and where will things go in the short-term? Let us examine Iraq. With respect to the rule of law, there is a lot to be done. A few glaring observations tell it all. We have antitrust law in the United States—we have had it since the early 1900s when Teddy Roosevelt decided to bust the Standard Oil trust. There is no such thing as antitrust law in Iraq and that means you can be as predatory as you want.

Also, there is no such thing as an action for interference with economic advantage or contract in Iraq. You can bring a lawsuit in an Iraqi court for breach of contract, but if someone interferes with your contracts there will be no action. Further, business opportunities and advantages come out of intellectual property. However, the intellectual property laws of Iraq are, in fact, in need of reform. Microsoft will not go into Iraq because it does not have the protections it needs; others will not go into Iraq for the same reason. I can get a copy of Microsoft Office for two dollars on the streets in Baghdad and it works fine. But of course I do not because I am an American lawyer and I do not want to be sued by Microsoft. But Iraqis do. How do you develop an intellectual property industry in Iraq under these circumstances? The commercial law of Iraq is fairly well-developed, however. When you look at the law of contract in Iraq, it has a legal tradition that goes back to the Ottomans. Thus, there is a movement afoot right now to revise the laws of Iraq to provide protections for businesses and to create a business-friendly environment for entrepreneurs.

The second observation concerns the availability of capital and financial facilities. I like to tell a tale of “Where is the money coming from?” For the traditional family businesses, follow the money. Less than two months after
the Saddam regime fell, I was invited to the home of one of the most wealthy Iraqi businessmen. He said, "Look, I'd like you to represent me in Washington." I thought, "Wow, you know, this is a very enlightened guy." I said, "You have no other lawyers?" He replied, "I have those twenty lawyers that work for me in Geneva and I have all the money I earned under Saddam's regime in Geneva."

Those Iraqis have deep capital and they use it. They use it to buy up and gain influence over Iraqi mid-size firms. The mid-sized firms come to them and say, "I need money to perform this contract that I just got but I don't have the money." The wealthy Iraqis say, "Fine, I'll give you the money, you give me fifty-percent of the contract and a seat on the board I'll control your business henceforth and we'll have a wonderful partnership." It is a good arrangement for those that loan the money.

There are no banks in Iraq that currently loan to businesses in any significant way. The Al-Rasheed Bank, the state-owned bank, is having extreme difficulties. It was used as an instrument of the Hussein regime to loan to businesses the regime favored but it is not lending now. One of the major problems is getting loans into the country. There is a $500 million facility that has been established by U.S. taxpayer dollars and they are looking for projects from Iraqi businesses.

This observation brings me to my next point, regarding barriers to market entry. How difficult is it to enter a market in Iraq and capture a share of that market? For companies that sell automobiles, like GM, or sell food, or similar businesses, it is difficult. You do not want to be in these businesses in Iraq unless you want to deal with companies that act predatorily and have seen the market up. However, there is a vibrant entrepreneurial class in Iraq and they know how to do business. They know how to do business because they did business under some of the most adverse conditions that existed: under the Hussein regime and under the UN sanctions regime. They have found ways to get by.

If you are in Iraq and you want to become entrepreneurial, then it is better to find your way into an area where business has not existed before. What are some of those areas? For one, petrochem. There is only one petrochem plant and it is owned by the state. But with the amount of oil in Iraq, there is plenty of opportunity, if you happen to know how to do it, to enter into partnerships with some of the Western firms that are in petrochem. There are also agriculture and processing and technology businesses such as IT and Internet service providers. Think of Iraq being like 1950s town, with hardly anything connected technologically. Finance and insurance: Did you know every
American company that goes to work in Iraq wants to buy insurance? Nobody is selling insurance in Iraq! And financing of contracts, financing of cars, and financing of mortgages—that business does not exist.

Back to number four: the availability of modern business management systems and partnerships with capable non-Iraqi businesses. This will require a lot of work because mid-size and small businesses have not done this before. It will require reeducation of the Western partners to not go to the large companies that were favored by the regime, because the real opportunity in Iraq is not with those companies (some Western firms have had some difficulties with those companies), but instead with the medium-sized and smaller firms. Unfortunately, it is difficult to find information on who they are or what their capabilities are if you do not speak Arabic. Very few American businesses going to Iraq bring Arabic language speakers with them.

Turning to Afghanistan, I will be short and speak summarily because so much has been covered on the rule of law in Afghanistan. The rule of law in Afghanistan and the commercial realm of law is beginning to develop in Afghanistan. It is possible to do business in Afghanistan under the commercial laws and you do not get the kind of interference you get in Iraq. Afghanistan does not have the problem of predatory firms.

As for number two, the availability of capital: recognizing that a market economy needs capital to establish businesses, the availability of capital in Afghanistan is slight to none for most Afghan businesses. With respect to barriers to market entry and penetration and the ability to capture market share: typically this has been a problem because you could not compete with the state-owned enterprises in Afghanistan under Afghan law. However, that has been swept aside and they are flat right now (by flat I mean hardly operational).

The barrier to market entry and capturing market share comes from the bureaucracy. How many ministries do you have to stop in to get permits to do business? The attendant corruption that goes with the acquisition of licenses and permits is also a barrier that needs to be addressed.

With respect to availability of modern business systems and partnerships with non-Afghan-capable businesses: there are two or three examples of success with this in Afghanistan. One is the hotel sector, where there have been some joint ventures between the Afghan state-owned enterprises that own the hotel facilities; and firms like Hyatt, Marriott, and Intercontinental. Another is the communications sector, where the entire telecom structure of Afghanistan, including the operating company, has essentially gone private
with a partnership from outside Afghanistan. Otherwise, in these sectors, there has been tremendous struggle.

What is the lesson from all of this? The lesson is that thirteen years from the end of the Cold War, we still struggle to do the things we know we must do. Yet, I am very optimistic about Iraq in the long term. I think in the next three to five years, Iraq will emerge as economically vibrant. Within ten years, provided we solve the security problem, Iraq will become the jewel of the Middle East. I am not so sanguine about Afghanistan because there is so much more work to be done and so many problems to face. But we have come a long way in a short time in Iraq; we are not quite so far away in Afghanistan. The success of market democracy will be the one determinant of whether we have political and social stability in both places.

I will leave you with this one thought: In the 1930s we had unemployment in the United States that rose to almost thirty percent of heads of households. We had a political crisis that almost resulted in revolution. In Iraq, I give you this one figure: In Fallujah and Ramadi, eighty percent of the heads of households are out of work and have been out of work for a year. In the rest of the country sixty percent of the heads of households are unemployed. Unless we solve this problem and solve it through the creation of market democracy, we will not see stability in either Iraq or Afghanistan. Thank you.

Dr. Gatewood: Tim, thank you very much. Keith Crane is a Senior Economist at the RAND Corporation where he works on issues pertaining to Iraq and the Middle East, post-conflict societies, and the transition economies of Eastern Europe. In the autumn of 2003, Dr. Crane was on loan to the Coalition Provisional Authority (CPA) in Iraq as an advisor on economic policy. While in Iraq, Dr. Crane participated on task forces involved in developing economic policies on exchange rates, price liberalization, and the social safety net. Prior to his work in Iraq, Dr. Crane was a co-author of the RAND book, America's Role in Nation-Building: From Germany to Iraq. He has also served as Chief Operating Officer and Director of Research at PlanEcon Inc., a Washington, D.C.-based research and consulting firm focusing on Central and Eastern Europe and the former Soviet republics. In addition to his work at RAND and in the private sector, he has taught at Georgetown and George Mason universities and has held a Fulbright Professorship at the Central School of Planning and Statistics in Warsaw, Poland. Few individuals are as qualified

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to discuss present and future economic conditions in Iraq and Afghanistan as Dr. Crane.

Keith Crane: I would like to thank the University of Georgia and Clete Johnson for inviting me here. The CPA, or the Coalition Provisional Authority, is the governing authority of Iraq until June 30. Last fall, I had the honor of working with Ambassador Paul Bremer on economic policy at CPA. My efforts did not meet with a lot of success, but I did have an impact on tariff policy and exchange rate policy. A number of other things were left undone.

The CPA has three main objectives for Iraq. One is to create a safe, secure environment for Iraqis. As you know, the security environment has actually deteriorated in recent months. The second is to create a democracy and the third is to create a market economy. Market economies have been proven to provide the only means of generating sustained growth and increasing per capita incomes, making people better off. Thus, creating a market economy was a key objective of the CPA.

The question facing us in Iraq was how to get from a distorted, state-controlled economy to a well-functioning market. First, however, we need to define where "here" was. The other speakers made some excellent comments about economic conditions in Iraq at the end of the conflict. However, I thought it would be useful to throw out a few facts and figures before talking about where Iraq is heading. I will also talk about some of the stumbling blocks that exist in Iraq to creating an environment for strong growth.

Through February 2004, Iraqis enjoyed a substantial increase in living standards and output since the end of the conflict. This should not be too surprising. The United States has spent an awful lot of money on Iraq. It would have been very puzzling if nothing had happened.

The increase in living standards comes from a very low base. Anytime a country is at war, the economy all but stops. During last March and April, the economy in Baghdad had stopped. U.S. tanks and armored personnel carriers were roaming the streets. Once the economy began to function again, the percentage growth in output was very rapid. By February 2004, oil output had gone up to near to or above pre-invasion levels. Electricity output has recovered pretty rapidly as well. There has been a huge inflow of cash into the economy.

Much of the cash has gone into government salaries, with the result that employment in government has become attractive again. I talked to one store owner:—before the invasion, he was much better off working in the private sector than in the government. In fact, he had abandoned a government job to set up a tiny store, not much bigger than this table, where he sells Coca-Cola, crackers, and other foodstuffs. He was making more money running that store than hanging around in the government bureaucracy. Thanks to our generosity, entry-level government wages have risen to $60 a month and, for many positions, are now up to $120. This may not sound like a lot of money but it is several times what government workers were making last year at this time. It is also much more than the store owner was making.

As a consequence of all this money coming in and increases in government salaries, there has been a huge influx of imported consumer goods into Iraq. Anyone who has been in Iraq, especially in Baghdad, but also in the other towns, has seen piles of imported consumer electronics and appliances sold on the street markets. Under Saddam, partly because of sanctions, partly because of the regime, if you wanted to buy a color TV or a Sony Walkman or an air conditioner, forget it. The only people with access to imported goods were those with government connections.

After CPA eliminated tariffs and other barriers to trade, Iraqis were able to enjoy the benefits of free trade. Now, they can buy anything they want. Trucks are rolling across the border. All of downtown Baghdad is filled with television sets and air conditioners.

I was puzzled as to how expensive goods can be sold in open air street markets in a country which has a pretty high crime rate. How is this possible? Virtually everybody is armed in Iraq, including street vendors. The vendors collaborate. If anybody grabs something and starts to run, all of the merchants, not just the merchant from whom he steals, go after the thief.

For several months after the invasion, there were no statistics on inflation and employment. Finally, some statistics have been published: inflation is pretty high, 36%, a figure to which Americans have a hard time relating. Earlier in the mid-1990s, however, inflation in Iraq had reached very high rates, over 400%. Although nowhere near these levels, inflation is still quite high right now. This rate of inflation is partly due to all the money that has flowed into Iraq, and partly because Iraq has a very weak central bank.

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One of the things I did in Iraq was to work with the Central Bank. I was a senior adviser to the Iraqi delegation that met with the International Monetary Fund in Amman, Jordan. Based on my experiences, the Central Bank is not yet very good at its job and it has a long way to go.

A number of individuals claim that Iraq’s unemployment rate is 50-60%. These unemployment figures are exaggerated. Most people in Iraq work in the informal economy; in fact in most developing countries most people work in the informal economy, either running their own very small businesses or working as day laborers. For example, the warehouses that distribute food do not have many permanent employees but hire day laborers as needed. Use of day laborers is quite common in the United States as well. In Washington, D.C. or L.A., if you want someone to help with your garden or want to do a little construction work, you can go to street corners and hire young men from Mexico or El Salvador who will work for a day. Much of Iraq’s labor market operates this way.

Official unemployment figures are more accurate than those cited by the press. The national statistical office recently completed a labor force participation survey; they found that the unemployment rate was about 26%.\footnote{See, e.g., id.} In short, most people in Iraq do not receive a weekly paycheck, but they do work or are searching for work on a daily basis. Some days they find work, some days they do not.

Although most Iraqis would prefer a regular paycheck, the major problem for Iraqi workers is not so much how steady work is, but how much they earn. Iraqis are quite poor, much poorer than I had expected them to be. If any of you have been to Mexico, it is a lot better off than Iraq. It is not as poor as Afghanistan, however.

Where does Iraq go from here? 2004 and 2005 are likely to be good years, if the security situation does not continue to deteriorate. Increased oil output and the influx of U.S. aid should lead to rapid growth in the Iraqi economy. However, the security situation could derail growth. In July 2003, CPA employees would visit Babylon on weekends and were fairly comfortable moving around Baghdad. By fall, the security situation had deteriorated. The Ba’athists, Wahabists, who came from Saudi Arabia, and Al-Qaeda were making concerted efforts to keep things hot in Iraq. However, even at that time, the insurgents did not consist of a huge number of individuals. The violence was heavily concentrated in the Sunni areas, sometimes called the “Sunni Triangle,” which includes Fallujah and Tikrit.
The violence has worsened greatly in the last month. Iraq has moved from a situation where just a few individuals are involved in the violence to one where a substantial number of people are willing to engage in violence to push the Americans out. For example, in Fallujah, 60,000 out of 300,000 inhabitants are camped outside of the town because of the threat of a Marine operation taking place in the city. In short, if the security situation gets worse, the turmoil and shootings will kill off economic growth.

The United States is making a big push to increase oil output and oil output seems to be going up. Oil accounts for a large share of the Iraqi economy. It is not the whole economy, however. Iraq benefits greatly from oil. Oil provides virtually all government revenue. Because of oil reserves, Iraq imposed virtually no other taxes. However, very few people work in the oil sector. Out of roughly twenty-six million people, most are either working in the informal economy (60% or so are trying to scratch out a living from the informal economy) or they are working in government ministries: education, health, et cetera. In Iraq, there is this peculiar situation where most of the government’s revenue comes from a sector which is state-owned, very important, but has relatively few employees. Everybody else works in other areas.

The Iraqi state owns a large number of enterprises; these in general are disasters. I worked on policy towards state-owned enterprises and visited one up north, a sugar refinery. This particular enterprise had been bombed in the Iran-Iraq War. There is a big hole in the roof and nobody had gone back to work for sixteen to seventeen years. Some of you probably had not even been born when this factory was bombed yet all the workers are still on the payroll. This story should give you a little sense of how things work in the state-owned enterprise sector in Iraq.

If the violence declines, Iraq is likely to enjoy two years of growth. Much of the growth in 2004 and 2005 will be funded by U.S. taxpayers. Congress appropriated $18.3 billion for the reconstruction of Iraq. This is an enormous amount of money: nearly as much money as we are providing in aid to the rest of the world. No one country has received this much money since the Marshall Plan. This sum is only slightly smaller than most estimates of the size of the Iraqi economy.

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7 Id. at 4.
Despite the massive amount of assistance going to Iraq, I am pretty pessimistic about long-term prospects for growth. The Iraqi economy is one of the most distorted economies I have ever seen and I have looked at some distorted economies. The greatest problem is distorted prices. Prices for gasoline and diesel are ridiculous. The current prices of gasoline and diesel fuel were set in the 1980s. At that time, they were somewhat normal. However, Iraq suffered very high rates of inflation and Saddam never bothered to change the prices. Consequently, gasoline is currently sold for 3.2¢ a gallon. I had lunch with one young soldier in the National Guard. He said when he returns home he is going to continue to drive to Iraq and fill up. At 3.2¢ a gallon, a full tank costs less than a dollar.

What do we know from economics when you try to sell something at 3.2¢ a gallon in Iraq when the price in neighboring countries like Turkey is three dollars a gallon? The Iraqis smuggle gasoline and diesel fuel to neighboring countries to sell at the higher price. Smuggling of fuel is rampant. Every truck coming into Iraq has extra tanks. The truckers fill up and drive back to Turkey where they sell it for one hundred times the official price. The same thing happened in Russia in 1991, when the current crop of Russian millionaires made their fortunes by smuggling. Because fuel is being smuggled outside the country and because the low price encourages waste, there is not enough fuel in Iraq to meet demand. Iraqi motorists stand in line for hours to fill up their tanks.

Price controls also create corruption. Across the river from where I lived in the Green Zone, a large number of $500,000 homes are going up and brand new BMW convertibles are seen on the streets. Where does this money come from? It comes from people who have contacts in the Ministry of Oil who are able to buy gasoline and diesel at the official price and ship it to somebody who will pay them the market price for it.

No one starves in Iraq. Saddam put in place a food ration system that provides everyone a monthly package of food: sugar, rice, beans, and other staples. The system creaked along during the UN sanctions. During my stay, I visited three stores which distributed food rations. Once the locals found I was analyzing the system, I was immediately surrounded by a horde of Iraqi housewives who gave me a list of complaints concerning the program. The soap gives them a rash, they want lamb in the rations, and the rice is substandard. Of course, they wanted me to fix these problems.

This ration system is highly dysfunctional. It prevents Iraqi farmers from selling produce to their fellow citizens because everybody gets their food for free. The system suffers from corruption all down the line. Many Iraqis are
unhappy with the quality and selection of foods. It is a business that neither
the Iraqi government (especially the CPA) should be in. It needs to be
changed.

What has the CPA done in order to establish growth? In November 2003,
the U.S. Congress passed a large bill that provided $18.3 billion in supplement-
al funding for Iraq. This funding was provided to kick-start the economy.
The funding is not being used as well as it could. In some ways, funding
decisions are being made on the basis of last summer’s wars. Last summer,
Iraq experienced continual blackouts. There was a perception, a correct one,
that the Iraqis became upset when the lights went out. The flip side of this
contention is, that if we can get the lights on, all of our problems will go away.
It reminded me almost of Lenin, who equated electrification with progress. 8
The CPA slogan became “electrification equals pacification.” Because of this
equation of electric power availability with popular unrest, the CPA placed a
very high priority on investing in electric power. The CPA also put a lot of
money into the new Iraqi army and also into water resources development.

The emphasis on electric power badly misallocates your tax dollars. Right
now, the CPA does not charge for electric power. So what do Iraqis do? They
go out and buy an air conditioner with their new salary (provided by the U.S.
government). Air conditioning is cheap because they do not have to pay for
the electricity to operate the air conditioner. You know as well as I do that the
biggest costs in air conditioning are the costs of running the thing. More air
conditioners result in greater demand for power, which is likely to cause even
longer blackouts this summer than last despite all the money that is going into
electric power investment. People are buying air conditioners faster than we
can build power plants.

The CPA is also spending $680 million of your money to import diesel fuel
and gasoline for Iraq. The Iraqi government then turns around and sells this
fuel at 3.2¢ a gallon. The fuel in turn is often sold by Iraqis to Turks and
Iranians and Syrians.

The supplemental funding has also been heavily skewed towards creating
a new Iraqi army. A good friend of mine recruited for the Iraqi army. Many
of the guys who joined the new Iraqi army said that they chose to join the army
rather than the police or other security forces because they did not want to
shoot Iraqis. They want to defend their country but are not at all interested in
doing internal policing.

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I do not know if you noticed in the newspaper, but last week one of the battalions mutinied when commanded to fight in Fallujah. The soldiers said that they were not going to go to Fallujah to shoot Iraqis. There was a real mismatch between what was promised the enlistees and the mission that they were called upon to perform. Funds would have been better spent on the police. We need to expand police training. Iraqi police get two weeks of training, are assigned to police stations which are not fortified, and are expected to apprehend heavily armed criminals and to combat insurgents. Iraqi police come from a long tradition of not doing anything but sitting around the station house and drinking tea. In short, more should be spent on police training and less on creating a new army that lacks a clear cut role.

What could we do instead? We need to fund more training and mentoring of police. That should be the first priority. Unless there is an effective police force in Iraq we are going to be in trouble. The problem in Iraq, as opposed to Vietnam, is that two-thirds of Iraq's people live in cities. In an urban environment, the only effective way to combat an insurgency is to have a police force that is working with the local people. The police are the face of the government to the local people and the providers of day-to-day security. Iraq needs a good police force to create a modicum of security in the country.

U.S. assistance also needs to be used to install financial control systems in government ministries. The government and outside auditors need to be able to track how money is spent. Iraq also needs to put controls on how many people are hired by the government. A good colleague of mine works as a senior advisor in the Ministry of Electricity. The Ministry has increased the number of director-generals, which is the same as an assistant secretary in the United States, from eighteen to eighty in three months. And guess who got those jobs? They were the friends and relatives of people on the Governing Council.

One of the last tasks I was asked to do was to put together a small model of the Iraqi economy and forecast output in the coming years. I found that unless the current distortions in the economy are cleaned up, growth is likely to be anemic. We have learned from the experiences of the transition economies that until the prices are right, nothing works right. So as long as Iraq sells gasoline and diesel fuel for next to nothing and electricity is given away, all of the decisions in the economy are all going to be skewed, in many ways, the wrong way.

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Unless policies are changed and prices liberalized, unless Iraq gets rid of a food rationing program that discriminates against Iraqi farmers, economic growth will not have legs. Once supplemental spending disappears in 2005 and 2006, there will not be enough "oomph" in the economy to keep it growing.

Dr. Gatewood: Thank you very much. Our third speaker is Lee Reed, Professor of Legal Studies and Real Estate in the Terry College of Business. Except for a visiting professorship at the Wharton School of Business, he has spent his entire career here, and has been a very valuable member of our faculty, former president of the Academy of Legal Studies and Business and a former editor-in-chief of the American Business Law Journal, he has received five national research awards in his discipline and has been a recipient of a senior award of excellence, the highest award that the 1,000 member academy grants. During the last decade his work has come to focus on the role of property-based legal systems as a foundation for prosperous private markets. Lee will argue that the gradual institution of a strong property-based legal system under the rule of law provides the best hope for a prosperous and free democracy in Iraq and Afghanistan.

Lee Reed: How can I possibly disagree with my distinguished colleagues? They have spent more time in Iraq between them than everyone else in this room combined. I do not intend to disagree with them. In fact, they each have said something that I agree with thoroughly. Tim Mills has said we need the rule of law in Iraq and Afghanistan and I agree with that fully. Keith Crane has talked about the importance of the private market. I could hardly hold my head up in the business school if I did not think the private market was of vital significance to the creation of wealth and prosperity as people define it. But there is something else that they have not talked about yet and that is fortunate for me because it left me with something to say today.

Five hundred years ago, all of the world was poor. In many respects, the Europeans arriving in the New World had standards of living lower than the Native Americans. But now, some nations are prosperous while others are impoverished. Why? What happened? Let me give you a fairly new but increasingly accepted view, accepted by Alan Greenspan, by George Bush, by Bill Clinton, and by the last three Treasury secretaries. And also by the G-8

10 See infra p. 197.
11 See infra p. 203.
finance ministers who will soon meet on the coast of Georgia. Their view and mine is that the connection between private markets, rule of law, and prosperity can be explained by just three concepts: property, property, property.

I assert that the maximum conditions for national prosperity can come only from the institution of property. This certainly applies in Iraq and Afghanistan, but it also applies to emerging economies everywhere. The concept of property has great explanatory power. I will warn you in advance: this may be a little different from the way you are used to thinking of property. However, property explains why Western and some Pacific Rim nations are prosperous while most other nations are impoverished. It explains why the devastated economies of Europe rebounded so quickly at the end of World War II. It explains why West Germany had one of the highest national per capita incomes in the world when East Germany, the same people, with the same education, and the same background, lagged far behind. Property explains why South Koreans are driving Hyundais and Kias in the streets of Seoul while North Koreans are starving. It explains why the United States has seven times the per capita income of its neighbor to the south, Mexico; why Japan went from being a defeated nation of poor peasants to a wealthy industrial giant in a mere handful of years. Property explains why the Chinese economy is soaring and why citizens in Singapore, the world’s wealthiest per capita country, can drive twenty miles and be in Indonesia, one of the world’s many poor nations.

Differences between rich and poor nations are not explained adequately by many other things that are frequently put forward as explanations. The differences are not explained by such things as the remnants of colonial exploitation, by international corporate buccaneerism, variations in natural resources, population densities, education levels, or by technology. They are not explained by national cultural variation or by and I may disagree here with Keith Crane just a little bit, the mere existence of a private market. Only by a private market, in my assertion, that is based upon a property-based legal system; only property, property, property explains the persistent economic gulf between rich and poor nations.

Property establishes the maximum conditions for resource generation under the rule of law. Because property is so important, I will define it. Before doing so, however, I would like to make the following claim: I have as much

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property as Bill Gates. Now, before Dean Gatewood drags me away in embarrassment and shame, let me explain what I mean when I say, "I have as much property as Bill Gates." In the sense that I am using it here, property is a legal right, a type of law that relates people to each other with respect to limited resources. Property is not the resources themselves. Therefore Bill Gates and I do have exactly the same property; we have the same rights, even as he owns over 100,000 times my resources.

Specifically, property is the legal right of ownership that allows us to keep others, including the state itself in most instances, from interfering with the resources that we produce or acquire, without coercion, cause, or theft. The right to keep others from interfering is sometimes called "the right of exclusion." Commentators as varied as Thomas Hobbes, William Blackstone, Oliver Wendell Holmes, Jr., and the progenitor of modern sociology, Emile Durkheim, have all identified the right to exclude others from resources as the essence of what it means to have property.

I do not want to argue with law professors in the room who are going to go through the difficult and problematic definitions of property that have existed at common law. I want you to accept—give judicial notice to, if you will—the essence of property as being the right to tell others to stay away, to keep off, not to interfere with something that is proper to me or to you. Property defines and protects what is legally proper to me and what is proper to you. Each of us can use property to keep others from interfering with, infringing upon, or trespassing on what we have. Here, I am talking about private property, not public property, or even common property.

So far, my claim about the efficacy of the exclusionary right called property has been unsupported, but there is increasing empirical evidence to support this claim. A 2002 study concluded that nations with "very high" protection of property had a per capita income of $23,700 annually; "high" property protection, $13,000 annually; "moderate" property protection, $4,900 annually; "low" property protection, $3,000 annually; and "very low" protection averaged $2,600 per capita annually.\textsuperscript{13} I believe both Iraq and Afghanistan are well under even the low figure in that regard. Another study found that countries that strengthened the property right the most during the period from 1975 to 1995 registered a 2.7% annual GNP growth, whereas those nations that weakened the property right the most during that period averaged 0.6% annual GNP decline.\textsuperscript{14} A 1988 analysis of all studies then

\textsuperscript{13} GERALD P. O'DRISCOLL, JR. ET AL., 2002 INDEX OF ECONOMIC FREEDOM 37, 40 (2002).
\textsuperscript{14} JAMES D. GWANTREY ET AL., ECONOMIC FREEDOM OF THE WORLD: 1975-1995 99-100
available concluded that property-strong nations grow at three times the annual rate of property-weak nations.\textsuperscript{15}

I want to point out something to the audience. Economic historians often place the widespread institution of property in England and in the Netherlands between two and three hundred years ago.\textsuperscript{16} I want to point out something interesting to you about growth. If, since that time, being property-strong, as opposed to being property-weak, accounted for only two percent higher growth per year in the property strong nations, can you even imagine the difference in the annual per capita income over a couple of hundred years? At two percent, in approximately thirty-five and a half years, one nation would have twice the per capita income of another that was property-weak, the property-strong nation having doubled in that time. In 200 years there is a sixty-seven-fold difference. The property-strong nation would have sixty-seven times the annual per capita income as the property-weak nation.

I made up those figures (except for the doubling, the doubling figures are correct). I made up the idea that a property-strong nation is necessarily two percent annually of a higher increase in per capita income. But my example gives you some inkling why Western nations in particular are so much more wealthy than the rest of the world. Because at the heart of the legal systems of all Western nations is a very strong view of what is proper to me and what is proper to you; what is proper to their citizens, what is property. If you look at the constitutions of Europe you find this. Some of those countries are social welfare states but they still have a very strong concept of property.\textsuperscript{17} I was in Innsbruck a couple of summers ago and all around town there were signs that said “Privat Grund,” which I took to mean, “private ground, no trespassing.” That is a very strong indication of the exclusionary right of property.

How is it that property-strong legal systems promote maximum conditions for increasing national prosperity? I can only give you a quick summary here, we could go on for a great length of time, but in quick summary, strong property systems, number one, provide the greatest incentive and certainty


which are necessary for new resource development in a private market system. As economists have long believed, something quite natural to human behavior induces people to produce more when they have this kind of incentive and certainty, when they get to keep the increase from their efforts for themselves and for their families. Certainty about the stability of property also encourages the investment of resources in fixed locations such as businesses and business constructions; it also provides the certainty necessary to increase production from private resources. Douglass North won a Nobel Prize in 1993 in part because he traced in Europe how people began to put their resources in fixed locations once the kings, the state, could no longer arbitrarily take these resources.18

The second thing that property does is to permit residents to work outside their homes by formally protecting land and housing from seizure by others. I do not know to what extent this is a problem in Afghanistan and Iraq, but in many parts of South America, in many parts of Africa, and in parts of Southeast Asia, it is a truism that people stay at home rather than go out and work so that they can protect their land from being taken by others.

The third thing that property does is to facilitate the generation of the development capital that Tim Mills told us was greatly needed in Iraq.19 Property facilitates the generation of development capital from land and other resources by enabling these resources to be put up to secure loans at reasonable rates of interest. The purchase price of money is much lower if you can put up your land to secure a loan—this is the theory of Hernando de Soto, the Peruvian economist.20 I was privileged to meet him two weeks ago. He is now working in Egypt helping to establish land ownership for people who do not own land, but who live on land. The government has very high hopes in Egypt that this will help small businesses grow through being able to obtain capital at reasonable rates or reasonable prices.

The last thing that property does: it makes resources, especially resources from land more easily divisible so they can be transferred to those who value them most. That is just basic economics. From the stimulus to new resource development that property provides, we can draw the following conclusion: a nation should apply property to whatever it wants its citizens to produce more

19 See infra at p. 197.
of. Whether it is widgets or something else, make production legally proper, so people can exercise the right of property over production. This gives them incentive and certainty by creating a stable, enforceable expectation of the right to keep others from interfering with what an owner has and what an owner produces. This is the way to develop more of the resources associated with whatever people want to call prosperity. Notice that I am not recommending that the U.S. export to Iraq and Afghanistan any particular set of U.S. laws, like the *Uniform Commercial Code* or the *Restatement of Property*. But I am recommending a general concept for consideration, whether it is in the creation of new constitutions or in the development of a new commercial law. That is what I am calling the “concept” of property.

How does this relate to Iraq and Afghanistan? Much of what General Shinseki, and various panels, and what Tim Mills and Keith Crane, and others have talked about fits under my idea of property under the rule of law in a private marketplace. The need for security of one’s person against violence in those countries is definitely property-related in “Reed’s World of Property,” if we only consider that one’s body and exercise of his or her faculties is the primary resource on which the production of other resources is predicated. Property enforcement is a very important part of property-based legal system. If there is no enforcement, no security of property will exist. Some things that have already been mentioned that fit under the heading of the importance of property: Tim Mills has mentioned intellectual property and he has mentioned predatory business practices;\(^2\) I think Keith Crane mentioned better police training and how important that was.\(^2\) All of that fits neatly in “Reed’s World of Property.”

I think it is very important though to talk about this not as a variety of different kinds of things that people might need to do, but as central to a key understanding of why Western nations are so prosperous and why many other nations of the world are so poor. The adequate implementation and enforcement of property is fundamental to the creation of a prosperous private market in Iraq and Afghanistan. If this process is not easy it is nonetheless necessary and required. The beginning is for us to understand what creates prosperity and how to communicate it adequately by asserting and showing that we are in those countries in order to establish and protect what the people themselves believe is proper to them. Not what we want for them, but what they want for themselves.

\(^{21}\) *See infra* p. 199.

\(^{22}\) *See infra* p. 209.