

**WORKING DRAFT
AUGUST 1, 2003
REVISED SEPTEMBER 10, 2003**

**Transforming Oil For Food (OFF) Into Efficient Market-Oriented Social Programs and
Modern Management of Oil Revenues**

Executive Summary

This paper deals with the transition of the Oil for Food Program (OFF) from the UN and its current Iraqi Administration to the Coalition Provisional Authority (CPA). The paper is offered as a means to discuss options. The current OFF deals with both food (and its distribution) and non-food (medical supplies, agricultural machinery, etc.). It is recommended that the current program should evolve from in-kind subsidies channeled through administrative means to direct subsidies offered directly to the population, provided through food stamps with monetary value allocated to households, with food and non-food assistance distributed via markets and prices. Appendix One offers an overview of how best to manage and invest Iraqi oil revenues.

Stephen Lewarne and David Snelbecker
September 2003

Submitted to USAID under
Iraq Economic Governance Project
BearingPoint/USAID

Transforming Oil For Food (OFF) Into Efficient Market-Oriented Social Programs and Modern Management of Oil Revenues

This paper offers recommendations and discusses options for making fundamental changes to the Oil For Food (OFF) Program, as it is transferred to the Coalition Provisional Authority (CPA). Key measures include:

- Maintain subsidies to the population, but change the vouchers into foodstamps with monetary value that can be traded or redeemed for any food items (not just for OFF food baskets).
- Replace the bureaucratic OFF food distribution channels with market-oriented mechanisms based on prices and private actors over the short-term. Food aid would be allocated to distributors (preferably chosen by lottery), who would in turn resell the food into the economy as they see fit (i.e. in response to market prices and opportunities). In the long-term, phase out food purchases (which are a distortionary production subsidy), maintaining only the targeted subsidies to consumers (the population).
- Integrate the funding of this assistance into the CPA/MoF budget—purchases of foodstamps and food on the budget expenditure side, and contributions from oil sales on the budget revenue side.
- Maintain Universal Coverage of subsidies in the short-term (until 2005).
- Collect sufficient information to allow the Ministry of Finance to discuss means testing options, including an ongoing food subsidy system, continued universality, a mixed system, over the longer term.
- Coordinate reforms of the many OFF non-food programs with overall efforts to restructure the Government.
- Develop a comprehensive approach to management of Iraqi oil revenues, taking into consideration the various possible uses of revenues and the institutions necessary to manage those purposes effectively. (See Appendix One)
- Move quickly with those aspects of reforms that can be put into place easily (particularly the introduction of monetized foodstamps and of market-based distribution).

The goals of these measures would be to increase the efficiency of delivery of subsidies, to reduce distortions in the economy that impede domestic production and wholesaling, to reduce the international role in what should be Iraqi private-sector wholesaling activities, and to improve transparency and accountability throughout the economy.

One of the main recommendations is to replace coupons currently issued by the Ministry of Trade and the UN with a voucher system that would approximate a food stamp program. In the new system, foodstamps will have a monetary value and citizens will be able to redeem the stamps for food from any participating store or merchant (regardless of whether the food that is bought is through international assistance). Stores and merchants will redeem the vouchers for cash from the government. This option is offered as the best way to convert the OFF food program (both basket compilation and distribution) into an efficient social safety net. By moving to a demand driven system, we will be able to stimulate both domestic production, as necessary, and/or imports in order to meet other food needs.

It is important that the food vouchers are transferable and exchangeable for any kind of food. This will fundamentally change the current rigid system that is import dominated to the detriment of domestic production. Most importantly, the food vouchers are redeemed for money by merchants—this will stimulate a trade network, which is currently operating, but under very dysfunctional and non-transparent price and quantity signals.

In this first phase of the paper we are recommending the conversion of the food portion of OFF from a system of subsidies for foreign food producers and government distributors to a subsidy offered directly to the Iraqi population.

The population would benefit in two ways from the new assistance programs. First, because the proposed food stamps, given directly to families, will now have monetary value, their receipt constitutes a direct transfer or subsidy to households. Second, because of the amount of food assistance imported into the domestic market, paid by oil revenues, overall food prices throughout the economy will be lower. (It is of course exactly this price reduction that distorts and harms domestic production. Therefore, while food purchases might continue to make sense for an interim period, particularly to ensure against price spikes while other changes are introduced, in the medium term they should be phased out, leaving only the subsidies to consumers.)

1. BACKGROUND

The OFF program, despite its name, is a comprehensive program providing registered households with basic goods and services that normally would be delivered by markets and government line ministries. Only 25% of resources are spent on food—the rest is spent on additional programs that have been added. Fourteen main Ministries and international agencies are involved. The breakdown of internal and external assistance is as follows:

	External Administration	Internal Administration (only in the center and south; in the north only international agencies work)	Value between Dec. 2002-June 2003 (\$US Millions)
Food			1,557
Food Distribution	WFP	Ministry of Trade	1,275
Food Basket Compilation	WFP	Ministry of Trade	282
Non-Food			
Agriculture	FAO	Min. of Ag./Min. of Irrigation	444
Health	WHO/UN Inter Agency Hum Prog.	Min. of Health	143
Water and Sanitation	UNICEF	Min. of Interior/Mayoralty of Baghdad	260
Electricity	UNDP/ENRP	Shipped directly to Power Stations	273
Housing	UN Habitat	N/A	80
Telecom/Trans.	ITU	N/A	243
Education	UNESCO	Min. of Education	192
Nutrition	UNICEF	N/A	21
Construction	UN: N/A (UNOPS?)	Min. of Trade via State Company or Construction	100
Industry	UN: N/A (UNOPS?)	Min. of Ind. and Mining	210
Information	UN: N/A (UNOPS?)	Min. of Information	50
Culture	UN: N/A (UNOPS?)	Min. of Culture	20
Labor and Social Affairs and Sport	ILO (?)	Min. of Labor/Board of Youth and Sports	33
Justice	UN: N/A (UNOPS?)	Min. of Justice	4
Finance	UN: N/A (UNOPS?)	Ministry of Finance	20

Central Bank	UN: N/A (UNOPS?)	CBI	25
Oil		Ministry of Oil	600

Source: UN, WFP, FAO, CSIS

The system as presently organized suffers from problems similar to those found in any non-market system. It is excessively bureaucratic, discretionary, inefficient, corrupt, costly, and non-transparent. The true value of subsidies (and their beneficiaries) is not readily apparent. There is excessive presence of international donors and government agencies at all stages of distribution, meaning little role for private-sector actors. The extensive use of international agencies also impedes development of competent Iraqi agencies.

2. IMPLEMENTATION ISSUES

Transfer functions to Ministry of Finance and Local Welfare Offices. Efficient food subsidization requires restructuring financing and logistics of distribution. Since we are introducing a demand driven subsidy structure, it should be recognized by the consolidated budget and represent part of the Ministry of Finance’s expenditure policies. It is expected that this will mesh with the current reforms underway at the Ministry of Finance for the operation of a treasury system. These reforms must include the transition of OFF in their plans. This will allow decisions on the size of overall food and non-food purchases to be taken within the context of overall prioritization of expenditures. The financing of the Food portion of OFF may take initially some \$259 million a month (if we use the last phase of the UN OFF program as a starting point). However, these costs include substantial mark-ups for foreign suppliers and UN distribution costs. The marketizing of OFF overall (both Food and Non-Food) will reduce these costs.

While most distribution activities will be transferred to the private sector, at least two will remain in CPA/Government hands—the foodstamps program and the initial acquisition of food and transfer to distributors. These functions likely should remain with Ministry of Trade, at least initially. The local food agent offices are currently being used to register coupons and receive food baskets from the government warehouses. These offices will still need to perform registration of those receiving food vouchers and report this to the Ministry of Finance for recording in the Financial Management Information System (FMIS) that is already planned.

Registration of individuals and households and distribution of food stamps. The of issue of a sound registration process is important to ensure that all families are served and that no families receive more than their due in vouchers. To facilitate this, a program of verification of identity cards and current registrants must be instituted (it is our understanding that virtually all Iraqis have identity cards with unique identification numbers and that a very large proportion of the population is already registered with the food assistance program). Further, processes must be put in place to provide identification cards to any who have lost their cards during the conflict. Over time, the registration system must be automated and procedures need to be put in place to prevent fraud. Similarly, the security system for food stamps must be robust because food stamps have monetary value and require measures and procedures to prevent counterfeiting, theft, monitoring and auditing. Transparency and accountability must be put into place across all processes and institutions.

Procurement. Procurement of goods should take place through rule-based, transparent, open tender processes. Procurement decisions should be taken without regard to national origin, while a portion of food procurement could be reserved for purchasing Iraqi production in order to reduce the extent to which the international aid harms domestic production. It is presumed that some donors will continue to give free assistance in-kind, in which case such assistance will be received without a competitive process.

Food distribution. To the extent possible, private-sector actors should be used. The large state distribution network should be eliminated. In its place, private distributors should be chosen, to whom food assistance should be given at the ports of entry (or at the nearest warehouses where allocation can take place). The distributors should be free to sell the food wherever they choose across the country. In this way, food assistance would make its way into the country through market economic channels. The whole system of controlling, licensing, and restricting distribution could be eliminated through this action.

Food distribution rights. The rights to receive food at ports of entry can be allocated according to several means.

Open lottery. A lottery could be held in which any individual or organization (domestic or foreign) is eligible to apply. Winners would be drawn from a lottery and would be awarded distribution rights (distribution rights would be freely tradable.) In effect, winners would be allocated food free of charge.

Restricted lottery. Distribution rights could be offered in a lottery that is somehow restricted. For example, competing companies could be required to demonstrate a certain asset level or ownership of warehouses or trucks, or to make a deposit (refundable or non-refundable) that demonstrates seriousness in order to participate.

Auction. Distribution rights could also be auctioned off to the highest bidder just like broadcasting rights are auctioned off by the FCC in the United States.

Administrative decision. Administrative decision could be used to determine who has the right to distribute food, as is the current practice.

We believe that the best approach is to offer rights to distributors through a lottery. The rights should be given freely (or at small nominal cost) and should be freely tradable. The lottery could be either fully open or restricted, depending on how quickly we believe an open lottery will result in the resale of rights to the most competent distributors (who would value the rights the most because of their belief in their ability to sell food most successfully for maximum profit).

While the granting of rights constitutes a giving of wealth to the winning distributors (since they receive food for free that they then sell at whatever cost the market will bear), this method should result in lower costs than the current system and would be far more efficient. Rights could be auctioned to the highest bidder, but this would only increase costs to consumers. More analysis is necessary to determine the optimal number of rights to be auctioned, however several tens or several hundreds per point of entry seems most reasonable.

Non-food programs. These programs are so extensive that their reform must be integrally linked to USAID's overall programs in Iraq throughout the government and economy. In

particular, they must be fully integrated into budgeting, spending, and government restructuring decisions. Some brief suggestions for reforming non-food programs are given in Appendix Two.

Access to financing in non-food assistance. While food distribution mechanisms and food markets are relatively simple in structure, other markets where OFF operates are much more complex. A good example is agriculture where scale and long market cycles (from planting to harvest) often require more intervention (by government or donors). In particular, specialized institutions are necessary to provide financing for agriculture in order to allow agricultural producers to buy inputs at the beginning of the cycle that can only be paid for at the end of the cycle. In this case (and others), additional assistance may be required for programs that succeed OFF.

Dismantling current structures. While many of the current OFF structures may not be necessary any longer, for instance all the food distribution networks, they do nonetheless employ thousands of people, so some consideration will need to be given to the timing of closing them down, severance packages, their relative political clout and therefore need for providing payoffs or alternative tasks, etc.

3. OPTIONS FOR THE FUTURE

Means Testing vs. Universal Distribution vs. Mixture. In an ideal world, it might be preferable to give vouchers only to those in need rather than universally to the whole population. However, there are at least two reasons for not moving quickly to needs-based targeting. *First*, setting up the administrative apparatus for needs testing in a country like Iraq is particularly difficult. For needs testing to work, offices would have to be established across the country staffed with personnel skilled in making needs assessments, according to objectively determined criteria specified in official procedures. Information about the wealth and income of citizens must be easily attainable (such as bank statements, appraisals of property value, information about housing and car ownership, tax return statements, wage statements from employers).

Given these considerations, it will obviously take time to build capacity to do needs testing. Complicating these concerns is the possibility of prejudicial treatment by government assessors based on religious, political, and ethnic status, as well as concerns about security issues involved in making home visits by government officials to verify wealth and income claims.

Second, income distribution of the Iraqi population is relatively flat—a few are quite wealthy, while the vast majority are poor. While some parts of the majority are poorer than others, the difference between the various deciles is not very great in absolute terms, and even harder to measure.

Consequently, it would be best to maintain the program as a universal subsidy to the population, at least over the short-term. For instance, the first year or two might be focused on changing the nature of the program from a subsidy for producers (particularly foreign) and distributors to a program of subsidy for consumers (i.e., households), based on markets and prices rather than

administrative processes. At a later phase, when necessary government capacity is built, it might make sense to consider shifting the program from universality to needs-tested social assistance.

Possible future of the voucher program. Over the next 2-3 years, there are two possible visions of the program:

- a. The program could evolve into needs-based social assistance, once capacity is built within government to be able to make needs assessments in an accurate, transparent, efficient, non-discriminatory manner; or
- b. The program could evolve into a means of universally sharing some of the proceeds from oil revenues across the entire population of Iraq. In this manner, it would become a program similar to the program in Alaska that distributes a share of oil revenues to the whole population.

4. SEQUENCING OF ACTIVITIES

Immediate steps (by December 2003)

- Monetize the coupon program by allowing tradability and transforming it into a voucher system in which households redeem food stamps for goods at face value and merchants redeem vouchers for money from government.
- Choose distributors and begin giving food assistance to distributors at points of entry, bypassing administrative supply networks, and replacing foreign institutions with Iraqi institutions across the distribution system.
- Improve registration of participants and the printing and distribution of vouchers to reduce opportunities for corruption, theft, and counterfeiting.

Year One

- Gradually phase out purchase of food purchases, allowing markets to take over this role, for commercial import of food and domestic production.

Year Two-Three

- Decide whether to move from universal subsidy to means-testing.

APPENDIX ONE

THE USE, INVESTMENT, AND OVERSIGHT OF IRAQI OIL REVENUES: CREATION OF AN IRAQI PETROLEUM FUND

There are a number of possible uses for Iraqi oil revenues. Given the large sums involved, it is important that investment and oversight institutions and procedures be chosen that are suitable for the intended purpose. It is suggested that many, if not all, of these uses could best be achieved through creation of an Iraqi Petroleum Fund, which would allocate revenues to the various uses. The items on this list are not exclusionary—oil revenues could be spent on any of these activities that are deemed appropriate.

- A portion of petroleum revenues could be **universally shared** among the whole population of Iraq. In this way, it would become a program similar to the program in Alaska that distributes a share of oil revenues to the whole population. In this case, a share of oil revenues should be allocated to the general state budget, while subsidies to the population should be distributed, perhaps in the form of food stamps.
- Revenue sharing could evolve into **needs-based social assistance**, once capacity is built within the government to make needs assessments in an accurate, transparent, efficient, non-discriminatory manner. In this case, a share of oil revenues should also be allocated to the general state budget, while subsidies to the population should be distributed, perhaps in the form of food stamps.
- Revenues could be used for **capital improvements and infrastructure projects**. In this case, expenditure decisions should be made as part of preparing the annual capital budget, in collaboration with donors taking into consideration donor funds allocated for similar purposes. In this case, experts are needed for project appraisal so that the “social return” on investments can be calculated so that projects are chosen that will have the highest return. Evaluators would have to take into consideration not only projected future benefits but also the ownership, governance and management structure of the project to ensure that projects are likely to succeed.
- Revenues could form a fund for the purpose of **investment for development**. In this case, revenues would be invested and expected to earn a return. A formal fund would be created, utilizing fund managers, investment advisors, and procedures necessary to ensure all the checks and balances of international best practices in investment oversight and asset management are utilized.
- All capital should be held as **investments for income and growth** and should be managed using international best practices. It is likely that an outside asset manager should be chosen through an open international tender. It is also preferable that any significant assets be held outside Iraq in a country with developed capital markets. This could be in Kuwait or UAE within the region, or London or New York.

In thinking through these questions, it is useful to look at models in other countries. The Norwegian Petroleum Fund is considered to be the world's best managed petroleum fund, with strong institutions and international best practices to manage investments. (Investments are all held outside the country, intended to benefit the population over the long-term.) The Alaska Petroleum Fund is an example from the US. The Kuwaiti Petroleum Fund is a relatively good model from the region. The Saudi experience of using petroleum revenues to fund education and infrastructure projects has been successful. Pension funds in many ways are similar to petroleum funds—often, pension fund and petroleum fund managers attend the same conferences and follow the same principles of governance and investment. Good models of pension funds from international practice include the Canadian Pension Fund, the Irish Pension Fund, the New Zealand Pension Fund, and (for a post-conflict example) the Kosovo Pension Savings Trust.

APPENDIX TWO

NON-FOOD PROGRAMS

The following table lists the various kinds of assistance given under OFF, with recommendations for the future of these programs.¹

Area	Allocation, Phase 13 Plan, US\$ million	% Share of OFF allocations	Activity	Recommendation
Food	1275	25.88%	Humanitarian supplies distributed to population	-
Food handling	282	5.72%	Spare parts and equipment	-
Construction	100	2.03%	Materials and machinery for building schools, mosques, hospitals, water infrastructure, etc	Should be integrated into MoF capital budget and Public Investment Program, funded by revenues and donors
Housing	80	1.62%	Construction of housing and utilities	Should be integrated into MoF capital budget and Public Investment Program (PIP), funded by revenues and donors
Health	143	2.90%	Import equipment, rebuild hospitals, import medicine and supplies	Capital investments should be absorbed into MoF capital budget programs; distribution of medicines and supplies should continue as is until further evaluation
Electricity	272.50	5.53%	Purchase of gas combines, rehabilitate networks	Should be integrated into MoF capital budget and Public Investment Program, funded by revenues and donors
Agriculture	443.33	9.02%	Purchase of equipment, fertilizer, pesticides	Should continue as is until further evaluation
Education	192	3.89%	Construction and rehab of schools, resources, transport for teachers	Construction should be transferred to PIP. Teacher transport should continue as is until further evaluation
Transport and telecom	243	4.93%	Purchase of equipment, trucks, and training	Purchase of trucks should cease, and programs succeeded by telecom restructuring strategy
Water and sanitation	359	7.59%	Purchase of equipment	Should be integrated into PIP
Labor and social affairs	3	0.06%	Supplies	Should be integrated into current budget
Youth and sport	30	0.61%	Olympic sport city constructed	Should be integrated into current budget

¹ Information on activities comes from CSIS, A Wiser Peace: An Action Strategy for a Post-Conflict Iraq, 14 February 2003, pp5-7 of Supplement II. Proposals for what to do with these activities are ours.

Industry	210	4.26%	Supplies and subsidies	Should be integrated into current budget
Information	50	1.01%	Purchase of TVs, vehicles, equipment	Should be integrated into current budget
Culture	20	0.41%	Purchase of equipment	Should be integrated into current budget
Religious affairs	25	0.51%	Purchase of equipment	Should be integrated into current budget
Justice	4	0.08%	Purchase of equipment	Should be integrated into current budget
Finance	20	0.41%	Purchase of equipment	Should be integrated into current budget
Central Bank	25	0.51%	Purchase of equipment	Should be integrated into current budget
Housing and settlement	104	2.10%	Emergency shelter, sanitation, etc, especially for IDPs	Should be integrated into current budget
Mine-related activities	25	0.51%	Demining	Should be integrated into demining activities
Nutrition	21	0.42%	-	-
Health rehabilitation	56	1.13%	-	-
Special allocation	344	6.98%	Aid to vulnerable populations	Should be integrated into current budget
Oil	600	12.18%	Purchase of spare parts, materials, equipment	Should be integrated into current budget and oil-sector rehabilitation program
TOTAL	4926	100.00%	-	-

Many of the programs that are related to infrastructure construction and rehabilitation should be incorporated into the MoF capital budget and Public Investment Programs, to be funded by tax and oil revenues and donor grants. Programs related to support to current expenditures should simply be integrated into the current budget process and funded to the extent they make sense given revenues and other spending priorities. These measures can be done quickly without too significant disruption. Several of the programs are particularly complex and sensitive (in particular, in health, agriculture, teacher transport). These programs should be continued as is until further evaluation is done.