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State-Owned Enterprises: Post-Conflict Political Economy Considerations

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Participants at a recent USIP working group meeting on infrastructure development in conflict environments discussed the viability of revitalizing State-Owned Enterprises (SOEs) in Iraq. The meeting, held on February 1, 2007, focused specifically on Deputy Undersecretary of Defense for Business Transformation (BTA) Paul Brinkley's effort to revitalize a selection of the nearly 200 SOEs that once produced consumer and durable goods, but which have been shut down since the beginning of the stabilization and reconstruction (S&R) effort in 2003.^{1 2} Brinkley is attempting to rescue what is salvageable through this controversial SOE revitalization project. In January 2007, after eight months of research and investigation, Brinkley announced that ten factories had been selected to initiate his SOE revitalization project and would be open within two to three months.³

There are myriad projections of how SOE revitalization will affect the economic, social, and political situation in Iraq. Assessments of the economic viability of the selected factories in Iraq are promising and have inspired enthusiastic support for the BTA project. In addition to these traditional economic measures, however, it is critical to do an assessment of how reopening SOEs will affect the dynamics of the conflict. This USIPeace Briefing provides an overview of SOEs in Iraq as well as relevant insights learned from the United Nations Mission in Kosovo's (UNMIK) experience overseeing SOEs (known in Kosovo as publicly owned enterprises (POEs)), in order to show where such programs may be vulnerable, and what measures must be built into any plan to revitalize SOEs so that the efforts do not fuel ongoing conflict.

Overview of the Policies Regarding SOEs in Iraq

The decisions made in the early days of Iraq reconstruction in 2003-2004 reflected well-intentioned policies, based on optimistic economic forecasts, to promote the transition to and development of a free-market economy. Officials stated that analysis supported the dismantling of inefficient SOEs in order to foster the emergence of a vibrant private sector. As Ambassador Bremer wrote in a *Wall Street Journal* op-ed on June 20, 2003, "While the ultimate future of Iraq's economy will be determined by the Iraqis themselves, economic growth will depend on the birth of a vibrant private sector. And this will require the wholesale reallocation of resources and people from state control to private enterprise, the promotion of foreign trade, and the mobilization of domestic foreign capital."⁴ The sale of SOEs was intended to generate capital, as well as integrate and consolidate economic operators in order to transform Iraq's economy. The attempt to stimulate a free market economy was, as is now clear, handicapped by the

emergence of internal conflict. This plan failed at least in part because the political and security uncertainty was too risky for potential investors.⁵

The development of a free market intended to fill the void left by these still-dormant consumer and durable goods enterprises did not occur with sufficient speed or commitment. As a result, provinces are unable to raise revenue with factories closed, and public funds are spent on stipends for Iraqis formerly employed by SOEs to not go to work.⁶ The sluggishness of the private sector and the increased violence in Iraq are inspiring policymakers to look for methods by which to create employment. Experiences elsewhere, such as in Kosovo, suggest that increased employment might reduce frustration and perhaps diminish support for counterinsurgency and violent reaction.

Pros and Cons of SOE Revitalization

Proponents of revitalizing SOEs hope that doing so will reinvigorate production of Iraqi goods, bring people back to work, and create enterprises that could ultimately deliver goods or services in demand in Iraq. In addition, reopening even a small number of SOEs in partnership with the Iraqi government might show joint commitment to progress and restore a sense of normalcy. Not all factories can be restored to operational condition. But over numerous trips since mid-2006, Brinkley and his team have found several that may be restorable. The project is currently focusing on ten of the most promising factories, which would employ a total of 11,000 Iraqis.⁷ One of Mr. Brinkley's explorations of potential factories, showcased by *The New York Times* in January 2007, included three promising sites—a bus factory south of Baghdad, a tomato paste factory in the Kurdish north, and a floor tile plant in Ramadi.⁸

Despite the support many policymakers have expressed for this project, some observers are voicing concerns that resuscitating SOEs may not yield the positive results for which Brinkley hopes. [Merriam Mashatt](#), director of USIP's Economies and Conflict Center of Innovation and the chair of the USIP working group, cautioned that plans to revitalize SOEs must include a conflict assessment in addition to conventional forms of economic analysis related to efficiency and competitiveness. Implementers of the program must have a solid understanding of which actors become empowered as a result of revitalization. Revitalization should empower Iraqis to support the peace process rather than those who have a stake in perpetuating conflict. In the current environment, the drivers of conflict are so complex that it is simplistic to think that violence will be reduced simply because individuals are offered jobs. Safeguards are needed to ensure that the facilities do not fall into the hands of spoilers.

Mashatt also stated that plans for SOE revitalization must address the long-term sustainability of the facilities. Once restarted, these facilities will need additional funding for asset management such as sufficient operations and maintenance. This will require a clear commitment from the Iraqi government to protect the investment initially made to restart the facilities.

Keith Crane, a senior economist at the RAND Corporation and former adviser to the Iraq Coalition Provisional Authority, also counseled caution. He believes that revitalizing SOEs in Iraq, which were historically dysfunctional and overstaffed, offers little by way of new employment opportunities. They are far from being economically viable, he said. Furthermore, given that improving the security environment is critical to reconstruction, Crane wondered whether SOEs are the right investment, and said that he sees little promise that revitalizing them will help reduce violence. "A third [of the state-owned enterprises] are damaged beyond repair, another third are hopelessly unprofitable, and the rest are a mismanaged assortment of plants, a few of which could potentially produce something of value, but only with proper management and incentives," he said. "Trying to give these hopelessly inefficient enterprises a new lease on life would make Iraqis poorer without reducing the violence."⁹

In Crane's estimation, the conflict that is being waged is a struggle for power, not a quest for economic justice or a better life, and SOE revitalization will do little to mitigate the conflict over power. Crane also notes that under Saddam, state enterprises were used to funnel money to Saddam's favorites. Under the

current regime, they are likely to be used to funnel money to political figures and their supporting militias. By resuscitating state-owned enterprises, the United States is likely to increase funding for insurgents and militias, contributing to, rather than dampening, the violence.

Lessons from Kosovo

The United Nations Mission in Kosovo's (UNMIK's) experience is primarily with SOEs that provide public utilities, but the experience offers lessons for the current SOE program being launched in Iraq. James Wasserstrom, head of the Office for Oversight of the publicly-owned enterprises (POEs) for UNMIK, joined the February working group at USIP by telephone and was asked to share some of the critical lessons he had learned.^{10 11} Wasserstrom's commentary on the political economy of POEs underscored the importance of linking SOE revitalization projects to the peace process:

SOEs offer opportunities for advancing the political strategy behind post-conflict stabilization and reconstruction, opportunities poorly understood by political strategists and tacticians. Getting SOEs to work right offers immediate tangible benefits to local populations whose support is essential to earning trust and credibility for foreign military interventions. This is so because in post-conflict situations local populations are traumatized, their well-being has almost always gone through severe deterioration, so providing concrete improvements to daily life that they can see, taste, touch, smell, and hear gives arms and legs to go along with hearts and minds.¹²

The potential role that SOEs can play in legitimizing an international intervention comes with the obligation to ensure they do not empower the spoilers or enhance the drivers of conflict. Safeguards must be put in place to establish and maintain accountability and transparency.

Corruption and Cronyism

The economic plans first pursued by UNMIK focused on liberating the private sector and dealt perfunctorily with POEs, inadvertently creating an environment in which corruption flourished. Fifty-five publicly owned enterprises, which together accounted for more than \$1 billion in assets and which had been "dominant sources of legitimate revenue in Kosovo's economy," were left to operate with minimal oversight. The uncertain and pliable organizational structure allowed individuals at the helm of POEs to wield their powers largely unchecked. POE leadership found ways to skim money from the POEs, particularly from the lucrative areas of procurement, recruitment, and finance. The result was that the previously formal, or "white" public utilities moved into a less legitimate or "gray" economic space.¹³

Corrupt practices also brought illicit power structures into the utilities. The "local talent" employed to jumpstart the utilities had close ties to political leaders with questionable commitment to building a democratic state. These individuals used their power to hire political cronies, and employees funneled wages to organizations said to be fronting for Albanian extremists. Not only did these schemes line the coffers of political parties and individual bank accounts, they compromised the success of the utilities, possibly funded terrorists, and distorted the process by which aspirants to political office rise to power "legitimately."

An audit of the POE system was conducted in 2002 and in late 2003. UNMIK took strong control of the POEs to address their systematic mismanagement and corruption. UNMIK is now implementing intensive oversight mechanisms, starting with the incorporation of POEs into joint stock companies with functioning boards of directors. In addition, screening and hiring processes, internal and external audits, and public procurement and recruitment processes are being put in place. Managing directors have all been replaced and investigations are underway.

UNMIK's experience has shown that it is necessary for the peace process and the economic recovery

projects to complement each other so that economic resources are used to further the peace process instead of falling into the hands of obstructionists. Mechanisms aimed at economic recovery must be designed to further the goals of the peace process. Thus, they may differ from traditional economic development strategies.

Lessons: Smart oversight, in real time, is essential, and is the sine qua non of success. This means researching and knowing the local people. It means getting directly involved in setting appropriate policies in key corporate functions such as hiring, firing, promotion, procurement, finance, and audit, before these functions are put in place and precedents are set. Transparency should be ensured by setting clear lines of accountability and establishing effective, non-cumbersome means of enforcement. Managers should track implementation carefully and directly, and get involved in the details. Systematic engagement is best, but frequent, random engagement is acceptable. Managers can ease off once things are functioning smoothly, but cannot expect to disengage as long as they are responsible.

Incompetence and Instability

In Kosovo, some POEs were used as job-creation vehicles for former Kosovo Liberation Army (KLA) combatants, leading to an incompetent workforce. The enterprises were filled with redundancies and employed workers who often lacked the requisite skills. This drained KEK, the electric company, for example, of money that could have been spent supplying Kosovars with electricity.

The inability of the international community to manage and deliver regular electricity supply has become a symbol for the failure of the international forces and has fomented instability in Kosovo. "Why should we trust the international community with our nation," Kosovars wonder, "if after eight years and one billion euros, they still can't get our toasters to work?" The problems at KEK add to instability, impede economic development, and serve as a rallying cry for those opposed to UNMIK.

Lessons: If publicly owned enterprises are going to be used as vehicles for demobilizing and reintegrating ex-combatants, this should never be done at the expense of the public service's viability. If a reintegration program must be instated, conditions and limits should be imposed on the program, and it should be closely monitored. If ex-combatants do not have the required skills, a human capacity development program is needed to support the reintegration process.

Consider Political Economy

The UNMIK experience exposes some of the ways in which reopening SOEs can affect the relationship between resources and politics. It is critical to pay attention to wealth-power relationships in particular because, "depending on the nature of that nexus, a postwar political economy can either fuel further violence or promote peace."¹⁴ This suggests that as the United States engages in the process of revitalizing SOEs in Iraq, it is important to take an integrated analytical approach that addresses questions such as: Who is directly empowered by opening a factory? Who is empowered along the supply chain as providers or recipients of goods and services created by an operational facility? Where are the points along that chain that require particularly rigorous oversight? As the forthcoming USIP Special Report, "Employment Generation and Economic Development in Stabilization and Reconstruction Operation," observes:

If not carefully executed, well meaning schemes to revitalize economic activity, such as state-owned enterprises, could inadvertently empower spoilers and fuel conflict. Safeguards must be put in place to ensure that those empowered do not perpetuate conflict. These safeguards include: real-time oversight, audits, boards of directors, and payroll mechanisms designed to benefit employees and limit corruption. ¹⁵

Lessons from Kosovo underscore the need for conflict analysis to inform the decision to revitalize SOEs. UNMIK's experience also illustrates that in order to realize the utility of reopening these enterprises in a post-conflict environment, safeguards must be implemented to ensure that resources generated through the

operation of SOEs do not empower the drivers of conflict.

Notes

1. Sara Wood. "U.S. Restoring Iraqi Factories." *American Forces Press Service*, Jan. 18, 2007. Accessed at <http://www.defenselink.mil/News/NewsArticle.aspx?id=2741> on February 23, 2007.
2. It is important to note that significant resources have been dedicated throughout the S&R effort to secure and maintain those Iraqi SOEs that provide essential services such as water, electricity, and transportation (roads and bridges). The SOEs that are the subject of BTA's recent efforts produce consumer and durable goods such as rubber, cement, automotive goods and pharmaceuticals.
3. Sara Wood. "U.S. Restoring Iraqi Factories." *American Forces Press Service*, Jan. 18, 2007. Accessed at <http://www.defenselink.mil/News/NewsArticle.aspx?id=2741> on February 23, 2007.
4. L. Paul Bremmer. "Operation Iraqi Prosperity." *Wall Street Journal*, June 20, 2003. Accessed at <http://usinfo.state.gov/mena/Archive/2004/Feb/12-536238.html> on February 23, 2007.
5. Pamela Hess. "Analysis: Restarting Iraq's Factories." *United Press International*, January 9, 2007. Accessed at <http://www.upi.com/SecurityTerrorism/view.php?StoryID=20070108-032116-8471r> on February 23, 2007.
6. Sara Wood. "U.S. Restoring Iraqi Factories." *American Forces Press Service*, Jan. 18, 2007. Accessed at <http://www.defenselink.mil/News/NewsArticle.aspx?id=2741> on February 23, 2007.
7. Sara Wood. "U.S. Restoring Iraqi Factories." *American Forces Press Service*, Jan. 18, 2007. Accessed at <http://www.defenselink.mil/News/NewsArticle.aspx?id=2741> on February 23, 2007.
8. James Glanz, "Iraqi Factories, Aging and Shut, Now Give Hope." *The New York Times*, January 18, 2007. Accessed at <http://www.nytimes.com/2007/01/18/world/middleeast/18factory.html> on February 22, 2007.
9. Keith Crane. "Iraq's Jobs-for-Peace Mirage." *Project Syndicate*, February 11, 2007. Accessed at www.project-syndicate.org on February 22, 2007.
10. James Wasserstrom. Presentation at USIP Infrastructure and Conflict Working Group, February 1, 2007.
11. In Kosovo, state-owned enterprises are commonly referred to as publicly-owned enterprises (POEs).
12. James Wasserstrom. Presentation at USIP Infrastructure and Conflict Working Group, February 1, 2007.
13. Stephanie A. Blair, Dana Eyre, Bernard Salomé and James Wasserstrom. "Forging a Viable Peace: Developing a Legitimate Political Economy" in *The Quest for Viable Peace: International Intervention and Strategies for Conflict Transformation* edited by Jack Covey, Michael J. Dziedzic, and Leonard R. Hawley. Washington, D.C.: United States Institute of Peace (2005), p. 232.
14. Blair, Eyre, Salomé and Wasserstrom, p. 206
15. Johanna Mendelson-Forman and Merriam Mashatt. "Employment Generation and Economic Development in Stabilization and Reconstruction Operations." United States Institute of Peace Stabilization and Reconstruction Series No. 6. Washington, DC: United States Institute of Peace, March 2007.

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