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Investing in Iraq and Jump-Starting the Iraqi Economy: Business Views on Legal and Regulatory Reform

Abdulwahab Alkebsi
Regional Director, Africa and the Middle East, CIPE

Aleksandr Shkolnikov, Ph.D.
Senior Program Officer, Global Programs, CIPE

Article at a glance

Recently, CIPE carried out a series of in-depth focus group interviews with more than 120 Iraqi business leaders in an effort to provide a deeper understanding of the issues they face in conducting business in Iraq. The interviews engaged business people from across the country, including those from Arbil, Babel, Baghdad, Basra, Kirkuk, Najaf, and Sulaymaniyah, as well as Iraqi business owners and investors residing in Amman, Jordan. Major findings include:

- The Iraqi business community suffers from a lack of clarity in legal and regulatory frameworks and administrative corruption.
- The current framework for implementing the 2006 Investment Law lacks clearly defined responsibilities and objectives, undermining its effectiveness.
- Although local business are the best source of information for policymakers on legal and regulatory changes, mechanisms for participation, such as business associations and chambers, need strengthening.

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1155 Fifteenth Street NW • Suite 700 • Washington, DC 20005 • USA
ph: (202) 721-9200 • www.cipe.org • e-mail: cipe@cipe.org

The Importance of Investment and Trade in the Iraqi Economy

After the recent second Iraq Oil and Gas Summit held in Houston, Texas, an exasperated energy executive, commenting on investment prospects in Iraq, concluded that "obviously people see potential, but how do you do business in Iraq? Nobody is going to jump in with two feet."[1] While this particular statement speaks to the attractiveness of Iraq's lucrative petroleum industry, foreign investors seeking to do business across all sectors of the Iraqi economy share the very same sentiment.

Corruption, ineffective regulation, and the resulting lower levels of investment have weakened the bread-and-butter of the Iraqi economy – its natural resource sector – just as they have other economic sectors, especially those relying on trade. The Iraqi Commission on Public Integrity (CPI) has confirmed that since 2003 the losses from smuggling of crude oil and other oil products have amounted to $90 billion. Moreover, only 441 oil wells out of more than 1,000 in the country are fully operational and less than half of the 4.2 million barrels of export capacity is being utilized, according to CPI. In the past five years, not a single new refinery has been built despite a multitude of offers from foreign investors.

It is not just foreign investors who are frustrated over the wasted investment potential in the country – the domestic business community shares the same concerns, seeing opportunities but not always being able to take advantage of them. In fact, there is little difference between foreign and domestic investors in terms of their mindset – everybody wants their investment to be safe and secure. Yet, if there is one advantage that domestic investors really do have, it is local insight and key market information that may not be easily recognized by an outsider.

In this regard, foreign investors look to the domestic business community as a crucial indicator of the investment climate quality and the country's development course. If the domestic business community is staying put and would rather keep its money safe elsewhere, foreign investors have every reason to take that as an indicator of a weak investment climate. What assurances would they have that the rewards will outweigh the risks? As such, the attitudes and experiences of the Iraqi business community provide important insights into investment potential of the country, the quality of the business climate, and reform priorities of both the government and the private sector.

Since 2004, the Center for International Private Enterprise (CIPE) has regularly surveyed the Iraqi business community to measure its views on a host of economic, social, and policy issues related to the country's transition from a centrally planned economy to a more market-friendly environment. In 2008, CIPE carried out a series of in-depth focus group interviews with more than 120 Iraqi business leaders in an effort to provide a deeper understanding of the issues they face in conducting business in Iraq. The interviews engaged business people from across the country, including those from Arbil, Babel, Baghdad, Basra, Kirkuk, Najaf, and Sulaymaniyah, as well as Iraqi business owners and investors residing in Amman, Jordan. Most of the participants who were queried were owners of their own business (55 percent), with those in family-owned enterprises (23 percent) and involved in other types of business partnerships (21 percent) also constituting a significant share. The majority of respondents were engaged in trade (48 percent), industrial activities and construction (18.5 percent each), and financial services (9 percent), with 90 percent of interviewed firms employing 20 workers or less.

The strong representation of Iraq's trade sector provides certain glimpses into its economic structure – mainly indicating that trade activities have been some of the major drivers of the Iraqi economy, both in the formal and informal sectors. Many business people interviewed by CIPE commented that the industrial and agricultural sectors of the Iraqi economy have been fading away, as the increase of imports from neighboring countries continues to grow. In fact, some participants noted a strange irony in the fact that Iraq, known for its abundant water and fertile land, imports vegetables from countries like Jordan, which is essentially a desert.

The importance of the trade sector in the Iraqi economy also meant that a significant share of the focus group discussion focused on the Import/Export Law, which has a direct bearing on the ability of traders to survive and succeed. Investment as well as finance and taxation laws were also important discussion topics. Stock exchange and ownership laws were generally deemed less relevant for the broader segment of the business community.

The Need for Legal and Regulatory Reform

Much of the focus group discussions centered around the need for regulatory reform as a means of jump-starting the Iraqi economy and attracting investment. Although regulatory reform has become a buzzword in development, and, as a result, its meaning has been stretched thin, it can generally be regarded as reforms encompassing regulatory development, enactment, and implementation, along with fair and consistent enforcement. CIPE's private sector consultations in Iraq focused on the ultimate goal of ongoing reforms – building a more market-friendly economic environment. This requires overcoming the challenges of consolidating very different legal and regulatory frameworks: Saddam-era, Coalition Provisional Authority (CPA), and post-2004 sovereign Iraqi laws and regulations.

The focus group discussions illustrated the importance of balancing the need for new legislation with refining and ensuring enforcement and implementation of existing legislation. Moreover, the process through which such reforms are initiated and implemented – and not just their resulting outccome – is a defining feature of their success. Only when the process of lawmaking is transparent and open to various stakeholders can reforms be successful and generate the feeling of local ownership. For instance, during the focus group discussion on the Investment Law, Iraqi Businessmen Federation representatives were very supportive, calling it the best law in the region and citing their own recommendations that were included in the final version. Other private sector groups, who were not part of the process of drafting the Investment Law, were less enthusiastic.

This dissonance underscores the challenges of the regulatory reform process, especially in post-conflict settings. Reforms often start from the outside, with international experts flying in to develop new legislation based on international best practices, which is then introduced in place of outdated laws, rules, and regulations. Although such a process may provide countries with important access to a high-quality knowledge base, it also

Major Iraqi laws reviewed in CIPE focus groups

- Import/Export Law
- Investment Law
- Stock Exchange Law
- Finance Law
- Taxation Law
- Ownership Law

The Import/Export Law generated the most discussion, reflecting the composition of the focus groups (48 percent of participants engaged in trade) and the fact that trade remains a major activity in the Iraqi economy. The Investment Law also generated discussion and was noted as a milestone in the development of the Iraqi economy. The Kurdistan region exhibited most interest in this law, which is explained in part by a more stable security situation there and consequently a more stable flow of investments (as compared to other parts of Iraq).

The Finance Law, regarded as essential for moving investment deals from the conception stage into actual projects, generated most discussion in Arbil, Kirkuk, and Sulaymaniyah. The Taxation Law was not widely discussed, with business owners in Arbil most interested in identifying the existing issues within the law. The Stock Exchange Law was generally regarded by respondents as bearing relevance only for Baghdad, with business owners from Babel also showing some interest. The Ownership Law did not generate much discussion, except for business owners in Basra who viewed it as an important tool to protect property and a variety of commercial, industrial, and foreign investment activities.

leaves the local business community on the sidelines, since much of the dialogue happens among international experts, economists, and key government officials, without local stakeholders.

Where business consultations on regulatory reform are part of the process in post-conflict settings, time, security, and other constraints may limit participants to a few prominent business interests rather than a broad swath of a country's private sector representatives. Yet, the business community at large is still expected to comply with these regulations, which frequently end up serving the narrow business interests that influenced them rather than providing a better institutional environment for all businesses to create jobs and spur development and post-conflict reconstruction.

In evaluating the regulatory reform priorities in Iraq, the business community noted three distinct needs:

- Updating existing laws pertaining to the business community and ensure their consistent and fair enforcement.
- Reducing red tape as it relates to conducting business operations.
- Enacting the Investment Law of 2006 to promote inclusion of international firms in the Iraqi economy. The focus group responses are generally consistent with CIPE's earlier surveys of the Iraqi business community, which have shown that 63 percent of Iraqi business owners consider regulatory reform as the most important issue facing the business community besides the security situation.

One key issue in dealing with existing regulations and in initiating reforms, as noted in focus group discussions, is the inability of the Iraqi business community to easily access laws, regulations, and the policymaking process that creates them. This reflected CIPE's 2007 survey of the Iraqi business community, when 74 percent of respondents felt that Iraqi trade laws and regulations were not easily available or understood by the private sector. Similarly, 52 percent of respondents in the same survey felt that the Iraqi business community had little or no influence on government policy on business-related legislation.

The overlapping nature of existing laws and multi-ministerial oversight of most business-related laws compounds the challenge of regulatory reform. For example, Investment Law 13-2006 ostensibly sets the framework by which both domestic and international firms may invest in Iraq. This law created both the National Investment Commission and Provincial/Regional Investment Commissions, each of whose responsibilities and means of achieving objectives are not clearly defined and even understood by all relevant parties in Iraq.

The Investment Law involves no fewer than three ministries and the National Investment Commission in making decisions about each stage of conducting business. The Ministry of Trade

Private sector comments on the Iraqi Investment Law

The 2006 Investment Law was generally regarded as a milestone for the development and progress of the Iraqi economy. The Iraqi business people recognized it for providing the framework for private sector development, infrastructure improvement, and job creation. CIPE's focus group participants noted its role in encouraging foreign and stimulating domestic investment, as well as setting proper boundaries for the government's role in investment promotion. The law has also led to the establishment of provincial investment commissions with private sector representation, a marked improvement in Iraq according to the business community.

However, while the law itself is very relevant for Iraq, its implementation and enforcement have lagged. Partly due to a weak legal and regulatory structure, high levels of administrative corruption still play a significant role in discouraging investment. The security situation adds to corruption woes and also keeps investors from committing to the Iraqi market regardless of the opportunities present. Some have also noted that the country has been hurt by the years of embargo, which kept its business community from acquiring many modern technologies and management tools.

provides the appropriate paperwork to start a business, the Ministry of Finance has final say on land and tax issues, and the Ministry of Industry and Minerals provides additional licensing requirements. The National Investment Commission oversees the entire process. Additional ministries may also be involved in the process depending on the nature of the potential investment.

CIPE's focus group and survey results regarding the need for regulatory reform are further validated by the World Bank's annual *Doing Business* surveys of the impact of government rule-making on business activity. Since 2006, Iraq's ranking in *Doing Business* has slipped from 114th in the world to 152th in 2009. These results look grim when compared to a Middle East and North Africa (MENA) regional average ranking of 81 and the Gulf countries' average ranking of 38.

Iraq's key deficiencies noted by the 2009 *Doing Business* survey include: starting a business, protecting investors, enforcing contracts, and closing a business. In each of these areas Iraq ranks below average or at the bottom of MENA region countries. The confusion and lack of knowledge regarding business-related legislation and regulations on the part of the Iraqi business community, demonstrated in CIPE's focus group and survey results, is also evident to the international business community.

This lack of legal clarity inevitably leads to lower levels of foreign investment and/or higher premiums sought by those firms choosing to invest in Iraq. Given the current state of the global economy and the relative scarcity of credit, investors only want to enter countries that have a clear legal framework and offer efficient and transparent means to pursue profitable endeavors.

Iraq simply does not meet these criteria. Yet after decades of conflict and international sanctions, Iraq urgently requires large amounts of foreign investment to upgrade its obsolete infrastructure. Upgrading Iraq's petrochemical and electricity generation capabilities alone are estimated to cost $50 billion[2] and $20 billion,[3] respectively, over the next five to six years. The need for foreign investment is clearly demonstrated in Iraq; what is not clear is whether Iraq can make competitiveness a top national priority at best, or at least provide an average, stable environment to meet investment needs without paying an exorbitant risk premium to both the domestic and international business community.

Interest rates and letters of credit in Iraq

Two specific business-related items noted by CIPE's focus group respondents centered around the issue of financing opportunities in Iraq: the rate of interest charged by banks and the ability to issue an international letter of credit.

Since 2003, interest rates in Iraq have been governed by the Stand-By Agreements concluded between the government of Iraq and the International Monetary Fund. As a pre-condition of sovereign debt-relief for Iraq and in the interest of price stability, interest rates were set in the high teens by the Central Bank of Iraq. This led banks to put greater emphasis on placing deposits with the Central Bank, and gaining a high, risk-free rate of return, instead of taking a much higher risk of loaning funds to commercial and consumer customers with no guarantee of repayment. Recent changes to the Stand-By Agreement have lowered interest rates in Iraq to approximately 10 percent.

The issuance of international letters of credit in Iraq by the private banking system is an impediment for Iraqi businessmen transacting with foreign firms. Much emphasis is placed upon the technical ability of private Iraqi banks to issue and transmit letters of credit on behalf of Iraqi customers, and this emphasis is misplaced.

The basic rules of international letters of credit dictate that there must be both an issuer and a beneficiary in order for a transaction to take place. Currently, most private banks in Iraq do not have the appropriate correspondent relationships with banks outside of Iraq. This is the reason why letters of credit are rarely written by private Iraqi banks, since there are no corresponding beneficiaries who will honor the letters of credit. This situation can be remedied by private Iraqi banks through the adoption and implementation of international banking standards, transparency, proper corporate governance, and the establishment of correspondent relationships with non-Iraqi banks.

The Problem of Corruption

Whether as a result of the lack of regulatory reform or part of its cause, corruption in Iraq is a grossly debilitating phenomenon. Respondents in CIPE's focus group and earlier survey results noted corruption must be addressed by the Iraqi Government in a real and effective manner. In 2007, CIPE found that 87 percent of all Iraqi business owners viewed corruption as a significant problem facing the country. In the same CIPE survey, 53 percent of respondents estimated that corruption adds over 20 percent to their cost of doing business and 43 percent of respondents claiming 30 percent or more in additional costs due to corruption.

Participants in CIPE's focus group discussions and earlier 2007 survey findings note the processing of business applications, service delivery, and gaining proper access to necessary imports as the main areas of corrupt practices. Additionally, CIPE's 2007 survey of business owners show that 52 percent of the business community believe the Iraqi Government is not transparent when awarding of contracts through various ministries.

Focus group respondents have drawn some connections between lack of regulatory reforms and high levels of corruption, especially in the area of trade (as related to the Import/Export Law). While administrative corruption has flourished since the rule of law collapsed due to conflict, it has not been the only reason. Corruption has grown as the Import/Export Law has turned out to be ineffective in setting up a framework for fair and competitive trade dealings.

This flawed law prompted many businesses to engage in various importation and trademark manipulation of procedures, ultimately resulting in the payment of bribes for processing applications or expediting transactions. For instance, some have imported counterfeit goods, but have obtained legitimate quality certificates from the government through bribery. Not only does this law encourage corruption and put honest competitors out of business, it also endangers the public – especially when authenticity is approximate to safety, such as in the case of spare vehicle parts.

CIPE's focus group discussions and earlier 2007 survey findings are also bolstered by Transparency International's annual *Corruption Perceptions Index* (CPI). Iraq ranks at the bottom of Transparency International's most recent CPI survey with a score of 178 for 2008. This compares to a MENA average of 76 and a Gulf country average of 49, both also for 2008.

Similar to problems with regulatory reform, the Iraqi Government's efforts to curb corruption are clouded by legal and regulatory inconsistencies and overlapping prerogatives of various anti-corruption institutions. There are three national agencies whose mission is to combat public sector corruption in Iraq: the Board of Supreme Audit, the Commission on Public Integrity, and the Offices of Inspectors General. The roles and responsibilities of each agency remain unclear and appear to be gripped by political and administrative indecision.

In addition, as noted by a recent Organisation for Economic Co-Operation and Development survey, information on the powers and resources of Iraqi institutions responsible for procurement control is lacking and clarification of their tasks and responsibilities in legal sources remains weak. Furthermore, documents needed for monitoring public auditors and inspectors in Iraq are rarely available, and where they are – access is limited.

Developing the Private Sector's Capacity to Create Jobs

Beyond major laws, focus group participants also identified a number of other reforms needed to spur economic growth and provide the private sector with an environment conducive to creating jobs. The lack of private sector capital and high interest rates for small and medium-sized enterprise loans (in many cases over 20 percent) has led business owners to call for an increased government role in providing financing for business. Respondents from nearly all Iraqi regions have highlighted the lack of available capital for running and growing their enterprises. This finding also corresponds to

CIPE's earlier surveys of the business community, which have shown that the majority of small business owners raise capital through their friends, family, and savings, rather than obtaining loans from banks and other financial institutions.

Most focus group participants supported the introduction of stricter import controls, mainly to control dumping and protect the local market from low-quality goods, thus providing some base for domestic producers to compete on a fair basis. Counterfeit and low-quality goods dumped on the Iraqi market have been responsible, at least in part, for the deterioration of the country's industrial base, significantly contributing to the high levels of unemployment (as high as 50 percent according to some Iraqi estimates). Some participants even blamed government policies for facilitating this process – in several industries licensing requirements stipulate importation of industrial inputs even though local substitutes are readily available. According to business owners, marketing of locally available production inputs should be done more effectively by the government, especially in larger government projects.

Among other measures suggested to stimulate trade were the establishment of free trade zones along Iraqi borders with the infrastructure already provided by the government; development of non-governmental organizations (such as trade associations) to support the private sector; and provision of official venues for fairs and exhibitions (which has proven to be quite effective in Sulaymaniyah).

Numerous focus group sessions brought up the point on infrastructure, especially as the discussion turned to the need for and the lack of foreign investment in Iraq. Currently in most regions, foreign investors are responsible for developing all the infrastructure associated with their investment – provision of power, water, sanitation, communications, and roads. These costs discourage many potential investors. Kurdistan, however, takes on the provision of basic infrastructure for investment projects and, in addition to the stable security situation, high levels of investment have been linked to this commitment.

Iraq reform priorities

In CIPE's focus group discussions, the private sector identified the following reform priorities needed to spur investment and economic activity in Iraq, as related to the six major laws reviewed by the participants:

- Set proper controls on imports and exports to ensure quality control and provide a competitive field for domestic producers.
- Work with the Standards and Specifications Office to improve product standard guidelines.
- Launch a private sector awareness campaign to encourage the use of resources for domestic production rather than export for processing abroad and then re-importation (encourage domestic value creation).
- Engage customs authorities in developing the relevant measures to combat dumping and promote exports.
- Streamline taxation of imports, cancel or reduce the tax rates on imported items essential for local production.
- Improve procedures for issuing the letters of credit.
- Strengthen investment promotion activities, especially in the Kurdistan region, capitalizing on available resources and a stable security situation.
- Review the Finance Law to ensure consistency in how regions are treated in regards to financing of business activities.
- Develop specific industrial banks to finance business activities.
- Develop new mechanisms for verifying tax payment on business operations and provide independent audits.
- Ensure that the stock exchange is fully open to participation of foreign investors.
- Enforce the Ownership Law as an assurance for foreign investors against possible nationalization of their assets.
- Develop private sector enterprise support services.
- Ensure that government provides the necessary infrastructure instead of stipulating that investors develop infrastructure on their own.

Corruption in Iraq links directly to a large bureaucracy, often operating with little transparency, unclear mandates, and much discretionary authority. Business people from most of the regions surveyed by CIPE, except those from

Arbil and Babel, have decried administrative corruption and actually supported bureaucracy as a mechanism to control corruption, especially in the provision of services and processing of various business applications. The difference, perhaps, stems from how one views corruption – whether it is initiated by public officials (extortion) or by the private sector to gain competitive advantage (bribery).

Overall, participants identified several major reasons for high levels of corruption in Iraq:

- The government is not willing to do much to combat corruption as it itself is part of many corrupt transactions.
- The media is unwilling and untrained to report on corruption and conduct investigative journalism.
- Bureaucracy, red tape, and complex systems as well as opaque and conflicting laws.
- Weak judicial system.
- Poor accounting and taxation rules.
- Weak enforcement of ownership rights
- Centralization of administrative systems.
- Lack of public awareness of the levels and costs of corruption.
- Low salaries for public employee.

The Role of Chambers of Commerce

Membership in chambers of commerce was also an issue discussed in detail during focus groups. As private sector institutions, chambers provide an avenue for collective action – such as channelling private sector frustration over basic failures in governance into concrete reforms and advocacy programs. They also provide a number of important services to support essential private sector operations such as drafting contracts and other legal documents, dealings with government entities, or organizing trade shows and fairs to promote investment and facilitate trade.

Services expected from chambers of commerce

CIPE's focus group participants outlined and ranked services they would like to receive from chambers in order of importance:

1. Sponsoring conferences.
2. Providing information on local and national laws.
3. Advocating on the behalf of the private sector.
4. Distributing membership directories and other publications.
5. Providing members with needed information.
6. Improving in the quality of the services provided.
7. Creating and providing professional development opportunities.
8. Strengthening networking with business people abroad.
9. Providing market analysis relevant to business performance, such as economic forecasts.

Although many Iraqi businesses join chambers and pay a membership fee, the focus groups revealed a perception that chambers do not fulfil their mandate, whether by not providing the services expected or serving for the purposes of the executive committee rather than broad-based membership. Although participants noted that in some regions the membership in chambers is relatively high, it is still far from their potential. Many businesses refuse to join chambers because services are often of a poor quality and membership procedures are too complex.

Conclusion

Iraq faces a paradox in terms of developing a more free market business environment. There is little disagreement as to the country's needs for investment and infrastructure rebuilding. While the needs are great, the business environment continues to suffer from a lack of clarity in the legal and regulatory frameworks and rampant levels of corruption. These two elements will continue to hamper Iraq's ability to attract and sustain domestic and international investment crucial to rebuilding the country and establishing Iraq as an economic force in the region. Iraq must decide on the path it wishes to take in terms of economic policy and regulatory reform. Failure to address these issues in a coherent and systemic fashion will lead to a lack of legitimate business activity in the country and high premiums paid for those firms (domestic and international) willing to operate inside the country.

The Iraqi business community has an important role to play in implementing the necessary reforms. As CIPE's surveys and focus groups clearly show, local businesses are the best source of information for policymakers on what legal and regulatory changes are needed to improve the country's business environment.

In order to further Iraq's reconstruction and market-oriented development, the government should take advantage of this local knowledge and make the broad-based business community a partner in reform. The paradox that must be addressed is that government must take more seriously its role as regulator and enforcer, but it must also see that role as one that enables private sector leadership in development rather than purely public leadership.

Endnotes

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Abdulwahab Alkebsi is the Regional Director for Africa and the Middle East at CIPE. Prior to joining CIPE, Alkebsi served as the Director of the Middle East and North Africa division at the National Endowment for Democracy (NED), where he oversaw a portfolio that included Afghanistan, Iran, Iraq, the Gulf nations, the Levant, North Africa, and Yemen. Before working at the NED, Alkebsi served as the Executive Director at the Center for the Study of Islam and Democracy (CSID). Alkebsi was born in Yemen, and resides in Chantilly, Virginia with his wife and three daughters.

Aleksandr Shkolnikov is the Senior Program Officer for Global Programs at CIPE, where he manages a variety of programs on corporate governance, anti-corruption, democratic development, and business association advocacy. A native of Moscow, Russia, Shkolnikov holds a Ph.D. in economics, a master's degree in international commerce and policy, and a bachelor's degree in marketing – all from George Mason University in Fairfax, Virginia.

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