



March 2006

**The
Third Annual
Iraq and
US Defense Budget
Issue**

**Iraq's crude oil
production is
half a million
barrels per day
less
than it was before
the invasion.**

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EPS QUARTERLY

the newsletter of economists for peace and security

Contractual Rip-off: The Cost of PSAs to Iraq

Greg Muttitt

While the advantages of production sharing agreements (PSAs) for multinational oil companies are clear, there is a severe shortage of independent analysis of whether PSAs are in the short-, medium- and long-term interests of the Iraqi people. Unfortunately, the Iraqi people have not been informed of the pro-PSA oil development plans, let alone their implications, which have transformed so seamlessly from US State Department recommendations into Iraqi government policy.

Our analysis shows that production-sharing agreements have two major disadvantages for the Iraqi people:

1. The loss of hundreds of billions of dollars in potential revenue;
2. The loss of democratic control of Iraq's oil industry to international companies.

PSAs may also undermine an important opportunity to establish effective public oversight and end the current corruption and financial mismanagement in the Iraqi oil sector.

Once signed, PSAs generally last (with fixed terms) for between 25 and 40 years. The Iraqi people would have to live with the consequences for decades.

Losing revenue: how much would PSAs cost the Iraqi people?

In order to understand why foreign oil companies are so keen to invest in Iraq, one needs to look at the economic results of applying PSA contracts to the Iraqi oil sector.

We have produced economic models of 12 of Iraq's oilfields that have been listed as priorities for investment under production sharing agreements. We do not know yet what terms Iraqi contracts might contain (that will

not be known until they are signed - and possibly not at all, if they are not disclosed to the public). We have therefore taken contractual terms used in other comparable countries, and applied them to the physical characteristics of Iraq's oilfields (based on data from the Iraqi Oil Ministry, the US government and respected industry analysts such as Deutsche Bank). This process allows us to project the cashflows to the Iraqi state and to foreign oil companies, under a range of assumptions (such as oil price).

Specifically, we look at terms used in Oman and Libya (both having comparable physical conditions to Iraq) and Russia (the only country with any PSAs which has reserves at all comparable in scale to Iraq's). The terms recently applied in Libya are widely viewed to be among the most stringent in the world. We have then compared the results with expected revenues of a nationalized system, administered by state-owned oil companies.

Using an average oil price of \$40 per barrel, our projections reveal that the use of PSAs would cost Iraq between \$74 billion and \$194 billion in lost revenue, compared to keeping oil development in public hands (see Table 1, page 6).

This massive loss is the equivalent of \$2,800 to \$7,400 per Iraqi adult over the thirty-year lifetime of a PSA contract. By way of comparison Iraqi GDP currently stands at only \$2,100 per person, despite the very high oil price.

It should be noted that these figures relate to only twelve of Iraq's more than 60 undeveloped fields. Iraq has identified 23 priority

(continued on page 6)

**The use of PSAs
would cost Iraq
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and \$194 billion in
lost revenue.**

President's Budget Request Increases DoD Spending by 7%

Chris Hellman

"Top Line" Funding: The Bush Administration is requesting \$439.3 billion for the Department of Defense in Fiscal Year 2007, which begins on October 1, 2006. This is \$28.5 billion more than the current level of \$410.7 billion, an increase of 7 percent. This figure does not include funding for the nuclear weapons activities of the Department of Energy, which is considered part of total Defense Department spending. Nor does this figure include the costs of ongoing military operations in Iraq and Afghanistan.

The Office of Management and Budget estimates that total annual funding for the Defense Department alone will grow to \$502.1 billion by fiscal year 2011. Total Pentagon spending, not including funding for the Department of Energy or for actual combat operations for the period FY'07 through FY'11, will exceed \$2 trillion. Meanwhile, in January the Congressional Budget Office estimated that the deficit for FY'06 will be \$360 billion.

Funding for Contingency Operations (Supplemental Appropriations): In addition to its annual budget request, the Pentagon also announced that it will shortly request \$70 billion in supplemental funding for combat operations for Fiscal Year 2006, which is in addition to \$50 billion in FY'06 supplemental funding approved by Congress as part of their regular 2006 budget work. In addition, the request includes plans to seek a \$50 billion "bridge fund" request to cover Iraq and Afghanistan operations during the first part of FY'07. Congress has already approved over \$300 billion in supplemental funding for operations in Iraq and Afghanistan.

Missile Defense: The Administration is requesting \$10.4 billion for missile defense in FY'07, up roughly \$1.7 billion from the current \$8.7 billion. Missile defense continues to receive more funding than any other weapons program in the annual Pentagon budget. This total does not include \$669 million for the Space-Based Infrared System (SBIRS-High) satellite program. The Airborne Laser program is transitioning from a deployment program to more of a technology demonstration program.

Shipbuilding: The request includes funding for the continued development of the Aircraft Carrier Replacement Program (\$1.1 billion), the DD(x) Destroyer Program (\$3.4 billion), and the Littoral Combat Ship (\$840 million). It includes \$2.6 billion for the purchase of one SSN-774 "Virginia" class nuclear attack submarine.

Aircraft: The request includes \$2.7 billion for 30 of the Navy's F/A-18E/F "Super Hornet" (although news reports indicate that an additional six aircraft are being funded through supplemental appropriations), \$2.3 billion for procurement of 16 V-22 "Osprey" tilt-rotor aircraft, and \$5.3 billion for continued development of the F-35 Joint Strike Fighter and the procurement of the first five aircraft. The request also includes \$2.8 billion for the F-22 "Raptor" fighter but includes no aircraft, but instead funds advanced procurement and RDT&E for a 60 aircraft multi-year procurement beginning in F'08.

Military Personnel: The request includes an increase in base pay of 2.2 percent. According to the Pentagon, base pay

already has risen 25 percent since 2001. There are also targeted pay increases for specific skills, and \$1.9 billion for recruiting and retention.

Homeland Defense: The request contains \$16.7 billion for Pentagon activities related to homeland security including detection of and protection against weapons of mass destruction, emergency preparedness and response, and protecting critical infrastructure. NOTE: A footnote on the budget's Table "Homeland Security Funding By Agency" (Table S-5) indicates that DoD's contribution to homeland security has been revised upward significantly due to a change in methodology. Thus the budget shows a \$16.4 billion DoD contribution to homeland security in FY'06, rather than the \$9.5 billion shown in last year's request. The increase in DoD's contribution over last year is 1.6 percent.

Cooperative Threat Reduction (CTR): The Administration is requesting \$372.1 million for the CTR (also known as "Nunn-Lugar") program, 10.4 percent below the current level of \$415.5 million. Further, the request recommends a reduction (or rescission) of \$4.5 million in current funding. The CTR program assists Russia and the former Soviet republics safeguard weapons of mass destruction and related technologies.

Chris Hellman is Defense Budget and Policy Analyst at the Center for Arms Control and Non-Proliferation, in Washington, DC. This article is reprinted with kind permission.

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Letter from the Director

[T]he majority of the country has already decided that the war in Iraq has become too costly. Americans have rejected the prospect of funding a massive and prolonged occupation... Questions about the price of war keep resurfacing not because there's a credible argument for most Americans that the price is reasonable, but because our elected officials thus far have only pushed those costs ever higher... What remains is for us bring the political price of war into line with the human and financial costs that we will continue to bear.

- Mark Engler, *Alternet*, Feb.25, 2006

This is our third "anniversary of the Iraq War" issue. Kate Cell, editor of *EPS Quarterly*, and I decided that it was appropriate and right that our organization should take time each March to present analysis of various aspects of the war and its economic effects.

One thing that can be said for dictatorships is that they provide a certain amount of stability. Remove that heavy hand and old unsettled issues are bound to out. The current Sunni/Shiite conflict in Iraq was a predictable, even likely, consequence of removing Saddam Hussein from power without a clear plan for what to do next. Now the US is stuck in an unwinnable situation. To replace the dictatorship with half a million US troops, imposing order with an equally iron hand? To leave now, having unleashed a big mess, admitting defeat, and throwing the average Iraqi to the wolves? To continue to try to assist Iraq in building a stable democracy, at an extreme cost to the US and Iraq? There are no really viable choices available. And thus, as Walter Cronkite said in February of 1968 about another famous mess,

To say we are closer to victory today is to believe, in the face of the evidence, the optimists who have been wrong in the past... To say that we are mired in a stalemate seems the only realistic, yet unsatisfactory, conclusion.

In this issue, as Iraq struggles to create a government, establish economic policy and begin the business of recovery and rebuilding, two of our authors look at the formation of Iraqi economic policies. They examine the influence that American liberal market philosophy is having on the formation of these policies, and present

some alternatives that they believe would create more prosperity for more Iraqis.

A recent *Washington Post* article opined, "[T]he goals of balancing the budget, waging a global fight against terrorism and making Bush's first-term tax cuts permanent may be fundamentally at odds." We tend to agree. And so in this issue we also take a look at the US federal budget request and the Quadrennial Defense Review (QDR), both released in early February.

In a nutshell, the Pentagon is digging in for a "Long War against Terrorism," defense spending is up, social spending is down, and the deficit is not being ameliorated. The president proposes a budget driven by the assumption that military muscle is the primary tool for creating global stability, world peace, international security, and safety for the people who live in this country. According to the Friends Committee on National Legislation, 42 percent of our income taxes went to military spending in 2005. Since the Iraq occupation is being future-funded this number looks like it will continue to rise.

There is some good news, however. Due in part to pressure from EPS members and other citizen activists, the Bush Administration has taken its request for funding for Robust Nuclear Earth Penetrators, also known as Bunker Busters, off the table. Additionally, the request for the "advanced concepts initiative," that could have included a new, small nuclear weapon, has been left out. The White House has been keen on these programs, but Congress has refused to fund them in years past.

It's going to take a lot of work to get Iraq to the point of democratic self-government. Certainly I do not have a magic solution. Still, I remain an optimist; things will change in Washington. It is our job at Economists for Peace and Security "to promote greater understanding of the full range of economic causes, costs and consequences of violent conflict," including the political costs. I think those politicians who have not yet realized that public opinion is overwhelmingly against the war will find out for sure next November. Meanwhile, as we have since before the war started, EPS will continue to educate those in Washington and beyond as to the folly of continuing on our current path.

Thea Harvey

March 2006

The *EPS Quarterly* is published by Economists for Peace and Security, which promotes economic analysis and appropriate action on global issues relating to peace, security, and the world economy.

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The Latest Bush Budget Request: Key Numbers

National Security Legislative Calendar

\$562 billion: total military budget in fiscal year 2006 (including Iraq and Afghanistan wars and Department of Energy budget)

\$513 billion: total military budget request for fiscal year 2007 (including war funding thus far requested and Department of Energy budget; it is expected that the Administration will request more war-related funding later)^{1,2}

\$439.3 billion: Pentagon-only budget request for fiscal year 2007 (the number most often cited in media analyses)³

\$187 billion: total Bush Administration recommended cuts in non-defense programs over the next 5 years, including education, environmental protection, cancer and heart disease research, child care, assistance for low-income families, children, elderly and disabled people³

\$124.5 billion: supplemental request for Iraq and Afghanistan wars: of this total, \$74.5 billion is for fiscal year 2006, bringing that total to \$120 billion, while \$50 billion is for fiscal year 2007)

\$375 billion: total provided by Congress before the expected new request for Iraq and Afghanistan wars plus enhanced security at military installations, including more than \$260 billion for the Iraq war alone

\$499 billion: total for Iraq and Afghanistan wars plus enhanced security after the \$124.5 billion request

\$6.1 billion: monthly costs for Iraq war²

\$10.4 billion: missile defense, up \$1.7 billion from current budget

\$372.1 million: Cooperative Threat Reduction program (also known as Nunn-Lugar), a 10% cut from current level of \$415.5 million⁴

Zero: Nuclear bunker buster weapon (Robust Nuclear Earth Penetrator)

Zero: Advanced concepts initiative that could have included a new, small nuclear weapon

\$14.8 million: nuclear test ban readiness, a reduction of \$5 million from current level (the Administration has abandoned plans to accelerate preparations for a possible resumption of nuclear bomb testing at the Nevada test site from 24 to 18 months)

\$27.7 million: Reliable Replacement Warhead program

\$250 million: nuclear reprocessing initiative⁵

\$423 billion: projected federal budget deficit in fiscal year 2006, the largest in history

Sources:

1. Figures from Steven Kosiak, Center for Strategic and Budgetary Assessments, February 6, 2006.

<http://www.csbaonline.org/>

2. Figures from House Budget Committee, Democratic Minority, February 9, 2006.

http://www.house.gov/budget_democrats/analyses/07budget_summary_and_analysis%20.pdf

3. Figures from Center on Budget and Policy Priorities, February 10, 2006.

<http://www.cbpp.org/2-6-06bud.htm>

4. Figures from Christopher Hellman, Center for Arms Control and Non-Proliferation, February 6, 2006. <http://www.armscontrolcenter.org/archives/002239.php>

5. Figures from Alliance for Nuclear Accountability, February 6, 2006.

http://www.ananuclear.org/budget_rollout06/NNSA_04-07.pdf

The National Security Legislative Calendar, an e-mail service of the Council for a Livable World, is published every Monday morning when Congress is in session. You can subscribe, for free, at <http://www.clw.org/cgi-bin/dada/mail.cgi/list/nscalendar/>.

AEA/ASSA 2006 - Diary of a New EPS Board Member

Clark Abt

Saturday, January 7

At 10:15 in the large Sheraton (Boston) Constitution Room I attended the informative and inspiring Economists for Peace and Security (EPS) Roundtable, *Grand Strategy Against Global Poverty*, organized and chaired by Jamie Galbraith. The program featured two Nobelists, Amartya Sen and Joseph Stiglitz, Richard Jolly, and Nancy Birdsall, the President of the Center for Global Development. I had known Sen personally from occasional conversations with him about his anti-poverty and economic development work at Harvard's Institute for International Development

(now defunct) over the last 15 years, had tried to involve him in my and my company's overseas development work in Eastern Europe, Africa, and Asia, and was eager to hear his latest views on the worldwide anti-poverty campaign that had preoccupied me and my company and colleagues at Abt Associates for 40 years.

But the choice was not so easy, because my other personal preoccupation for four decades with the economics of defense and arms control was being addressed simultaneously in an American Economics Association session at the Hynes Convention Center next door on *The*

Economics of National Security, with Martin Feldstein presiding and interesting discussants Peter Garber and Alan Krueger.

At first I thought I would try shuttling between the two simultaneous sessions in two adjacent buildings. I went to the the EPS Roundtable room first, 15 minutes early, and found the large room half empty except for the first few rows. I put down my overcoat and papers on one of the few empty front row seats, went up to say hello to Jamie and Amartya, and told them I'd be back.

(continued on page 12)

Investors' Rights Trump Social Justice in Iraq

Herbert Docena

In June 2005, an Iraqi newspaper published what was then the latest draft of the constitution being negotiated by Iraqi politicians. Its contents revealed that the Iraqis wanted to build a Scandinavian-style welfare system in the Arabian desert, with Iraq's vast oil wealth to be spent upholding every Iraqi's right to education, health care, housing, and other social services. "Social justice is the basis of building society," the draft declared.

In other words, the Iraqis wanted nothing of the kind of economic and political system that US officials have been attempting to create in Iraq since the end of the war. As direct occupiers, the US enacted the so-called Bremer Laws. These give foreign investors equal rights to Iraqis in the domestic market; permit the full repatriation of profits; envisage the sale of state-owned companies; and privatize all kinds of social services; all of which could have been rendered unconstitutional under the June draft.

Enter Zalmay Khalilzad, the newly appointed US ambassador who was accused of serving as the "campaign manager" of pro-US candidate Hamid Karzai in Afghanistan's presidential elections. Khalilzad was a permanent fixture behind the closed doors where the real constitutional debates took place, and was described by the *Financial Times* as playing a "big role in the negotiations." He was backed up by US embassy officials who, according to the *Washington Post*, were working from a Kurdish party headquarters to "help type up the draft and translate changes from English to Arabic for Iraqi lawmakers." At one point, Khalilzad's team of US diplomats even offered their own proposed text of the constitution to the Iraqis.

One Kurdish member of the constitutional committee who was involved in the caucuses complained: "The Americans say they don't intervene, but they have intervened deep" [sic]. Nor were they acting as neutral mediators. US and UK officials, he said, were "being governed by their domestic agenda."

While Khalilzad and his team of US and British diplomats were all over the scene, some members of Iraq's constitutional committee were reduced to bystanders. One Shiite member grumbled, "We haven't played much of a role in drafting the constitution. We feel that we have been neglected." A Sunni negotiator concluded: "This constitution was cooked up in an American kitchen not an Iraqi one."

By the time the next draft constitution was leaked in late July, the progressive provisions in the June draft had disappeared. Gone was the article proclaiming a

The June draft promised free education and health care.

commitment to social justice as the basis of the economy. In its place was a provision binding the state to "reforming the Iraqi economy according to modern economic bases, in a way that ensures complete investment of its resources, diversifying its sources and encouraging and developing the private sector." Instead of revoking the so-called Bremer Laws, the new draft constitution would make Iraqis constitutionally bound to enforce them.

Also gone was the provision obliging the state to safeguard Iraq's oil. Instead, Article 110 of the draft constitution lays the ground for selling off oil assets by obliging the state to "draw up the necessary strategic policies to develop oil and gas wealth to bring the greatest benefit for the Iraqi people, relying on the most modern techniques of market principles and encouraging investment." By "modern techniques of market principles" the draft is referring to current plans supported by the interim government's top leadership to privatize the Iraqi National Oil Company and to open up Iraq's oil reserves to the big oil corporations. The constitution paves the way for the eventual acquisition of Iraqi assets by foreigners or multinational corporations. While the June draft stated that

"Iraqis have the complete and unconditional right of ownership in all areas without limitation," the final draft dropped the words "unconditional" and "without limitation" and added instead the qualification "except what is exempted by law." Given that Bremer's Order 39 already allows foreign ownership of Iraqi assets and that this order will be perpetuated as a law, the constitution in effect removes the restriction giving Iraqis exclusive ownership over assets in Iraq.

The June draft promised extensive welfare commitments to Iraqis, including free education and free health care. A subsequent draft said that welfare services will be provided but only if the government can afford them. The final draft gave vague assurances that the services will be delivered, but added new wording on the private sector's role in delivering them.

Iraq's constitution is critical because, as the basic law of the land, it establishes the fundamental legal foundation on which Iraq's neoliberal edifice is to be built. The media has tended to focus on the sectarian provisions of the constitution and ignored the insertion of economic provisions. But what most likely happened was that the US tolerated the adoption of religious provisions and agreed to the establishment of a federal system, as demanded by the Shia and Kurdish parties, in exchange for the introduction of neoliberal economic provisions in the constitution.

In the quid-pro-quo, investors' rights trumped women's rights and social justice. The June draft provided a hint as to what kind of constitution the Iraqis might have chosen if they had been left to their own devices.

Herbert Docena is a researcher with Focus on the Global South (www.focusweb.org), who has been following the reconstruction and political transition in Iraq. This article originally appeared in Red Pepper magazine and is reprinted with kind permission; a longer version of this report was published at www.atimes.com.

The Costs of PSAs in Iraq (continued from page 1)

fields on which to potentially sign contracts in 2006. Thus when the other 11 fields are added, along with a further 35 or more later, and especially other fields yet to be discovered (recall that Iraq's undiscovered reserves may be as large or even double the known reserves), the full cost of the PSA policy could be considerably greater.

Both the corporate lobby group ITIC and the British Foreign Office have argued that foreign investment can free up Iraqi government budgets for other priority areas of spending, to the tune of around \$2.5 billion a year. Although technically true, this is deeply misleading - as the investment now would be offset by the loss of revenues later.

Amazingly, in ITIC's report advocating the use of PSAs, the economic impact is only examined up to 2010 - ignoring the fact that any foreign investment must be repaid. It is as if one took out a bank loan but only considered the economic impact prior to paying it back!

In contrast, in our report, we look at the impact of PSAs over the whole length of the contract. Economists and indeed oil companies compare investments using the process of "discounting," and the concept of "net present value" (NPV). NPV is a measure of what the later income or expenditure would be worth if they were received or incurred now.

When looked at in these terms, far from "saving" the government \$8.5 billion of investment (the whole investment over several years, in 2006 NPV), these contracts will cost Iraq a (2006) NPV of \$16 - \$43 billion, at a 12% discount rate.

Our assumed oil price for these calculations is \$40 per barrel. The oil price is currently fluctuating around \$60 per barrel, and there is an argument that structural factors, such as increasing demand in China and India, mean that oil prices are likely to stay at this level - which would make our \$40 assumption conservative.

However, the oil price is notoriously difficult to predict. We therefore also look at the models at a higher price of \$50 and a lower price of \$30 per barrel. Here the models show that Iraq would lose \$55 to

Table 1: Impact of PSAs on Iraqi State Revenues

	Total undiscounted revenue (US\$ billion)	State take	Total revenue loss under PSA scenario (US\$ billion)
Nationalized	971	100%	-
Russia PSA terms	779	80%	192
Oman PSA terms	777	80%	194
Libya PSA terms	897	92%	74%

Figures in real terms (2006) prices, at constant \$40/bbl oil price, for the period 2006 - 2035. For details of full results, data sources, methodology and modeling assumptions, see <http://www.globalpolicy.org/security/oil/2005/crudedesigns.htm#A4>.

Table 2: Impact of PSAs on Discounted Iraqi State Revenues

	Total undiscounted revenue (US\$ billion)	State take	Total revenue loss under PSA scenario (US\$ billion)
Nationalized	183	100%	-
Russia PSA terms	140	77%	43
Oman PSA terms	147	80%	36
Libya PSA terms	167	91%	16%

Figures in real terms (2006) prices, at constant \$40/bbl oil price, for the period 2006 - 2035. For details of full results, data sources, methodology and modeling assumptions, see <http://www.globalpolicy.org/security/oil/2005/crudedesigns.htm#A4>.

\$143 billion at \$30 per barrel, while if the oil price averaged a higher \$50 per barrel, Iraq would lose far greater revenues of \$94 - \$250 billion, compared to the nationalized model. (See Table 2 above and Table 3, facing page.)

Massive profits: how much do the oil companies stand to gain?

Our economic model has also been used to calculate the key measure of oil project profitability - the Internal Rate of Return (IRR) - that the oil companies are expected to make. This provides another measure of whether PSAs represent a fair deal for Iraq.

Profitability varies according to the size of the oil field, so we have based our projections on three different fields that (in Iraq terms) are typical small, medium and

large oil fields.

Our figures show that under any of the three sets of PSA terms, oil company profits from investing in Iraq would be quite staggering, with annual rates of return ranging from 42% to 62% for a small field, or 98% to 162% for a large field. This shows that under PSAs, Iraq's loss in terms of government revenue will be the oil companies' gain. By way of comparison, oil companies generally consider any project that generates an IRR of more than a 12% to be a profitable venture. For Iraqi oil fields, even under the most stringent PSA terms, it is clear that the oil companies can expect to achieve stellar returns.

Even at prices of \$30 per barrel, profits are excessive on all fields, with any terms, ranging from 33% on a small field with stringent terms to 140% on a large field with

lucrative terms. At \$50 per barrel, the profits are even greater, ranging from 48% to 178% (See Tables 5 and 6).

Losing control: the democratic cost of PSAs

Iraq's democracy is new and weak. Having suffered decades of oppression by Saddam Hussein, Iraq's institutions and civil society need time to develop and mature. Many Iraqis may feel, in this situation, that they do not immediately wish to lock their country into any single model of oil development over the long term. Unfortunately, this is exactly what Iraqi politicians, under US and UK pressure, appear to want to do.

In theory, PSAs would

ownership and control over their oil resources.

tice they will impose severe restrictions on current and future Iraqi governments for the full lifetime of the contract.

(cont. on page 8)

Table 3: Impact of Alternative Oil Price Scenarios on Iraqi State Revenues

	Projected oil company Internal Rate of Return (IRR)			
	Total undiscounted revenue (US\$ billion)	Total NPV revenue at 12% (US\$billion)	Total undiscounted revenue (US\$ billion)	Total NPV revenue at 12% (US\$billion)
Nationalized	716	133	1,227	232
Russia PSA terms	580 (136)	104 (30)	977 (250)	175 (57)
Oman PSA terms	573 (143)	107 (26)	982 (245)	186 (46)
Libya PSA terms	661 (55)	122 (12)	1,113 (94)	212 (20)

Table 4: Impact of PSAs on Oil Company Profitability

	Projected oil company Internal Rate of Return (IRR)		
	Amara Field (small)	Nasiriya field (medium)	Majnoon field (Large)
Russian PSA terms	62	105	162
Oman PSA terms	51	83	120
Libya PSA terms	42	67	98

For \$40 per barrel average oil price, in real terms (2006 prices). For details of full results, data sources, methodology and modeling assumptions, see <http://www.globalpolicy.org/security/oil/2005/crudedesigns.htm#A4>.

Table 5: Oil Company Profitability at Different Oil Prices

	US\$30/barrel scenario			US\$50/barrel scenario		
	Amara	Nasiriya	Majnoon	Amara	Nasiriya	Majnoon
Russia PSA terms	46%	82%	140%	74%	122%	178%
Oman PSA terms	41%	67%	107%	60%	95%	131%
Libya PSA terms	33%	53%	53%	48%	79%	109%

The Costs of PSAs in Iraq (continued from page 7)

PSAs have four key features that will in practice limit and remove democratic control from the Iraqi people:

1) **They fix terms for 25 to 40 years, preventing future elected governments from changing the contract.** Once a deal is signed, its terms are fixed. The contractual terms for the following decades will be based on the bargaining position and political balance that exists at the time of signing - a time when Iraq is still under military occupation and its governmental institutions are weak. In Iraq's case, this could mean that arguments about political and security risks in 2006 could land its people with a poor deal that long outlasts those risks and is completely unsuited to a potentially more stable and independent Iraq of the future.

2) **They deprive governments of control over the development of their oil industry.** PSA contracts generally rule out government influence over oil production rates. As a result, Iraq would not be able to control the depletion rate of its oil resources - as an oil-dependent country, the depletion rate is absolutely key to Iraq's development strategy, but would be largely out of the government's control. Unable to hold back foreign companies' production rates, Iraq would also be likely to have difficulty complying with OPEC quotas which would harm Iraq's position within OPEC, and potentially the effectiveness of OPEC itself. The only way to avoid either of these two problems would be for Iraq to cut back production on the fields controlled by state-owned oil companies, reducing revenues to the state.

3) **They generally override any future legislation that compromises company profitability, effectively limiting the government's ability to regulate.** One of the most worrying aspects of PSAs is that they often contain so-called "stabilization clauses," which would immunize the 60% to 80% of the oil sector covered by PSAs from all future laws, regulations and government policies. Put simply, under PSAs future Iraqi governments would be prevented from changing tax rates or introducing stricter laws or regulations relating to labor standards, work-

place safety, community relations, environment or other issues. One common way of doing this is for contracts to include clauses that allocate the "risks" for such tax or legislative change to the state. In other words, if the Iraqis decided to change their legislation, they would have to pick up the bill themselves. The foreign oil companies' profits are effectively guaranteed.

4) **PSAs commonly specify that any disputes between the government and foreign companies are resolved not in national courts, but in international arbitration tribunals which will not consider the Iraqi public interest.** Within these tribunals, such as those administered by the International Center for Settlement of Investment Disputes in Washington DC, or by the International Chamber of Commerce in Paris, disputes are generally heard by corporate lawyers and trade negotiators who will only consider the narrow commercial issues and who will disregard the wider body of Iraqi law. As the researcher Susan Leubuscher comments, "That system assigns the State the role of just another commercial partner, ensures that non-commercial issues will not be aired, and excludes representation and redress for populations affected by the wide-ranging powers granted [multinationals] under international contracts." They may also - especially if connected to bilateral investment treaties - make a foreign company's home state a party to any dispute, thus enabling that country to weigh in on the company's behalf.

Loss of control: the case of Georgia

This loss of democratic control is illustrated by the case of BP's Baku-Tbilisi-Ceyhan (BTC) oil pipeline, which is being built from the Caspian Sea to the Mediterranean. This project is governed by a Host Government Agreement, some of whose legal provisions are comparable to those in PSAs.

In November 2002, the Georgian Environment Minister said she could not approve the pipeline routing through an important National Park, as to do so would violate Georgia's environmental laws.

Both BP and the US government put pressure on the Minister, through then President Shevardnadze. The Minister was forced first to concede the routing with environmental conditions, and then to water down her conditions. Part of the reason for her weak bargaining position was that two years earlier Georgia had signed the Host Government Agreement for the project, which set a deadline for environmental approval within 30 days of the application and stipulated that the contract had a higher status than other Georgian laws. The environment laws the Minister referred to were irrelevant. Ultimately, on the day of the deadline, the President called the Minister into his office, and kept her there until she signed, in the early hours of the morning.

Shortly after Shevardnadze was overthrown in a "rose revolution" in November 2003, new President Mikhail Sakashvili commented, "We got a horrible contract from BP, horrible" - but he could not change it.

Multinational companies favor complexity

Another feature of production sharing agreements is that they are the most contractually complex form of oil contract. PSAs generally consist of several hundred pages of technical legal and financial language (often treated as commercially confidential). It is their complexity, not their simplicity, which is advantageous to oil companies.

The simplest form of oil fiscal system is the royalty (defined as a percentage of the total value of the oil), which can be seen as a company paying the state for its oil - effectively "buying" it. This is used in most concession agreements, and sometimes in PSAs. In comparison with production sharing formulae, it is very clear what the state should receive from royalties - a fixed percentage of the value of oil. As long as the number of barrels extracted is known, and the oil price, it is easy to work out what royalty is due from the oil companies.

However, oil companies dislike royalties and prefer systems based on an

assessment of profits, such as PSAs. The reason is that they want what they call "upside" (i.e., opportunities for greater profits) - ways they can reduce their payments, rather than being subject to a fixed level of payment for oil extracted.

Under profit-based systems, revenue is based on the profit remaining when the oil companies' production costs have been deducted from the total revenue. As such, they depend on complex rules for which costs can be deducted, how capital costs are to be treated, and so on. The more complicated the system, the more opportunities there are for a company to maximize their share of the revenue by sophisticated use of accountancy techniques. Not only do multinational companies have access to the world's largest and most experienced accountancy companies, they also know their business in more detail than the state they are working with. Consequently a more complicated system tends to give multinationals the upper hand.

For example, in the Sakhalin II project in Russia, the complex terms of the PSA resulted in all cost over-runs being effectively deducted from state revenue instead of from the Shell-led consortium's profits. During the planning and early construction of the project, costs inflated dramatically. In February 2005, the Audit Chamber of the Russian Federation published a review of the economics of the project, finding that cost over-runs, due to the terms of the PSA, had already cost the Russian state \$2.5 billion.

Although three PSAs were signed in the mid 1990s in Russia, they have been the subject of extreme controversy ever since. The changing view of PSAs in Russia in general also illustrates the loss of democratic control inherent in PSAs - if the government or political climate changes, the terms of a PSA cannot change to reflect new priorities. In Russia's case, the rush to privatize in the early 1990s is now being questioned - but with the PSAs already in force it is impossible to rectify mistakes.

The Sakhalin II PSA is an example of a special type of PSA, which is growing in prominence. In such PSAs, the sharing of "profit oil" is based not on a fixed proportion, but on a sliding scale, based on the foreign company's profitability. The state

receives only a low proportion of profit oil (or in the Sakhalin case, none) until the company has achieved a specified level of profit. Thus, states are deprived of revenue, while corporate profits are guaranteed.

[All PSAs] are subject to distortions through petroleum price fluctuations in world markets, and they generally fail to provide the host country with its proper rent if the field turns out to be greater than expected.

Iraq would fare no better

In theory, Iraq may be able to negotiate PSAs with much more stringent terms than those used elsewhere in the world. As noted above, we do not know what exact terms Iraq might adopt if it uses PSAs. Iraq could also, in theory, avoid some of the more draconian legal clauses outlined above.

However, we have also seen that there are a number of structural features of PSAs that are likely to act against Iraq's interests, whatever the terms. Helmut Merklein, a former senior official of the US Department of Energy, explains this based on the concept of economic rents - the excess profits of oil production (after deducting production costs and a reasonable return on capital):

For all the sophistication and the bells and whistles these contracts have.... they all have two basic flaws, which make them less than perfect in terms of capturing rent. They are subject to distortions through petroleum price fluctuations in world markets, and they generally fail to provide the host country with its proper rent if the field turns out to be greater than

expected. Various triggers in those agreements reduce the host country's exposure, but they never really eliminate it.

The generation of rents is a feature of oil production. Because of oil's sheer value, its extraction generates profits beyond what is normally expected on an investment. These rents should belong to the country that possesses the oil resource. However, Merklein's point is that PSAs cannot - in unpredictable economic circumstances - deliver the country its fair share of the rents, and inevitably tend to give foreign oil companies excessive profits at the country's expense.

To the flaws identified by Merklein, we would add the long-term and restrictive nature of PSAs, that their terms are fixed as negotiated in a situation which - one hopes - will not persist in Iraq; and that they also place legal constraints beyond the issue of revenue-sharing, as we have seen.

In some countries, circumstances in the oil sector may favor investment through a mechanism such as PSAs, in spite of these disadvantages - such as where fields are offshore, risk capital for exploration is required, or the country lacks technical competence. In Iraq, however, these conditions do not apply, and given the country's huge oil wealth, it does not need to accept the negative consequences of PSAs.

On top of these structural flaws in PSAs, there are grounds to doubt whether the specific terms Iraq might achieve would be any better than in other countries, despite Iraq's enormous oil reserves. The key issue here is bargaining power: the Iraqi state is new and weak, and damaged by the ongoing violence and by corruption, and the country is still under military occupation.

In fact, rather than negotiating a more stringent PSA deal than elsewhere, the oil companies will inevitably wish to focus on the current security situation to push for a deal comparable to - or better than - that in other countries in the world, while downplaying the huge reserves and low production costs which make Iraq an irresistible investment.

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The Costs of PSAs in Iraq (continued from page 9)

Indeed, precisely this point is being pushed by the oil companies and their governments. The corporate lobby group ITIC attempts to invert conventional economic logic, by implying that there is greater competition among oil-producing countries than among private companies:

Although Iraq's potential petroleum wealth is enormous, the government still faces competition from other countries offering petroleum rights to investors. ... Investors, too, are competing for access to attractive petroleum deposits but competition among them may be limited if the project in question requires scarce expertise or depth of financial resources.

Thus one of ITIC's key recommendations is that Iraq "offer to companies profit

potential consistent with the risk they bear."

Their argument that countries, not companies, must compete is especially perverse given the high oil price, and the wide recognition of supply constraint: that there is a shortage of access to reserves, not of access to capital.

Similarly, the US government's development agency USAID has advised the Iraqi authorities that:

Countries with less attractive geology and governance, such as Azerbaijan, have been able to partially overcome their risk profile and attract billions of dollars of investment by offering a contractual balance of commercial interests within the risk contract, one that is enforceable under UK and Azeri

law with the option of international arbitration.

If Iraq follows that advice, it could not only concede a contractual form which is not in its interests, but specific terms which radically understate the country's attractiveness to the international oil industry. Along with much of its future income, Iraq could be surrendering its democracy as soon as it achieves it.

This article is an excerpt from Chapter 5 of Crude Designs: The Rip-Off of Iraq's Oil Wealth, by Greg Muttitt of Platform and is reprinted with kind permission. The full report, including an appendix on the economic modelling used, is available at www.crudedesigns.org.

Abt, Harper and Parker Join EPS Board

At the annual Fellows' Meeting during the AEA/ASSA 2006 conference in Boston, three new members were elected to the EPS Board of Directors.

Dr. Clark Abt, member-at-large, is Chairman Emeritus and past President of Abt Associates Inc., a research and consulting firm in Cambridge, MA. Dr. Abt is also an Associate of the Belfer Center for Science and International Affairs, Harvard University; and a founding Director of the Roxbury Entrepreneur's Club. Dr. Abt was born in Germany and came to the United States in 1937. He served in the US Air Force from 1952 to 1957. From 1957 to 1964 he held engineering and management positions at the Raytheon Company, including managing its advanced systems department. He founded Abt Associates in 1965.

Dr. Abt has a PhD in Political Science from MIT and has taught at Boston University, Columbia University, Harvard University, Johns Hopkins University, State University of New York (Binghamton), the University of California Business School, and the University of Massachusetts. From 1991 to 1993, Dr. Abt directed the Center for the Study of Small States at Boston University.

Dr. Alan Harper, treasurer-elect, is past president of the New York Association for Business Economics, a chapter of the National Association for Business Economics. Dr. Harper will assume his duties as treasurer upon the completion of EPS's most recent audit.

Dr. Harper will take over the role of treasurer from John Tepper Marlin, who has served EPS in that capacity for ten years. Dr. Tepper Marlin has expertly guided EPS through financial difficulties and we are all grateful to him for his service.

Dr. Richard Parker is Lecturer in Public Policy and Senior Fellow of the Shorenstein Center. An economist by training, he is a graduate of Dartmouth College and Oxford University. He has worked as an economist for the UNDP, as cofounder of *Mother Jones* magazine, and as head of his own consulting firm, serving congressional clients, including Senators Kennedy, Glenn, Cranston, and McGovern, among others. Parker has held Marshall, Rockefeller, Danforth, Goldsmith, and Bank of America Fellowships. His books include *The Myth of the Middle Class*, a study of US income distribution, and *Mixed Signals: The Future of Global*

Television News. His most recent book is the intellectual biography of one of EPS's founding trustees. *John Kenneth Galbraith: The Making of American Economics* has been critically claimed as "splendid, immensely readable," "literate and fascinating." His articles have appeared in numerous academic anthologies and journals and in the *New York Times*, *Washington Post*, *Los Angeles Times*, *New Republic*, *Nation*, *Harper's*, *Le Monde*, *Atlantic Monthly*, and *International Economy*, among others.

Following a recent revision of the EPS by-laws, the Board of Directors cannot seat more than ten people. The purpose of this change is to ensure that the Board can meet quarterly, rather than yearly as it used to, and to guarantee strong oversight of EPS's financials and program of activities.

The Board also voted to create two new members of the Trustees, an honorary board shared by all thirteen EPS affiliates. Dr. Clive Granger, recipient of the Nobel Prize in Economics in 2003, has been an EPS member for several years. Richard Jolly, knighted in the UK for his distinguished service to UNICEF and the UNDP, moves from the Board of Directors to the Board of Trustees.

The State of Iraq

Security Indicators	Nov 2004	Nov 2005	Nov 2006	Economic and Quality of Life Indicators			
				Nov 2004	Nov 2005	Nov 2006	
US Troop Fatalities (Number from Homemade Bombs)	82 (20)	137 (18)	96 (40)	Crude Oil Production (in millions of barrels per day; prewar: 2.5)	2.1	2.0	2.0
Iraqi Military and Police Fatalities	65	160	176	Availability of Household Fuels (percentage of estimated need)	76	77	87
Estimated Iraqi Civilian Fatalities from War	125	1500	600	Average Electrical Power (in megawatts; prewar: 4.3)	3.6	3.2	3.7
Multiple-Fatality Bombings	6	11	41	Annual GDP (in billions of 2005 dollars; prewar: 30)	19	28	29
Kidnappings of Foreigners	1	5	11	Cumulative US Aid Disbursed (in billions of dollars)	0.1	3.6	12.0
US/Other Foreign Troops (in thousands)	123/24	138/24	160/23	Registered Cars (in millions)	1.5	2.5	3.1
Iraqi Security Personnel (in thousands)	95	114	212	Unemployment Rate (percent)	50	35	32
Number of Iraqi Security Personnel in Top Two Tiers of Quality (in thousands)	0	5	35	Felony Cases Resolved in Courts	500	700	850
Estimated Number of Insurgents	5,000	20,000	18,000	Telephone Subscribers (prewar: 600,000)	600,000	2,200,000	5,000,000
Daily Insurgent Attacks	32	77	90				
Daily Tips Received from Iraqis about Insurgents	5	10	150	Public Opinion/Politics			
Source: "The State of Iraq," created by Michael O'Hanlon and Nina Kamp of the Brookings Institution's Saban Center for Middle East Policy. This table was prepared using data collected in the "Iraq Index," which is updated every Monday and Thursday and is available online at http://www.brookings.edu/iraqindex . Reprinted with kind permission of the authors.				Percentage of Public Optimistic about Future	65	54	49
				Iraqis Favoring Near-Term US Troop Withdrawal	30	35	80
				Expected Sunni Arab Share of Iraq's Future Oil Revenue (percent)	20	20	5-10

Diary of a New Board Member (continued from page 4)

Then I started to rush to the Hynes for the other session with Marty Feldstein on the economics of national security, but as I did so I encountered a steady stream of economists of all ages rushing toward the room from which I had just emerged.

"Wait a minute," I thought, "maybe I ought to reconsider my shuttle strategy." I stopped in the hall and reviewed the Feldstein session's papers more closely. They were by academics unknown to me on topics I had already studied for years. By now it was 10:10. The light bulb went off, my choice was simplified, I was relieved of my strenuous and frustrating shuttle diplomacy, and turned quickly around and strode back to the EPS Roundtable.

Imagine my surprise when, approaching the room, I found people lined up in the hall outside the room. I looked at my watch: 10:15! "Uh-oh," I thought, "I may be late." I shouldered past the waiting line, remarking on the way to the scowls of those passed by that I was returning to my already taken seat. The room was absolutely packed with over 250 people, and 50 more standing in the hallway, while I retained a front-row seat at what was to be the most memorable discussion of global poverty reduction and development I had yet heard, by four top economists.

What did they say? I wish I had taken better notes, scrawled in my 372-page program book, and will try to summarize it all, but first I want to record how I felt about it. Over the last few years I had shifted my interest in domestic and international anti-poverty development to public health and defenses against deadly contagious diseases, following my lifelong career's policy of always addressing the chief threats to human welfare, from nuclear war to poverty and revolution to bioterrorism to natural emerging disease pandemics. Domestic and international economic development, both in theory and practice, had come to seem to me a failed dream, with little real measurable progress relative to the magnitude of the socio-economic problem, both by its theoreticians and practitioners, and by my colleagues at my company and me, in the last two decades. As the saying goes, the rich got richer and the poor got children - many of

them starving or succumbing to preventable diseases. Hence my shift to focusing on public health, and indeed also that of over half my colleagues at the Company.

So I was not optimistic, yet still hopeful that at least these very top economists on the topic would throw new light and perhaps even re-inspire me to give global anti-poverty efforts another chance. In this I was not disappointed.

Stiglitz and Bilmes estimated the costs of the Iraq War at \$1 - 2 trillion dollars.

What did they say? Human development requires goal setting not only for material wealth but also for freedom, justice, and human rights. Quantitative measures are needed for all these goals to measure progress, and we need to develop further and pay attention to the human development index that is the combination of the two. Amartya and Nancy both pointed out that the error in concentrating on the Millennium Development Goals' *declarations* is not just a matter of material progress but also of human rights and values. Here Amartya ventured another comparison of China and India in which he suggested that the overall economic growth in China was retarded by their relative neglect of human rights.

I learned from Joe Stiglitz's talk that resource rich countries do worse in economic reform and growth than resource-poor countries, much to my surprise, because, as he said, there's more to steal, and hence more corruption. He also reiterated his belief, not shared by all, that market failures in less-developed countries require greater government investment to avoid knowledge market failures. Nancy Birdsall had a great idea for the people of Iraq and domestic government of Iraq: sharing their oil resources for greater accountability. She also pointed out that donor nations are not the key players in development, but should concentrate on the experiments and evaluations of local efforts.

The next great learning opportunity of this great Saturday feast of reason was the

6:30 EPS annual dinner in honor of our trustee, Amartya Sen. Introductory remarks were made by Sir Richard Jolly, Nancy Birdsall, John Lord Eatwell (who had worked for me as a graduate student in the sixties, and we exchanged some fond memories), Diana Strassman of the International Association for Feminist Economics, Harvard President Larry Summers, and Nobelist Joseph Stiglitz. Larry Summers made the best speech, pointing out Sen's two great contributions to human rights and economics, only one of which I had known about (that there was no world food shortage, starvation being the result of poor distribution rather than scarcity). Sen identified the fact that 100 million women were missing in the world's population data - think of it, 100 million women unaccounted for!

Sunday, January 8

Sunday there were two great EPS panel discussions: one on the costs of war, and another the economics of national security. (I also got elected to the board of directors of EPS, at the annual Fellows' meeting.)

The 8AM meeting on the Costs of War featured a presentation by Joe Stiglitz and Linda Bilmes on the cost of the Iraq war and its aftermath, which they estimated conservatively as between 1 and 2 trillion dollars for the US alone. That finding was featured in *Boston Globe*, *NY Times*, and *London Financial Times* articles. William Nordhaus, in his paper, "Is Military Spending Justified by Security Threats," made the telling point that too little is written on the costs of war. Allen Sinai of Decision Economics showed with his macroeconomic model of the US economy that the war thus far probably depressed the GDP about one to two percent, despite other growth areas.

At the 1PM EPS *Economics of National Security* Roundtable, I learned from MIT Prof. Carl Kaysen that the alleged economic bargain of nuclear weapons - the fifties touted "more bang for the buck" - simply wasn't. It turned out on analysis that nuclear weapons and their associated systems had absorbed fully 30% of US defense budgets since 1945, without ever being used except twice in 1945. Kaysen concluded that they

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QDR 2006: Do The Forces Match the Missions? DoD Gives Little Reason to Believe

Carl Conetta

As originally conceived the Quadrennial Defense Review was meant to help ensure the internal consistency of mid- and longer-term US defense planning. By "internal consistency" I here mean a concordance of strategy, assets, and budgets. As critics often put it in the past: the point is to show how the force fits the strategy and the budget fits the force. The exercise is supposed to "connect" our military strategy with our force development plans and, in turn, connect these with current and future budgets. In this regard, the 2006 QDR is long on assertion and short on quantification - "short" as in utterly lacking.

Secretary Rumsfeld's second QDR confidently assures us that all the variables align, but gives us no reason to believe. Quite the contrary: the new iteration of the Pentagon's "force sizing construct" should leave all Americans wondering where the Secretary and his staff have been these past few years.

Reasonable people can disagree about the value of the Iraq war and whether it is being won. But no one can reasonably contest that it has turned out to be a hard slog, as the Secretary belatedly has observed. While we can disagree about whether or not the effort is driving the Army and the Reserves into the ground, no one can honestly deny that the war and other post-9/11 operations have significantly "stressed" our armed forces. And no amount of "stop loss" orders, tour-of-duty extensions, or Reserve call-ups has yet allowed us to assemble a presence in Iraq able to stabilize the country.

In brief: the pedal is to the metal, but we are still not up to speed.

The QDR's authors admit as much when they allow that "operational end-states defined in terms of 'swiftly defeating' or 'winning decisively' against adversaries may be less useful for some types of operations...such as...conducting a long-duration, irregular warfare campaign" - a remarkable (but welcome) retreat from the over-confidence of previous QDRs. This

concession to reality has not led the Secretary to prescribe fewer such adventures for the future, however. Quite the contrary: the QDR foresees increasing the demands on our armed forces in this domain (irregular warfare and nation-building) as well as in almost every other.

**The pedal is
to the metal,
but we are still
not up to speed.**

Are planned force enhancements sufficient to support another quantum leap in activity? For that matter: are they sufficient to close the existing gap between missions and capabilities apparent in Iraq? Based on the information provided in the QDR, it is anyone's guess. But the experience of the past few years should, at minimum, dent any tendency toward passive faith in the Secretary's assurances.

Other observers and critics have addressed the correspondence (or lack of it) between the proposed force and the budget meant to support it. Likewise, others have addressed the broader and mounting fiscal constraints bearing on the DOD budget. (See references below). This essay focuses on the match between future missions and assets (people, structures, and things). The following sections summarize the key missions outlined in the QDR, the major force enhancements it proposes, and how we might assess the correspondence between the two.

Future Missions

Looking to the future, the QDR usefully divides military missions and activities into "steady-state" and "surge" categories.

Steady-state activities include:

- Conducting multiple, irregular operations of varying duration. These would encompass counter-terror and stability operations as well as smaller-scale counter

insurgency operations and nation-building activities (such as in Afghanistan and Colombia).

- In addition, the armed forces would maintain a presence in more places than currently with the aim of deterring threats to the US homeland, US allies, and US overseas assets. They also would seek, more generally, to deter and spoil transnational terrorist attacks and inter-state aggression in regions of concern. And they would regularly pay special attention to detecting and interdicting WMD proliferation as well as deterring and defending against WMD attack.

- Our general purpose and special forces would continuously interact with partners of various sorts in order to reassure them, build their capabilities in areas of mutual interest, and create closer working relationships. More than that, they would take a bigger hand in defense sector reform.

- Finally, the services would undertake routine efforts to generate, train, and sustain the nation's armed forces - an imperative that encompasses not only the reproduction of ready forces but also their transformation.

In sum, as a matter of routine activity, the QDR foresees an increase in stability and nation-building operations, more long-term counterinsurgency operations, an increased frequency of offensive counter-proliferation activities, and US force presence in more places involving a greater variety of "partnership" activities.

Regarding transformation, it prescribes continuing the process of global reorientation, an increased focus on developing capacities for irregular warfare, and continuing the efforts to advance inter-service cooperation and build "netcentric" armed forces. The Army will have to train to a new tactical structure and all the services will have to integrate new generations of "big ticket" platforms. This is a bit like combining the modernization wave of the 1980s with the transformation wave of the

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QDR 2006 (continued from page 13)

late-1990s in the context of conducting major operations reminiscent of the Vietnam era while reorienting the force as was done in the post-Vietnam War period.

While carrying out its steady-state, routine, and transformation duties, the armed forces must also be prepared for surge activities of several types, notably:

- Helping to manage the consequences of a domestic WMD attack or catastrophic event;

- Conducting large-scale counterinsurgency and security, stability, transition and reconstruction operations; and

- Waging two nearly simultaneous conventional campaigns (or one plus a large-scale irregular campaign) with the aim of "regime change" in one of the campaigns.

Of course, the addition of a large-scale counter-insurgency war to the big war mix increases requirements even though DOD has retained the two-war limit.

The two wars to which the QDR refers may be either two conventional conflicts or one each conventional and irregular. Many assets would be at least partially applicable to both two-war scenarios - but not all. So from where is the additional irregular warfare capability to come? Perhaps DOD has downgraded the requirements for one of the conventional wars in order to allow greater investment in irregular warfare capabilities? If so, this trade-off presumably is occurring within the ground forces, rather than between the ground and other forces - because no ground troops are being added to the US arsenal overall. This implies that the two imagined conventional wars will be more air power dependent than previously planned. Either that or DOD proposes to make our ground forces' conventional and irregular capabilities fully fungible - that is, one force fights all. This option is not fantastic, but it demands some explication.

Future capabilities

Turning to planned force enhancements and reductions, the QDR carries forward or newly proposes a variety of initiatives. It directs the armed forces to:

- Reduce active-duty end strength from current levels by about 75,000, 40,000 of

these being USAF personnel, the rest Army and Marine Corps - thus bringing the overall size down to the level set by the previous administration: approximately 1.35 million active-component personnel;

- Through reprogramming, add 13,000+ personnel to the current roster of 52,000 special operations forces personnel;

- Increase the irregular warfare capacities of regular ground forces;

The US Armed Forces must prepare to wage two simultaneous conventional campaigns, with the aim of "regime change" in one.

- Complete conversion of the active-component Army from 33 to 42 Brigade Combat Groups - each with two maneuver battalions and one reconnaissance battalion;

- Proceed with measures already underway to improve efficiency in the use of military personnel. These measures include global realignment, which will free 60,000-70,000 personnel from their current stations in Europe and Asia, and altering the division of skills between the active and reserve components, which by 2010 will affect 125,000 positions;

- Accelerate the retirement of the F-117 fighter and the U-2 reconnaissance aircraft;

- Add 322 unmanned aerial vehicles (UAVs) by 2011;

- Reduce the number of B-52H bombers from 95 to 56, modernize the remainder of the bomber fleet, and begin development of a new long-range strike system, two decades early;

- Reduce the arsenal of deployed Minuteman III ballistic missiles from 500 to 450;

- Convert four Trident submarines for use in conventional strikes and develop conventional warheads for the Trident missile;

- Continue procurement of most previously planned major weapon systems. During the next two decades this will mar-

ginally increase deployment capabilities, substantially increase air power capabilities for longer-range precision strike, and add littoral and riverine naval capabilities. As before, traditional platform-centric programs gobble up the largest chunks of modernization funding. In the three-way budget battle between counter-insurgency advocates, info-tech networkers, and platform jockeys, the latter are the clear winners.

Whither transformation?

Least impressive is the progress achieved or planned for the 2001-2010 time period in the areas of networking the armed forces and improving joint cooperation. Here, only "pockets" or "flashes" of real transformation are substantiated. Likewise, planned and achieved progress is modest in the 2001-2010 time frame with regard to the goal of assembling a global intelligence, surveillance, reconnaissance network that fuses existing capabilities, enables persistent surveillance of the battlespace, and rapidly distributes intelligence across services and down to the tactical level.

Where is the real beef of transformation - that is, the reliable and significant enhancements - available to the armed forces within the next five or so years? In several areas: precision strike capabilities, more special operations personnel, and a few hundred more UAVs. The proposal to train regular soldiers to take on more of the tasks performed by today's special operations forces, although potentially significant, is too poorly specified to evaluate, which does not bode well. Other planned changes in the Army, including the modularity and Stryker initiatives, are also putatively significant. But the net benefits of both these programs are hotly contested, as is the value and feasibility of the longer-term Army Future Combat System. (See references below).

While increasing the number of active Army brigades will significantly reduce the deployment demands placed on each one, their capabilities also will be significantly less - at least until new technologies and fighting techniques are developed,

integrated, and proven. Effective information networking of tactical ground units with each other and with other force elements is proceeding slowly (on the whole). And the challenge of learning to fight effectively with two equivalent maneuver battalions rather than the traditional three or four is no small thing. Concerns such as these has led one trenchant critic, the Army reformer Col. Douglas Macgregor (ret.) to conclude:

The concept looks like an attempt to equate a near-term requirement to rotate smaller formations through occupation duty in Iraq or Afghanistan with the transformation of the Army into a new warfighting structure... (Macgregor, 2004)

Conclusion

So where does this leave us regarding the concordance between proposed missions and the QDR's force development plans? In the dark, mostly - and sure of only one thing: the Pentagon will spend \$2.5 trillion during the next five years, not counting the incremental cost of operations (which by current standards could add as much as another \$500 billion to the five-year price tag).

Meaningful assessment and refinement of DOD's plans require that Secretary Rumsfeld and the Chiefs say more about how they intend to spend the nation's treasure. Several steps of clarification are essential:

First, DOD should illustrate in broad terms how the armed forces might allocate assets to fulfill their "steady-state" duties under various conditions. How many troops of what types will go where? These "snap shots" should include typical rotations and also take into account the demands of sustaining, training, equipping, and transforming the force.

Second, DOD should illustrate how the force might handle several types of

"surge" situations - especially complex ones involving multiple conflicts. What force packages might it deploy, how fast, and under what rotation scheme? How would the illustrative scenarios affect routine and "steady-state" activities? And how would the services handle the need to reset the force?

Obviously a few "snap shots" of the proposed force "in action" would not exhaust the many scenarios that might arise. But DOD might and should choose illustrative complex scenarios that show how different circumstances might pull the force in very different, but equally demanding directions. This would indicate the strength, pliability, and resilience of the force that Secretary Rumsfeld proposes. Only then could we affirm the match between strategy and structure. And should the risks inherent to the plan prove unacceptable, we might then turn to consider different goals, a different strategy, different forces, or a different budget.

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Carl Conetta is Co-Director of the Project on Defense Alternatives, which seeks to adapt security policy to the challenges and opportunities of the post-Cold War era. Toward this end it promotes consideration of the broadest range of defense options. For more information, visit www.comw.org/pda/.

Diary (continued from page 12)

they were no bargain. He also showed some of the thinking in the Kennedy Administration (in which he took an important part) about the enormous nuclear buildup responding to the alleged

but absent missile gap.

All in all, an inspiring three days of learning that at least some economists of great intelligence and good will have much to offer the world for peaceful and

secure poverty reduction. There's much good work being done, and much more to do.

Dr. Clark Abt is the founder of Abt Associates in Cambridge, MA.

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Stanislav Menshikov

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February 23, 2006

Today the trial of opposition leaders accused of treason is set to begin in Addis Ababa, Ethiopia. Among the jailed leaders is Berhanu Nega. Dr. Nega received a PhD in Economics from the New School for Social Research in 1991. Since his return to Ethiopia, he has taught *pro bono* at the Addis Ababa University Economics Department. He has also served as president of the Ethiopian Economic Association, founded the Ethiopian Economic Policy Research Institute, and serves as a consultant for the UN Economic Commission for Africa. He is also the vice-chair of the Coalition for Unity and Democracy (CUD).

Dr. Nega was arrested after over a million Ethiopian citizens took to the streets to protest the government's interference with the national elections last year. The CUD accuse the government of Prime Minister Meles Zenawi of paying lip service to free and open elections while at the same time spreading rumors that the CUD supports genocide, detaining poll watchers, and declaring a re-election victory with only half of the votes counted. Dr. Nega believes that had all the votes been fairly counted the CUD candidates would have had significant victories. He wrote:

For the first time in our ancient history, we Ethiopians have voted our conscience. Our people have played their part with courage and discipline. They deserve the opportunity to build a genuine democratic political system. That is their only guarantee to live in peace and to achieve prosperity.

For holding these beliefs, he now faces execution.

On behalf of the Board and Trustees of Economists for Peace and Security, an organization of professional economists in the United States and worldwide, we have written to Secretary of State Condoleezza Rice to ask that she act to secure the release of our professional colleague, Dr. Berhanu Nega. This case has all the attributes of an act of political repression, on which the United States cannot and must not remain silent. We have urged her to deploy all resources at her disposal to see that Dr. Nega and his associates are released.

James K. Galbraith

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To learn more about Dr. Nega's case and how you can help,
visit www.savenega.org.

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