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Despite Crushing Costs, Iraqi Cabinet Lets Big Subsidies Stand

By JAMES GLANZ

BAGHDAD, Iraq, Aug. 10 - A proposal by Iraq's finance minister to reduce the enormous fuel and food subsidies that consume roughly a third of the government's budget and largely crush economic growth has been rejected by the cabinet after a recent similar move in Yemen set off fatal riots there.

The subsidies, which artificially produce some of the lowest gasoline and heating fuel prices in the world and finance free basic foodstuffs, have been singled out by financial institutions both inside and outside Iraq as a crippling burden when the country is trying to create a free-market economy as it grapples with insurgent violence and sabotage of its oil and electricity infrastructure.

"They've reached the point where they've become insane," the finance minister, Ali Abdulameer Allawi, said of the subsidies just before he presented the plan to the cabinet in late July. "They distort the economy in a grotesque way, and create the worst incentives you can think of."

But after his proposal's rejection, Mr. Allawi said the cabinet had judged the measure "inopportune politically." A second member of the cabinet, Ibrahim Bahr al-Uloum, the oil minister, said that he had been among the leaders of a group that blocked the proposal, and that he had raised the specter of the riots in Yemen, in which dozens of people died, after the government ended fuel subsidies there.

Mr. Uloum said that while he supported the idea in principle, it could safely be put in place only after a public education campaign, preferably after the next national elections. Both ministers said the cabinet did approve a measure that would, for the first time, allow private industry to enter what is now an entirely state-run oil-export business. "This is the point," Mr. Uloum said. "We got something new."

Mr. Uloum had no immediate details on the agreement, but he mentioned that other components of what oil insiders call the downstream infrastructure, like refining, would also be open to private investors. Upstream refers to things like drilling and pumping oil wells, which for now will stay exclusively in government hands.

Fareed Mohamedi, an economist and senior director at PFC Energy in Washington, said that bringing in private investors could help increase domestic supplies of refined products and help the government conserve on its own expenditures. But he said that, as in other areas, security problems could trump all.

"Which private investor is going to put up a big refinery?" Mr. Mohamedi said. "It's a sitting duck."

Some Iraqi officials began pressing the American-led occupation to cut the subsidies shortly after the 2003 invasion. But this time the effort was turned back by the Iraqis themselves, who also feared that a rise in fuel prices would make it more expensive for people to use generators to produce electricity because the national electrical grid remains inadequate.

The maneuvering over the subsidies has largely taken place in closed cabinet sessions, but was described by Mr. Allawi and Mr. Uloum in a series of interviews. They also gave an accounting of how Iraq's fluctuating oil exports - mostly in decline this year because of sabotage - have managed to sustain the nation's budget only because oil prices have skyrocketed.

Aside from grants and loans, fully 98 percent of Iraq's revenues come from oil, which Mr. Allawi said is the highest ratio in the world. Last year's budget was 32 trillion dinars, or about $21 billion, and this year's is projected to be around $19 billion.

Last year, oil exports peaked in April, at 1.8 million barrels a day, Mr. Uloum said. This year, sabotage attacks on oil pipelines, particularly in the north, have kept the number around 1.4 million, although it was up slightly in July, he said. The low production created a budget squeeze early in the year, but with oil spiking above $50 a barrel in May, June and July, "the situation ameliorated," Mr. Allawi said.

Of this income, 17 percent goes to Iraqi Kurdistan, which spends it according to its own priorities. More than $3 billion goes to capital costs for new refineries and oil field equipment in the Oil Ministry.

The other top-spending ministries are defense, health, interior, education and electricity. But the real budget-breakers are the food and fuel subsidies, Saddam Hussein-era holdovers that cost the country roughly $8 billion a year.

"I'm afraid people here, for the last 30 years, have become addicted to various subsidies," Mr. Allawi said.

In a report released last month, the World Bank concluded that when Iraq's largely free - if unreliable - electrical service was taken into account, the amount spent on subsidies may add up to more than half of the country's gross domestic product. The subsidies "result in large fiscal costs and serious disincentives in the economy while leaving massive demand for public services unmet," the report said.

Because its refining capacity is so low, Iraq is forced to import more than half of the 23 million liters of gasoline it consumes a day. The country pays 30 to 35 cents a liter for the imported gasoline and sells it for a cent and a half. There are about four liters in a gallon.

Undetermined amounts of the product end up either being sold on the black market in Iraq or smuggled into Turkey, where gasoline sells for more than $1 a liter. "It's a great racket," Mr. Allawi said.

The previous oil minister, Thamir al-Ghadban, who is now a member of the committee that is drafting Iraq's permanent constitution, said he was disappointed the government still had not decided to cut the subsidies.

"Politicians are afraid to do this," he said. "But we have to change it. Otherwise Iraq will not flourish."

Although Iraq's prices are far below any other country's in the region, Gal Luft, executive director of the Institute for the Analysis of Global Security, which follows the Iraqi oil industry closely, said the government would nevertheless have to move with great care to avoid making a bad situation worse in the name of economic efficiency.

"If you're an economist, you look at it and say this is something that needs to be done," Mr. Luft said of removing the subsidies. But he added, "the government needs to establish legitimacy, and their position is very shaky. And I can see why they could resist something that could shake public support for them."