

Can Iraq Overcome the Oil Curse?

Robert Looney

A central issue in Iraq—as well as the U.S. and other countries—remains whether the people control government through voting and taxes or the government controls the people through a monopoly on natural resources. To break that monopoly, the Bush administration and the Iraqi Governing Council have a momentous opportunity to instate a new paradigm. Only an owner-people can ensure a prosperous Iraqi state.¹

Vernon Smith, Nobel Laureate

Introduction

In an important document² released toward the end of 2005, the United States outlined its strategy for victory in Iraq. Victory is defined in states: (1) Short term, Iraq is making steady progress in fighting terrorists, meeting political milestones, building democratic institutions and indigenous security forces; (2) Medium term, Iraq is in the lead defeating terrorists and providing its own security, with a fully constitutional government in place and on its way to achieving its economic potential; and (3) Longer term, Iraq is peaceful, united, stable and secure, well integrated into the international community and a full partner in the war on terrorism.

The U.S. strategy is essentially three pronged: developing democracy, providing security, and reviving the economy. With the critical December 2005 elections completed, 2006 represents a pivotal year for Iraq. Or, as noted by Ambassador Khalilzad:

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¹ Vernon Smith, "The Iraqi People's Fund," *Wall Street Journal*, December 22, 2003.

² *National Strategy for Victory in Iraq* (Washington: National Security Council, November 2005).

This will be a year of decision in Iraq. Full participation in the December national elections by all communities has created the opportunity to significantly advance our strategy for success as recently outlined by President Bush. Building on this momentum is up to the Iraqi people. However, the United States will work intensively with Iraq's leaders to make progress on all three tracks of our strategy: developing democracy, providing security and reviving the economy.³

In the economic area, U.S. and coalition efforts to date have focused on helping Iraq restore the country's neglected and damaged infrastructure in an effort to restore and expand essential services. Other goals include the start of market-based economic reforms, and greater transparency and accountability in the public sector. "The international community has been instrumental in these efforts, but there is room for the international community to do more. Foreign direct investment, over time will play an increasing role in fueling Iraq's economic growth."⁴

The logic of this strategy is straightforward:⁵

1. The rebuilding of Iraq's infrastructure and the provision of essential services will increase the confidence of Iraqis in their government and help convince them that the government is offering a brighter future. People will then be more likely to cooperate with the government and provide intelligence against the enemy, creating a less hospitable environment for the terrorists and insurgents.
2. Efforts in the reconstruction realm have significant implications in the security realm when they focus on rebuilding post-conflict cities and towns. Compensations for civilians hurt by counterterrorism operations and the restoration of some economic vibrancy to areas formerly under terrorist control can help ease resentment and win over an otherwise suspicious population.
3. Economic growth and reform of Saddam-era laws and regulations will be critical to ensuring that Iraq can support and maintain the new security institutions that the country is developing, attract new investment to Iraq, and become a full, integrated member of the international community.
4. Economic growth and market reform—the promotion of Iraq's private sector—are necessary to expand job opportunities for the youthful Iraqi

³ Zalmay Khalilzad, "The Challenge Before Us," *Wall Street Journal*, January 9, 2006, A.12

⁴ *National Strategy for Victory in Iraq* (Washington: National Security Council, November 2005), p. 22.

⁵ *Ibid.*

population and decrease unemployment that makes some Iraqis more vulnerable to terrorist or insurgent recruiting.

While this strategy has many merits, it is basically a continuation of the long-term approach taken by Ambassador Bremer and the Coalition Provisional Government (CPA) in 2003. Subsequent to the release of the National Development Strategy (NDS), Ambassador Bremer expressed reservations over the course he set out for Iraq's economic recovery:

We also placed too much emphasis on large-scale reconstruction projects. While the urgent need for modern highways, electrical generating plants and the like was clear, we should have anticipated that building them would take a long time. Our earlier efforts should have been directed more tightly at meeting Iraqis' day-to-day needs.⁶

Iraqis themselves are increasingly skeptical of the viability of the post-war economic strategy. Certainly the ability to complete infrastructure projects on time and within budget has proven to be a nearly impossible task. As noted by the U.S. Inspector General for Iraq Reconstruction, infrastructure programs in that country have been plagued by "violence, corruption and mismanagement."⁷ As a result, "the ambitious US reconstruction effort in Iraq is likely to fall far short of its goals because soaring security costs and poor management have slashed the amount of American money available for rebuilding projects."⁸ Just as serious is the all too apparent long lead time before any tangible benefits in terms of improved living standards are seen by the average Iraqi:

US officials largely measure progress in Iraq in terms of numbers: more than \$14 billion spent so far on reconstruction, or in terms of electricity, the numbers of kilowatt hours produced by Iraqi power plants. This year (2005) for the first time, US officials say that the number has surpassed prewar levels. The average Iraqi measures progress in numbers too: how many hours of electricity he gets each day before the lights go out. Right now that's roughly two for every five hours of blackout.⁹

Implicit in Ambassador Bremer's assessment is that the main flaw in the U.S. strategy has been its inability to deliver short-run economic gains to

⁶ L. Paul Bremer, "In Iraq, Wrongs Made a Right," *New York Times*, January 13, 2006.

⁷ Quoted in Tom Regan, "US Inspector General for Iraq Paints 'Grim' Picture of Reconstruction Effort," *Christian Science Monitor*, November 1, 2005.

⁸ *Ibid.*

⁹ Jamie Tarabay, "Despite Progress, Iraqis Still Face Daily Challenges," NPR, All Things Considered, December 20, 2005.

large segments of the Iraqi population. Unfortunately, the NDS does little to address this issue and appears content simply continuing the existing strategy.

On a more fundamental level, other than noting that oil revenues will assist in financing infrastructure and much of the country's capital expenditures, the NDS does not explicitly address the role of oil in Iraq's future. Yet there is a vast literature suggesting that the oil sector and the allocation of its revenues is *the* critical variable in shaping both the economic structure and political systems of countries like Iraq. For the most part this literature focuses on the so called "oil curse" or the "paradox of plenty."¹⁰ These colorful phrases capture the gist of oil's potentially destructive powers—unless properly managed, oil revenues more often than not undermine the economic, political and social fabric of countries, irrespective of how well intended their long run goals and objectives.

The purpose of the sections that follow is to examine ways in which the proper management of Iraq's oil revenues can facilitate that country's economic recovery. In part, this entails not only addressing many of the shortcomings of the country's current supply-side development strategy, but also examining whether an alternative demand-oriented approach might be more likely to succeed in the current Iraqi environment.

Ramifications of oil wealth

As noted above, the political and economic ramifications of oil wealth, especially in the developing world, have received considerable attention in recent years.¹¹ In fact, economists have long observed that resource abundant countries tend to underperform relative to resource deficient economies. Sachs and Warner,¹² for example, provide empirical evidence that higher levels of oil and mineral dependence tend to reduce a country's rate of economic growth. Similar findings have been obtained in a number of subsequent studies.¹³ Often slow growth stems from

¹⁰ Terry Lynn Karl, *The Paradox of Plenty: Oil Booms in Petro-States* (Berkeley: University of California Press, 1997).

¹¹ For an excellent summary of much of this literature, see Svetlana Tsalik, *Caspian Oil Windfalls: Who Will Benefit?* (New York: Open Society Institute, 2003).

¹² J. D. Sachs and A. M. Warner, "Natural Resource Abundance and Economic Growth," Development Discussion Paper No. 517a, Harvard Institute for International Development, 1995.

¹³ See, for example, Jeffrey Sachs, "Globalization and Patterns of Economic Development," *Weltwirtschaftliches Archiv* 136:4 (2000), pp. 579–600.

significant declines in productivity experienced by the oil producing countries.¹⁴

Focusing on growth outcomes, Ross¹⁵ found that after controlling for levels of GDP, countries that have higher mineral and oil dependence (defined as oil and mineral exports relative to GDP) are consistently deficient in the critical areas of child mortality and nutrition, have lower literacy and school-enrollment rates, score lower on the UN Human Development Index, have larger shares of their population in poverty, devote a greater share of government spending to military spending, and are more authoritarian.

In other areas of significance, Looney,¹⁶ Leite and Weidman¹⁷ and Glyfaslon *et al.*¹⁸ report that higher oil and mineral dependent countries exhibit greater corruption. Of particular relevance for Iraq, Collier and Hoeffler's work¹⁹ suggests they also have a greater probability of civil war for any given five-year period. There are at least four ways that oil and mineral dependence tend to promote civil war and conflict, and, unfortunately, all are currently present in Iraq to one extent or another:

1. Slower growth and poverty creates repressed resentment and frustration, often leading to terrorism and eventually a full-blown civil war. Much of the present insurgency in Iraq has been attributed²⁰ to that country's persistent unemployment rate of 30%–50%.
2. Corruption in government fosters a drive for regime change. Unfortunately, the prestigious Transparency International has ranked Iraq as the most corrupt country in the Middle East. As World Bank President James Wolfensohn noted: "The diversion of funds from publicly financed projects represents an unacceptable tax on the poor. In the construction sector it represents a deplorable opportunity lost for

¹⁴ Robert Looney, "Iraq's Future: Will Oil Be a Blessing or Curse?" *Middle East Business and Economic Review* 16:1 (June 2004), pp. 15–29.

¹⁵ M. Ross, "The Political Economy of the Resource Curse," *World Politics*, 51:2 (1997); and M. Ross, "Does Oil Hinder Democracy," *World Politics*, 53:1, April 2001, pp. 325–361.

¹⁶ Robert Looney, "Profiles of Corruption in the Middle East," *Journal of South Asian and Middle Eastern Studies* 30:3 (Fall 2005), pp. 285–303.

¹⁷ C. Leite and J. Weidman, "Does Mother Nature Corrupt? Natural Resources, Corruption and Economic Growth," IMF Working Paper WP/99/85, 1999.

¹⁸ T. Glyfaslon, T. Herbertsson and G. Zoega, "A Mixed Blessing: Natural Resources and Economic Growth," *Macroeconomic Dynamics* 3 (June 1999), pp. 204–25.

¹⁹ P. Collier and A. Hoeffler, "Greed and Grievance in Civil War," Policy Research Working Paper 2355, Development Research Group, World Bank 2000.

²⁰ Robert Looney, "The Business of Insurgency: The Expansion of Iraq's Shadow Economy," *The National Interest* 81 (Fall 2005), pp.67–72.

the delivery of essential services and it undermines citizen trust in government.”²¹

3. Authoritarian rule enables one party to gain control of resources and use them for its own benefit, thereby creating resentment among political outsiders. The result is often regional secession movements as with the Kurds under Saddam, and perhaps the current Sunni concerns of a Shiite/Kurd alliance depriving them of future oil revenues.²²
4. Sale of looted natural resources can provide rebel groups with financing—as exemplified by conflict diamonds, and trade in cocaine and opium, and of course smuggling and black market oil in Iraq.²³

The relevant causal explanations for oil’s destructive effects fall into three broad and somewhat overlapping categories: the rentier thesis, the repression thesis, and the rent-seeking thesis.²⁴

According to the rentier state thesis, oil wealth crates weak state–society linkages. Specifically, the direct receipt of oil revenues means the state does not need to represent and monitor social groups for the purpose of extracting taxes and developing public policies that justify the level of taxation. During booms, oil governments tend to rapidly ratchet up expenditures, flooding the domestic economy with excess cash stimulating inflation pressures. Conversely, sharp declines in oil revenues make it impossible to continue patronage and the weaknesses of the state bureaucracies make it impossible to obtain revenue from other sources. Significantly, Iraq has very limited non-oil sources of revenues, with 95% of government revenues coming from the petroleum sector.

Oil states also have unique structures that contribute to the problem. Unlike agriculture, the oil sector employs few unskilled people. The inherent volatility of commodity prices hurts the poor the most, as they are least able to hedge their risks. And because the resource is concentrated, the resulting wealth passes through only a few hands—and so is more susceptible to misdirection.

The repression thesis argues that oil wealth keeps the authoritarian states in power, because wealth is used to strengthen the military and the

²¹ Quoted in “Iraq Facing Corruption Threat,” BBC News, March 16, 2005.

²² Phyllis Bennis, “The Iraqi Constitution: A Referendum for Disaster,” Institute for Policy Studies, October 14, 2005 <http://www.ips-dc.org/comment/Bennis/tp34constitution.htm>

²³ Robert Looney, “The Business of Insurgency: The Expansion of Iraq’s Shadow Economy,” *The National Interest* 81 (Fall 2005), pp. 67–72

²⁴ Excellent early country case studies illustrating each can be found in Alan Gelb and Associates, *Oil Windfalls: Blessing or Curse?* (New York: Oxford University Press, 1988).

police and keep opposition forces out. While repression may be a major factor in the political area, it is not necessarily a factor in the economic realm. Oil rich governments often do not have a major incentive to develop non-oil sources of wealth. Nor do they have a pressing need to raise revenues through taxes, and the ruled (but untaxed) consequently have little incentive to hold their rulers accountable.

The rent seeking argument sees oil wealth as spoils for those who seize and retain power. This will stimulate greed-driven rebellions as contrasted to scarcity-driven rebellion. The government programs more often than not focus on distribution rather than production.

Summing up the problems for economic development posed by an abundance of natural resources, Nancy Birdsall notes:²⁵

The curse of being blessed with natural resources is a problem not just in Chad but in Bolivia, Venezuela and Nigeria. The evidence is overwhelming that oil and mineral wealth hurts growth in developing countries. It generates more corruption than good jobs, and it undermines the development of property rights, responsive local government and the other political institutions that a successful economy requires.

Prevention of these effects in Iraq could take several approaches or their combination:

Privatization—completely separate the government from the oil sector. This action was originally proposed by MIT economist M. A. Adelman²⁶ who recommended the auctioning of Iraq's producing oil reserves, which he estimated were worth around \$100 billion, to the highest bidder. The authorities would then be forced to institute a comprehensive tax system to fund its operations. He did not, however, address the question of how the government would spend the money after it comes in. Given the current political climate in Iraq, combined with suspicion of U.S. motives for that country, the window has been missed for this alternative.

Disbursement—automatically allocate a fixed share of oil revenues for transfers to the population at large.

Transparency—if the government retains control of oil revenues, rules and procedures must be established to assure full transparency and accountability as the oil revenues flow through the system.

²⁵ Nancy Birdsall, "Beating the 'Curse' of Natural Riches," *Los Angeles Times*, January 2, 2006, B.9.

²⁶ M. A. Adelman, "Let's See Auction: Iraq's Oil—For Sale to the Highest Bidder," *Wall Street Journal*, April 2, 2003.

Many other variants are possible. The World Bank's recipe for sustainable development based on resource extraction requires three principles at the national level: (1) the establishment of transparency and accountability with respect to revenues earned and their disposition; (2) consultation with principal stakeholders in developing plans for the use of resource revenues; and (3) credible oversight and audit of the implementation of these plans.²⁷

These principles, reiterated by G8 members at the 2003 Sea Island Summit and underpinning international efforts such as the Extractive Industries Transparency Initiative,²⁸ can be embedded in the very structure of an Iraqi government founded on checks and balances including parliamentary oversight and on local consultation to prevent interregional rivalries and conflicts between the central and local governments.²⁹

Other solutions to the "oil curse" have been advanced. Reminiscent of the "rules vs. authorities" debates³⁰ in macroeconomics, one promising direction of policy assumes that increased transparency, together with the minimizing of the discretionary power governments have to spend, will enable countries to avoid, or at least minimize somewhat, the three main areas of difficulty noted above. This approach draws on the potential effectiveness of oil funds in assisting countries overcoming aspects of the three causal mechanisms noted above.

Oil funds

Oil funds have become fashionable in the wake of recent high and volatile oil prices and new discoveries. In recent years, many countries have either established oil funds or are considering doing so. These funds have different rules and names, but their objectives are the same: to help governments deal with the problems created by large oil revenues.³¹

²⁷ World Bank, "Oil and Gas Sector Issues and Policy: Social and Economic Impact," available at <http://www.worldbank.org/ogmc/wbogpolicysocioeconomic.htm>.

²⁸ For more information on EITI, see <http://www.eitransparency.org>. For more on the G-8's position on good governance of natural resource revenues, see "Fighting Corruption and Improving Transparency—A G8 Action Plan" available at <http://tinyurl.com/dbo62>

²⁹ Protecting the Future: Constitutional Safeguards for Iraq's Oil: An Iraq Revenue Watch Report, May 2005.

³⁰ Cf. Bennett T. McCallum, "The Case for Rules in the Conduct of Monetary Policy: A Concrete Example," *Economic Review*, September/October 1987.

³¹ Jeffrey Davis, Rolando Ossowski, James Daniel and Steven Barnett, "Oil Funds: Problems Posing as Solutions?" *Finance & Development*, 38:4 (December 2001).

Over the last ten or fifteen years, at least three types of oil funds have been introduced. Stabilization funds are used to smooth-out government expenditures over an oil cycle: in principle, when oil prices are high, revenues are set aside; when prices fall, governments use the funds to maintain aggregate demand. A related idea is to use an oil fund to invest a large proportion of revenues in international markets. In theory, such funds would not only help spread the wealth over several generations but would also help avoid appreciation of the local currency and the resulting harm imposed on the non-oil export sectors of the economy—the so called “Dutch Disease.”³² Finally, in line with the philosophy that ultimately oil resources belong to the public, distribution funds disburse a certain amount of oil revenues directly to the population at large.³³

While oil funds seem at first glance an attractive option, from an economic perspective they receive much less interest. Any fiscal policy decision that can be made in the context of an oil fund—any particular decision about the use of oil revenue over time—can also be made without an oil fund. Similarly, an oil fund is not required for a government to save oil-related revenues abroad thereby preventing exchange rate pressures from these revenues and easing the task of the monetary authorities. The rationale for the creation of an oil fund must thus be based on political economy arguments rather than on purely economic grounds.³⁴

Clearly, natural resources and oil wealth should be of benefit to countries. The fact that they often are not can be linked to failures of governance that are connected with failures of democracy and public accountability. An important contribution of an oil revenue investment/distribution fund is that it may significantly remedy this political failure by creating a sense of citizen ownership, in turn prompting buy-in to the political system.³⁵

To date, the results of oil fund based strategies in other countries have been mixed. At issue is whether one or more variants of established and/or proposed oil funds hold out promise for success in the Iraqi environment.

³² Robert Looney, “A Monetary/Exchange Rate Strategy for the Reconstruction of Iraq,” *Middle East Policy* 10:3 (Fall 2003), pp. 33–42.

³³ “The Paradox of Plenty,” *The Economist*, December 20, 2005.

³⁴ John Wakeman-Linn, Paul Mathieu and Bert van Selm, “Oil Funds and Revenue Management in Transition Economies: The Cases of Azerbaijan and Kazakhstan” (IMF).

³⁵ Thomas I. Palley, “Combating the Natural Resource Curse with Citizen Revenue Distribution Funds: Oil and the Case of Iraq,” *Foreign Policy in Focus*, Special Report, December 2003.

Stabilization funds

As their name suggests, stabilization funds are intended to shield the economy from the negative effects of volatility due to variations in government revenues. Ideally, through transferring resources to the stabilization fund the government is able to improve overall fiscal discipline. Stabilization funds usually use pre-announced accumulation and withdrawal rules that are contingent on the natural resource price or revenue levels.

The fund accumulates a portion of natural resource revenues when prices exceed a pre-announced threshold level; it releases assets to finance government expenditures when prices are below a threshold level. The thresholds may be defined in a number of ways, including arbitrarily setting the value of natural resource price or revenues as a formula-calculated value based on historical natural resource prices or revenues sometimes including price/revenue projections.³⁶

Performance of stabilization funds has been mixed. Chile's Copper fund operates as a stabilization fund; transfers go directly into the budget and the elected legislature decides how to allocate funds through the budgetary process. Venezuela, on the other hand, has had much less success with its stabilization fund because its ultra-presidential system allows the executive to allocate transfers from the fund without meaningful legislative oversight.³⁷

Another example of potential abuse of stabilization funds comes from Chad. That country passed a revenue management law for its anticipated oil proceeds from the Chad–Cameroon pipeline project. Although the law requires 80 percent of the government's oil revenues be dedicated to education, health, infrastructure and other development projects, the law does not specify where the funds should be spent. In other words, all the investments could be made in one region. In Chad, as in Iraq, where ethnic cleavages coincide with geography, inequitable spending could reignite Chad's long running war.³⁸

Chad illustrates another important lesson: If Iraq decides to create an oil fund, the best way to ensure its stability would be to create it in the country's constitution, thus protecting it from future political pressures. In late

³⁶ Christian Petersen and Nina Budina, *Governance Framework for Oil Funds: The Case of Azerbaijan and Kazakhstan* (Washington: World Bank, 2002).

³⁷ Cf. Svetlana Tsalik, *Caspian Oil Windfalls: Who Will Benefit?* (Open Society Institute, 2003).

³⁸ Ibid.

2005, the Chadian parliament voted to scrap a fund set up to safeguard a portion of the country's oil revenues for future generations. It also modified the fund noted above to include state security expenditures. In addition, the Parliament modified the terms of service from three years to nine years of a special group whose task it is to monitor the operation of the funds. These developments led Gilbert Maoundonodji, head of a civil society coalition monitoring the oil funds, to note: "These changes mean more bad governance and more unchecked corruption."³⁹

Governance issues aside, the main problems with stabilization funds occur in designing rules for accumulation and transfer to the current budget. The international price of oil does not appear to have a constant average, or at least one to which it reverts to in a reasonable period of time.⁴⁰ In the period 1970–1980 the real price of oil rose by about 1,300 percent. From 1986, it dropped by about two thirds. It was fairly steady in 1986–1997, fell further in 1997–1998, and then more than tripled after February 1999.

A major problem in setting a price of oil for stabilization fund purposes is that speculation is a major factor in affecting prices. It is likely that speculation affects cartel prices more than competitive prices.⁴¹ Oil prices fluctuate more because betting on price must include calculations about not just supply and demand, but also about OPEC's quota decisions, plus the likelihood of member cheating on agreements and other elements of cartel behavior not easily gauged. Buyer panic is also another factor affecting prices. In the huge oil price spike of late, the change in supply was almost trivial, yet the price effects were massive. Hence the world oil market is less predictable, more volatile than most markets. The result is that it is extremely difficult to say with confidence that oil prices will fall or rise in the future or that a price change is permanent or temporary. Stabilization funds governed by rules that assume otherwise face either continuous accumulation or rapid exhaustion of resources.⁴²

³⁹ "Chad: Parliament Defies World Bank, Scraps 'Future Generations' Oil Fund," IRIN news.org, December 30, 2005.

⁴⁰ Jeremy Grantham, "Oil Defies Natural Process of Markets Reverting to the Mean," *Financial Times*, July 21, 2005.

⁴¹ M. A. Adelman, "The Real Oil Problem," *Regulation*, Spring 2004, p. 20.

⁴² Jeffrey Davis, Rolando Ossowski, James Daniel, and Steven Barnett, "Stabilization and Savings Funds for Nonrenewable Resources: Experience and Fiscal Policy Implications," IMF Occasional Paper 205 (Washington: International Monetary Fund, April 13, 2001).

The way oil prices behave helps explain why many domestic and international commodity price stabilization schemes collapsed or were terminated in the 1980s and 1990s. Given the uncertain state of affairs in Iraq, the problems associated with setting rules for a stabilization fund would be compounded many times over: Should the fund's rules be set by prices or revenues? How would fluctuations in production stemming from insurgent attacks be handled? Should fluctuations in foreign assistance also be included? One can easily think of additional elements that might make any set rule designed by Iraqi authorities obsolete in a matter of months.

Inter-generational funds

Several leading economists⁴³ have proposed that an inter-generational fund along the lines of Alaska's would facilitate Iraq's economic recovery while avoiding many of the difficulties associated with an oil-based economy.

In the 1970s during the construction of the Trans-Alaska Pipeline, the state realized that the new oil leases would produce an enormous windfall. Its citizens set up the Alaska Permanent Fund to manage this income, directing that the revenue be invested, the principal remain untouched and the gains be used for state infrastructure investments. Part of the proceeds was to be distributed as dividends to every Alaskan.

The Alaska Permanent Fund (APF) was created by an amendment to the state constitution and enacted through a popular referendum. Public oversight and an engaged citizenry have resulted in wise investment decisions, and consequently the fund has remained financially strong.⁴⁴

No doubt the stability of the APF is due largely to its status as a constitutional amendment. In contrast, the Alberta Heritage Savings Fund (AHSF) in Canada was created through the normal legislative process. As a result, the AHSF's management structure, investment rules and organization are subject to the ups and downs of the political process. The different strategies and priorities of the AHSF and the APF have resulted in significant earnings discrepancies. While the AHSF has declined in value over the last 15 years, the APF has had a real rate of return of over 12 percent for the same period.⁴⁵

⁴³ See for example Vernon Smith, "The Iraqi People's Fund," *Wall Street Journal*, December 22, 2003, and Steven C. Clemons, "Sharing Alaska-Style," *New York Times*, April 9, 2003, A.19.

⁴⁴ Tsalik, op. cit.

⁴⁵ Ibid.

Clemons has proposed that a fund similar to the Alaska fund be set up in Iraq. The proposal is that Iraq should save a fixed portion of its oil revenues, which would be invested in a portfolio of international equities and bonds. This portfolio would effectively become the national trust fund and the fund's income would be distributed to Iraqi citizens on an annual basis. Over time, the fund would grow as a result of continuing saving of part of oil revenues, and so too would the dividend distribution.

Most of those advocating a similar fund for Iraq would tend to agree with Clemons' observation that in its significance the fund goes somewhat beyond a simple widespread inter-temporal sharing of the country's oil wealth:

Most revolutions that produce democracies expand the number of stakeholders in the nation's economy. America's occupation of Japan succeeded not just because the United States purged Japan's warmongers and established a peace constitution but because it imposed land reform. American occupiers broke up vast estates held by the Japanese aristocracy and redistributed the land to farmers, thus linking Japan's most lucrative resource to millions of citizens. Now America should do the same with Iraq's most lucrative resource oil.⁴⁶

When Clemons first proposed an Alaska-type fund for Iraq in April of 2003, the country's annual oil revenues were anticipated to come to approximately \$20 billion. With that figure he calculated that a postwar government could invest \$12 billion a year in infrastructure to rebuild the nation. The other \$8 billion could anchor an Iraq Permanent Fund to be invested in a diverse set of international equities. The resulting income would go directly to Iraq's six million households. These payments would make a huge difference to families in a country whose per capita gross domestic product rests at about \$2,500. More importantly, Clemons felt that by spreading capital broadly among new stakeholders, the plan would also prevent a sliver of Iraq's elite from becoming a new kleptocracy.

In sum, with oil revenues constituting a large portion of the economy—as much as 74% of GDP in the case of Iraq—channeling them through government means that effectively the government runs the economy. Not only does government have too large a say over economic activity, it also becomes the target for corruption and rent-seeking.

⁴⁶ Steven C. Clemons, "Sharing Alaska-Style," *New York Times*, April 9, 2003, A.19

Clearly, the establishment of an Alaska-type fund in Iraq might have the potential to change the structure of the economy and incentives in ways that could facilitate lasting economic and political change. Not only could it diminish the natural resource curse with its risk of stagnation and civil conflict, it would likely institute affirmative changes that (1) empower citizens to take charge of the process of economic growth, and (2) give citizens an incentive to engage in democratic politics.⁴⁷

It is safe to assume that the extent to which these last two factors might play a significant role in shaping Iraq's future depend in part on the direct distribution formula—how oil-related money is disbursed directly to the country's citizens.

Direct distribution funds

The Alaska fund was established in a state with a high level of good governance. The gradual accumulation of revenues has over the past 25 years built up the Alaska portfolio, and as the portfolio has grown so too has the dividend distribution. This has had the intended effect of provision for the future and building citizen ownership and engagement. However, whereas the slow process of accumulation was right for Alaska, it may not be right for Iraq, which starts from a condition of economic collapse and with a history of autocratic, kleptocratic governance. Thomas Palley⁴⁸ for one has argued that the country's current needs are so pressing that a significant share of oil revenues should be disbursed to the population immediately rather than being invested for future generations. His tentative figure was that 25% of revenues be distributed, although his figure is amenable to change.

In addition, Palley proposes the establishment of a companion fund that would distribute a share of oil revenues to provincial and local governments. This second fund is intended to ensure a fair regional distribution of revenues, thereby reducing the potential for regional grievances, which, as noted, have led to civil war in several countries and certainly could lead to one in Iraq.

At first glance, Palley's proposal would seem unrealistic given the country's financial plight. The United States is unlikely to authorize an increase

⁴⁷ Thomas I. Palley, "Combating the Natural Resource Curse with Citizen Revenue Distribution Funds: Oil and the Case of Iraq," *Foreign Policy in Focus*, Special Report, December 2003.

⁴⁸ *Ibid.*

in the \$18 billion it has already set aside for Iraq. At the end of 2005, half of this had been distributed. The remainder will take perhaps another 18 months to spend, and then Iraq will presumably be on its own. As the commander of the U.S. Army Corps of Engineers in Iraq, General William McCoy, noted: “We were never intending to rebuild Iraq. We were providing enough funds to jump-start the reconstruction effort in this country.”⁴⁹ Other observers have severe doubts as to how the country will be able to complete its reconstruction efforts:

With the world’s third-largest oil reserves, Iraq ought to be able to pay its own way...But with oil revenues accounting for more than 90 percent of government revenues (there is no tax system to speak of) and output still below pre-war levels, there are profound fears about how Iraq will cope.⁵⁰

Rough pictures of the harsh environment facing the Iraqis are contained in the country’s National Development Strategy. As the NDS notes, Saddam Hussein’s economic legacy will be present for some time. In particular, that regime’s questionable economic policies, its mismanagement of the economy together with political repression, internal conflicts, wars and sanctions have left a number of serious impediments to recovery and growth. While some of these obstacles are lessening thanks to the reforms⁵¹ put in place by the Coalition Provisional Authority (CPA), others were created or reinforced through postwar policy errors and miscalculations,⁵² and a number remain:⁵³

1. The oil sector dominates the economy, accounting for around 74% of GDP. Iraq now depends solely on oil exports for finance of investment and consumption expenditures, for government revenues—of which oil export proceeds exceed 93%—and for 98% of foreign currency earnings.
2. Centralized decision making and intrusion of the state into economic life have distorted the pricing structure in many sectors to the extent that prices often do not reflect the real value of the product or service. In turn, distorted prices have caused inefficiencies and waste.

⁴⁹ “Iraq’s Reconstruction Funding Drying Up,” United Press International, January 15, 2006.

⁵⁰ Heather Steward, “Iraq’s Future Still Going Up in Smoke,” *The Observer* (London) January 15, 2006.

⁵¹ Cf. Robert Looney, “Iraq’s Economic Transition: the Neoliberal Model and its Role,” *Middle East Journal* 57:4 (Autumn, 2003), pp. 568–587.

⁵² Documented in Robert Looney, “The Viability of Shock Therapy in Iraq,” *Challenge*, 47:5 (September–October 2004), pp. 86–103.

⁵³ The Iraqi Strategic Review Board, *National Development Strategy 2005–2007* (Baghdad: The Ministerial Committee on The National Development Strategy, September 2004), pp. 3–4.

3. The public sector is over represented in the economy, leading to inefficiency and decreased growth. Many state enterprises (SOEs) are currently dormant. The weakness of the private sector has limited its role in economic development, increasing the lack of diversification.
4. Social inequalities are widespread in a broad range of fields covering health, education, public services, and social services to low-income groups, the disabled, internally displaced persons, refugees, single-parent households, and other vulnerable groups, across geographic areas.
5. With over 50% of the population under 24 years of age, rapid rates of population growth are likely for many years. Many in this large demographic group are alienated due to violence and limited access to education, training and career prospects.
6. There is widespread unemployment, ranging to about 50% and absolute poverty where more than 60% of the population depends on the government's rationed food basket. Unemployment has led to an increase in demands for social assistance.
7. Poor governance practices are common, including widespread nepotism in public appointments and corruption among public servants. The lack of accountability and transparency in managing state resources has abetted corruption and increased its corrosive effect on growth and efficiency.
8. Iraq's decades long isolation has resulted in the digital divide, outdated institutions, administrative systems and know-how. Technological stagnation and the use of outmoded production methods have weakened the economy as a whole.
9. Public sector institutions have witnessed serious looting, theft and destruction.
10. Another legacy of the past was the total dependence on monetary expansion to finance the deficit in the budget, which led to average inflation of 50% annually during the 1990s. While monetary policy is now on a sounder footing, the inflation psychology, lack of a developed government bond market, together with supply side shocks have resulted in volatile movements in price and an inflation rate still in double digits.
11. The traditional family unit and the community have remained the core of Iraqi society, ensuring solidarity and social cohesion against all

odds. However, conflict and inequality have eroded the social fabric of communities and families throughout the past three decades.

12. In Iraq, social capital establishes an important relation between incomes and human capability to withstand shocks. Iraqis have witnessed a depletion of social capital, which has led to social deprivation in most sectors of society.
13. Civic participation and recognition of human rights were denied during the previous regime. They remain poorly understood and lack ancillary support structures.
14. A large informal economy coexists with the formal sector. This informal economy may account for as much as 65% of Gross Domestic Product.⁵⁴ Even more worrisome is the large criminal element that controls large segments of the informal sector.⁵⁵

A recent UNDP household survey⁵⁶ documents the impact these factors are having on the average Iraqi household:

1. The UNDP survey suggests the poorest 20% of the population earns 7% of the income, while the top 20% earns 44%.
2. Iraq's median household income of 144 dollars has dropped from a post-war high of 255 dollars in 2003.
3. One-third of Iraqis canvassed by UNDP described themselves as being among the poor.
4. One-sixth of interviewees met all or most of the criteria suggesting that they lived beneath the poverty line.

The International Monetary Fund's assessment⁵⁷ of the Iraqi economy stresses the difficulty of implanting policies in that country especially in light of the constraints imposed by the new, fragile and very incomplete institutional setting,⁵⁸ the public sector's limited administrative capacity and the precarious social, political and security situation.

⁵⁴ Robert Looney, "The Economics of Coping: The Plight of Women in Iraq's Informal Economy," *Journal of Social, Political and Economic Studies* 30:3 (Fall 2005), pp. 285–303.

⁵⁵ Robert Looney, "The Business of Insurgency: The Expansion of Iraq's Shadow Economy," *The National Interest* 81 (Fall 2005), pp. 67–72.

⁵⁶ United Nations Development Program, *Iraq Living Conditions Survey 2004, Volume I: Tabulation Report* (Baghdad: Central Organization for Statistics and Information Technology, Ministry of Planning and Development Cooperation, 2005).

⁵⁷ Statement by A. Shakour Shaalan, Executive Director for Iraq, August 1, 2005 in Staff Report for the 2005 Article IV Consultation, Supplementary Information (Washington: IMF, July 25, 2005).

⁵⁸ Cf. Robert Looney, "The Business of Insurgency: the Expansion of Iraq's Shadow Economy," *The National Interest* 81 (Fall 2005), pp. 67–72.

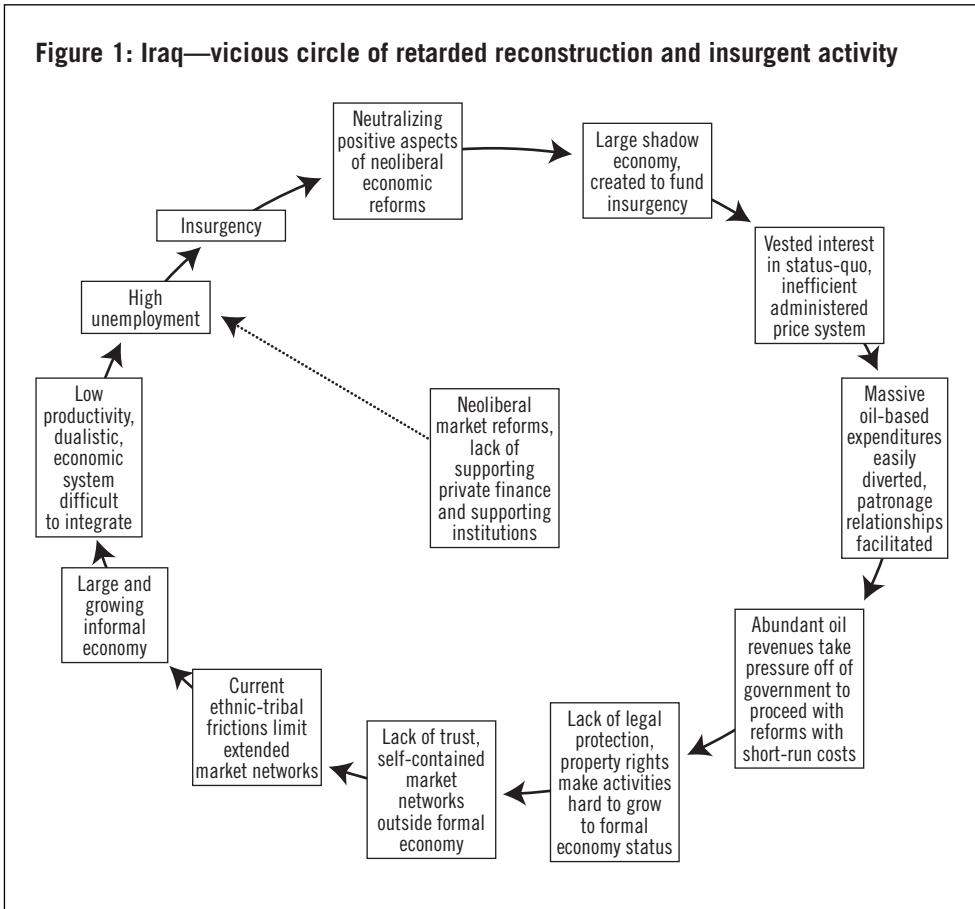
Distribution fund based development strategy

How did this sad state of affairs come about? Needless to say there is no simple and short answer. In retrospect, starting with the adoption of a questionable development, a vicious circle seems (Figure 1) to have prevented the economy from gaining any sort of traction. Specifically:

1. Given the postwar state of affairs in Iraq, adoption of a neoliberal/ Washington Consensus free market development strategy was unrealistic.⁵⁹ While an ideal policy mix in certain situations, as applied in Iraq it has gone down a number of dead-ends as a result of serious miscalculations and faulty assumptions.
2. By its nature, this strategy largely precludes large segments of the population from the decision making process; only those with the prerequisites—the proper education, appropriate skills, financial capital to draw on, etc.—can immediately thrive. Few of these skills or assets exist in today's Iraq.
3. Its main strength is in providing incentives to private investors, but in a conflict country like Iraq this is not enough to offset the high level of uncertainty. As Stephen Glain has observed, “In the relatively peaceful months that followed Saddam's removal, it seemed Iraq would no longer need Jordan as an enclave. Two years later, the colony of affluent Iraqis in Amman is a measure of how estranged war-torn Iraq has become from its private sector.”⁶⁰ Even in Chile, its main success story, several years of difficult restructuring under a very stable government occurred before investors felt confident in taking a stake in the country's future.
4. While many have argued that a trade oriented development strategy might provide added incentives for the private sector, shifting international markets and trade relationships might create added instability through sudden drops in the output from industries with limited domestic markets. Also, it appears that reforms in the trade area for

⁵⁹ For a detailed description and assessment of the neoliberal reform package in Iraq see: Robert Looney, “The Neoliberal Model's Planned Role in Iraq's Economic Transformation,” *Middle East Journal* (Autumn, 2003); Robert Looney, “The Viability of Economic Shock Therapy in Iraq,” *Challenge*, 47:5 (September–October 2004); and Robert Looney, “Postwar Iraq's Financial System,” *Middle East Policy*, XII:1 (Spring 2005).

⁶⁰ Stephen Glain, “Land of Tycoons: Many Iraqi Businessmen are Running their Emirates from Self Exile in Jordan,” *Newsweek* (International Edition) June 27, 2005, p. 46.



countries at Iraq’s stage of development are not particularly effective in inducing follow-on reforms in key areas of governance.⁶¹

5. The neoliberal approach is not evolutionary: when things begin to go wrong, there is not an automatic adaptive policy. In mature economies, this adaptation is usually through price movements, but in a country coming out of war, sanctions and a long history of socialism, a period of institution creation and strengthening is necessary before markets can be expected to perform this function.
6. As in other parts of the world, the neoliberal program is an easy target for radical groups. While in abstract terms it makes a great deal of

⁶¹ Robert Looney, “U.S. Middle East Economic Policy: Are Trade Based Initiatives an Effective Tool in the War on Terrorism?” *Strategic Insights* IV:1 (January 2005).

sense, its stress on openness to trade and foreign investment make it an easy target for arguments contending that the program is just another form of imperialism—a program largely designed for exploitation of weaker countries and groups. The extreme form of neoliberalism introduced in Iraq lends considerable credibility to these claims, as does the initial stress on privatization.

7. The neoliberal philosophy also discourages large-scale government intervention in the economy. This, together with market instability, creates high levels of uncertainty and the impression that the government is powerless to respond to crisis or adversity. As a result, unemployment has stabilized in the 30%–40% range, with large segments of the Iraqi population having a sense of hopelessness concerning their futures.
8. The insurgency aside, it is problematical whether the neoliberal reforms would have jumpstarted the economy. A large shadow economy exists, perhaps accounting for 65% of Gross National Product and 80% of the labor force. This market is largely outside the normal forces of supply and demand, requiring specific and directed policies to assure its transition into the regular economy.
9. Transition economies with large shadow economies, but much more favorable initial conditions, experienced sharp contractions for up to five years after introducing even milder reforms. Even under normal circumstances, this would have been the likely scenario for Iraq.
10. While one intent of the reforms was to dismantle as quickly as possible institutions linked to the previous regime, the neoliberal policies were not, as expected, capable of initiating a process of new institutional development. The resulting vacuum was largely filled by already organized groups: religious, criminal and radical elements.
11. Because the neoliberal reforms were only partially introduced, with a number of controls still in effect, significant and sizeable black markets have developed—the most important being in petroleum products. The resulting scarcity of fuels has had a debilitating effect on several important sectors of the economy. It has also lent credibility to extremist claims that the Coalition is only there to appropriate Iraqi oil.
12. In effect, the economic system to date has been much more efficient at creating an environment for criminals and extremist elements to

thrive than it has for private investors. Much of the funding for extremist groups comes from black market arbitrage, further enabling their recruitment efforts.

In sum, the current development strategy with its emphasis on market reforms, infrastructure development and private foreign investment is not working and is not likely to revive the economy in the foreseeable future. It is an export-oriented strategy, but other than oil, the country currently has limited potential in this area. Nor, under the current circumstances marked by violence and uncertainty, is it likely to be competitive in international markets for some time.

As a result, the massive expenditures in infrastructure have not produced the significant follow-on investment as Hirschman's⁶² unbalanced growth strategy might have anticipated. Instead, infrastructure projects have been an easy target for the insurgents and a financial drain for the United States and the Iraqi government. The top-down nature of the post-war strategy is another reason for its limited impact. There has been limited Iraqi input and participation and, consequently, many of the investments undertaken are not nearly as productive in the Iraqi context as they would have been if they were indigenously designed to respond to a tangible domestic need.

The value of a distribution fund along the lines suggested above is that it has the potential, through reorienting the economy from the foreign investment/export orientation to that of developing the domestic market, to enable the economy to break out of the vicious circle of high unemployment, increased violence, insignificant private investment, low incomes, high unemployment. Moreover, it is likely that through diverting funds from the public to the private sector it will provide, in addition to the benefits of the Alaska-type funds noted above, an improved overall policy environment. As Palley notes:⁶³

Moreover, government may lack the capacity to effectively absorb and dispense these revenues in a welfare maximizing fashion. Under such conditions shifting toward decentralized absorption is desirable. This can be done by distributing oil wealth to the people and letting them spend it on what they deem is needed for their welfare. Economic development surely involves the accumulation of public capital and infrastructure, and this requires government investment. But

⁶² Albert O. Hirschman, *The Strategy of Economic Development* (New Haven: Yale University Press, 1958).

⁶³ Thomas I. Palley, "Combating the Natural Resource Curse with Citizen Revenue Distribution Funds: Oil and the Case of Iraq," *Foreign Policy in Focus*, Special Report, December 2003, p.9.

economic development also requires the accumulation of private capital based on the decentralized decisions of individuals. Putting extra money into the hands of individuals can help this process.

The logical argument against an oil distribution fund with a large share of oil revenues dispensed directly to the public is whether the country can afford such a program. As we have seen, the reconstruction costs in Iraq are enormous, and with the United States severely limiting its expenditures in Iraq, there will be a large funding shortfall.

Here it is important to note that the so-called funding shortfall is a contrived number. It is based on the assumption that funds are being diverted from projects with maximum impact and/or rates of return to activities of little economic importance. Given the high costs of these projects due to security costs, foreign staffing and the like, together with the limited effectiveness of many, this shortfall is largely illusory.

In any case, the true test of the expenditure of scarce resources in Iraq should be the total contribution to political and economic development. Expenditure patterns that contribute to the avoidance of the resource curse are likely to be the most productive for the country's eventual recovery and growth. An oil distribution fund is the best way to ensure that outcome. It stands to raise political engagement and improve democracy, reduce government corruption, and reduce the likelihood of civil conflict by diminishing cause for regional grievance. An oil distribution fund also promises to accelerate private sector economic development through a process of demand led growth. And, as the supply side of the economy grows this can provide the tax base needed to fund public infrastructure.⁶⁴

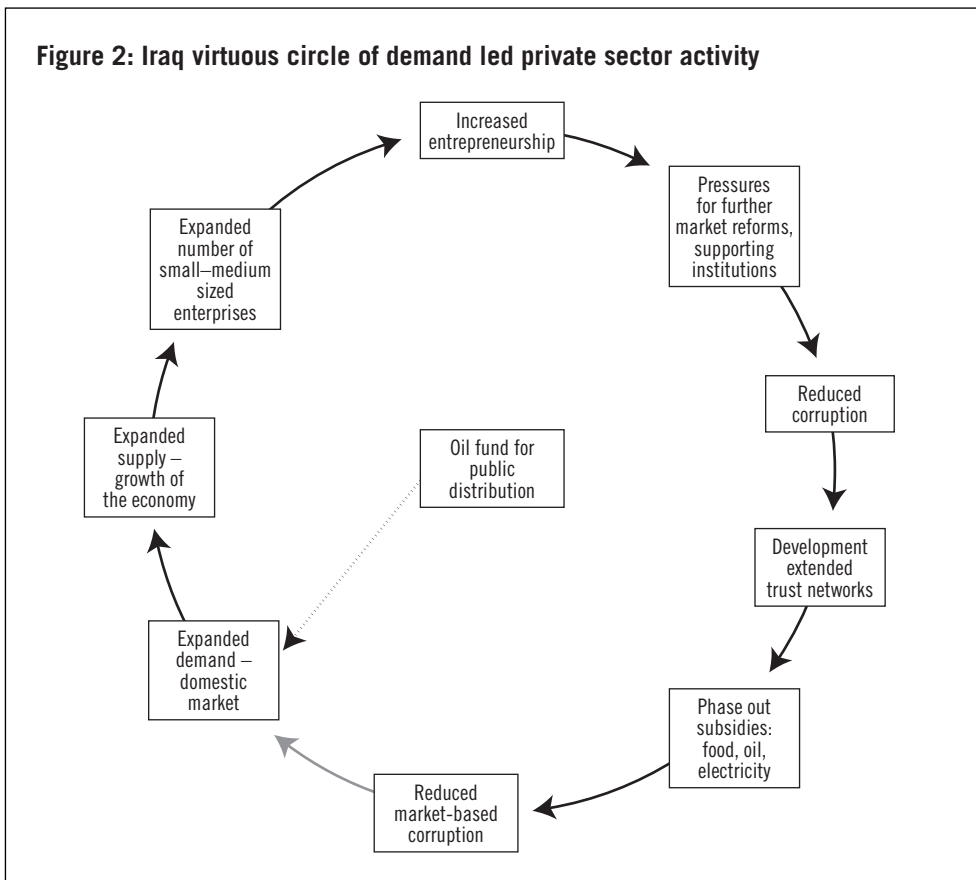
Finally, one area of investment critical to the country's future is the oil sector. Iraqi goals for the sector are to triple current production levels within ten years at an estimated investment cost of \$20 billion.⁶⁵ Clearly much of this will have to be foreign investment or financed through borrowing. Iraqi oil in the ground can be used as collateral for such borrowing, but this should still leave current oil revenues free for distribution. Thus, investment in the oil industry if appropriately financed is not inconsistent with the creation of an oil distribution fund of the magnitudes outlined above.

⁶⁴ Palley, *op.cit.*

⁶⁵ "Iraqis Ponder How to Manage their Oil Wealth," Nooz.com, October 1, 2005.

Assessment

Summing up, in addition to the obvious popularity of a direct distribution fund, its great strength lies in the prospect of the establishment of a virtuous circle of demand-led growth (Figure 2), as opposed to the current economic malaise or even vicious circle noted above. Most importantly, by breaking the direct link between oil and the government, it holds out the distinct prospect of enabling Iraq to avoid the oil curse that has plagued so many resource-rich developing countries.⁶⁶ In addition, there would be many tangible benefits associated with a disbursal program of this type, each of which can play an important role in the country's recovery:



⁶⁶ A similar view can be found in Nancy Birdsall and Arvind Subramanian, "Saving Iraq From Its Oil," *Foreign Affairs* 83:4 (July/August) 2004.

1. The Iraqi people would have increased incentive to protect the country's oil facilities by providing intelligence on insurgent groups attempting to disrupt the production and flow of oil.⁶⁷
2. It might even help stem the insurgency, especially if much of that activity is driven by Sunni fears that they will receive considerably less than their accustomed amount under the new Constitution.
3. Men and women would receive equal distributions.
4. It would establish an irrevocable personal identity under the law—essential for establishing titled property rights, bank accounts, human rights protection, voter lists and taxpayer lists.
5. It would expand banking and credit access for small and medium sized businesses.
6. It could help offset public resistance to gas price increases which will be needed to cut back oil smuggling. A related benefit is that it would also greatly help the government cut back on gas subsidies which currently amount to billions of dollars a year.
7. Without equitable distribution of oil revenues, competition among various groups for oil money could turn ugly and even erupt into violent conflict in Iraq. Rifts over oil revenues already run deep, as Iraqi Kurds, Arabs, and Turkmen struggle for control of oil-rich Kirkuk.⁶⁸
8. Citizens eligible for fund payouts would have an incentive to monitor the government and participate in the political process to guard the value of their entitlement.
9. A related effect is that oil funds are likely to encourage efficiency in the petroleum sector. Since the size of payments to citizens will depend on the efficiency of the oil industry, this should contribute to political pressure to improve efficiency.
10. Oil funds are expedient: rather than the long time intervals needed to improve government accountability and anti-corruption drives, they can be put in place immediately. They are doubly desirable when governance is weak, and the need for institutions to handle oil revenues is immediate.

⁶⁷ Gordon O. F. Johnson, "Iraq's Oil Revenues Should Empower the People," speech, Heritage Foundation June 3, 2004.

⁶⁸ Protecting the Future: Constitutional Safeguards for Iraq's Oil: An Iraq Revenue Watch Report, May 2005.