Combating the Natural Resource Curse with Citizen Revenue Distribution Funds: Oil and the Case of Iraq

By Thomas I. Palley | December 2003

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Introduction: The Case for Oil Revenue Distribution Funds[i]

In a *New York Times* op-ed earlier this year (April 9, 2003), Steve Clemons of the New America Foundation has proposed that Iraq establish an Alaska-style oil fund that would pay annual dividends to the citizens of Iraq.[ii] In Alaska, revenues from oil leases have been invested in a permanent fund, which has grown to $23.5 billion in 2002; part of the fund's income is now distributed directly to Alaskans as a dividend. Clemons has proposed that a similar 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.

The current paper proposes a modification of this proposal, suggesting the creation of an Iraq oil revenue trust fund that would directly distribute oil revenues to Iraqi citizens. Thus, rather than saving a share of revenues in a trust fund and building up the fund over time, a significant portion of oil revenues would be immediately and directly paid to Iraq's citizens. As an opening suggestion, the paper proposes that 25% of revenues be distributed—though this figure is amenable to change.

In addition, the paper proposes the establishment of a companion fund that would distribute a share of oil revenues to provincial and local governments. This second fund can ensure a fair regional distribution of revenues, thereby reducing the potential for regional grievances, which can lead to civil war. This is a major concern in Iraq, which is afflicted by significant regional divisions.

The reason for this more robust approach to oil revenue distribution is that there is an urgent need for political and economic reform in Iraq, and this need cannot be met under the more gradual Alaska oil fund approach. The Alaska fund was established in Alaska, a state with high governance quality. 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 provisioning for the future, and building citizen ownership and engagement. However, whereas a slow process of accumulation was right for Alaska, it is not right for Iraq, which starts from a condition of economic collapse, and with a history of autocratic, kleptocratic governance. Consequently, an accelerated transformation is needed in Iraq. This bespeaks the need for large-scale direct distribution of oil revenues, rather than gradual intermediated distribution done via a trust fund financed by financial asset accumulation.

An oil revenue distribution fund stands to benefit Iraq. But the arguments for directly distributing revenues to citizens and provincial and local governments also apply to other natural resource rich developing countries. Owing to weak, undemocratic governance and cultures of corruption, these countries are often afflicted by the natural resource curse, whereby oil fosters economic stagnation and civil conflict rather than growth and development. Developing efficient states with good governance takes a long time. Developing oil fields and building pipelines happens far faster.[iii] Oil revenue distribution funds and transparency measures can be put in place immediately. They are policies one might want even if quality of governance is high—as in Alaska. They are doubly desirable when governance is weak, and the need for institutions to handle oil revenues is immediate.

More than this, revenue distribution funds change the structure of the economy and incentives in ways that can trigger lasting economic and political change. Not only do they diminish the natural resource curse with its risk of stagnation and civil conflict, they also institute affirmative changes that (i) empower citizens to take charge of the process of economic growth, and (ii) give citizens an incentive to engage in democratic politics.

Finally, it is critical that any decision to implement an oil revenue distribution fund be taken by the Iraqi people, through legitimate, democratic institutions. Paul Bremer, the top U.S. administrator in Iraq, has recently expressed support for such a fund (*New York Times*, July 13, 2003). Whereas it is appropriate for Bremer to contemplate some form of temporary distribution during the transition to constitutional democracy in Iraq, any permanent arrangement must be the decision of the Iraqi people. This is the only way an arrangement can have lasting political legitimacy.

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The Natural Resource Curse Revisited

Iraq is abundantly rich in oil, having proven reserves of 112 billion barrels, which represent 10.8% of total world proven reserves. Moreover, many believe that Iraq's potential may be far greater as the country is relatively unexplored due to years of war and sanctions.[iv] However, like many other countries rich in natural resources, Iraq has failed to benefit from its oil wealth. In a real sense, Iraq exemplifies the workings of the "natural resource curse." The autocratic regime of Saddam Hussein used Iraq's oil revenues to finance domestic political suppression, military aggression, and state looting—as exemplified by wasteful spending on presidential palaces and transfers of funds to personally owned foreign bank accounts. The result has been two decades of economic stagnation, during which Iraqi per capita GDP has fallen by over 50%.[v] Iraq has also fought two costly destructive wars of aggression with Iran and Kuwait, and it has had to endure the censure of the international community in the form of United Nations sponsored economic sanctions.

The problem of the natural resource curse is now gaining prominence. *The Economist* (May 24, 2003) recently featured stories on oil wealth as the "Devil's excrement," and on the role of natural resources in fuelling civil war. Building on a decade of scholarship (Gelb, 1988; Sachs & Warner, 1995; Karl, 1997; Ross, 1997, 1999) on this important subject, the NGO community is actively promoting a new policy agenda aimed at addressing the curse. Global Witness (December 1999) was an early contributor with its report, *Crude Awakening: The Role of Oil and Banking Industries in Angola's Civil War and the Plundering of State Assets*. Oxfam America (Ross) released a report, *Extractive Sectors and the Poor*, in 2001. In May 2003 the Open Society Institute's Caspian Revenue Watch (Tsalik) released a major study, *Caspian Oil Windfalls: Who Will Benefit?*. The study focused on needed transparency and accountability improvements to the state oil stabilization funds that have been set up in Azerbaijan and Kazakhstan. Christian Aid also released a report, *Fuelling Poverty: Oil, War and Corruption*, in May 2003. And most recently, Catholic Relief Services (Gary and Karl) released its report, *Bottom of the Barrel: Africa's Oil Boom and the Poor*, in June 2003.

The natural resource curse hypothesis maintains that rather than fuelling growth and development, natural resource wealth can become the cause of economic stagnation, corruption, and civil war. Early research focused on macroeconomic dimensions of the curse. One key problem is "Dutch disease," whereby the real exchange rate appreciates as capital flows into a country in response to a natural resource boom.[vi] This appreciation renders domestic manufacturing and agriculture uncompetitive, causing lost jobs and higher unemployment. These lost jobs are not compensated for by growth in the natural resource sector, which is capital-intensive. The decline of manufacturing and agriculture also makes the economy dependent on natural resources, contributing to economic volatility since natural resource earnings are highly volatile.

A second macroeconomic problem concerns fiscal policy and inflation. Oil booms tend to raise expectations, and contribute to unrealistic projections of future income. This in turn leads to loss of control over public spending, including taking on high-cost public infrastructure projects, often financed with foreign borrowing. These projects can also become the vehicle for corruption and influence peddling. The net result is loss of fiscal discipline that contributes to inflation, the build-up of external indebtedness, and the development of cultures of corruption.

In addition to these macroeconomic problems, the natural resource curse undermines governance and democracy. Oil generates large streams of foreign exchange, and these flows become the basis for patronage that supports dictatorship and autocracy.[vii] A second feature is that oil- and mineral-dependent economies tend to spend a significantly greater share of their GDP on military expenditures. Finally, oil- and mineral-dependent economies are significantly more prone to conflict and civil war.

There is strong empirical support for all of these findings. Sachs and Warner (1995) have documented in cross-country statistical regression analysis that higher levels of oil and mineral dependence tend to reduce a country's rate of economic growth. This finding has been replicated by Leite and Wydmann (1999) and Glyfalson et al. (1999). Ross (1999, 2001) documents that after controlling for levels of GDP, countries that have higher mineral and oil dependence (defined as oil and mineral exports relative to GDP) also 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. Leite and Weidman (1999) and Glyfalson et al. report that higher oil- and mineral-dependent countries exhibit greater corruption, and Collier and Hoeffler (2000) report that they also have a greater probability of civil war for any given five-year period.

There are four ways that oil and mineral dependence tend to promote civil war and conflict. First, slower growth and poverty creates resentment and frustration that are the tinder for civil war. Second, corruption in government fosters a drive for regime change. Third, authoritarian rule enables one party to grab control of resources and use them for its own benefit, thereby creating resentment among political outsiders. This promotes regional secession movements—as exemplified in Aceh and Southern Sudan. Fourth, sale of looted natural resources can provide rebel groups with financing—as exemplified by conflict diamonds, and trade in cocaine and opium.

As is argued below, there are good grounds for believing that direct oil revenue distribution funds may be the most effective way of circumventing the natural resource curse in oil-rich countries. Not only do such funds have positive macroeconomic growth and development properties, they can also help address the causes of civil war and contribute to affirmative political development.

Iraq could greatly benefit from such a fund. It has already suffered from the natural resource curse, but the future may be bleaker still given that central government has collapsed. Owing to Iraq's tremendous ethnic and religious regional differences, there are significant centripetal forces making for civil war and conflict. In this circumstance, oil distribution funds can help guard against a break-up of the Iraqi state, with all the negative regional implications that this would carry.

Advantages of an Oil Revenue Distribution Fund (ORDF)

Natural resources and oil wealth should be of benefit to countries. The fact that they often are not is because of failures of governance that are connected with failures of democracy and public accountability. An important contribution of an ORDF 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. The reason is that citizens eligible for fund payouts would have an incentive to monitor governments and participate in the political process to guard this benefit. ORDFs create an entitlement, and with that entitlement comes political buy-in—just as entitlement to Social Security encourages political engagement within the U.S. system. Another parallel is with home-ownership, which can be viewed as contributing to political stability by creating a vested middle class. ORDFs can do some of the same by giving all a stake in economic society.

Lack of widespread public political participation is one source of governance failure. Government corruption is another. Here too, an ORDF stands to help by effectively pre-empting kleptocracy. Since a portion of oil revenues would be pre-committed to public pay-out, this would leave less in the hands of government officials that could be stolen.

The simplicity of an ORDF offers further protection against corruption. The fund would publicly declare its annual dividend payment, and the size of that payment would become public knowledge. Every eligible Iraqi would therefore know what they are supposed to receive, which would guard against skimming in the distribution process. The principal sources of corruption the fund would have to guard against would be making payments to non-existent persons, and making multiple payments to the same person.

Moreover, by taking these monies out of the hands of government, this could also reduce the risk of civil war and conflict. The academic research cited earlier clearly shows that natural resources can drive civil conflict, as parties struggle to gain control of over resource revenues. Excluded groups have an incentive to try and wrest control, while dominant groups have an incentive to take a disproportionate share of benefits. Creating a system in which all receive an equal pre-determined share can alleviate these tensions. Once the resource is seen as belonging to the public, the incentive to wrest government control for personal benefit is reduced as the value of control over government is diminished.

Another advantage of an ORDF is that it is likely to encourage efficiency in the oil industry. 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.

Beyond these political economy benefits, there are also more standard economic gains from such funds. When oil revenues constitute a large portion of the economy—as much as 50% 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.[viii] Moreover, government may lack the capacity to efficiently 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 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.

Linked with this important benefit is the fact that such distributions can promote domestic demand, which in turn can contribute to economic growth. Moreover, the contribution to domestic demand should be enhanced since the oil dividend will be paid equitably across society. This should help remedy a persistent problem in developing countries, which is the failure to develop robust, domestic, demand-led growth that contributes to deep domestic market development. Instead, developing economies have too often sought to rely on export-led growth, which tends to promote enclave development that lacks strong linkages with the rest of the economy (Palley, 2002). This feature is particularly true of countries that have relied on oil and mineral extraction.

Another economic benefit of an ORDF is that it can contribute to the development of credit markets. The dividend distribution will provide eligible citizens with a steady stream of income, and this income can then be used as collateral to borrow against. In many developing countries lack of access to credit is a restriction on entrepreneurship and development. The dividend entitlement can serve as seed money giving people access to credit. And as people borrow, this will stimulate small business, stimulate the growth of credit markets, stimulate financial development, and entrench laws of contract, commerce, and property.

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ORDFs also stand to have a progressive impact on national income distribution. Though each eligible person (rich and poor alike) will receive the same absolute payment, this will amount to a much larger percentage increase in poor people's income. Rather than being a weakness, this common payment feature is a strength. First, it contributes to transparency and simplicity. Second, there is a political message in treating rich and poor alike in a developing country context. Third, there is little to be gained from trying to micro-engineer the oil dividend payment to enhance its progressivity. Most developing countries are characterized by a wealthy elite, a small middle class, and a large class of poor people. Paying less to the wealthy would free up relatively little money, at the cost of creating complexity and potential for political resentment.

Finally, a last benefit of an ORDF is that it will require an administrative structure to implement it. This structure can become the backbone of a formal economy in which workers and entrepreneurs pay taxes, workplace conditions are regulated, and the government is able to track economic activity. Once again there is a parallel with Social Security in the U.S. economy, where an individual's Social Security number provides the basis for many different forms of economic record keeping, both public and private.

Disadvantages of an ORDF?

The advantages of an ORDF are multiple. Are there any drawbacks? One claimed drawback is that it could generate a welfare dependency effect. Under this hypothesis, an oil dividend entitlement is supposed to produce a national epidemic of laziness. This is of course possible, but if so it bespeaks an urgent public policy need to raise upper income bracket tax levels—especially on dividend and interest income—as too much income promotes laziness. The bottom line is that though being economically meaningful for poor Iraqis, any oil dividend will not be sufficient to provide an affluent lifestyle. Consequently, the incentive to economic action will remain intact.

A second problem is that oil dividends will reduce the amount of funding available for public infrastructure, health, and education spending. As a developing country, Iraq has huge needs in these areas—particularly after two decades of war and economic sanctions. This need is undisputed, but at the same time there must be grave doubts about Iraq's governmental capacity to undertake these types of investment.

In addition, private individuals have pressing private needs, and using part of Iraq's oil revenues to meet these needs may yield greater social welfare gains. Economic development policy always involves trade-offs. Funding an ORDF will reduce funds available for infrastructure spending. The question is: Do the benefits, in terms of contribution to private sector and political development, outweigh the losses from reduced infrastructure spending?

Finally, the net loss of public investment resulting from funding an ORDF may be quite small. First, marginal public investments adding the least to welfare will be cut first, while more essential investments will be retained. Second, reducing government revenues will reduce the incentive for corruption and rent-seeking. By hardening the government budget constraint, the Iraqi government may end up providing better value for money, thereby diminishing the net reduction in public investment spending.

A third objection is that making such dividend payments risks creating a political culture of opposition to government and collectively provided public goods, both of which are needed ingredients for a successful economy. Here, the argument is that individuals will come to persistently push for increased oil dividend payments, thereby ultimately starving government of funding, to the detriment of the economy. The danger of creating such a political culture is real, but it is also the case that having an inefficient, corrupt government contributes to the creation of anti-government sentiment. Thus, putting in place an ORDF that helps to reduce government corruption and inefficiency, may on balance strengthen support for government rather than reduce it.

A last possible disadvantage concerns the potential impact of an oil fund dividend on population growth. The possibility of this effect is contingent on specification of the eligibility requirement. In particular, if all citizens—including children—are eligible, this could provide an incentive for Iraqis to have more children. Iraq has a relatively young population, and it would be unwise to create a need for even faster job growth in a country and region with high unemployment. This suggests that only adult citizens be eligible, thereby removing any incentive to have children to get additional oil dividends. Furthermore, by reducing the number of recipients, it would raise the payment per recipient, in turn strengthening the incentive for adult Iraqis to become politically engaged to protect the ORDF.

The Case for a Companion Provincial and Local Government Fund

An ORDF would distribute oil revenues to individual citizens. In addition, countries may wish to establish a provincial and local government revenue fund. This arrangement would reserve a share of oil revenues for distribution to provincial and local government, with distribution done on a per capita basis.[ix] Such a fund has the important political benefit of placing regional distribution of oil monies on automatic pilot, thereby reducing potential for regional grievances that can cause civil war.

This proposal has special salience for Iraq, which is divided into three mutually hostile regions—the Kurdish north, the Sunni middle, and the Shiite south. These divisions create the real prospect of civil war and the possibility of the disintegration of Iraq—a prospect that stands to be enhanced if regions feel that they are being short-changed by central government. A fund that ensures a fair regional distribution of national revenues can help defuse this problem.

A Comparison with Alternative Possible Arrangements

Privatization

An ORDF represents one possible arrangement for dealing with large oil revenues in an environment of weak democratic governance. Another widely canvassed possibility is privatization, which involves selling the state oil industry and oil production rights to private-sector investors. In most instances, the majority of these assets are likely to end up in the hands of multinational oil companies.

Privatization has been a big part of the development agenda pushed by the international financial institutions (the International Monetary Fund, the World Bank, and the multilateral regional development banks) over the past two decades. The argument is that it promotes productive efficiency by restoring the profit motive. It also resonates with the neoliberal political agenda of shrinking the economic involvement of the state. For these reasons, it is popular among economic conservatives.

However, privatization suffers from significant political and economic problems, and these problems are especially acute in Iraq. Regarding political problems, the fact that Iraq is an occupied country means that privatization may be interpreted by Iraqis as a self-interested action of the occupying power. This perception stands to be reinforced by the fact that most of Iraq's oil industry would end up in the hands of foreign multinational oil companies, the largest of which are American and British.

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Not only does this lack of political legitimacy stand to create short-term political problems, it also stands to undermine the privatization process. Investors, recognizing the lack of political legitimacy and the fact that a future Iraqi government might unilaterally reverse privatization, will bid less for the assets. The lower prices obtained under the privatization process will then further undermine legitimacy by deepening beliefs that privatization was not in Iraq's self-interest.

Beyond these political difficulties there are other problems with privatization. First, the history of large-scale privatization is fraught with failure. This is particularly evident in the former Soviet Union, where the selling-off of industry created a new oligarchy, and the state failed to get its money's worth. Now, not only is the Russian state significantly poorer than it would have been had privatization worked as predicted by the book, but new problems—perhaps worse than the earlier ones—have also been created. Earlier, the problem was productive inefficiency and the featherbedding of an inefficient state bureaucracy. The new problem is an oligarchy whose wealth enables it to exert a corrupting and corrosive influence on democratic governance and the economy.

A second problem with large-scale privatization in weak governance countries concerns what to do with the proceeds. Even if privatization is effected legitimately at fair market prices, there remains the problem of what to do with the proceeds. A principal problem in natural-resource-rich countries is kleptocratic government. Privatization may compound this problem. If done properly, privatization sale proceeds should equal the net present value of all future profits. In effect, privatization converts future profits into a lump sum. This conversion gives kleptocratic governments an even larger sum to spend and steal—a case of jumping from the frying pan into the fire. If privatization aims to cure corruption, theft, and waste of state revenues, nothing could be worse than putting even larger amounts of money under government control.

Applied to Iraq, the bottom line is that oil sector privatization is unlikely to work for both political and economic reasons. These arguments against oil privatization also apply in other developing countries.

Share distributions

An alternative to privatization is a full or partial distribution of shares in state companies to citizens. The advantage of full distributions is that they would ensure that ownership and control passes to the private sector, whereas if the government retains a significant stake it can exercise *de facto* control. The putative benefit of a share distribution scheme is that it provides citizens with a vested interest, thereby creating incentives for greater political involvement to ensure good business management and good governance.

Balanced against this, there are significant drawbacks to share distribution schemes. First, the initial distribution creates hundreds of thousands of small shareholdings that are extremely costly to administer. Second, many of these shareholdings tend to be sold immediately, thereby driving down the share price—though this effect can be delayed by barring immediate sale upon distribution. Third, if history is any guide, over the longer term there is consolidation of holdings. Consequently, the putative political benefit of mass engagement of small shareholders is forfeited. Fourth, and finally, share distributions prejudice the interests of future generations in favor of today's generation. In Iraq, a share distribution would hand over the oil industry to today's Iraqis, allowing them to spend the wealth as they wish. Some, no doubt, would invest the proceeds in ways that benefit future generations, but the forces of inter-generational altruism are imperfect. Consequently, a share distribution will fail to properly protect the interests of future generations.

In sum, share distributions tend to generate limited and short-lived political gains, while prejudicing the interests of the future. They yield only a fraction of the benefits available from an ORDF, yet have all the costs and many others as well.

Oil Stabilization and Saving Funds

A third alternative is the creation of an oil stabilization and saving fund. Such funds have been examined by the IMF (Davis, et al., 2001). Their basic purpose is to shield the government budget from the revenue uncertainty and volatility of natural resource revenues, and to save for future generations given that natural resources are often non-renewable.

Such funds can make a contribution to improved governance, particularly by contributing to greater transparency of natural resource revenue flows. They can also help guard against the problem of "Dutch disease" by ensuring that some of the revenues are directed to the accumulation of foreign assets. This helps prevent exchange rate appreciation, which undermines international competitiveness. Finally, to the extent that government spending is tightly tied to fund revenues, they can contribute to fiscal discipline.

These are real benefits, yet at the end of the day such funds represent a relatively shallow form of reform. This is because there remains the problem of governing the fund, and ensuring that its revenues are used for the benefit of citizens rather than being wasted or stolen. Furthermore, governments can avoid the putative income constraint by borrowing. The bottom line is that to work well, oil stabilization funds need good governance. However, these funds do not themselves produce the institutional and political change needed for good governance. In effect, the money remains in the hands of dishonest governments that sit atop systems in which incentives for citizen political engagement are limited. This contrasts with an ORDF in which the money is distributed to the citizenry, thereby changing incentives for political engagement.

Democracy and Transparency: Other Measures to Strengthen an ORDF

The workings and effectiveness of an ORDF can be greatly strengthened by other institutional changes. For every institution there is the question of "who will monitor the monitors?" The challenge is ensuring that the institution is run efficiently in the interests of its legal beneficiaries.

Democracy is a key ingredient, as it can serve as a means by which citizens protect their interests against government failure. Democratic process (i.e. formal elections) is the easy part. The difficult part is creating a culture of democracy marked by trust in the process (i.e. if you lose an election you hand over power), and inclusion of the interests of supporters of the party out of power.

The introduction of formal democratic processes can help ensure the success of an ORDF. However, interestingly, an ORDF can also help ensure the success of democratic reforms. This is because the fund will automatically distribute revenue to all citizens, thereby giving all an incentive to engage politically. Simultaneously, by reducing government revenues, it will reduce the ability of government to favor select groups at the expense of others. This feature is particularly important in Iraq, which is divided into three major ethnic blocs—Kurds, Sunni Muslims, and Shiite Muslims—which have a history of antagonism and mistrust.

Embedding the rules of the ORDF in the constitution, and requiring that changes to the rules meet the requirements of constitutional change can be another important protection. Since constitutional change needs super-majorities, this guards against simple majority governments making changes that exclude opponent groups.

Transparency of the ORDF and the oil industry will also be critical. This means the fund should have audited public accounts, and it should publish its revenues and administrative costs in a transparent, accessible fashion. The U.S. Social Security system again provides a model, publishing as it does an annual, detailed report, and sending a simple annual statement to every beneficiary.

To the extent that the state oil company remains the single producer, it must be subject to full transparency and accountability. Its financial accounts and production figures must be audited and made public, while its top management and board of directors must be subject to public accountability and control. In the event that production is leased to private producers, these producers must "Publish

What They Pay (PWTP)" government in the form of signing bonuses, lease purchase costs, production sharing, oil payments in kind, and taxes.[x] PWTP is an important transparency mechanism that uses the power of double-entry bookkeeping to guard against corruption, since companies' payments sum to provide a check on the reported oil revenue of government. Having companies publish what they pay is in the public interest, since it contributes to a system in which incentives for corruption are minimized.

In addition to publishing what they pay, as part of the establishment of an ORDF, oil companies should Publish What They Contract—that is publish the commercial details of their oil production contracts with government. These contracts should be subject to public competitive bidding, and an ombudsman process allowing for complaints about corruption and violation of process. Competitive bidding and publication of contracts is essential to ensure that countries get value, and to bar sweetheart deals purchased with illegal side-payments.

The Extractive Industry Transparency Initiative (EITI), launched by Prime Minister Blair in the United Kingdom in June 2003 with the cooperation of other G8 leaders, offers the perfect vehicle for beginning the change process. EITI is intended to reduce corruption in natural resource industries by having governments and companies publish what they earn and publish what they pay respectively. It is a country-level voluntary compact, to which countries and companies both sign on. And much work has already been done designing appropriate revenue and payment reporting templates.

Iraq, even while under U.S. administration, should sign on to this process.[xi] It is a step toward transparency that will be needed no matter what. And it is a step that will facilitate the transition to peace and democracy by showing that the occupying administration is indeed accounting properly for Iraq's oil production. Moreover, since EITI is an international process, it can contribute to the internationalization of governance in Iraq, thereby helping the U.S. begin smoothly transitioning from its current politically difficult position—which has it widely viewed as an occupying power.

Finally, natural-resource-rich developing countries frequently need financial assistance from the IMF and World Bank, as will Iraq. This assistance should be closely tied to natural resource revenue flows. To be eligible, governments should have to provide detailed estimates of anticipated oil production and revenues.[xii] The fact that countries want the assistance provides a nice incentive for an honest revelation of their revenue potential. Understating for purposes of siphoning off monies for corrupt purposes, will reduce the amount provided.

Further Details about Fund Payments: How the Fund Might Work

If an ORDF is established in Iraq, an important issue will be who is eligible for distributions. One possibility is to make all Iraqi citizens eligible. Given Iraq's population of 25 million, and assuming annual oil revenues of $11 billion of which 25% are distributed, this would translate into an estimated per capita payment of $110 per year.[xiii] For Iraqi households this represents a significant payment since Iraq's estimated per capita GDP was $2,500 in 2001, of which households only saw a fraction (perhaps 60%).[xiv]

An alternative is to make distributions to only adult citizens. Iraq has a population of approximately 25 million, of which 17 million are adults. Again assuming a distribution of $2.75 billion (i.e 25% of $11 billion), this would translate into a larger estimated payment of approximately $160 per adult—a bonus equal to as much as 10% of the average Iraqi's income.

There are a number of reasons for preferring a system that only distributes to adults. First, a principal goal of the arrangement is to obtain citizen political buy-in. This requires reaching the adult population, and it is best done by making meaningfully large payments to adults. Second, making payments to all citizens could have unintended negative population effects by creating an incentive to have additional children. This is something to be avoided. Like other Arab countries, Iraq has a relatively youthful population, and it also has chronically high unemployment. Creating a plentiful supply of decent-wage paying jobs represents one of Iraq's great economic challenges, and increasing the rate of population growth only compounds the scale of this challenge.

Can Iraq Afford an ORDF?

The analytical arguments for an ORDF are strong. That raises the question of whether Iraq can afford such a program. The principal objection to such a fund is that the costs of reconstruction in Iraq will be enormous, and these costs already exceed Iraq's projected income. Diverting income into an ORDF would therefore further the shortfall.

This shortfall argument is fundamentally flawed. The test for Iraq should be how to best spend its scarce resources so as to promote maximum political and economic development. For Iraq, the greatest return will come from putting in place measures that avoid a return of the natural resource curse. An ORDF 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 ORDF 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.

If the shortfall argument fails with regard to an ORDF for individual citizens, it fails even more comprehensively regarding a fund for distributing to provincial and local government. In this case, it is not a matter of taking away money from government, but rather one of changing the distribution within government. Instead of central government directing the reconstruction effort, provincial and local governments would. This may even improve the quality of reconstruction. At the same time, it ensures regional fairness, thereby reducing the danger of civil war and the break-up of the Iraqi state.

> An oil revenue distribution fund could unleash positive and lasting economic and political transformation in Iraq.

One area where reconstruction investment will be critical is the oil industry itself. Investment in this industry is needed to ensure a steady and growing flow of revenues to Iraq. However, as with any business, investment expenditures which are long-lived and pay back over many years, are best financed by borrowing. Iraqi oil in the ground may 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 an ORDF.

One last concern is Iraq's foreign debt, which is estimated to be as high as $300 billion. Iraq is unlikely to be able to pay back this debt, and nor should the debt be allowed to prevent Iraq from pursuing those policies that are in its best interest—which includes setting up an ORDF. Once a national government is constituted, Iraq should approach the Paris Club for significant debt cancellation. If this is not forthcoming, Iraq should consider invoking the doctrine of "odious debt" to repudiate some of its debts. This doctrine was invoked by the U.S. after the Spanish-American war of 1898, and has standing in international law (Adams, 1991). The basic rule is that debt can be considered odious if (1) it was incurred without the consent of the people (i.e. by non-democratic regimes), (2) it was not used to benefit the people, and (3) lenders were aware of (1) and (2). These conditions almost certainly apply to much of the debt incurred under the regime of Saddam Hussein.

Conclusion

This paper has proposed the creation of an oil revenue distribution fund that would directly distribute part of oil revenues to Iraqi citizens. Such a fund could unleash positive and lasting economic and political transformation in Iraq. On the economic side, it stands to empower citizens to lead the process of economic growth. Oil-rich countries frequently suffer from corruption and conflict, and economic activity is skewed toward excessive government and unproductive activity. An oil distribution fund can help rectify this. On the political side, it would give citizens a sense of ownership, thereby creating an incentive for political engagement to protect that ownership.

A companion fund that distributes oil revenues to provincial and state governments could ensure a fair regional distribution of revenues, thereby reducing the potential for regional grievance, which can cause civil war.

These measures should be accompanied by regulations asserting transparency and accountability in the oil sector. All oil companies, state and private, should be obliged to publish oil production contracts and publish what they pay government. This can help ensure that oil revenues are properly accounted for, and corrupt sweetheart deals are avoided. As a first step, Iraq should also immediately sign up for the revenue transparency procedures inaugurated under the Extractive Industries Transparency Initiative, which has been endorsed by the G8.

These proposals also apply to other resource-rich developing countries. They are especially relevant for Caspian basin and West African countries, where large oil flows are starting to come online. These countries risk being afflicted by the natural resource curse owing to weak, undemocratic governance and cultures of corruption. Rather than fostering growth and development, oil often causes stagnation and civil conflict. Oil distribution funds, accompanied by transparency measures, can make a critical contribution to growth, democracy, and political stability. Development of efficient states and good governance takes a long time. Developing oil fields and building pipelines happens far faster. Oil funds and transparency measures can be put in place immediately. These are institutions and policies that one might want even if the quality of governance were high—as in Alaska. They are doubly desirable when governance is weak, and the need for institutions to handle oil revenues is immediate.

A final issue concerns the politics of creating oil funds. Any permanent ORDF must be the creation of the Iraqi people, done through legitimate democratic institutions. Only that can ensure lasting political legitimacy. Lastly, revenue distribution should appeal to both economic policy conservatives and liberals. For economic conservatives, they represent shrinking government and giving money back to citizens to control their own economic destiny. For economic liberals, they can ensure that a nation's wealth is equitably and fairly shared.

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ENDNOTES

[i] In thinking about this issue I have benefited from discussion on Steve Clemon’s Alaska-style fund proposal held at IMF headquarters, Washington DC, on June 3, 2003. The usual disclaimers apply.

[ii] Proposals in a related vein have also been put forward by others. For instance, *The Economist* (April 19, 2003, p.10) suggests “it would be wise to pay some cash out of oil revenues to every Iraqi.” The current paper fully articulates the economic and political case, and expands and formalizes this proposal.

[iii] This point is emphasized by Gary and Karl (2003) in their report on Africa’s oil boom. They urge a “big push” in the policy environment so that policy can catch up. Oil distribution funds represent such a push.

[iv] See U.S. Department of Energy Iraq Country Analysis Brief, http://www.eia.doe.gov/emeu/security/esar/esar.html

[v] “Special Report Iraq: Economy—Assessing Iraq’s Economic Future,” Janet Matthews Information Services, Quest Economics Database, MEED Weekly Special Report, June 20, 2003.

[vi] This phenomenon is referred to as Dutch disease after the experience of the Dutch economy following the discovery of large North Sea natural gas deposits in the 1960s.

[vii] Bueno de Mesquita and Root (2002) analyze the political economy of autocracy, and emphasize the role of patronage. Even dictators need a political base of support, and oil is the perfect commodity for financing patronage.

[viii] Rent-seeking is the economists’ term for describing the political process (lobbying, bribery, etc.) of seeking to get abnormal profits.

[ix] Note, whereas distributions to families on a per capita basis create an incentive to have additional children, such distributions to state governments do not, as individuals do not directly get the benefit but they bear all the cost.

[x] It is important that taxes be paid to the oil revenue distribution fund. Absent this, government could raise taxes on the oil industry, squeezing out all the financial surplus and leaving nothing available for the fund.

[xi] At this stage it would be Iraq’s national oil company that publishes what it pays government. Later, if some of Iraq’s oil production were leased to private sector firms, they too would publish. EITI is intended to apply to both private and state oil companies, as ensuring transparency in the state sector is a major problem. Having Iraq’s state oil company sign up would establish an important precedent that would benefit all countries.

[xii] This policy suggestion was put forward by an IMF official at the June 3, 2003, discussion on Clemons’ Alaska-style oil fund proposal.

[xiii] The $11 billion figure is based on a daily production rate of 1.5 million barrels sold at a net profit of $20 per barrel. Oil prices are widely anticipated to be around $25 per barrel, and Iraq has low costs of production, which are generously covered by assuming costs of $5 per barrel.

[xiv] The estimate of Iraq’s per capita GDP is from the CIA.

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