Saving Iraq From Its Oil

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ESCAPING THE RESOURCE CURSE

As the United States, the United Nations, and the Iraqi Governing Council struggle to determine what form Iraq's next government should take, there is one question that, more than any other, may prove critical to the country's future: how to handle its vast oil wealth. Oil riches are far from the blessing they are often assumed to be. In fact, countries often end up poor precisely because they are oil rich. Oil and mineral wealth can be bad for growth and bad for democracy, since they tend to impede the development of institutions and values critical to open, market-based economies and political freedom: civil liberties, the rule of law, protection of property rights, and political participation.

Plenty of examples illustrate what has come to be known as the "resource curse." Thanks to improvements in exploration technology, 34 less-developed countries now boast significant oil and natural gas resources that constitute at least 30 percent of their total export revenue.[1] Despite their riches, however, 12 of these countries' annual per capita income remains below $1,500, and up to half of their population lives on less than $1 a day. Moreover, two-thirds of the 34 countries are not democratic, and of those that are, only three (Ecuador, São Tomé and Principe, and Trinidad and Tobago) score in the top half of Freedom House's world ranking of political freedom. And even these three states are fragile: Ecuador now teeters on

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the brink of renewed instability, and in São Tomé and Principe, the temptations created by sudden oil wealth are straining its democracy and its relations with next-door Nigeria.

In fact, the 34 oil-rich countries share one striking similarity: they have weak, or in some cases, nonexistent political and economic institutions. This problem may not seem surprising for the several African countries on the list, such as Angola and the Democratic Republic of the Congo, that have only recently emerged from civil conflict. But it is also a problem for the newly independent, oil- and gas-rich republics of the former Soviet Union, which have done little to consolidate property and contract rights or to ensure competent management or judicial independence. And even the richer countries on the list, such as Libya and Saudi Arabia, suffer from underdeveloped political institutions. Concentrated oil wealth at the top has forestalled political change.

Can Iraq avoid the pitfalls that other oil-rich countries have fallen into? The answer is yes, but only if it is willing to implement a novel arrangement for managing its oil wealth with the help of the international community. This arrangement should not mimic the much-maligned oil-for-food program set up in the aftermath of the Persian Gulf War, under which Iraq's oil income was directly controlled and administered by foreigners. Instead, the Iraqi people should embed in their new constitution an arrangement for the direct distribution of oil revenues to all Iraqi households—an arrangement that would be supervised by the international community.

FROM MANNA TO WITCHES' BREW

To understand the corrupting effect that oil can have on a country, it is useful to understand the way thinking about development has changed over the last five decades. Development theory—the prevailing view of how to ensure economic and political development in non-

[1] The list includes Algeria, Angola, Azerbaijan, Bahrain, Brunei, Cameroon, Chad, Colombia, the Democratic Republic of the Congo, Ecuador, Egypt, Equatorial Guinea, Gabon, Iran, Iraq, Kazakhstan, Kuwait, the Kyrgyz Republic, Libya, Mexico, Nigeria, Oman, Qatar, Russia, São Tomé and Principe, Saudi Arabia, Sudan, Syria, Trinidad and Tobago, Tunisia, Turkmenistan, the United Arab Emirates, Venezuela, and Yemen.

industrialized countries—has evolved through three phases. In the first phase, in vogue until the 1970s, development experts emphasized augmenting a society's physical capital or "hardware," such as its dams, roads, and power plants. Following the popular success of the Marshall Plan in Europe and what was then seen as the success of the Soviet model, the World Bank, the United States, and other official donors concentrated on financing infrastructure-related projects in the world's poor countries. The approach promised to deliver quick and visible results for newly independent governments shaking off the yoke of colonial rule.

In the second phase, popular during the 1980s, the ideological pendulum shifted to getting poor countries to pursue liberal economic policies—including opening themselves up to trade and foreign investment, reducing the role of the state, encouraging competition through privatization and deregulation, and maintaining sound fiscal policy. This approach, later dubbed the "Washington consensus," was driven by disenchantment with the meager results of the hardware approach and a widespread recognition that appropriate economic incentives were necessary to stimulate private-sector participation in an economy.

In the 1990s, the development community gave up on the expectation that growth would automatically trickle down and turned to health, education, and other investments to reduce poverty directly. By the end of the 1990s, however, it had become clear that even the right hardware, the right policies, and the right poverty-focused programs would not guarantee sustained growth and development. Latin America, for example—a champion of privatization and openness to trade—managed a growth rate of only 1.6 percent per capita during the 1990s despite major increases in infrastructure and social spending, whereas growth in sub-Saharan Africa declined by 0.2 percent a year despite massive externally funded investments and the constant guidance of the World Bank and the International Monetary Fund. Meanwhile, the economies of eastern Asia, especially China's, grew rapidly during this period, despite their obvious deviations from the liberal model.

The prevailing view of development theory has thus started to shift again. Today, experts emphasize the "software" of an economy: the institutions, customs, laws, and social cohesion that help to create and sustain markets. Good software can come in many forms, ranging from the European Union's independent central bank to the ingenious Chinese experiment with the village enterprise system. In some societies, software can take less tangible forms: the long-standing trust that exists between private contracting Chinese parties, for example, was key to the investments from expatriate Chinese that fueled early growth in Malaysia and now in China. In others places, it takes the form of enforceable property titles and contracts and an uncorrupted court system.

Conversely, it is becoming increasingly clear that economies without the right software will falter. Poor supervision of banks can lead to financial crises; civil service systems without performance standards and rewards undermine public services; and abuses of property rights discourage small business.

The problem for newly reconstituted states such as Iraq is that growth-friendly institutions cannot simply be imported. They must be nurtured domestically over long periods of time. And time is a luxury that troubled developing countries with vast natural wealth rarely have.

Throughout history, many countries with natural resources have fared worse than "poorer" nations. In the seventeenth century, the Netherlands outdid resource-rich Spain, despite the fact that the latter's coffers were overflowing with gold and silver acquired in the New World. Similarly, Japan and Switzerland moved past Russia in the nineteenth and twentieth centuries. More recently, resource-poor countries in eastern Asia have surged ahead of resource-rich Argentina, Mexico, Nigeria, and Venezuela, all of which repeatedly went bankrupt or lapsed into political upheaval. Natural resources may seem like manna from heaven at first, providing new states the means to escape poverty and invest in schools and roads. And indeed, sometimes the money is spent wisely, as in Kuwait and Bahrain. More often, however, such riches prove a curse.

There are several explanations for why oil undermines societies. World prices for oil and similar resources are notoriously volatile, especially compared to those for manufactured goods, and so countries that rely on the export of natural resources are exposed to much greater uncertainty and risk. Fluctuations in price can create a dangerous cycle in which governments spend wildly when they are flush, only to be forced into disruptive and costly spending cuts (leaving schools without teachers, or public buildings unfinished) when prices fall.

A second explanation for the oil curse is the so-called Dutch disease. As the Netherlands experienced when it discovered natural gas in the North Sea in the 1960s, the exploitation of mineral resources can crowd out other activities in a country's economy. When resources are discovered or their prices increase, a country's currency becomes stronger. This hurts domestic manufacturers, who soon find it difficult to compete with lower-priced imports. More of the country's labor and capital starts to be deployed in local nontradeable sectors, and unless corrective steps are taken, soon the whole country suffers, since it loses the benefits—such as technological innovation and good management—that a strong domestic manufacturing sector can provide.

> Natural resources tend to impede the development of a country's economic and political institutions.

The most important explanation for the oil curse, however, has to do with the role natural resources play in impeding the development of a society's economic and political institutions. Oil works its poison in many ways. Natural resources, unlike output created by human endeavor, yield large "rents," which are rewards in excess of effort. But such rents are easy to appropriate—either by the state or by the few who control the resources' extraction. In the former case, as in Iran, Libya, and Saudi Arabia, one set of problems arises. The state is relieved of the pressure to tax and has no incentive to promote the protection of property rights as a way of creating wealth. As for the country's citizens, because they are not taxed, they have little incentive and no effective mechanism by which to hold government accountable. This can lead to the unchecked abuse of state power and undermine the process by which political systems reconcile conflicting interests and demands. Indeed, such conditions make it very hard for political institutions to develop.

When a subset of the population is able to control the natural resource wealth, meanwhile, it can "buy" or "become" the state, as occurred in Angola or in what was then Zaire (now the Democratic Republic of the Congo). Even where the state and those who control its resources remain distinct (as in Russia and Venezuela), public officials tend to become corrupt. Vicious fights over the distribution of resources often result. These battles are often portrayed as ethnic rivalries, when in fact they may actually be simple fights to monopolize wealth. Even when the resulting problems do not explode into outright civil conflicts, they discourage investment and growth and corrode political institutions.

According to economic historians, this pattern explains the very different ways North and South America developed. In the latter, large plantations of sugar allowed landed elites to maintain concentrated economic and political control, and these elites resisted democratic reforms and the institution of property rights. In North America, by contrast, the cultivation of wheat and corn on small farms led to a dispersion of economic power and more favorable conditions for democratization and institutional development.

SCARCE SUCCESS

NOWHERE HAVE all the pathologies associated with oil manifested themselves more clearly than in Nigeria. In the late 1960s, the Biafran war of secession—then Africa's biggest civil war, which killed a million people—was, in part, an attempt by the country's eastern, predominantly Igbo, region to gain exclusive control over oil reserves. Nigeria has also suffered the assassination of two of its leaders, six successful coups and four failed ones, and 30 years of military rule. Its "pirates in power," as one Africa historian called its leaders, have plundered Nigeria's oil wealth to the tune of perhaps $100 billion. The explosion in windfall-financed government expenditures has also provided increased opportunities for kickbacks. All of these forces have contributed to poor economic growth and other staggeringly malign results. Between 1970 and 2000, the number of people living below the poverty line in Nigeria increased from 19 million to nearly 90 million, and inequality widened: the top 2 percent of the population, which earned as much as the bottom 17 percent in 1970, now earns as much as the bottom 55 percent.

Nor are such statistics unique to Nigeria. In different forms and at different times, natural-resource wealth has wreaked similar havoc in Angola, Equatorial Guinea, Gabon, and Venezuela, and now threatens to affect tiny São Tomé and Principe. In Angola, an estimated $4.2 billion has gone missing from government coffers over the last few years. In Venezuela, poverty has nearly doubled since the late

1970s and the share of national income going to business owners has increased from 50 percent to nearly 80 percent; as a result, ordinary workers now get a mere 20 percent of the economic pie.

The oil-rich countries of the Middle East have so far escaped some of the worst side effects of mineral wealth—but only because of the sheer magnitude of their oil resources relative to the size of their populations. And they have not avoided the stunted political and social development associated with oil. The UN Development Program's 2002 *Human Development Report* identified the lack of press and other freedoms and the low status of women as key obstacles to the Arab world's long-run progress. Moreover, although current economic performance in the Middle East may be broadly satisfactory, it cannot be expected to remain so for long. Venezuela shows how even a relatively affluent country can deteriorate over time as the fight over easy oil wealth corrodes its political and economic institutions.

Indeed, amid all the examples of countries undermined by their own resource riches, two success stories stand out: Norway and Botswana. And even these examples serve only to reinforce the dangerous impact of natural resources. Norway discovered its oil in the 1970s, well after it had developed mechanisms for accountability. The country survived its sudden boom because well-entrenched checks and balances prevented oil revenues from being wasted or siphoned off. Decisions about how to spend oil money were taken through the normal democratic process.

Even more interesting is the case of Botswana, which has mined diamonds for several decades. Botswana did not succumb to the resource curse because it is one of the few countries in Africa that emerged from British rule in 1966 with strong institutions, thanks to pre-existing local and tribal traditions that fostered broad political participation. Fortunately, colonial administration never penetrated deeply enough into Botswana to destroy these traditions, which, after independence, formed the foundation for a functioning democracy. Uninterrupted democracy and good political leadership have ensured that the rents from natural resources were not squandered, as they have been elsewhere in Africa.

Norway and Botswana illustrate that the natural resource curse can be avoided if states have institutions strong enough to cushion themselves from the usual malign influences. Oil and other natural resources do not predestine all developing countries to failure. Indonesia and Mexico provide guarded optimism that the oil curse can be avoided. Although Indonesia has suffered economic and political setbacks ever since the onset of the Asian financial crisis in 1997, it did enjoy two decades of sustained growth and poverty reduction before the crisis hit. Meanwhile, Mexico has also managed its oil responsibly, and in 2000 elected an opposition candidate, Vicente Fox, as president. In both cases, however, the jury is still out on whether they will be able to durably defy the oil curse. Chile and Malaysia provide even better examples. Although they started the development race economically poor, institutionally weak, and heavily dependent on resources (copper in Chile and rubber in Malaysia), they have subsequently managed to grow rapidly and escape resource dependence.

CURE FOR THE CURSE

Given how bad oil and other natural resources have proved for the development of markets and political freedom, how should they be managed in Iraq and other countries? Three options should be considered: privatizing oil resources, creating special oil funds that limit government discretion in spending the money, and transferring the proceeds from oil directly to the people.

The first approach—privatizing the oil sector—has proved disappointing. In countries with weak institutions, assets of immense value have too often been sold at throwaway prices to a lucky few who happen to have good financial or political connections. In Russia, for example, privatization of the country's Soviet oil companies and other resources only entrenched the economic imbalances of the status quo. The resulting oligarchic capitalism has undermined Russia's market economy, making it more difficult to foster public trust in market institutions such as private property, the rule of law, and the sanctity of contracts.

When privatization leads to greater economic imbalances, these in turn impede a country's transition to democracy or result, as in the case of Nigeria or Russia, in what *Newsweek's* Fareed Zakaria has called "illiberal democracies." In such cases, elections are held periodically, but civil liberties are limited and the state sometimes undermines, rather than protects, individual freedom and property rights. Oil tends to perpetuate the power imbalances by favoring incumbents (who have easy access to oil resources) and encouraging patronage and corruption.

The second alternative for dealing with a country's oil wealth—the creation of special oil funds with constitutional or other restrictions on the use of revenues—has been used in Kuwait and Norway for several decades, and in Colombia and Venezuela since the 1990s. Azerbaijan and Chad have also recently created such funds, and East Timor and São Tomé and Principe plan to do so this year. Although they vary in detail, these national oil funds all represent an attempt to insulate and render transparent the spending of some or all of a country's oil revenues. The funds are meant to help stabilize a country's spending—building up resources during the fat years to help the country weather lean ones—and to help it save revenues for the benefit of future generations. The newer funds also aim to force suddenly cash-rich governments to focus their spending on socially productive investments.

Unfortunately, apart from Norway (with its strong government institutions and healthy democracy), the experience of national oil funds has not been encouraging. In Venezuela, for example, the government has changed the rules stipulating how money in the oil fund should be spent six times in the last few years. As a result, the fund's resources have practically dried up, and it has not managed to ensure prudent revenue management or an improvement in the quality of spending. In Azerbaijan, ad hoc expenditures from the fund have also started to raise questions about its long-term promise. And in Chad, where the oil fund was created as a condition of a World Bank loan to help finance an oil pipeline, the country's president—despite oversight by nongovernmental organizations—still managed to use the first wave of revenue to buy a presidential airplane. Although the fund itself was not actually raided, the airplane purchase was unexpected and inconsistent with the overall budget program agreed on by Chad and its international creditors. Oil funds, therefore, seem unable to insulate oil revenues from appropriation by weak or unaccountable governments. They are no substitute for public accountability or for the checks and balances provided by the press and a healthy democracy.

The third alternative for managing a country's oil wealth—distributing it directly to the people—has a better record, at least in the few places (the state of Alaska and the Canadian province of Alberta) where it has been tried. (In both cases, the interest from oil funds, rather than oil revenue itself, is distributed.) Such systems minimize opportunities for corruption and misappropriation, since windfall revenue stays out of the hands of public officials. They also avoid the imbalance of economic and political power associated with private control of revenues. Moreover, in developing countries, the direct distribution of oil revenues would instantly increase per capita income, sometimes substantially. In Chad, for example, where per capita income is about $200 a year, equally distributing the country's expected net oil revenues among its population would increase average income by 20 percent in 2008; in São Tomé and Principe, the increase would be greater still. Such an increase would enable parents to keep their children in school, help farm producers diversify, and stimulate more government investment in roads and other infrastructure. In other words, distribution of oil revenues would aid the development of homegrown markets and local politics.

> The best alternative is to distribute a country's oil wealth directly to its people.

Proposals to distribute oil revenues to the public, however, are often met with two standard objections: that the loss of oil revenue to the government could cause macroeconomic instability, and that distributing revenues to the people only to then partially tax them back to finance public investment and other sensible government expenditures is inefficient. Neither objection is compelling. In macroeconomic terms, channeling oil wealth to the public instead of government shifts the problem of price volatility to individual households. And in countries with weak institutions, households are much better at managing volatility than is the government; in fact, they are better judges not only of how much to spend, but of what to spend it on. Recent history is replete with examples of governments creating white elephants during revenue upsurges, such as Indonesia's benighted commercial jet industry or Nigeria's infamous Ajakouta steel complex (which has not produced a single ton of saleable steel in more than four decades). It is hard to imagine individual investors making mistakes of such magnitude or duration.

The second objection—that distribution followed by taxation is wasteful—has some logic. But the costs in efficiency are eclipsed by the benefits of encouraging public scrutiny of government spending. Governments that derive revenues from natural resources such as oil live in a dangerous supply-sider's paradise. When the marginal cost of raising public resources is virtually zero, governments have little incentive to manage well, provide adequate public services, respond to citizens' demands, or invest in and sustain the software of market economies and good governments. Ironically, good government and strong institutions require that the raising of public resources be costly.

Distributing oil revenues directly to people would be difficult in poor countries with limited administrative capacity, but not necessarily impossible. Before political problems overwhelmed Bolivia's reforms, for example, its government managed to distribute the "pension" returns from its share in privatized enterprises to all senior citizens. And although initially identifying all potential recipients and ensuring consistent and efficient distribution (probably via coupon-like vouchers) would be challenging, it would not be qualitatively different from that of immunizing children, which many poor countries have managed. It could in fact be easier, since citizens, eager for their windfall, would be quick to cooperate.

The greater problem with implementing a distribution plan would be political. Change would meet resistance on the part of current beneficiaries with a vested interest in the status quo, be they workers in a state-owned enterprise, oligarchs, or political incumbents. After the first year or so, moreover, the administrative apparatus for distribution would become vulnerable to cheating and corruption. Even immunization programs in poorer countries, for example, tend to need donor attention if they are to maintain their integrity.

HELP FROM OUTSIDE

LUCKILY, Iraq is not as poor as Angola or Nigeria. And despite its current difficulties, Iraq is, in one respect, an economic policy practitioner's dream: it provides a relatively clean slate, allowing new policy approaches to be attempted with a minimum of resistance from vested interests. With the right solution in place—the distribution of Iraq's oil revenue directly to its people—Iraq has a good chance of beating the oil curse. To ensure that this happens, a provision should be incorporated into the new Iraqi constitution enshrining the right of each Iraqi household to receive a share of the country's oil proceeds. This right would extend for a minimum period of, say, ten years. The justification for this forfeiture of traditional, Westphalian sovereignty is straightforward: it would prevent future Iraqi governments—even democratically elected ones—from changing the arrangement for the given period. After it expired, the people of Iraq could, through the democratic process, determine their own arrangements for managing future oil proceeds.

This temporary forfeiture of traditional sovereignty, frustrating though it may be, would actually uphold and strengthen the underlying sovereignty of the Iraqi people. It may be the only practical way to develop democratic institutions free of the corrupting influence of oil and to ensure the long-term economic and political empowerment of ordinary Iraqis.

The international community, ideally in the form of the UN, would supervise the implementation of this proposal. With some UN officials now under investigation for mishandling oil-for-food funds in the 1990s, more effective arrangements for transparency and accountability would have to be developed under the new system. Iraq today is an intrinsically more open environment than it was during the sanctions era. Greater involvement by civil society and the Iraqi people themselves—who would assert their constitutional right to claim their share of the oil resources—would help ward off mishandling and misappropriation of the funds.

The direct distribution of oil proceeds to the people could also help resolve the problem of Iraq's foreign debt. Many new democracies, such as Nigeria, have tried to get their external debts lifted, especially when a sizable part of the debt is "odious" (that is, contracted by previous dictators, often with the creditors' complicity). But donors will be justifiably wary of absolving the debts of a fledgling, faction-ridden Iraqi government. Transferring oil proceeds directly to the people rather than the government could allay this fear and hence make donors more amenable to granting debt relief.

Just how much of Iraq's oil revenues should be distributed? On the one hand, the more that goes to the population, the less the chance that oil will spoil the new Iraq. On the other hand, 100 percent distribution is probably infeasible. The new Iraqi government will face pressing needs, notably the rehabilitation of an infrastructure ravaged by the recent war and years of neglect under Saddam Hussein, as well as the servicing of some of its international debt. In the short run, financing these expenses through taxation will be unrealistic because Baghdad's machinery of taxation remains rudimentary. Some oil revenues should thus be retained by the government. But at least 50 percent should be distributed to the people.

In the long run, and not just in Iraq, the international community needs to put pressure on oil companies, which too often abet local corruption. For example, during the last several years, some 34 multinational oil companies paid the Angolan government to extract and refine its oil without ever disclosing where the money was going or what it was being used for within Angola. The international community should push governments and oil companies for greater transparency in the governance of natural resources. Collective action is key, however, since it is not in the interest of any one company to become transparent and honest on its own. Such collective action can be ensured through coordinated efforts by government, the private sector, and civil society. Many efforts have already been made in this regard, including the Extractive Industries Transparency Initiative sponsored by the United Kingdom's Department for International Development—although so far with limited success. Real efforts must also be made to crack down on corruption. Western countries should pass laws analogous to the EU's attempts to make the bribery of foreign officials a crime, and build on the UN's Convention Against Corruption.

If the Iraqi experiment succeeds, the result will be a major boon—and not just for Iraqis. A success in Iraq would also provide a powerful example for other resource-rich countries to follow, illustrating how they could improve their economies and political systems. Resource-rich countries must realize that change, even radical change, is less risky than maintaining the status quo, in which oil continues to wreak the kind of damage it has so often around the world.