

Iraq's Oil Revenues Should Empower the People

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THANK YOU HERITAGE

As I was preparing for this talk, I picked up the Washington Post and came across William Raspberry's column reporting that a University of Illinois undergraduate had come up with 23 different rationales for the war in Iraq, based on her analysis of available public statements by the Administration and the Congress between Sept 12, 2001 and October 11, 2002. My guess is that none of those public rationales involved Iraq's oil or Iraq's oil revenues. No one talks much about Iraq's oil.

And yet it was Iraq's oil revenues that Saddam Hussein used to build palaces, prisons and a vast military/intelligence structure, suppress any opposition and threaten his neighbors. Saddam's oil revenues are still helping support unemployed insurgents and their backers and paid for most of the munitions still at work today to kill and maim both coalition forces and Iraqi citizens. Could Saddam have done what he did, for as long as he did, without those oil revenues?

1. OUR MISSION IN IRAQ

a. In discussing the future prospects for Iraq's oil, it is important that we recognize that OIL MONEY has to be the underlying reason we are in Iraq today: Not our access to the oil, but the money that comes from the oil. Money pours into the Middle East from all over the world to buy the region's oil. Yet despite all this money - or more likely because of all this money -- the region has the largest deficit of economic freedom anywhere in the world. (Look at the Heritage world map of economic freedom -- those red "unfree" areas are mostly all oil producers.)

i. Oil is Money. Money is Power. As Lord Acton observed over a century ago, "Power tends to corrupt, and absolute power corrupts absolutely." In Iraq we had a corrupt and dangerous government where, unlike other oil rich governments, the leader held all the power absolutely.

ii. I have come to believe that there should be an 11th Commandment: "No government should receive income from any source other than its citizens." Oil money comes out of the ground and makes a government independently wealthy, no longer accountable to its citizens.

b. Saddam Hussein was no ordinary tyrant: He had 35 years of oil revenues to concentrate power and strike fear in the hearts of the people so they would do whatever he commanded. Regime change in Iraq was necessary sooner rather than later, but had become impossible to accomplish from within.

i. Secretary Wolfowitz (who rarely admits any mistakes,) admitted in a recent congressional hearing that he had come to realize, after several recent visits, that he had underestimated the depth of the fear embedded in the hearts and minds of Iraqi citizens after 35 years under Saddam Hussein. This deep fear had been Saddam's great strength, and its continuing presence has made our mission vastly more difficult and costly.

c. Our Mission now must be to prevent another Saddam: WE MUST DIFFUSE THE POWER THAT STEMS FROM IRAQ'S OIL.

i. We must find a way to place the power of oil money in the hands of the people.

ii. There are three possible avenues to pursue to diffuse the power inherent in Iraq's oil revenues.

(1) Privatization -- take all the oil money away from the government and let the government tax the people to get some of the money back.

(2) Set-Aside -- take some of the money away from the government and put it in the hands of the people.

(3) Transparency -- If the government does get to keep some or all of the oil money we must be sure they operate in a fish bowl -- we must make sure there is full transparency on all Iraqi oil transactions.

2. PRIVATIZATION AND NATION BUILDING

a. Privatization was not in the dictionary when we started the Center for Privatization to consult for USAID in 1984 and we learned very quickly that privatization is primarily a political process, not just a simple economic transaction. It didn't occur to any of us then that the real reason for privatization is to remove government's access to "free money" - all the companies we worked on were problem companies which were a cash drain on government. Most were losing money and submerged in heavy debt and excess employees. If there were any income producers, they were off limits, because the government intended to keep them. Oil companies are inherently profitable, and oil countries were too rich to be eligible for USAID "help" so we never got to privatize an oil company. Now, with the benefit of hindsight, I would say that oil companies should be the first to be privatized because of the huge inflow of revenue subject

to misuse and abuse in the hands of government.

b. Prosperity comes from unleashing human capital -- not from natural resource capital like oil. (Again see the Economic Freedom Map - note that the big new success stories -- Singapore, Hong Kong, South Korea, Taiwan -- had very few natural resources.) There is much talk among development experts about building democracy and free markets and free trade and a strong middle class etc. but I suggest that these desirable results all depend on, and grow from, two underlying conditions: (1) diffusion of power and (2) a system of titled property rights. Those are the two objectives we need to focus on in Iraq. Oil revenues can be a significant obstacle.

i. Diffusion of Power: In his 1994 book, "Centuries of Economic Endeavor," U. Colorado Professor John P. Powelson concluded, based on a study of ten centuries in every region of the world, that nations prospered where there was genuine earned diffusion of power, but where power became centralized under a ruler with a few elites, the people suffered. (Note on the Economic Freedom map that Northern Europe and other English speaking countries with inheritance from Northern Europe, which achieved the greatest diffusion of power according to Professor Powelson, are today ranked highest in Economic Freedom.)

ii. Titled Property Rights: Hernando De Soto wrote "The Mystery of Capital" in 2000 to apply globally his earlier pioneering research in fighting terrorism in Peru. He pointed out that in developing countries everywhere, the poor are poor primarily because they are excluded from the engine of growth we call capitalism - they actually hold an estimated \$9.3 trillion in assets, but those assets are dead assets. They sit outside Braudell's bell jar. (See the sketch for Chapter 1.) The elites sit inside the bell jar enjoying the good life with fancy cars and overseas bank accounts, while the rest of the people are left outside looking in. Their micro-enterprises stay micro because they have no access to equity or borrowed capital to grow big on. That drawing could just as well portray Iraq or any other oil-rich developing country where the elites enjoy all the power and the rest of the citizens are outside looking in. This creates fertile soil for terrorist recruitment.

3. WHEN GOVERNMENT CONTROLS THE OIL MONEY

Oil offers a unique opportunity for citizens to prosper, as in Norway and Alaska where the institutions of a civil society, such as the rule of law and accountable governments, were already in place before oil was discovered. In less developed nations, on the other hand, oil has fostered corruption and violence - Saddam was an extreme oil despot, but witness also events in Angola, Iran, Libya, Nigeria, Russia, Saudi Arabia, Sudan and Venezuela.

When government controls the oil revenues:

a. The National Economy Suffers:

- i. The currency of an oil-rich nation tends to be in demand and thus over-valued. This makes foreign goods cheap and local manufacturers become uncompetitive on global markets. This effect, known as the "Dutch disease," inhibits investment and job creation.
- ii. Reliance on oil eliminates economic diversity. The economy becomes completely dependent on oil, and on uncertain and volatile world oil prices.
- iii. Oil revenues flowing into the government weaken the private sector and stifle the middle class. Entrepreneurs go into government rather than the private sector because that's where the money is.
- iv. Income gaps widen - rich elites get richer - individual initiative is stifled. The poor become wards of the state and bend to government dictates.

b. National Governance Suffers:

- i. Oil wealth feeds incompetence, centralization of power and unsustainable spending increases by government.
- ii. Oil wealth finances the purchase of tools to repress the people - arms, military strength and prisons
- iii. Oil wealth can be used to bribe the masses with free schools, health care, telephones, cheap gas.
- iv. Oil wealth breeds corruption in myriad forms - overseas bank accounts - corrupt judiciary - media censorship.
- v. People live with fear rather than freedom and opportunity.
- vi. "Democracy" exists in name only: As wards of the state people do not vote out the hands that feed them. They vote for what harms them least.
- vii. Oppression creates a brain drain.

c. Oil Revenues May Generate Threats to Others:

- i. Oil country elites buy off terrorists by funding their activities elsewhere and blame the people's miseries on others - Israel, U.S.A., the West.
- ii. Oil money can fund development of WMD - support arms suppliers in other countries.

- iii. Oil money creates recruiting grounds for terrorists -- young people who feel powerless and without hope are prime prospects.
- iv. Violence in struggles for control over government and oil revenues creates refugees and problems for neighbor countries.
- v. Oil money allows granting favors to influence votes in the United Nations

4. **THREE APPROACHES TO REDUCE THE PERIL OF OIL MONEY**

- a. Privatization - Put the oil revenues in the hands of the people instead of the government.

There are two basic ways to do this:

- i. Distribute equity shares in oil companies and oil reserves, which are now owned and managed by the Iraqi government, to every Iraqi citizen, with a right to sell the shares after a specified minimum holding period. This would keep Iraq's "crown jewels" in the hands of Iraqis, not foreigners, but would not produce much near-term cash for the shareholders and likely would be an obstacle in obtaining desperately needed new investment capital to modernize and increase production.
- ii. Auction off oil companies and oil reserves to private buyers - put the proceeds from the sales in a trust fund to be used for specified purposes to benefit the Iraqi people. (Alaska, Norway, Chad, Vernon Smith and others) This keeps the proceeds from the sale out of the hands of the government, but is highly sensitive politically. The auction approach with a people's investment fund for the proceeds would attract needed investment capital, but is not likely to happen in the foreseeable future.

- b. Set Aside:

Place a lien on all Iraq's oil revenues to pay a fixed amount per barrel, say \$3 per barrel, into an Iraqi People's Oil Fund which would then pay out all receipts quarterly to every voting age Iraqi citizen. A levy such as this would create tangible evidence of the people's property right to the nation's oil and oil reserves, and would establish a new paradigm for ownership of oil in the Middle East

- i. A People's Set-Aside on oil revenues would reduce, but not solve, the oil peril problem. It would be the reverse of the feudal system where the Lord of the Manor levied a tax on everything the peasants produced on his land. In this case, the citizen owners of the oil are imposing the levy on all the oil revenues produced on their land by the government.

ii. Traditional modes of privatization of assets and equity ownership could still be accomplished later, if desired. This People's Oil Fund Set Aside would continue after privatization. This proposal would establish an immediate income stream with inherent incentives to increase oil production. Once this program is under way and past the shake-down period, the right to receive payments could be certificated in a marketable form to be bought and sold like bond coupons.

iii. Since this proposal involves only the distribution of oil income, not a transfer of assets, it would be within the authority of both the CPA before June 30 and the Interim Government after June 30. (The March 8 Transitional Administrative Law (TAL) provides that Iraq's natural resources "belong to all the people of all the regions and governorates of the regions and the administrations of the governorates." Under the TAL, the Iraqi Transitional Government shall have "exclusive competence" in "distributing the revenues resulting from their sale through the national budget in an equitable manner proportional to the distribution of population throughout the country. . .")

iv. There would be many psychological and policy benefits from a People's Oil Revenue Set-Aside program beyond enhanced accountability of government to the people.

(1) The Iraqi people would have increased incentive to protect "their" oil facilities by providing intelligence.

(2) Men and women would receive equal distributions.

(3) It would establish an irrevocable personal identity under law - essential for establishing titled property rights, bank accounts, human rights protection, voter lists and taxpayer lists.

(4) It would expand banking and credit access for small and medium businesses.

(5) It could help offset public resistance to gas price increases, which will be needed to cut back oil smuggling.

(6) It would provide a good campaign issue for free-market supporters seeking to win election.

(7) It would provide a model for neighboring oil-rich states.

c. Transparency:

Owners have a right to know what their government does with their money. Whether or not there are any oil revenue payments direct to the Iraqi people, we

should still strive for full and open transparency for all Iraq's oil transactions. This is vital to preserve the people's interest in Iraq's oil revenues and the accountability of their government in the generation and use of Iraq's oil revenues. It should be accompanied by a vigorous campaign by US officials to say over and over that Iraq's oil belongs to the Iraqi people. Although Secretary Powell made that statement at the beginning of last year, and Ambassador Bremer has talked and written about it, no top US officials in Washington have said much about this.

i. U.S. Public Diplomacy programs should be tasked to use the bully pulpit at every opportunity to promote the basic principle that Iraq's oil belongs to the Iraqi people not to the government and to maintain a continuing information program to make certain that the Iraqi people know in detail how their oil money is used. Some future Iraqi government can be expected to be reluctant to provide full financial information on oil transactions. To anticipate this, the U.S. government should devote considerable resources to uncovering this information by independent means. This should be done regardless of the final outcome of negotiations at the UN concerning the present oversight responsibilities.

ii. At the present time, the responsibility for oversight rests with the International Advisory and Monitoring Board for Iraq, established under UN Security Council Resolution #1483 in May last year. Its terms of reference require it to oversee audits of oil export sales and the operations of the Development Fund for Iraq ("DFI"). The CPA signed the audit contract with KPMG on April 5 and the audit work is proceeding.

iii. The US/UK draft Resolution on Iraq proposes to turn over the funds in the DFI for disbursement by the new Interim Government, but expects that future oil sales proceeds will continue to be placed in the DFI and that the Monitoring Board will continue after June 30.

iv. The French government, and Ahmed Chalabi's Iraqi National Congress party, have urged that complete responsibility for oversight of Iraqi oil transactions should be in the hands of the Iraqi government. We should strongly oppose their position.

5. **CONCLUSIONS:**

While access to Middle East oil is important to meet increasing world demand for oil, Iraq's oil production is relatively unimportant, since it will be supplying not much more than perhaps 3% of world demand for the rest of this decade. What is critical, however, is ensuring that Iraq's oil revenues will not be used again to oppress the Iraqi people or threaten the rest of the world, directly or indirectly through support of terrorists. Accountability of the government for its management of Iraq's oil revenues will be essential. Some corruption will be

inevitable in a state-owned and managed oil company, but a major effort to assure transparency will act as a restraining force, as well as guard against inappropriate use of oil revenues. Iraq's oil revenues should be structured to empower the Iraqi people, not oppress them.

APPENDIX

A. EXPERIENCE IN OTHER COUNTRIES

The Alaska Permanent Fund is often cited as the best model to insulate at least a portion of the oil revenues from the politicians in an oil rich country. Alaskans call it their "Rainy Day fund." The State pays about 25% of its oil revenues into a trust fund, keeping the remainder for disposition by the governor and the state legislature. Each year the fund distributes a portion of its earnings from its investments in stocks, bonds and real estate to every qualified Alaska resident. The annual dividend reached a high of \$1,964.00 in 2000 and was \$1,108.00 in 2003. In recent years, diminishing oil revenues and a pending budget shortfall have prompted a public debate about how best to use Fund income, including that portion historically used for dividends - some politicians are urging that the government needs the money more than the people. For more on the dividend plan, see: <http://www.apfc.org/alaska/dividendprgrm.cfm?s=4> and for more on the history, see: <http://www.apfc.org/publications/pfhistory.cfm?s=5>

For discussion of some of the issues facing the Alaska plan, see:

Jay Hammond (former Gov.) comments:

<http://www.akbottomline.com/?pid=19&archive=4&id=1014>

Ray Metcalf (former State Legislator) History:

http://www.juneauempire.com/stories/101203/opi_myturn.shtml

Fairbanks Daily Nov 2000:

http://peninsulaclarion.com/stories/112700/ala_112700ala0100001.shtml

Other countries with various forms of trust funds for the people include Bolivia, Chad and Norway:

(1) Bolivia first sold 50% ownership and management control of its energy companies to foreign investors. The purchase money went into the companies (not the government) to be used for modernization and expansion. The government then transferred its remaining 50% stock interest in its privatized energy companies to a trust fund for Bolivian retirement pensions. Note that ALL the privatization proceeds went to the companies, not the government.

(2) Chad has established an offshore oil trust fund with an independent oversight committee and a mandate to use oil revenues to finance education, health and rural development programs. The Chad model offers promise, but despite World Bank covenants and restrictions, monitoring by a nine-member Oversight

Committee and surprising support from Exxon Mobil, the jury is still out on the extent to which oil revenues will end up helping the people vs. lining the pockets of those with opportunities to influence the flow of funds. Further information on the Chad model can be found at:

http://wwwc.house.gov/international_relations/107/norl0418.htm

and: <http://www.globalpolicy.org/soecon/tncs/2003/0321beckon.htm>

(3) Norway has a trust fund to be used for the benefit of the Norwegian people, administered by an independent non-political commission. Note that Norway was fortunate to have well established institutions of democracy and free markets --rule of law to protect person and property plus an independent judiciary and free press -- BEFORE oil was discovered.

B. PROPOSALS FOR PRIVATIZATION IN IRAQ

There have been numerous proposals for Iraqi oil trust funds and privatization. Below are a few:

(1) MIT Professor M. A. Adelman proposed auctioning producing oil reserves to the highest bidder, which he estimates would bring in roughly \$100 billion soon, "and more would follow." He does not however address the question of how the government will spend the money after it comes in. His conclusion: *"Iraq has the opportunity to teach the world an invaluable economic lesson about the power of privatization to jump-start a young country's economy. But that's up to them: It's their oil."* <http://www.petroleumworld.com/storyT709.htm>

(2) Nobel Laureate and GMU Professor Vernon Smith has proposed an "Iraqi People's Fund" which is similar to the Alaska Permanent Fund, but with significant improvements -- he would place ALL the proceeds in the Fund, not just a portion. Like Professor Adelman, he would auction off all the oil assets over a period of time, but the proceeds would go into a giant mutual fund investing in index stocks and paying an annual dividend to all Iraqi citizens from the income. *"The new government would be required to obtain its revenue from taxes levied on the citizens who are willing to elect them and finance their spending programs."*

http://online.wsj.com/article_print/0..SB107205686739003900.00.html

Nancy Birdsall, President of The Center for Global Development, analyses the special problems that face developing countries rich in oil or other valuable natural resources and stresses the need for transparency and channeling the oil income to the people, rather than to the government. Her mechanism to insulate politicians from the temptations to corruption and unproductive state consumption would be to have the Iraqi government turn over the oil revenues, net of production costs, to the United Nations which would distribute a major portion of the revenue to citizens annually as a cash payment. This arrangement would

last for at least ten years and, by requiring the government to raise funds through taxes, would give the citizens a tool to make the government accountable. She would leave the production in the hands of Iraqis and does not address the problems which plague state owned enterprises around the world.

http://www.international-economy.com/TIE_F03_Birdsall.pdf

Jack Kemp would convert existing administrative subdivisions of the Iraqi National Oil Company into separate enterprises, each with its own Iraqi CEO and independent Board of Directors, and then give an equal share of stock in each of these enterprises to every Iraqi citizen. This would require the government to tax the people rather than tap the oil company's revenue stream, and would pull the country together as all citizens, both men and women, and all religious, ethnic and tribal backgrounds, became equal stakeholders in private economic enterprises. He does not address the pressing need for new capital to modernize and expand oil production facilities, nor how much, if any, cash flow would actually go to the Iraqi people in the near term. "Natural Sovereigns of Iraqi Oil" [http://www.empoweramerica.org/stories/storyReader\\$905](http://www.empoweramerica.org/stories/storyReader$905)

Several other useful papers on transferring ownership of Iraq's oil to the Iraqi people can be found on the Internet, listed below in chronological order:

(1) "Oil: Give Every Iraqi An Equal Share," -- Scott Pardee, Middlebury College, April 13, 2003
<http://www.washingtonpost.com/ac2/wp-dyn/A11142-2003Apr11?language=printer>

(2) "An Oil-for-People Program," -- Susan Lee, WSJ, April 30, 2003
http://online.wsj.com/article_print/0,,SB105166218434477900,00.html

(3) "Combating the Natural Resource Curse with Citizen Revenue Distribution Funds: Oil and the Case of Iraq"
-- Thomas Palley, OSI, July 27, 2003 --
<http://cog.kent.edu/archives/ownership/msg03338.html>

(4) "Give Iraqi Oil to the Iraqis" -- Leo Drollas, CGES, August 9, 2003
<http://www.gasandoil.com/goc/news/ntm34091.htm>

(5) "Give Oil Money to the People Rather Than the Despots" -- John Tierney, NYT, September 10, 2003
<http://www.progress.org/2003/oil08.htm>

(6) "Iraq's Oil Mess" -- Irwin M. Stelzer, Hudson Institute, American Outlook, Fall 2003

(7) "Models and Policies for Oil Production, Revenue Collection, and Public Expenditure: Lessons in Iraq" -- Ariel Cohen, Ph.D, Heritage Foundation, March 4, 2004 <http://www.heritage.org/Research/MiddleEast/bg1730.cfm>

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