THE OIL CURSE AND IRAQ

According to several studies, resource rich countries experience slow growth in their economies, several conflicts related to their natural resources. The paradox between economic problems and poverty related to their slow economic growth and development, and abundance on natural resources introduces “resource curse” concept. Resource curse is “a negative impact on long term growth of excessive reliance on exporting an abundance of primary commodities such as oil, gold and copper” (Kyrili, 2008, 2). In these primary commodities, oil based resource curse is the most common one. This paper will shed light to the oil based resource curse with a focus on negative impacts of resource curse and then the ways proposed to overcome the oil curse and how Iraq fits into these proposed solutions, since it is among the countries which suffer from the natural resource abundance.

I. Negative impacts of resource curse:

First of all, countries whose economies are dependent on their natural resources, mainly oil, become vulnerable because of volatility in their revenues from oil production. Oil prices are subject to high fluctuation. An evident example would be the decrease of oil prices to less than $50 per barrel in November 2008 from $140 per barrel in the second quarter of 2008 in global markets (Monthly Oil Market Report of OPEC, 2008, 68).

Besides changing demand and supply of oil are other elements, which increase vulnerability of oil, exporting countries. According to forecasts by OPEC, world demand to oil will fall by 0.15 mb/d (millions of barrels per day) to 85.68 mb/d in 2009. According to British Petroleum (BP) statistics, there are fluctuations in world oil consumption from 1997 (3433.3 million tons) to 2007 (3952.8 million tons). Although there is an increasing trend in the consumption of oil; percent changes year by year do not show a smooth increase, instead the volatility becomes evident in the consumption of oil. Change in consumption according to regions and organizations, is another factor affecting oil exporting countries. For example; in Statistical Review of World energy of BP (2008), decrease in oil consumption in European Union countries (-2.6 %) is greater than decrease in oil consumption in OECD countries (-0.9%) in 2007 over 2006. As Europe and Eurasia experience decrease in oil consumption by 2 %, total consumption in South and Central America increases by 5 % from 2006 to 2007. As predictable from these examples, the target countries for exporting the oil are factors affecting the oil revenues of oil-exporting countries.

In addition to these, world supply does not continue on a stable line. As the reason of a change in the world supply of oil may arise from change in world demand, according to Leonardo Maugeri (2006), “inadequate drilling systems, poor field management, the absence of modern techniques to enhance oil recovery, and overexploitation of certain parts of a field” might be other reasons of such a change. For instance; world oil supply has decreased by 2 % in 2007 compared to 2006 (Statistical Review of World Energy, 2008). This is another evident example for volatile oil revenues. “Regions with high primary export shares experienced term of trade volatility two or three times greater than industrial countries in the same period.” (Stevens, 2003, 10).
As mentioned above with examples, oil creates volatility in government revenues. “If these revenues are poorly managed, these revenues will lead to inflation and boom-bust cycles in government spending” (Harford & Klein, 2005) – which is the case in most underdeveloped countries. Alayli (2005) who touches upon weak institutions in resource-rich countries in his article *Resource Rich Countries and Weak Institutions: the Resource Curse Effect* mentions that one problem involves fiscal policy and inflation. “Oil booms tend to raise expectations and contribute to unrealistic projections of future income leading to loss of control over public spending (often financed by foreign borrowing). These projects can also become the vehicle for corruption with a net result of loss of fiscal discipline contributing to inflation” (Alayli, 2005, 5). Besides, Alayli (2005) states “resource revenues also tend to be collected by governments in ways that are usually difficult for citizens to track and easy for officials to divert.” In addition to corruption, bad decision-making also has a large impact. “Development of oil resources raises expectations of citizens – which pressures governments to take speedy responses. Besides having more money to play with tends to weaken prudence and normal procedures of the ‘due diligence’ thus decision making mechanism becomes trapped in fewer hands.” (Stevens, 2003, 14).

“Dutch Disease” (or named in some articles as “paradox of plenty”) is another problem for resource – rich countries. Ross (1999, 306) explains this problem as “appreciation of a state’s real exchange rate caused by the sharp rise in exports with a tendency of a booming resource sector to draw capital and labor away from a country’s manufacturing and agricultural sectors, raising their production costs”. By the exporting oil, these countries produce foreign currency earning. Unless these earnings are neutralized by sound monetary policy, because of the appreciation of currency, the country loses its international competitiveness of the export sectors of the economy, and also this causes decrease in demand to domestic products, since imports will become cheaper. Stevens (2003, 11) classifies the effects of “Dutch Disease” - which is defined simply as a contraction of the tradeable sector (whose prices are determined by the global markets) - into two; “resource movement effect” which is simply the shift in resources from tradeables to non-tradeables, and “spending effect” which is the demand which is met by higher imports when the prices of tradeables become less competitive.

Being resource rich “can damage institutions indirectly – by removing incentives to reform, improve infrastructure, or even establish a well-functioning tax bureaucracy, as well as directly – by provoking a fight to control resource rents.” (Harford & Klein, 2005). As this statement stresses the impact of corruption once more, it also emphasizes impacts of weak and unaccountable governments, as well as rent seeking. According to Alayli (2005), much of a government’s strength comes from its capacity to extract taxes. “A failure to develop this ability (extracting taxes) may also make the government unable to establish the type of bureaucracy that can provide effective public goods, and ameliorate social conflicts, and the result may be a danger of civil war.” (Alayli, 2005, 7). Ross (1999, 312) gives two perspectives about rents and rentier state deriving the links between resource rents and poor economic governance. The first one is that since governments are optimistic about their revenues, they devote their resources to guarding the status quo instead of promoting development. “An abundance of resources rents alters how electoral competition is conducted.” (Collier, 2007, 44). According to Collier...
The competition between different groups causes politics of patronage in most cost-effective manner. The second perspective is that this kind of states will have little social pressure since they earn low taxes – which make opposition groups discouraged. These impacts make governments, which get their revenues from oil become less democratic and hence less accountable compared to the governments, which earn their revenues through taxation. In addition to these, “rent seeking lowers steady state income and therefore growth along the steady state, meanwhile creates powerful lobby groups who are able to block much needed economic reforms and makes it more difficult for governments to adjust spending when faced with revenue fluctuations.” (Stevens, 2003, 15).

As mentioned before, foreign borrowing often finances loss of control over public spending. Basically expectation of having more income in the future yields governments to accumulate debt – although they earn revenues, – since interest payments on debts get cheaper. When the scenario turns into opposite situation, governments become obliged to pay penalty interest as their debts grows. Governments mostly prefer overcoming such problems with aid they get from foreign countries. Harford and Klein (2005) mention that aid money has very similar properties to oil revenues, which can be lost before reaching the intended target. Both aid and oil revenues have negative effect on institutions and worsen political risks for external investors and cause deterioration in institutions. “A country receiving more foreign aid … would expect to see a decline in the index of democracy by 0.6-1 point on a scale of 1-10.” (Harford & Klein, 2005). Moreover aid, which supports poor governments, has a negative effect on reforms since they remove the pressure on governments. This also causes moral hazard problem as governments wait for bailouts from donor countries. Governments will be weakened by aid and will not be able to focus on their own priorities since donors will decide where to extend aid.

II. Possible ways to overcome the oil curse:

“In countries that obtain a large share of their export revenues from resource-based activities, the goal of reducing resource dependence is frequently a major influence on policy.” (Martin in Lederman & Maloney, 2007, 323). According to Martin (in Lederman & Maloney, 2007, 323), there are four reasons for resource abundant countries to reduce their dependence on resource revenues; the first one is concerns about adverse trends in terms of trade, the second one is concerns about instability in the economy, the third one is perceptions about the technological change in resource-dependent activities may be lower than in manufactures, and finally the last one is concerns about rent-seeking, lower growth rates, thus risk of civil war. In order to achieve these goals resource-rich states should maintain macroeconomic stability with liberalized trade and exchange regime, privatization and deregulation (Humphreys, Sachs & Stiglitz, 2007, 271).

One of the first ways to overcome the oil curse is economic diversification. By reducing the importance of the oil-based production by developing other sources value added (Stevens,
These countries should increase products of sectors of agriculture and manufacture backing up with strong financial markets. By production in other sectors, taxing these activities will decrease the dependence on oil. However, diversification needs to be strengthened by private sector investment to maximize the resource revenue flow to the private rather than the public sector, because according to Karl (in Humphreys, Sachs & Stiglitz, 2007) diversification may fail due to oil-dependent countries, which do not combine it with sound fiscal and monetary policies. For example; resource poor countries develop by industrialization, which enables them to gain competitiveness. These countries mostly diversify their economies as capital - intensive and skill – intensive production. Through this diversification they benefit growth (on the contrary oil – dependent countries mostly suffer slow growth and underdeveloped economies) and resistance to external shocks (in oil dependent countries, oil shocks directly affect these economies with several negative aspects).

According to Karl (Humphreys, Sachs & Stiglitz, 2007) the other way is to sterilize the petroleum revenues by saving them in funds instead of launching them into the economy. Using these revenues directly will cause the economy to become overheated. Thus the “governments should avoid using the revenue and promises of more revenue to increase borrowing” (Stevens, 2003, 20) because increasing borrowings along with oil revenues can fuel Dutch Disease. In order to achieve this, these oil revenues should be invested outside the domestic economy. Stevens (2003) tells that these are achieved by setting a price assumption for budgetary purposes; if prices are lower than the world prices the fund assets are used to top up the budget. For example; “in 1990, the Norwegian parliament set up the Petroleum Fund of Norway to function as a fiscal shock absorber. This fund basically converts petrodollars into stocks and bonds by using the revenues and appreciation to ensure the equitable distribution of wealth across generations.” (Gross, 2004) Oil revenue funds may reduce corruption and rent seeking. In the countries, which experience high levels of poverty, these funds may be used to reallocate the income by distribution of these funds when necessary, so this shows that these funds can also be used in the future. Since the aim of these funds is to shield budget from oil revenue volatility and uncertainty, these funds can make contributions to improved governance and accountability. Existence of these funds may make people to put more pressure on government to abide good governance. Moreover they can become aware of use of oil revenues - which might yield institutional development.

On the other hand Karl (in Humphreys, Sachs & Stiglitz, 2007) states that accountability mechanisms that would ensure their proper functioning do not yet exist. He gives Kazakhstan, Republic of Congo and Equatorial Guinea as examples about the governments, which do not provide any information about their oil revenues. These funds can also turn the countries into a ‘honey pot’ since these funds are not substitute of appropriate fiscal and macro-economic policy. Besides, the use of these funds may change according to political circumstances and patronage and there is no guarantee that these funds will be used for the benefit of citizens.

Privatization is another alternative to overcome the oil curse. Privatization promotes productive efficiency by having profit motive. Besides, it decreases the government influence and involvement in the management. “Changing the ownership structure of the production process might mean inviting significant foreign participation (Kazakhstan) or permitting domestic private interests to take over – at least temporarily (Russia).” (Karl in Humphreys, Sachs & Stiglitz,
2007, 272). However there are limits to benefits of privatization. The new owner at the end of the reallocation of the property rights creates a problem. Karl (2007) (in Humphreys, Sachs & Stiglitz) mentions that strong nationalist views oppose the notion of ownership of an entity other than the state itself. “National oil companies (NOCs) are justified in relatively large countries that have the human and financial resources that make local oil industry a realistic and promising prospect.” (Bartsch, Cuc, Katz & Malothra, 2004, 47). According to IMF (Bartsch, Cuc, Katz & Malothra, 2004, 51), NOCs should be allowed to concentrate on maximizing revenue and have technical assistance to achieve administration better. Furthermore, there is no guarantee that domestic private oil companies will be well equipped or enough to run these resources. The other problem might be multinational companies are more advantageous than domestic private oil companies. Since they have a larger scale and are the major powers within the market, privatization of certain oil resources might be in the hands of multinational companies.

Funds of oil revenues, economic diversification and privatization work best in countries where governance is strong. Therefore transparency and accountability in oil sector operations are necessary to improve governance in oil – producing countries. “The IMF’s Manual on Fiscal Transparency states that comprehensive coverage of all fiscal activity undertaken by the central government is essential from a transparency standpoint.” (Bartsch, Cuc, Katz & Malothra, 2004, 52). Transparency in oil sector operations is needed to allow democratic debate on fiscal policy and spending priorities. Accountability is used as an instrument for preventing corruption; meanwhile transparency is an instrument for future planning (especially for the use of funds of oil revenues). It is difficult to achieve transparency when people cannot understand the origin of the government revenue and lose their trust in the governments. “To establish transparency in fiscal operations related to the oil sector, an administrative unit is needed that is trustworthy in the public’s eye and technically capable of handling the complex tasks involved in the follow – up of oil revenue.” (Bartsch, Cuc, Katz & Malothra, 2004, 54). To strengthen the improvement of transparency, new steps are taken. The “Publish What you Pay” Campaign launched in June 2002, along with “Extractive Industries Transparency Initiative” (EITI) which is launched by UK former Prime Minister Tony Blair in September 2002, encourage governments, public and private companies, international organizations to work together in order to promote transparency of payments and revenues of natural resources (Karl in Humphreys, Sachs & Stiglitz, 2007, 275; Bartsch, Cuc, Katz & Malothra, 2004, 55). Throughout these initiatives and campaigns, companies join voluntarily to report what they pay governments and what activities they pursue. Its weakness is that it is a voluntary compact. For example; Angola and Gabon did not join this initiative so that they do not have to contract transparency in their fiscal operations in their oil-based activities (Bartsch, Cuc, Katz & Malothra, 2004, 58 & 59).

III.
Iraq and the oil curse
Iraq is said to be “an isle sitting over a lake of oil” (2003, Xinhua News Agency). However Iraqi people paradoxically live in poverty and misery. This is unfortunately not a different scene from the scenarios derived from the points mentioned above.

According to an article in the Economist, *The Benefits and the Curse of Oil* (2008), Iraq’s oil averaged over 2.4 mb/d (which is the highest level since the US invaded Iraq in 2003). Besides the same article states that since Iraq’s oil reservoirs are close to the surface, extracting the oil is cheap in Iraq. Although Iraq has physical advantages of its resources, it suffers from other negative factors.

Looney (2004) mentions that Iraq was a predatory autocracy before the invasion of the US. He (2004) classifies the political features as unstable government which was legitimized by military force, and had corruption and no transparency. The economic implications are summarized as high procyclical expenditure and very high government consumption with absorption by elites through petty corruption and patronage (Looney, 2004, 23).

Iraq’s economy is dependent on its oil production (Looney [2006] states that the oil sector of Iraq dominates the economy for 74% of GDP, the share of oil exports in government revenues is exceeding 93% and these revenues compose 98% of foreign currency earnings), and this dependence brings negative impacts with itself. Slow growth rate and poverty are one of the most encountered situations. Generally authoritarian governments enable one group of people to earn the revenues and to use them in their own benefits. The rentier states generally have corruption in their governments. This is a clear statement to address the situation of Saddam’s Iraq and the current problems – coming from those periods and continuing today - Iraqi people suffer from.

Social inequalities exist in every type of services such as health, education. Besides increasing population along with high level of unemployment is a serious social problem. “50% of the population is under 24 years of age, and the unemployment rate has been ranging to 50%.” (Looney, 2006, 36). Unemployment leads to an increasing demand of social assistance and help. However Iraq is not at the level to supply necessary and efficient assistance to its citizens.

In addition to these, Iraq has been suffering from wars and conflicts fueled by these factors. According to what Iraq Institute of Strategic Studies (2007) states, before 2003, most of revenues were spent for militarism. Iraq has been experiencing sabotage, smuggling, and conflict. Wealth always causes problems. Looney (2006) gives the regional secession movements of Kurds under Saddam’s regime. Today the scenario is not different. Iraq’s autonomous Kurdish region wants as much as control as possible over the oil industry in their area (The Economist, 2008), and news coming from Iraq about attacks is an evident example of conflicts.

Attempt to prevent these effects in Iraq takes several ways into consideration. Since fast diversification of a country’s economy would be difficult when its economy is highly dependent on its oil revenues with high percentages, in the case of Iraq different solution should be
considered. The first ways might be privatization. As mentioned in the second part, privatization may prevent corruption since the government will be separated from oil sector and it can be eased to establish a comprehensive tax system (Looney on the other hand mentions a possible problem about the revenues. He questions how the government would spend the money earned from the taxation and privatization.). In addition to these positive effects, privatization brings technology and new and adequate methods of production. For example Iraq has been “negotiating with BP, Exxon Mobil and Total to modernize five of the country’s biggest oilfields.” (The Economist, 2008).

Oil funds are very practical against the problems caused by large oil revenues. However Looney (2006), on page 29, states that these funds may not be so attractive from an economic perspective, since “any fiscal policy decision that can be made in the context of an oil fund, can also be made without an oil fund”. On the other hand such funds evidently help to decrease political failure by creating awareness of citizens about the oil revenues.

Stabilization funds are one of the funds, which Iraq can use. These funds protect the economy from negative effects of volatility in the oil revenues (Looney, 2004, 25). “If Iraq decides to create an oil fund, the best way to ensure its stability would be to create it in the country’s constitution, thus protecting it from future political pressures” (Looney, 2004, 30). However the major problem of these funds is the price of oil. As given in the first part, price of oil experiences sharp fluctuations even in short terms. Thus these fluctuations affect calculations in the fund, supply-demand, since the world oil market is more volatile and less predictable than most of the other markets. However, sound fiscal policies with monetary stability will increase the effectiveness of these funds.

There are 2 other types of funds for Iraq’s possible attempts to overcome the oil curse. “Inter-generational funds, which emerged from the creation of Alaska Permanent Fund (APF), require that the revenue will be untouched and invested and then the gains will be used for other state infrastructure investments.” (Looney, 2006, 32). By creation of these funds, Iraq will save a fixed amount of its oil reserves. Since the government has to save a fixed amount, this will increase the government’s accountability and nation’s trust. Clemmons (2003) in his article in New York Times mentions how such a fund might help the Iraqi economy. “Iraq’s annual oil revenue comes to approximately $20 billion. A postwar government could invest $12 billion a year in infrastructure to rebuild the nation. The other $8 billion could anchor an Iraq Permanent Fund, to be invested in a diverse set of international equities. The resulting income would go directly to Iraq’s six million households. These payments would make a huge difference to families in a country whose per capita gross domestic product rests at about $2,500.” (Clemmons, 2003). Such a fund may change the economic structure as well as increase the social assistance for the Iraqi citizens. The other type of funds, “direct distribution funds”, aims to “ensure a fair regional distribution of revenues, thereby reducing the potential for regional grievances, which might lead to civil war.” (Looney, 2006, 34). Looney (2006), on page 42, also states that an oil distribution fund can improve democracy and decrease corruption in the government along with acceleration in the private sector economic development through a process of demand led growth.
IV. Conclusion

Most of the natural resource abundant countries suffer from negative impacts of this wealth. The oil curse is the most common natural resource – based problem. Since the world oil market is volatile and unpredictable, especially oil – exporting countries get vulnerable. Along with changes in price of oil, and supply – demand of oil, Dutch disease is one of the major problems. Weak institutions within the state fueled with corruption and patronage makes the problem more complicated. The worst scenario of this curse is the civil conflicts in these states – which has a social dimension as well as economic dimension.

To overcome the oil curse, several solutions have been proposed by scholars. Although there are some problems with each solution proposed, there are examples of countries, which overcame the oil curse, such as Norway, which is the third major country exporting oil. The first one, diversification in the economy, stands as the most affective, on the contrary the most difficult alternative to lift the oil curse. In order to be successful, it requires a long term sound fiscal and monetary policies, and appropriate circumstances for the country. Privatization is another solution, which might work under certain conditions. Oil funds, which bring accountability and transparency when used effectively, are the other alternative. In the Iraqi case, use of these funds would be more efficient as it is evident in the Norwegian case.

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