

Part III. Improving public management and accountability

Chapter 5. Managing oil revenues

Oil is central to the Iraqi economy and will remain so for the foreseeable future: its oil reserves can drive economic growth for decades to come. Even if it extracted 6 million barrels of crude oil a day—three times the current level of production—Iraq has more than 50 years' worth of oil left in its proven and developed reserves; more oil is likely to be discovered in areas that await exploration. But managing oil revenue well has challenged many producing countries, rich or poor. The economic performance of oil exporters is often inferior to that of resource-poor countries, an outcome often attributed to the harmful influence of oil wealth on governance and on the real exchange rate for the rest of the domestic economy (the Dutch disease).

Even with vast reserves, Iraq faces large uncertainties about its future revenues, because of the volatility in the volume and price of oil exports. In the short term, production and exports are heavily constrained by rundown facilities and sabotage (box 5.1). Over the medium term, however, revenues can rise dramatically, if oil production capacity recovers strongly and oil prices stay high. Even in the case of declining oil prices, Iraq may be able to maintain high export revenues by building up the volume of oil exports significantly. Alternatively, revenues may be considerably lower, if oil production stalls and prices decline. In 2004–05, oil export revenues ranged from \$1.1 billion to \$2.7 billion per month.

Whether rising or falling, revenues require production. In Iraq, substantial investment is needed to rehabilitate and expand the oil sector, which has long suffered from a lack of capital, deteriorating technology, and an aging workforce. Large investments are also required in the refining, petrochemical, and natural gas sectors. Without such investment, Iraq will have difficulty maintaining and expanding capacity.

Iraq faces an additional challenge of developing competitive, labor-generating nonoil traded sectors to diversify its economy. The National Development Strategy correctly calls for reducing oil dependency over the medium term by promoting market-based, private-sector development of nonoil traded sectors. Three main reasons underlie this strategy:

- *Preventing a rent-seeking society.* Oil revenues, or “rents,” find their way into the economy through the government’s fiscal system, which can create a dependency on the state. The government often becomes the largest employer and relies heavily on a very narrow tax base (the oil industry). The result is a “rent-seeking” society, i. e., an economy characterized by excessive, unproductive activities in exchange for government finance and support, which results in widespread corruption and stagnation.
- *Creating more jobs.* Despite its economic importance, the oil sector generates very little domestic employment. For the medium to long term, economic growth and jobs

will need to originate from more labor-intensive, traded goods sectors, focused on market-based private investment.

- *Reducing vulnerability and volatility.* Dependence on a single export makes an economy vulnerable: any deterioration in the terms of trade will hamper consumption, welfare, and stability. In Iraq, as in other oil economies, vulnerability is aggravated by the fiscal dependence on oil prices, which are notoriously volatile: price shocks inevitably lead to fiscal crises.

Beyond using the government budget to direct oil revenues to the needs of the nation, there exists an option of their direct distribution to people. Despite its apparent advantages, the direct distribution option is: (a) difficult to implement in Iraq's current circumstances; (b) prone to corruption and leakages; and most importantly, (c) at Iraq's current level of development and opportunities (unlike Norway or Alaska), the social rate of return to investment in public goods and targeted social spending is much greater and more equitable than the private rate of return on consumption by distributing oil revenues to all households. Redistribution of oil revenues to Iraq's provinces is becoming an equally serious problem, a part of an intergovernmental system design discussed in chapter 6.

Box 5.1. Generating oil revenues in Iraq

In addition to managing oil revenues, Iraq faces the challenge of generating export revenues from its massive oil reserves. Iraq's oil sector has long suffered from lack of investment—and more recently from looting and sabotage—and is in need of substantial investment to rehabilitate its oil fields and infrastructure and to increase its production capacity in the coming years. Many fields have been damaged by excessive injection of liquids to sustain output, and producing wells are badly in need of rehabilitation. The industry also has suffered from a lack of spare parts and equipment, a long reliance on outmoded technology, and a need to retrain and expand the workforce. The sector can absorb a lot of oil export revenues itself; it also needs technology and managerial and technical skills.

Iraq faces a range of options in financing its oil-sector development needs. This can be done by (a) using oil revenues to hire technical, managerial, and engineering skills the country might need to expand oil extraction; (b) funding these needs with additional borrowing; and (c) attracting equity capital from private investors. Attracting private investors into the oil sector can be valuable. Such investors, however, require appropriate legal, fiscal, and contractual frameworks—and this will take time.

The Dutch disease and oil price volatility

The Dutch disease, which got its name from the experience of Holland after the discovery of North Sea gas in the 1960s, describes the weakening of domestic industries in an economy that discovers and exploits an abundant natural resource, such as oil. An increase in net oil exports, irrespective of the exchange rate regime, typically leads to a real appreciation of the exchange rate. This reduces the competitiveness of domestic products in international markets, leading to a decline in nonoil exports, a rise in imports, and often some short-term hardship and adjustment in domestic industries. Although the fiscal authority that receives most of the oil rent could sterilize it entirely by accumulating only foreign assets, this is not a realistic option because then no benefits from oil exports would accrue to the nation. Hence, a portion of the rent will be spent domestically, some real exchange-rate appreciation will occur, and the nonoil traded

goods sector to some extent will be harmed. As nonoil traded goods decline, employment is maintained by the expansion of nontraded goods and services, very often in the form of an expansion of the public sector.

Although Iraq shows some signs of Dutch disease, its challenge is not adjusting to an oil boom, but preventing oil dependence from stifling job generation. The effect of the real appreciation can, in time, be more than offset by increases in productivity, if the boom can finance technological progress and draw investment. Policies aimed at improving the investment climate in the nonoil economy are the key antidote for the Dutch disease. Stable fiscal policy to encourage a stable real exchange rate and a sustainable public investment program can be augmented by targeting investment and other government expenditure at productive public goods. Best-practice policies for the oil economies are no different from any other (nonoil) context, but the oil economies have greater need for fiscal prudence because of the extreme volatility of oil revenue.

When oil prices fluctuate widely, the government transmits that external shock to the rest of the economy, and through repeated boom-bust cycles volatile oil prices translate into a volatile real exchange rate. The increased uncertainty in the nonoil traded sector is likely to depress investment, long-run diversification, and growth.

Reducing the transmission of revenue volatility to the economy may be accomplished by expenditure smoothing. If budgetary expenditure is planned and implemented according to “permanent” rather than “transitory” prices, then destructive swings in public expenditure can be avoided, and this will help stabilize the real exchange rate. Otherwise, public expenditure pattern based on current (boom) prices will not be sustainable, because when prices fall expenditure is forced to contract. It is often public investment that contracts first and most, because politically and socially it is usually the easiest budget item for governments to cut. This stop-go public investment behavior has long-run negative consequences.

Just as expenditure smoothing is necessary for macrostability, smoothing public investment can enhance its efficiency. Fluctuations in infrastructure investment reduce the efficiency of the investment program. Building roads, schools, and other facilities requires relatively skilled workers, and when investment levels decline unexpectedly, workers are laid off and buildings are abandoned. Erratic, stop-go investment entails high adjustment costs and waste. Because it is costly to adjust to changes in the level of investment, the optimal rate of investment should fluctuate substantially less than the price of oil.

Subsidies, such as free education, free energy, and interest-free loans for housing or business, create economic activity through spending and lead to a lack of financial discipline in the budget and political instability when governments try to roll back commitments. In Algeria, Indonesia, Iran, Mexico, Nigeria, Trinidad, and Venezuela, subsidies in the 1980s rose twice as fast as nonoil GDP. During periods of oil price decline, capital projects were canceled, but subsidies, together with public wages and salaries, were politically difficult to roll back. Unsustainable spending commitments

based on overly optimistic oil revenue forecasts should not be introduced in the first place.

Many oil-exporting governments find it difficult to strike the right balance between short-run needs and long-run growth and stability, and if they are also combating pervasive poverty and high unemployment, they will also find it difficult to withstand the pressures to spend. However, strong fiscal policies and institutions can help governments maintain a more stable investment strategy in an environment of highly volatile oil revenues. Oil price changes can be temporary or permanent; if they are likely to be permanent, governments would be wise to adjust the level of investment spending to the new sustainable level of future investment.

The quality of investment matters at least as much as the quantity, as oil windfalls have often produced huge, unproductive “white elephant” projects. Investment in heavy industry to promote diversification has generally contributed to huge, insolvent state-owned firms. Oil-exporting countries tend to experience periods of rapid expansion in investment and growth, followed by a collapse in growth that far outweighs the decline in investment.¹ From 1965 to 1998, per capita GNP among members of the Organization of Petroleum Exporting Countries decreased on average by 1.3 percent per year, with an average ratio of gross domestic fixed investment of 23 percent. The quality of investment is a key factor that separates resource-rich countries that have grown rapidly from those that have had less success (Gylafson and Zoega 2001).

Oil-based economies seem to be particularly susceptible to poor governance and corruption because the government is the direct recipient of the rents. Patronage politics play an important role in determining the use of oil revenues, when fiscal linkages are narrow and public scrutiny is weak. Developing mechanisms to enhance public oversight of expenditures can enhance transparency in managing oil revenues (box 5.2).

In Iraq, there is a premium on speed in allocating donor funds to rapidly disbursing reconstruction projects. Clearly, the priority is to address urgent needs of the population, but authorities are well advised to do so in ways that do not undermine the future fiscal and financial soundness of the Iraqi economy. Over the medium term, authorities would benefit by developing more capacity for independent evaluations. Such evaluations could include conducting cost-benefit analysis, projecting rates of return, analyzing risks and sensitivities, and evaluating client impact. An independent capacity to evaluate investments would significantly help to alleviate pressures for spending oil revenues hastily and help to improve the choice of projects.

Box 5.2. Transparency in managing oil revenues

Given their importance in the Iraqi economy, oil revenues must be managed with open and readily accessible policies and procedures. Such transparency can help foster a democratic debate, increase accountability, improve macroeconomic management, and enhance access to finance. Transparency is needed both in the flow of budgetary funds and in the accounts of the national oil company. The following characteristics are increasingly recognized as minimal standards in dealing with transparency in the oil sector:

- *An independent and credible audit* of revenues generated by the oil sector and financial flows between the producers and marketers of crude oil and refined oil products, including the national oil company and the government. It is advisable to extend the audit to all actors (national as well as international oil companies, if the latter are involved in the sector) and to physical production, sales, and costs. The results of the audit should be independently published and made available to the public.
- *The active involvement of civil society* is very desirable. The civil society, for example, can review and raise concerns about the terms of reference for the audit and the implications of its findings.
- *A financially sustainable plan for transparency* should be developed and implemented by the government. Complementary activities include institutional strengthening in tax administration, the central bank, and other institutions involved in receiving and managing oil revenues.

These principals would directly apply to the Development Fund for Iraq, owing to its central role in managing the oil revenue flow. The International Audit and Monitoring Board found systemic irregularities in the use of resources by the Development Fund for Iraq under the Coalition Provisional Authority, (www.iamb.info). The Iraqi government is considering measures to strengthen the accountability and transparency procedures for those funds. A joint IMF and World Bank public expenditure mission (February 2005) recommended setting up a committee to examine operations of the Development Fund for Iraq and to enhance the transparency of tracking Iraq's oil resources and other spending.

In the short to medium –term, it will be important to develop accounting concepts, rules, and procedures in the form of an accounting manual clearly specifying the accounting requirements, particularly those related to direct foreign investments, other bank accounts, oil assets, letters of credit, and other types of investments.

Enhancing fiscal discipline

A number of oil-exporting countries employ fiscal rules to help determine sustainable level of capital and current spending. While fiscal rules can help to break the link between current commodity prices and current expenditure levels, they also lessen the ability of fiscal policy to respond to severe, unforeseen shocks. In Iraq, this rigidity would be unwelcome, because of the country's need for fiscal flexibility and massive reconstruction in the face of uncertainty. Furthermore, fiscal rules require strong fiscal institutions to support them, which is not yet the case in Iraq.

Some oil-producing countries have set up oil funds to help in the implementation of fiscal policy. While funds have taken various forms, the basic aim is to set aside some portion of government oil revenues for when these revenues decline. Two main types of funds exist: (a) stabilization funds seek to reduce the impact of volatile oil revenues on the government and the economy and (b) savings funds aim to create a store of wealth for future generations. In many cases, governments use these funds for both purposes.

Although oil funds generally focus on managing revenue, expenditure policies are really the primary consideration for fiscal management and saving for future generations. Oil funds do not guarantee fiscal stability (Devlin and Titman 2004). Well-designed oil funds can enhance the transparency of oil revenues and expenditures, but they are no substitute for fiscal policy and overall improvements in public resource accountability (Devlin and Lewin 2005). A well-designed oil fund should be integrated with the budget and have appropriate asset-management strategies and mechanisms to ensure full transparency and accountability (Davis and others 2001).

In Iraq, an oil fund might be worth exploring in the medium and long term as one of several measures to exert adequate fiscal discipline over volatile oil revenues. However, in the short run the benefits of an oil fund will be limited, as the rates of return on investment in the depleted physical and human capital are likely to be vastly superior to returns realized from the stock of financial assets that such a fund could hold. In other words, the immediate benefits of an intergenerational transfer of wealth seem to be less relevant for Iraq, simply because the government has to give priority to the need for immediate investments over the potential for saving oil revenues. Yet, Iraq's large oil reserves provide a solid reason to explore how such a fund could be set up in the future. In the meantime, expenditure smoothing can possibly be more effective, if pursued within a unified budget framework with carefully designed fiscal rules.

Summary of recommendations

To maximize the long-term development impact of future oil export revenues, the Iraqi government may wish to consider the following steps:

In the near term

- Use oil revenues to address urgent needs of the population, but be careful not to embark on policies or programs that undermine long-term fiscal sustainability of the Iraqi economy.
- Develop transparent mechanisms to enhance public oversight of oil revenue expenditures, ensure accountability, and improve macroeconomic management.

In the medium to long term

- Minimize boom-bust cycles through expenditure and investment smoothing.
- Prevent development of a rent-seeking society dependent on government handouts from oil revenues, engaged in nonproductive economic activities, and susceptible to poor governance and corruption.
- Diversify away from oil and generate employment in nonoil traded sectors by creating an enabling regime for private investment.

Note

ⁱ Rodriguez and Sachs (1999) show that overinvestment could explain the sluggish growth performance of resource-dependent economies.