Iraq: Private ownership of oil and the quest for democracy

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Abstract

I argue that state-ownership and state-management of oil on behalf of the Iraqi people is not conducive to democracy and inconsistent with the principles of free market. I also argue that it can adversely affect economic development and might further impoverish the average Iraqi citizen. To resolve the problems, this note proposes a change to the "political" rules; i.e., change the Iraqi constitution, and provides an economic strategy to transfer oil wealth to the Iraqi people.

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1. Introduction

Iraq's proven oil reserves exceed 100 billion barrels, and its unproven reserves are just as much. It is well documented that only 15 out of 80 oilfields are in production. Three years after the US invasion and the future of Iraq is uncertain. Oil is the main reason of the political wrangling and violence. Political groups have been positioning themselves strategically to control oil wealth. The main problem is ownership, which will determine whether Iraq develops into a modern democracy, or not. The implications for the rest of the world are obviously numerous.

In the past Iraq was a centralized economy with public institutions. The state's control of oil has given it unlimited powers in the past. The state derived its power from its control over vast oil revenues; it did not need to consult with the people on how to spend them. History taught us that such economies could not deliver economic prosperity. And in such economies, impoverished people have bigger worries than democracy.

Private ownership is associated with political and economic freedom, See for example, Hayek (1944), Friedman (1962), Pipes (2000), and O'Driscoll and Hoskibs (2003). History tells us that development requires free market institutions and most importantly private property rights. There is reliable empirical evidence on the significance of private ownership on GDP growth. For example, historians North and Thomas (1973) and Rosenberg and Birdzell (1986) presented evidence that private property played a major role in enriching the West. Barro (1991) used proxies for the quality of private property to test the effect on GDP growth. Also Kormendi and MeGuire (1985) used measures of political freedom and civil liberties to proxy the quality of property rights and reported positive association with GDP growth. A recent paper by Heitger (2003) illustrates the same point.

The Iraqis are poor. Iraq's average annual rate of growth of real GDP per capita over the period 1950-2003 is -0.10. If we exclude the period of the Gulf War and the UN sanctions from 1991 onward the rate of growth is 1.5. For Iraq to make the transition to democracy and to develop its economy and its people, the ownership of oil is an issue that need to be resolved in a manner consistent with democratic and free market's principles.

Privatization of Iraq's oil has been proposed by some economists; see Wolf (2005) for example. However, there are a few problems that prevent immediate privatizations of oil and other assets. We will argue that although privatization is sensible it may not be attainable.[2] The objective of this note is to provide an alternative strategy such that it is not only consistent with and conducive to democracy, but also attainable.

[2] In a well-developed economic model one can probably show that it is an optimal first-best solution.

The essence of the strategy is gradualism and it covers two phases. In sections 2 and 3 we discuss the current situation and the alternative strategy and in section 4 we conclude.

2. The current situation

In Iraq's new constitution Article 109 states,

"Oil and gas is the property of all Iraqi people in all the regions and provinces."

The constitution acknowledges that oil and gas belong to the Iraqis, but there is a wrinkle because Article 110, says,

> *"The federal government and the governments of the producing regions and provinces together will draw up the necessary strategic policies to develop oil and gas wealth to bring the greatest benefit for the Iraqi people, relying on the most modern techniques of market principles and encouraging investment."*

The constitution implies that the government will control oil revenues and redistribute the wealth in a fashion similar to what has been happening in the past 85 years or so. It seems clear that the new constitution maintains the old rules under the old assumptions of government agent benevolence and omniscience. Boettke *et al*. (2006) cite Buchanan (1969, pp. 77-92) who taught us to question such assumptions. The rules of the past Iraqi regimes inhibited individual freedom and creativity and eventually were responsible for the backwardness of the Iraqi society and its dismal economic performance.

If oil is the property of the Iraqis then the Iraqis must own it directly. In most market-oriented democracies resources and factors of production are expected to be owned by the people.[3] Almost all the ex – Warsaw Pact countries, which became democracies, privatized their economies. It seems logical that Iraq should do the same. That could be done, for example, by distributing vouchers or shares in oil to the Iraqis. Alaska has a well-known scheme. However, there are a few problems with the immediate transfer of oil wealth to the people:

First is the lack of market-oriented economic institutions. Second are the decay of the infrastructure and the depreciation of physical and human capitals without which democracy and development cannot work. To rebuild them the government needs revenues. But, the main institutions that are typically used to finance the budget, which are the tax system and the financial market, are themselves dysfunctional and inefficient. The government will need some revenues to provide immediate services and to build the institutions and the infrastructure.

[3] Norway is an old democracy, but oil is largely owned by the state.

Third, immediate privatization might result in distributional problems. In Russia, for example, the oil industry ended up in the hand of a few with very complicated political and economic consequences. Fourth, Rotunda (2004) suggests that the Iraqi people don't understand capitalism, i.e., the Iraqis are unfamiliar with the concept of free market and they are mostly dependent on the state.

For these reasons, at least, a cold-turkey transfer of the ownership of oil assets to the people seems problematic in the short run. It will take time for market institutions such as the banking and tax systems to be built. To deal with the timing issue I propose a strategy of gradual transfer of oil wealth to the Iraqi people that is consistent with democracy and free market principles, hence conducive for development.

3. A proposed alternative strategy

Instead of a cold turkey strategy I propose a two-phase gradual strategy. In the first phase (1) we separate the state from the oil industry completely and establish private oil companies; (2) establish the market value of oil assets; (3) distribute the oil shares to the Iraqi people; (4) finance some of the budget deficits and (5) develop the remaining seventy oilfields and raise oil production to 6 million barrels a day. The second phase includes dividends payments to shareholders and gradual reduction of the contribution to the budget while simultaneously increasing the private ownership of oil to 100 percent.

3.1 Independence

Just like the judiciary and the central bank the oil industry must be *independent of the state.* This means that all decisions regarding oil are apolitical. This independence must also be constitutional.[4]

I propose *immediate* establishment of three private regional oil companies, the Southern Petroleum Company (SPC); the Northern Petroleum Company (NPC) and a Central Petroleum Company (CPC), hence the Iraqi Petroleum Company, (IPC). Evidence from experimental economics suggests that 4 to 5 firms would be sufficient to generate a competitive market.

The law states the objectives of the IPC, which are the management of the Iraqi oil processes of explorations, developments, productions, sales, exports and the revenues, and states its independence. The government can hire technocrat chief executives who are politically neutral. The CEOs and the government sign contracts, which determines the duties, the powers, the governance system – e.g., having a board or not, its duties, its members etc. and the form of decision making, - e.g., individual decision making, a committee, the makeup of the committee, etc., the length of the contracts and anything deemed necessary for

[4] In the future when more oilfields are developed in the west they can establish a fourth company, West Petroleum Company (WPC).

the CEOs to do the job. We have a good insight about the optimality of these types of contracts in monetary economics and this is not different in my opinion, Walsh (1995). The companies must be transparent and fully accountable.

3.2 Determining the share value

It is important that the IPC manages the privatization process totally independently. The second step in the first phase of the strategy is for the IPC to establish the market value of oil assets in Iraq. There are many ways to do so. Finance economists and engineers can work out the discounted present value of total oil assets and approximate a sensible value for the share, where every Iraqi regardless of religion, sect, and gender is a shareholder in this company.[5] Alternatively, anyone of the companies can go public and an IPO can determine the share value.

3.3 Managing the process

Lessons from the privatization experiences of the ex- Warsaw Pact countries are important for Iraq. In the Czech's Republic case, for example, people rushed into selling their shares. Excess supply of tradable shares caused the price to fall and the wealth ended up in the hand of a few wealthy people and organizations. Because shares are fully tradable at a market price and because Iraq's economy is weak, the majority of people are unemployed, poor, and desperate for cash, many are expected to sale their shares immediately.

To protect people, the process needs to be managed. The Parliament can regulate the process of ownerships, sales, transfer, inheritance etc, e.g., it could regulate the number of shares allowed per individual. Transactions must be approved in a court of law such as the financial court, which Iraq established recently. This will protect women, the elderly and sick people from exploitations. The share could be divided into n smaller denominations each of a value $1/n$, which enables the shareholder to sell a portion of the share and not all of it.

[5] Assuming oil production is 3 million barrels/day and given the market price of oil, a discount rate anywhere between 10 and 15 percent, a depreciation rate of 10 percent, cash flow grows at a constant rate of 5 percent a year and the cost of oil productions and development 2.5 dollars per barrel, I compute P the value of the Iraqi oil industry $P = \frac{1}{(1+r)^T} . \frac{C(1+g)^T}{r-g}$, where C is the cash-flows and is equal to revenues minus costs including the deprecation rate and required capital expenditures, g is the growth rate of cash flow, T is the number of years and r is the discount rate. Depending on the how many Iraqis are illegible for shares (e.g., 13 million adults are age 18 and over. Iraqis younger than 18 years should not receive shares to avoid population growth.) one can obtain a value up to 90000 US dollars per share.

3.4 Financing the budget deficits

The IPC can set aside 50% of total annual revenues for financing the government's budget. The rest can be (1) reinvested, and (2) sent to a stabilization fund to smooth out future oil price changes. No dividends are paid to the people during this period. The length of this period is likely to be determined by many factors some of which are technical such as the adequacy of the tax system and the normality of oil production etc, which we will discuss next.

3.5 Capital investments and development

Iraq's oil production has declined to below 3 million barrels a day because of sanctions and wars. Another element of the first phase of the strategy is to increase oil production by reviving previous plans to increase Iraq's oil production to 5.5 – 6 million barrels a day. To do so, capital is needed. However, the methods of finance are controversial. Estimates of needed capital vary, but most experts suggest 25-30 billion dollars. There are many ways to raise 30 billion dollars to rebuild the Iraqi oil industry.

The IPC can (1) reinvest its profits gradually; (2) borrow from investments banks and international organizations or (3) award limited contracts to international oil companies.[6] There is an argument that borrowing might be hindered by Iraq's large debt, but this will not apply if IPC is independent of the government. It could borrow and use the huge oil reserves as collateral.[7] Borrowing is straightforward and there is no sovereignty issue here.

The IPC can invite international oil companies and sign contractual agreements such as turn-key and joint ventures. The independent IPC's job is to manage the Iraq's oil on behalf of the Iraqis on economic basis just like the constitution stated in Article 110 (second), but with replacing the word "government" with the words "the independent IPC."

A sound recommendation surely depends on comparing the cost and benefits of each method. It should be emphasized that any method that surrenders the wealth of the Iraqi people to foreign companies or perceived to compromise the integrity and sovereignty of Iraq will trigger violent reactions. The history of Iraq is ripe with evidence of such reactions. Some political factions will exploit these issues and create more havoc.

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[6] If the IPC borrows 30 billion dollars to be paid over 30 years at 12% annually compounded interest, the debt service will amount to less than 2 dollars per barrel per day.

[7] Apparently, this is not what happened when Russia privatized its oil sector. Foreign companies did not immediately jump into Russia's oil industry because of uncertainties about the economic condition and the commitment of the Russians for pursuing free market economics.

As a guide, Iraqis need a good understanding of the lessons of the Ex-Warsaw Pact privatization experiences and the problems associated with the methods of contractual agreements with international oil companies such as Production Sharing Agreements. It is important that the IPC controls the rate of oil production. If the Iraqis lose control over the rate of oil production to foreign companies it might soon discover that all their oil has been depleted. Oil belongs to all Iraqis including the unborn. Foreign contracts should be subject to Iraqi laws, present and future and all disputes resolved in Iraqi courts. That being said, negotiations with foreign companies and investments banks require that the Iraqi oil companies have a high degree of bargaining power.

3.6 The second phase

The first phase of the strategy ends when all the investments are in place and when oil export reaches 6 million barrels a day. At this stage, the IPC can begin a process of paying back dividends to the Iraqis. Profits from *all three companies combined* are used in the calculation of the dividends. By this time also one would expect the banking system to be functional and most Iraqis will have checking accounts.

Gradually, the IPC should reduce its contribution to the budget from 50% and simultaneously increase the percentage of dividends to the Iraqis without compromising the services programmes.

As the dividends increase and the tax system become functional, the state can begin taxing the dividends gradually. At some point the budget will be entirely financed by non-oil revenues and the Iraqis own their entire oil wealth. Note also that the government can at this point or even earlier, borrow from the public; i.e., sell bonds to finance the deficits.

I predict that this strategy will have stabilizing effects. The people will recognize the good intention of the government. This empowers the government. The strategy will enhance democratic practices and contributes to the building of free market institutions such as the banking system, the tax system, the share market, the post office, etc that are required to achieve efficiency in the distribution of wealth. The incentive system will be set properly such that resource allocation becomes optimal and economic efficiency increases over time. It took New Zealand about 15 years to realize the fruits of its market-oriented policy reforms of the 1980s.

When Iraqis begin to receive dividends from oil shares they will become more interested in the performance of the oil industry as a whole regardless of the regions because when any one regional company makes profits all Iraqis will benefit. This kind of privatization and the independence of the oil business will unify the country as the people of Iraq will recognize that they own and share their country. It might also eliminate the need for federalism. Regional oil companies will also invest in their regions.

Private property laws reduce corruption and thus, increase potential growth. The strategy will make the Iraqis rich. There is evidence about the negative correlation between corruption and economic growth, for example see, Chafuen and Guzman (1996). High expected rate of repudiation makes corruption more possible. The number of Private individuals who bribe government officials increases in order to have their contracts honoured. Iraq is one of the worst countries in the world in terms of freedom from repudiation of contracts. Iraq also scored high on almost all corruption indices, Easterly (2002).

Private ownership and allowing Iraqis to hold shares in their own oil industry is also consistent with Islam. Interest rate is forbidden in Islam. But Muslims are encouraged to invest in stocks and equity so they share the gains and losses.

The Iraqi shareholders will benefit when the IPC, or any regional company, does well and the share price increases. However, if the new government of Iraq elects to pursue the old policies and keeps control over oil it will sooner or later become another authoritarian government and economic development will stall.

4. Conclusions

Previous Iraqi governments were powerful because they controlled oil wealth. They did not need to consult with the Iraqis on how the revenues are spent. Under those governments Iraq was a centralized economy with a dominant public sector. Those public institutions were inefficient and inhibited individuals' freedom and creativity. Iraq's economy was weak and the average Iraqi was poor relative to many others. It is puzzling that the new Iraqi constitution (articles 109 and 110) is still inconsistent with the principles of democracy and maintains the same rules of the past. It is believed that it is not conducive to economic development because it does not guarantee the transfer of oil wealth from the state to the Iraqis, which will inhibit economic freedom and creativity.

This paper argues that articles 109 and 110 of Iraq's new constitution must be changed such that oil wealth is redistributed to the Iraqi people. The new Iraq must have new institutions that guarantee economic freedom. Further, I propose a two-phase strategy that gradually returns oil wealth to the Iraqi people. In the first phase, (1) three independent (from the government) private oil companies are established. (2) Total oil assets are evaluated and share value is computed and shares are distributed to the Iraqi people. (3) Oil production is increased to 6 million barrels a day. (4) Also, the IPC finances 50 percent of the budget to rebuild the infrastructure and free market institutions such as the tax system and the banking and financial market.

In the second phase the oil company gradually reduces the contribution to the federal budget and in the same time increases private ownership of oil, and pays dividends to the Iraqi people. By the end of this phase the Iraqi government must have a functional tax system that finances the federal budget.

I predict that within a decade this setup will create a new Iraqi economy comparative with the rest of the democratic world. Also, it will unite the Iraqi people. Once the Iraqis realize that the benefits of oil are theirs they will support their government. Also, the world will be better off with a democratic Iraq and when decisions about its oil are apolitical and consistent with free market principles.

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