The *Real* Challenge for Iraqi Development

BY NANCY BIRDSALL

Oil wealth could be a great help—or hindrance—to Iraq's development prospects.

Iraq is rich in oil but surprisingly poor in human capital. Oil is a mixed blessing at best, a curse at worst. Among countries rich in oil are many that have failed at economic or political development or both: Angola, Nigeria, Venezuela, and Saudi Arabia. Human capital, on the other hand, is an unmitigated blessing. It's been central to the economic transformation of resource-poor countries, including Korea, Taiwan, Hong Kong, and now China, and in the larger sense of what development is fundamentally about, it's an end in itself. Indeed, you might say that education and health, the most straightforward indicators of human capital at the individual level, are the point of development.

Imagine a future moment (soon we hope) when the security situation in Iraq has settled down, the initial phase of reconstruction has taken hold, and there is a new recognized government. Even then, with today's immediate problems overcome, Iraqis will face daunting challenges in dealing with their surfeit of oil and their deficit of education. In the early post-combat months, there's been little thought to these challenges, and no sign of decision-making on them. Yet neglect and indecision now put at risk any real success later in building an open and democratic state.

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In fact the two challenges are not independent of each other. A radical approach to managing the oil, one that fully insulates Iraq's fragile new institutions from oil's corrosive effects, is the only hope for Iraq's desperately needed education fix as well, and for building an open, skill-based economy.

THE SURFEIT OF OIL

Iraq has similarities and differences with other oil-dependent states—mostly working against it. On the one hand Iraq is not Angola. It has an urban middle class and a history in which there has been an effective state, though colonial and then authoritarian and often abusive. There is a civil service system that has functioned for at least three or four decades in the organization and delivery of basic public services and in the production of oil. On the other hand, like Angola Iraq is war-worn and extraordinarily poor in the basic institutions of an open market economy: property rights and the rule of law. Like Angola, it has a history in which oil has brought wealth and power to a relatively small portion of the population, and for the rest, mostly trouble, bitter ethnic rivalries, and war over oil spoils.

So Iraq is not Angola but neither is it Norway. Norway was lucky: its oil went undiscovered until it had established and honed the institutions of a working democracy with an open market-oriented economic system. Those include not just contract and property rules and the institutions to interpret and enforce them, but a tradition of rule-based fiscal discipline. That tradition made possible good management by the state of the windfall income oil provided. In Norway, oil income is partly sequestered (in foreign currency accounts), reducing its pernicious influence on local incentives for investment in the non-oil sector, and allowing for sensible countercyclical fiscal spending when oil prices, historically volatile, are low. Transparency about the rule-based management helps minimize the constant risk that oil income will lead to unsustainable public spending.

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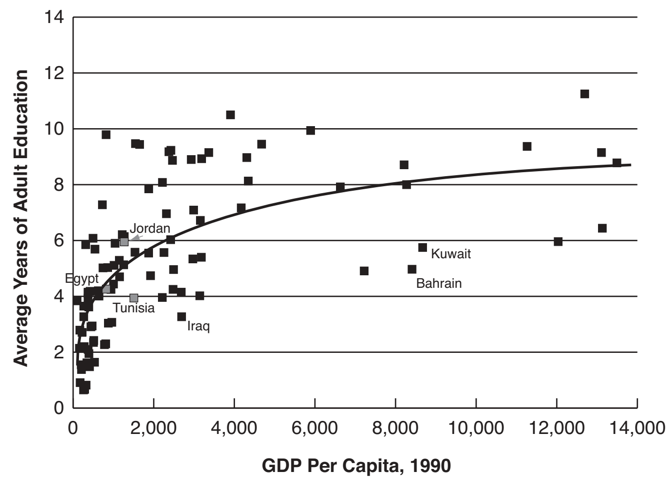
Iraq, in contrast, has characteristics that suggest it could become more like Venezuela. As in Iraq, oil brought Venezuela sufficient income to build roads and a university system, and to hire enough civil servants and employees of state-owned banks and power companies to constitute the core of an urban middle class. But in Venezuela, a long history as a democratic state has yielded to gradual deterioration into an illiberal, populist system, as oil wealth has fed incompetence, corruption, and the centralization of power. The effect of oil exports on the exchange rate makes manufactured and other tradable goods cheap to import and uncompetitive on global markets; this so-called Dutch disease inhibits investment, job creation, and the growth of small and medium enterprises. Moreover, in oil-rich countries without an accountable state, Dutch disease is only the tip of the iceberg. In Venezuela, Angola, Nigeria, Ecuador, and Russia, oil[1] has not only complicated economic management and inhibited broad-based growth; it has sustained a state that to stay in power need not tax its citizens nor be accountable to them, and need not develop mechanisms to represent their interests (in expanding education and providing for public health for example). Venezuela's electorate may yet rescue itself and its economy from its current downward spiral (in which income per capita has declined by more than 20 percent in recent years, and the proportion of those living in poverty has grown from 22 percent in 1980 to 50 percent today), but that will be despite not because of its surfeit of oil.

Oil wealth has fed incompetence, corruption, and the centralization of power.

THE DEFICIT OF EDUCATION

In 1980, Iraq was already relatively backward with respect to levels of education given its income (see Figure 1). It was typical of other oil states, where limited demand for skilled labor reduces incentives for societies and for parents to invest in their children's human capital. Compounding its education problem, Iraq like the other Arab oil states used its easy oil revenues to create plenty of patronage-based jobs in its civil service and state-run enterprises. The existence of these jobs made schools

FIGURE 1 EDUCATION AND INCOME



Source: Barro, Robert J. and Jong-Wha Lee, International Data on Educational Attainment: Updates and Implications (Harvard University, Center for International Development Working Paper no. 42).

a credentialing exercise without any emphasis on the approach to learning the skills now needed if Iraq is to participate in the global market economy.

Still, Iraq in 1980 was ahead of other Arab states, where average education levels have historically been reduced by the limited education of most women (see Table 1). Since 1980, however, Iraq has seen many members of its best-educated population leak away—driven abroad by fear or simply managing to choose kinder places for themselves and their children. And since 1980, secondary school enrollment rates have dropped—from an estimated 57 percent to 20 percent in 1998. Meanwhile other Arab states, particularly those without oil or other natural resources, stepped up their efforts to bring education to all, including girls. In Egypt, enrollment rates in secondary school rose from 51 to 81 percent between 1980 and 1998; according to UNESCO (the United Nations agency) there were 94 girls in secondary school for every 100 boys by the year 2000. In Tunisia, secondary enrollment rates rose from 27 to 73 percent in the same period, and girls are as likely now as boys to be enrolled. In Iraq, in contrast, the situation for girls is particularly worrying, with as few as 66 girls enrolled in secondary school for every 100 boys.

TABLE 1 SECONDARY ENROLLMENT RATES, SELECTED ARAB COUNTRIES

	1980	1998
Iraq	57.0	20.0
Jordan	59.1	65.9
Saudi Arabia	29.5	66.3
Tunisia	27.0	72.6
Egypt	50.5	81.0
Bahrain	64.0	93.5

Source: World Bank, *World Development Indicators,* 2002

HIVE OFF OIL SPOILS—FOR DEVELOPMENT AND EDUCATION'S SAKE

What can be done to minimize the risks that oil creates for the emergence of an open, skill-based economy built on human initiative and broad-based job opportunities? Iraq's new government, once it is formally created, needs to literally sign away its access to oil revenues for long enough to establish transparent politics and build accountable institutions. Divesting the government permanently of oil holdings—auctioning off claims on the international market—is not the answer. To avoid a complete giveaway of the Iraqi people's asset, the government would need to impose a permanent high marginal tax rate on oil exporters' revenue. That would mean the government would end up with automatic access to easy money.

What's needed is a mechanism to completely insulate politics from the temptations to corruption and unproductive state consumption that oil creates. The only way to accomplish that is for Iraqi authorities to ask the United Nations to manage Iraq's oil revenue (not its production) under an agreed mandate, for at least a ten-year period. Under such a mandate, the bulk of the revenue (net of operating costs) would be distributed directly to citizens annually as a cash payment, somewhat as in Alaska (though there it is the interest from invested oil funds that is distributed). This is equivalent to citizens holding an equity stake in the oil and receiving dividends, with fewer risks of the kinds of chicanery that gave post-privatization voucher schemes a bad name in the former Soviet Union. The cash distribution would create taxable income, encouraging development of a broad-based tax system and giving citizens a tool to make their government accountable.

The need to generate revenue via taxes will not of course alone guarantee effective use of revenue by the state. But it will prevent the worst forms of corruptive abuse that elsewhere have destroyed fragile institutions and upended development efforts. As an interim device, since investments like education cannot wait for a viable tax system, the UN mandate could allow for some revenues to go to an externally managed trust fund whose proceeds could be used solely to match local investments in public infrastructure and health as well as education. (The World Bank set up a similar arrangement like this for Chad's oil revenues, but without matching and without sufficient external control to prevent early on a government raid to buy a jet.) That would preserve some oil money for direct investments, while involving local governments. Finally, a small portion of oil revenues (at most 10 percent) might be left in the direct control of the new government. Ideally, as in Azerbaijan, Colombia, Kazakhstan, and Norway, the government would hold any revenues it controlled in offshore accounts (to control the rate of oil-related foreign exchange inflows), and would spend them locally only for countercyclical purposes.

None of these schemes is a substitute for hardwiring some form of transparency into the use of Iraq's oil (and other) revenue. In other poor, resource-based economies, the World Bank is overseeing intensive expenditure tracking, including by citizens' groups. In the end, the only answer is the build-up of strong democratic institutions. Until these are developed, external support for citizen watches—globally organized and financed and locally managed along the lines of the Iraqi Revenue Watch established recently by George Soros' Open Society Institute—is indispensable.[2]

What does external control of oil revenues have to do with advancing education in Iraq? First, Iraq desperately needs its diaspora's human and other capital to rebuild its fractured society. The educated Iraqi diaspora will bring that capital only when the outlines of an accountable and transparent state emerge, signaling that economic opportunities will go beyond privileged insiders in a transparent business environment. Starting that process now requires a strong and clear signal that external control will prevent oil from corrupting politics.

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In Venezuela, Angola, Nigeria, Ecuador, and Russia, oil has sustained a state that to stay in power need not tax its citizens nor be accountable to them.

But bringing home the highly educated will not be enough—not to jumpstart broad-based job-intensive growth nor to secure a democratic system. Development and democracy require a fast uptake of Iraqis, including girls and women, into secondary school. They require replacing a school system focused on doctrinaire propaganda with a system responsive to new demands for marketable skills. They require creation of education and training opportunities for young adults too old for traditional schools, who will otherwise be the angry losers in a more competitive and demanding job market.

Egypt is poorer than Iraq. But it has made progress in education in the last several decades (see Table 1). Its education problem is not lack of access to schools but low-quality schools adapting too slowly to changing demands. High enrollments in Egypt and in Tunisia make it clear that Arab parents want their children, including their daughters, to be educated; culture and attitudes are not the issue. The issue for Iraq is the remaking of a public education system and the rapid creation of employer-based skills and training programs. These need to be sufficiently local to be politically accountable to citizens and parents, and funded by tax revenues the use of which citizens can command and monitor.

A centralized and unaccountable state dependent on oil revenues will not deliver on education—or on development or democracy. Iraqis have, ironically, an opportunity to avoid having their oil create that unaccountable state. They can use their new sovereign rights to turn over to the UN, temporarily, one sovereign right: control of their own oil revenues. Otherwise, it is hard to believe that Iraq's development prospects will not be doomed. ◆

NOTE

1. Diamonds in Sierra Leone and tropical woods in Cambodia are other examples of development banes rather than bonuses.
2. http://www.iraqrevenuewatch.org.