COALITION PROVISIONAL AUTHORITY

BAGHDAD

INFO MEMO

October 28, 2003

FOR: THE ADMINISTRATOR

FROM: Keith Crane

SUBJECT: Comments on Tom Foley's and Peter McPherson's Proposals for Oil Trust Funds

PURPOSE & SUMMARY: The purpose of this memo is to evaluate the proposals for oil funds made by Tom Foley and Peter McPherson, respectively, in terms of the ability of the proposed policies to achieve the goals stipulated in the memos. On the revenue side, both memos provide cogently argued rationales for collecting monies from oil sales in separate funds. On the expenditure side, both memos advocate unduly restrictive policies, especially in light of current and prospective budgetary needs. If CPA's goal is to leave the next Iraqi government with an enduring institution that will collect oil monies in a transparent fashion and limit the ability of future Iraqi governments to use these funds for purposes other than direct redistribution to Iraqi citizens, the two current proposals need to be modified. In their current form, I am certain that a future Iraqi government would change the expenditure allocations. I have provided some suggestions on how the proposals might be modified below.

The Purpose of an Oil Fund

Both memos provide good arguments for collecting oil monies in separate funds. To recapitulate, if properly designed and managed, an oil fund could:

1. Help control diversion of funds at the collection stage;
2. Provide transparency in expenditure as well as collection;
3. More quickly call government attention to unexpected shifts in oil revenue flows;
4. Can be used to sequester funds for future or special purposes;
5. May dampen economic fluctuations by adding or withdrawing funds from a stabilization fund;
6. May cap the amount of oil income directly available to the government, causing the government to resort to other, broader-based taxes to obtain revenues.

Of these goals, those pertaining to revenue collection are the least controversial. Many countries and states establish separate funds for the collection of resource taxes: Iraq operated a

Development Fund based on oil revenues in the 1950s. An oil fund would put funds outside the control of the Ministry of Finance, permitting more automatic, timelier payouts for items that are on a regular payment schedule. The Iraqi Ministry of Finance has an institutional culture of multiple approvals and a very bureaucratic, autocratic disbursement system that is subject to individual decisions and whims.

Funds may have stipulations on the investment and allocation of monies. The Iraqi Development Fund, set up under the tutelage of the World Bank, mandated investment in infrastructure. Tom Foley's proposal restricts the share of the fund revenues that can be used for general revenues. Both proposals mandate investment in a capital fund and a "dividend" payment to each Iraqi citizen. Peter McPherson's proposal also calls for a stabilization account.

If this proposal is to last, the mandated allocation of funds has to provide incentives for future governments to adhere to the mandates; otherwise, once elected they will change the operation of the funds. The dividend payment is the easiest to make permanent because once households begin receiving it, they will not give it back. We have already introduced an "oil dividend" program: the monetization of the food basket and monetary compensation for increased energy prices. No other developing country of which I am aware could afford to provide monetary compensation for either food of fuel. Iraq's oil wealth makes this possible. Going through the accounts, I do not foresee any additional monies becoming available for another "dividend". To illustrate, a $15 a month per capita payment for food and another $5 a month payment for fuel generates an annual expenditure of $6,480 million annually. The 2006 budget assumes 2.5 mbd of oil exports and an oil price of $21 per barrel, resulting in annual gross oil revenues of $19,300 million. Assuming an additional 1 mbd in sales to domestic refiners that would also be sold at this price, total gross oil revenues would be $26,800, this one program would take a quarter of gross oil revenues and a substantially higher share of net oil revenues. In light of other demands on oil revenues, the monetization and energy compensation program leave little or no room for an additional dividend payment.

There are two other arguments against making a dividend payment separate from the monetary compensation programs. One, transaction (distribution) costs are very expensive in these programs. I have been working with Danilo Roseano on the costs of distributing the monetization payments. We do not yet know what the costs are, but they could easily run as high as $1 per transaction plus set up costs and set up costs will run in the millions of dollars. Setting up a dividend program separate from the monetization program seems very wasteful in this regard and would absorb a substantial share of the distributed funds. Two, the size of a separate dividend would probably be considered laughable by most Iraqis. I had thought about advertising the monetization of the food basket as an "oil dividend," but the amounts available are the minimal amounts necessary to keep a poor family fed. My guess is that Iraqis perceive substantial dividend payouts. Advertising monetization as an oil dividend would probably result in a popular outcry because most people do not realize how limited funds are.

I do not think that CPA would be well-advised to expend political capital on trying to push through these mandates only to see them immediately overturned. Thus, any CPA-inspired mandates need to survive a new Iraqi government. I am unconvinced by some of the proposed mandates. Both memos argue for capital funds in which oil revenues would be collected for future generations. Tom Foley caveats this mandate by stipulating that for the next five years, oil funds should be used infrastructure development for the next five years. I concur with Tom that monies should be channeled into infrastructure for the time being; I am skeptical that five years

will be enough time. The argument that funds should be set aside for portfolio investment, much of it abroad, would make sense if Iraq were at a mature or declining stage in oil production like Norway or Kuwait. However, the best thing that Iraq can do at this point in time would be to develop its oil resources so that future generations will be able to benefit from increased oil output. Politically, it would be very difficult to argue that the fund should invest abroad while foreign oil companies are being encouraged to invest in Iraq. My guess is that rates of return on funds invested in Iraqi oil in the coming few years will be high. Investing in infrastructure, if conducted sensibly, could also generate very high rates of return, however, measured. Investment in education should also generate high rates of return. In short, an infrastructure/education mandate would be much more palatable (and sensible) than a classic investment fund. Once the Supplemental runs out, I really see no other alternative. In light of Iraq's very young population and infrastructure needs, a classic fund that makes portfolio investments, many abroad, is a political non-starter and also not a good use of resources at this point in time. Those funds are more suitable for aging populations with fewer needs for infrastructure and education.

Another argument against national funds is their poor investment track record. If the government believes that oil revenues should be used to pay for future pensions, the most efficient solution is to provide a benefit to individuals and have them invest the benefit themselves in an accredited fund. Pension systems under which wage earners are compelled to invest a set share of income in privately managed savings accounts have been surprisingly popular and successful as alternatives to strictly state-run programs in emerging markets. In my view, it makes more sense to provide money through the oil for cash program and then tax back (show the amount taxed) a share for investment in individual retirement accounts than to have a national fund invest retirement savings and leave the government with the pension obligation. Under these systems, the government places strict conditions on funds eligible to participate in these programs. Everyone in the country monitors the performance of these funds because it is their money.

The track record of national funds, including the U.S.-East European enterprise funds has often been mediocre to abysmal. In particular, the idea that creating boards of directors formed of the great and the good will result in solid returns is often mistaken. Many corporate boards, including Enron's, are stacked with such people. A very good friend of mine was on the Hungarian Enterprise Board and, unfortunately, participated in some very bad decisions. These people usually like to be liked. They are very busy. Moreover, the money involved is not their own. Thus, they do not perform the oversight functions or challenge decisions the way they would if they were investing their own money. I would focus on disbursing funds to the government budget and individuals, not trying to have the funds invest it themselves.

The stabilization fund argument makes some sense, but is probably irrelevant for CPA as the likelihood that the Iraqi government will enjoy a surfeit of oil revenues in the medium term is very low. Good finance ministries do create set aside accounts and try to constrain spending in times of boom. This said, stabilization funds for countries or cartels (coffee, nickel, tin, etc.) have had a checkered history. I believe all of the commodity funds have gone bankrupt. The empirical evidence shows that no one can forecast long-term market trends. Thus, governments and cartels tend to spend too quickly and save too little. If CPA advocates a stabilization fund, it should be just that. It only makes sense to put money into these funds when commodity prices exceed a certain level (e.g., $32 a barrel) and only permit withdrawals when the price falls below

a certain level (e.g., $12 a barrel). I see no sense in putting money into such a fund when oil prices are "normal" and especially during a period like now when the Iraqi government has such limited revenue options. The Iraqi government would be better off setting up contingent lines of credit in the future or looking at other rainy day options than sticking a large share of resources into a fund.

I disagreed with the mandate that only 10 percent of oil tax revenues be used for general government revenue. It is not enforceable and is fairly arbitrary. It also puts the cart before the horse. A substantial number of oil economies have become successful or semi-successful: China, Malaysia, Mexico, Russia, some of the Gulf states, not to mention Texas, California, Great Britain and Norway. As these economies have developed, the share of oil revenues to total government revenues declines, not because of oil tax policies, but because the importance of the oil sector declines as a share of GDP because of economic growth, making it possible to tap other sources of tax revenues. Oil taxes can actually have one of the least distortionary effects on an economy. In Middle Eastern societies, other taxes have much more pernicious effects because they put power in the hands of tax collectors, a profession that has been reviled since Biblical times. Customs, sales, excise, VAT, property, and income taxes are all much more arbitrary in these economies and potentially much more detrimental to economic growth than taxes on oil. Iraq should use its oil wealth to build up a head of steam for growth and then introduce other taxes.

Iraq also lacks the resources to become a classic Persian Gulf oil economy. If production hits 7.5 mbd, roughly Saudi production levels, Iraqi output is likely to have a depressing effect on world market oil prices. However, even assuming that it does not, gross Iraqi oil revenues at $20 per barrel would still only be $2,000 per capita, not enough to make Iraqis wealthy.

Fund Mechanics: Revenue

Both memos stated that net oil revenues rather than oil tax revenues should be used as revenues for the fund. Tom Foley's memo argues that all upstream assets should become the property of the fund. I think both proposals are major mistakes. The fund should only draw on oil tax revenues; the national oil companies need to operate on a commercial basis, not as revenue sources.

Currently, the oil industry, despite the nominal existence of "companies,' is run by the Ministry of Oil as a budgetary institution, not as a set of independent units. Robert McKee notes that the best state-owned oil companies are those that are most independent from the Ministry of Finance and the worst run state-owned oil companies are those that are run by financial authorities. If Iraq is to have a strong oil industry, the industry needs to be run on a commercial basis and face as much competition as possible. To elicit the proper supply responses and to create a tax framework in which independent units can operate, the operating units need to be restructured into a set of independent profit centers with an eye to increasing competition in refined oil products markets. Each link in the state-owned supply chain needs to be operated as an independent profit center, making it possible to introduce competition at each stage. This will involve creating balance sheets, cash flow, and profit and loss statements. This financial information can then be used to make better operating decisions and provide proper incentives for management to compete for market share, control costs, and run their operations in a profitable manner. Creating proper incentives and inventory and financial controls is crucial,

because some managers will lose substantial sums of money because of reduced opportunities for graft.

The fiscal instruments used to tax the industry need to be consistent with multiple, independent producers. These include royalties, profit taxes, and dividends paid to the state. Royalties can be set as a percentage of world market prices or export prices. Profit taxes should be designed to leave enough retained earnings to enable the company to operate in a commercial fashion. The board of directors, which would consist of government appointees, would make decisions on dividend payments to the treasury. Eventually, excise taxes on motor vehicle fuels may also be levied. In this structure, taxes are levied at discrete stages of the production process. For example, percentage royalties are levied at the production stage and excise taxes on refined products at the wholesale or terminal stage. Such a tax system can be applied uniformly to all future participants in the oil sector, including foreign investors. A clear, transparent energy tax code will ensure both that the fund or funds will only draw on a clearly defined set of tax revenues from the oil sector and that state-owned oil companies will be able to retain sufficient funds to conduct their own operations efficiently. In this system, tax revenues from oil will be constrained by the international oil market and Iraqi oil companies' financial performance. The Iraqi government will not be able to treat the industry as a revenue source rather than a business.

For these reasons, I do not support giving an oil fund all oil assets. The treasury or state property holding company should hold the equity. The fund should benefit from taxes on the industry as a whole. It should not be involved in owning and managing operating companies.

Financial Implications

Table 1 shows summary data for the Iraqi budget for 2004-2006.

Table 1: Oil Revenues and the Iraqi Budget

Million Dollars

	2004	2005	2006
(1) Production mbd	12,000	18,500	19,300
(1) Gross Oil Revenues (exports only)	12,000	18,500	19,300
(2) Total Revenues	13,839.2	19,183.2	19,763.4
(3) Percent	86.7	96.4	97.7
(4) Gross Oil Revenues			
(4) Oil Tax Revenues assuming $5/barrel production costs			
(5) Household Compensation Payments	6,480		
(6) Government Operating Budget			

(4) – (5) – (6)			

[redacted]