



REVENUE WATCH

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Protecting the Future: Constitutional Safeguards for Iraq's Oil Revenues

The people of Iraq endured decades of corrupt and totalitarian rule under Saddam Hussein, who squandered the nation's natural and human resources on unwinnable wars, internal repression, and enriching himself and his cronies. With Saddam gone, Iraqis are now demanding a more just and economically viable future.

Many believe that a better life, funded largely by revenues from Iraq's massive oil wealth, lies ahead. However, any chance of securing this future depends on Iraqis creating laws and practices that will guarantee financial accountability and the equitable division of oil revenues.

Without such laws, Iraq is likely to suffer from the "resource curse" that has afflicted many other natural resource rich nations. Without transparency and accountability, policymakers can evade financial accountability and divert resource revenues into their own pockets at the expense of the wider population. Without equitable distribution of oil revenues, competition among various groups for oil money could turn ugly and, even erupt into violent conflict. In Iraq, rifts over oil revenues already run deep, as Iraqi Kurds, Arabs, and Turkmen struggle for control of oil-rich Kirkuk.

This report explores ways that Iraqis can avoid many of these problems by rising above the political rivalries and cronyism that threaten post-Saddam Iraq and embedding measures for accountability into the future Iraqi constitution. This paper explicitly omits discussion of the future structure and management of Iraq's oil industry, focusing instead on the constitutional mechanisms by which the present Iraqi government can enshrine basic levers of transparency and accountability in any future oil management regime. Now that elections have been held, the most important and contentious part of the journey to a democratic Iraq is still to come: drafting the permanent constitution and holding a national referendum on it, set for October 15, 2005.

Why the Constitution Matters

Every country addresses some issues in its constitution and others through legislation. Constitutions, which are typically difficult to change, aim to nail down the most basic principles that a nation values. Subsequent legislation provides the details about how those principles are to be exercised. Countries such as Iraq, which largely depend on oil revenues and have suffered from past revenue mismanagement, may wish to provide some constitutional safeguards to protect oil revenues. Many questions on how the oil industry should be organized are better answered through legislation. However, certain basic principles should be secured in a constitution to provide the basis for protecting against later abuses.

The Alaska state constitution is often cited as an example of how constitutional protections led to long-term benefits to citizens from the state's oil revenues. A constitutional amendment, not a legislative act, created the Alaska Permanent Fund (APF). The APF secures future state income by receiving at least 25 percent of all the state's mineral-based royalty revenues. A separate organization, the Alaska Permanent Fund Corporation, manages the APF, operating under the oversight of an independent, publicly appointed board of trustees and the state legislature. The APF's constitutional status protects it from the economic and political vagaries that might otherwise prematurely deplete the fund, as occurred in Venezuela and Mexico.¹

Iraq and Alaska, of course, are entirely different cases. Alaska has a long history of federalism, democracy, development, and domestic and regional stability that make its model less readily translatable to developing and transitional contexts. While instructive, Alaska's experience cannot speak to the specific challenges of ensuring responsible resource revenue management in a post-war, post-authoritarian Middle Eastern country such as Iraq. And it is reasonable to ask how a constitution can protect Iraqis from abuses of government in a part of the world where governments have a history of paying lip service to the separation of powers and other elements of constitutional "architecture," to the extent they exist.

Unfortunately, in the Middle East (including Arab states and Iran) constitutions tend to be weak, allowing the executive branch to control and manipulate the legislature and judiciary

under the cover of law. While there are signs of progress in a few countries, most Middle Eastern constitutions only ostensibly distribute power. In reality rulers are able to violate their own rules through unchecked executive authority, feeble parliaments, and clever legal loop-holes.²

The answer to this predicament is to strengthen constitutional provisions that limit executive authority in the Middle East –not abandon constitutions altogether a means to safeguard the public interest. Given the near failure in the Middle East to enact legislation protecting natural resource revenues from corruption, creating robust constitutional safeguards is crucial, even if it will later limit legislative flexibility.

A Transparent and Accountable Budgetary Process

The World Bank's recipe for sustainable development based on resource extraction requires three principles at the national level: (1) the establishment of transparency and accountability with respect to revenues earned and their disposition; (2) consultation with principal stakeholders in developing plans for the use of resource revenues; and (3) credible oversight and audit of the implementation of these plans.³ These principles, reiterated by G8 members at the 2003 Sea Island Summit and underpinning international efforts such as the Extractive Industries Transparency Initiative, can be embedded in the very structure of an Iraqi government founded on checks and balances, including parliamentary oversight, and on local consultation to prevent interregional rivalries and conflicts between the central and local governments.⁴

Transparency

The budgetary practices of *rentier* states (states reliant on externally generated revenues or 'rents', such as oil sales, as primary source of income) facilitate much of the corruption plaguing their national economies. State budgets rarely, if ever, reflect all of a government's expenditures and income, a practice that undermines democratic accountability in countries where national revenue is overwhelmingly derived from the extraction and sale of natural resources, and their associated production and transport industries. In Kuwait, for example, profits from the activities of the Kuwait Petroleum Corporation (KPC) other than the sale of crude oil (such as oil refinery and product sales) are not counted as income in the state budget.⁵ Neither are dividends and capital gains from investments held in accounts designed to reserve money for future generations; unsurprisingly, those rainy day funds became slush funds, often spent prematurely or used as collateral for taking out government loans. On the other side of the ledger, defense spending in Kuwait is off-budget.⁶

Accountability

The first step toward financial accountability and transparency is making sure that oil revenues and expenditures are included in the public budgetary process. Constitutional provisions assigning responsibility for the development and implementation of the Iraqi budget must

make that explicit. But that is only half of the equation. Accountability also requires oversight by all branches of government—executive, legislative, and judicial. Most oil-dependent states have “ultra-presidential” governments, which empower (or at the very least, enable) the executive branch to use resource revenues as it sees fit. In Venezuela, for example, the executive appropriated the state oil company’s \$5 billion investment fund in 1982 without opposition from the legislature.⁷ Foreign influence also has had a hand in promoting ultra-presidential systems. During the 20th century, companies mainly preferred to deal with one “negotiator,” either the president or his representatives, and the executive branch in many resource rich countries grew all-powerful as oil rents flowed through it.⁸ As foreign oil companies engage in more business with Iraq’s nationalized oil industry, Iraqis must be vigilant to the potential role of those companies in encouraging an ultra-presidential government.

Iraq, up to now, has fit neatly into the Arab constitutional tradition, with its record of establishing disproportionately powerful executives. Parliaments in the Arab world tend to play a subordinate role to the executive, especially in the budgetary process.⁹ The budget is often so vague that only intensive work by parliamentarians can reveal its critical features, and few parliaments in the Arab world are given the time and resources necessary to assume a true oversight role.¹⁰ Moreover, cabinet ministers, including the oil minister, are rarely called to account for their actions and decisions. There is usually no parliamentary procedure for the withdrawal of confidence from individual ministers or from the cabinet as a whole.¹¹

Most Arab constitutions have a provision for some type of auditing body to report to the government, although it generally reports only to the executive, and then only in secret. Article 170 of the Algerian constitution, for example, creates an Audit Office tasked with auditing the finances of the state. The Audit Office establishes a yearly report, but it is addressed only to the president. The same holds true for Morocco’s Audit Court (Chapter 10 of the Moroccan constitution). In Saudi Arabia, Article 79 of the constitution requires that an annual auditing report be submitted to the Council of Ministers, and Article 80 states that investigations of financial and administrative violations report only to the Council of Ministers.

Kuwait is an exception. Article 151 of the Kuwaiti constitution provides a model parliamentary oversight provision:

Article 151: A financial control and audit commission is established by a law, which ensures its independence. The commission is attached to the National Assembly and assists the government and the National Assembly in controlling the collection of the State revenues and the disbursement of its expenditures within the limits of the budget. The commission submits to both the Government and the National Assembly an annual report on its activities and its observations.

This kind of oversight has challenged executive authority, and made the Kuwaiti parliament a force to be reckoned with. In 1978, the Kuwaiti parliament ousted an oil minister for corruption. Throughout much of the 1990s, the parliament pursued corruption investigations involving a KPC affiliate, the Kuwait Oil Tanker Company, and implicated the company’s former

managing director and a former oil minister. Disgusted by mismanagement and corruption, technocrats working in the KPC cooperated with the parliament in its efforts.¹²

The Board of Supreme Audit in Iraq has existed since the early 1970s, but like the Moroccan, Algerian, and Saudi models, it reported only to the Office of the President. Today, the board is initiating and carrying out its own investigations. Despite the murder of former president of the board, Ihsan Karim, in a car bombing in July 2004, in what some suspect was an attempt by Iraqi or foreign insurgents to intimidate the ministry of finance, the board is continuing its investigation of the United Nations oil-for-food program.¹³ In February 2005, Karim's successor, Abdul Basit Turki Saeed, announced his intent to audit all contracts made since the U.S.-led coalition invaded Iraq in April 2003. The future Iraqi constitution should guarantee the independence and integrity of any future Board of Supreme Audit by ensuring parliamentary oversight.

The Equitable Distribution of Oil Revenues

In addition to the challenges of creating structures to ensure accountability in the constitution, a future Iraqi constitution also faces the difficult task of managing the often divergent interests of Iraq's Shiite, Sunni Arab and Kurdish populations.

The transitional process has already highlighted these divisions. Iraq is currently governed by an interim constitution known as the Transitional Administrative Law, which includes a provision to allow two-thirds of the voters of three of Iraq's eighteen governorates (or provinces) to veto ratification of a permanent constitution. Kurdish political leaders backed this provision so that the three northern governorates making up the Kurdistan Regional Government could block a constitution they oppose. After winning 75 of 275 seats in the transitional National Assembly in the January 2005 elections, Kurdish political parties are in a good bargaining position to pursue this provision during the constitutional drafting process.

Kurdish leaders insist that any future Kurdish federal region must include the town and governorate of Kirkuk, which has proven reserves of at least 8.7 billion barrels.¹⁴ Although Kirkuk no longer holds the country's second largest reserves - as it is estimated that the Majnoon and Nahr 'Umar oil fields (combined) near Basra contain 26 billion barrels¹⁵ - Kirkuk remains the subject of a bitter dispute involving control over resources (including oil) and the revenues they represent.¹⁶

The Kurds in Kirkuk are also working to reverse the ethnic cleansing they suffered under the Baathist Arabization campaign, in which government authorities forcibly displaced tens of thousands of Kurdish and Turkmen villagers from their land in Kirkuk. The Baathist authorities also had a policy of "nationality correction," pressing those who were permitted to remain in Kirkuk to change their ethnic designation to Arab.¹⁷ In what has alternately been characterized as an effort to redress past injustice and secure a viable future in Kirkuk or an

aggressive policy of reverse-Arabization, Kurdish leaders are providing incentives for Kurds to move into the city to tilt the ethnic balance in their favor.

There is also concern that the Kurdistan Regional Government may have negotiated and entered into oil contracts with foreign oil companies, prompting the Ministry of Oil to issue a public statement emphasizing the exclusive right of the central government of Iraq to make decisions on exploiting Iraq's oil resources.¹⁸

Fiscal federalism and local participation

The situation in Kirkuk helps demonstrate the ethnic, regional, and socioeconomic struggles over oil money that can emerge if fair and clear constitutional provisions do not address these issues. Saddam Hussein's government was highly centralized, and government spending amounted to little more than patronage. This practice left certain regions, particularly the Shiite south, less developed than the rest of the country, and they will surely be seeking to make up for lost time. Corruption exacerbated socioeconomic divisions as Saddam's clients grew wealthy through oil smuggling during the United Nations sanctions regime of the 1990s, while ordinary citizens plunged into poverty.

Given the destructive role that oil has played in the country's history to date, what are some of the policy options that could distribute oil revenues more equitably and prevent the drive toward ethnic and regional fragmentation in Iraq?

Kurdish politicians have proposed that Kirkuk's oil remain a national Iraqi asset, with Kurds receiving a percentage of Iraq's overall oil revenue proportional to their population.¹⁹ This proposal may be a good starting point for negotiation, but may not be appropriate to include in the constitution—doing so runs the risk of institutionalizing an ethnic and regional fragmentation of Iraq. A system of federal checks and balances, which would give local governments consultation and participation rights in oil exploration in their regions and oversight in the expenditure of oil revenues, would be a more durable constitutional solution. A similar system exists now in Russia; foreign oil companies must negotiate with government officials at the national and republic level.²⁰ While Russia is by no means a gold standard for good governance and transparent business practices, the constitution's guarantee of local participation in oil development negotiations is indeed a progressive clause, if meaningfully enforced.

A number of experts on governance and conflict prevention have recommended some degree of decentralization in Iraq by devolving power to the local level.²¹ In most decentralized systems, local budgets are funded with money from the central government and local taxation, and the autonomy of a local government depends on its fiscal independence. Local governments imposing and collecting taxes would help to decentralize power in Iraq. However, communities are likely to continue to depend heavily on central government funding for the foreseeable future.²²

In the Australian federal system, both the national government and the state and territorial governments have roles affecting petroleum exploration and development. The

Commonwealth is responsible for broad economic policy and international matters. The states and territories own and allocate petroleum rights, administer petroleum operations (including occupational health and safety), and collect royalties on petroleum produced.²³

Other countries have consultation mechanisms to protect indigenous people from exploitation by natural resource companies. In Colombia, the Constitutional Court held that an oil exploration license should not have been granted because the indigenous people had not been properly consulted, as stipulated by the right of participation enshrined in the Colombian constitution. The Canadian constitution contains similar protections for aboriginal rights. In British Columbia, oil and gas royalties from native reserve lands are administered and collected by the provincial government. All proposals for major hydrocarbon developments are subject to the Environmental Assessment Act, which enables native groups to participate substantially in the review process.²⁴

But once again, the success of these decentralization schemes is as much a product of the plans themselves as of the overall structure of government. Such plans have little hope for success in the absence of democratic and accountable governance.

Indonesia offers an important cautionary tale. In 2001, the national government enacted a “special autonomy” law for Papua to alleviate grievances among the Papuans and stem their calls for independence, arising from decades of severe human rights abuses and the exploitation of Papua’s extensive natural resources to the detriment of the local population. Under the special autonomy law, Papua is to receive 80 percent of state income from mining, forestry, and fishing in the province and 70 percent from oil and gas, with the latter falling to 50 percent after 25 years.²⁵ The money, however, is paid to Papua via Jakarta, where much of it reportedly is lost to corruption and bureaucratic red tape.²⁶ On the receiving end, the provincial government in Papua has run into similar problems. In addition to the special autonomy law, Indonesia has attempted to give local people more control over their natural resources through the creation of people’s cooperatives and licenses. But international and local human rights activists say that loggers and their allies in the state, who use compliant village leaders to rubber-stamp their decisions, often abuse these mechanisms.²⁷

In Iraq, ethnic conflicts can be averted if the country’s leaders create a constitution that guarantees local participation and equitable sharing of the oil wealth. Unless Iraqi politicians make top priority a constitution that gives these principles permanence and makes them a foundation for governance, efforts to make Iraq stable and coherent could fail, provoking conflict along ethnic, regional, and socioeconomic lines.

Constitutional Provisions for Managing Natural Resource Wealth

In addition to the structural models discussed above, drafters of the future Iraqi constitution should consider models of provisions that deal exclusively with natural resources. These provisions generally fall into three categories: state ownership requirements, “fiduciary duty” clauses mandating that natural resources be used in the public interest, and provisions creating natural resource funds (NRFs). An additional idea would be to include oil industry ownership restrictions in the Iraqi constitution.

State ownership

Iraq in 1972 was the first country in OPEC (Organization of the Petroleum Exporting Countries) to nationalize its oil industry.²⁸ The constitutions of Mexico, Venezuela, Iran and other countries also mandate state ownership of oil resources. In the cases of Mexico and Iran in particular, state ownership was an important step in asserting self-determination and independence from foreign powers. But state ownership is no guarantee that oil revenues will be used for the public good, and not siphoned off through public corruption.

An exploration of the advantages and disadvantages of national versus private ownership is beyond the scope of this report. The recent trend, however, has been toward privatization. Even Iran and Mexico are finding ways to sidestep constitutional state ownership requirements. In 1995, the Iranian *Majlis* passed the “buyback” system, which allows foreign corporations to invest in Iran’s oil and gas sector by making the National Iranian Oil Company (NIOC) responsible for using foreign investment money to manage the production and extraction of oil and gas. NIOC then shares the proceeds from successful production efforts with foreign corporations. Although the system in Iran has lured large companies like France’s Total, Italy’s ENI, and Royal Dutch Shell, most experts agree that the measure is still too risky for many foreign oil corporations.²⁹ However beyond the issue of exploration-risk, the level of foreign investment has also been hurt by the system’s required development targets in which compensation to foreign firms becomes dependent on project performance. International oil companies have been further deterred from increasing investment in Iran because there is little incentive to improve production targets for short term contracts (especially since the “buy-back” system offers no guarantees for long term involvement). Further, foreign firms have objected to the system’s proposed method of compensation (based on the sale of project output) because they are not given direct control of onsite business decisions.³⁰ Mexico has enacted similarly complex financing schemes to try to bypass the constitution. Yet constitutional constraints continue to impede Mexico’s ability to attract foreign capital to increase exploration, production and processing. Given this movement toward privatization, as well as the national oil company’s history of entering into similar agreements with foreign companies and the strong international (particularly American) oil interests in Iraq today, the future Iraqi constitution may not give the state exclusive ownership of the oil industry.

“Fiduciary duty” clauses

Some constitutions impose on the government a construct similar to fiduciary duty in its use of natural resources, mandating that they be “utilized in the public interest,” to borrow the term used in the Iranian constitution. The constitution of the Philippines states that the “natural resources of the state belong to its people,” and under the Namibian constitution, the state has a duty to use natural resources to “maintain the welfare of the people.” The South African constitution uses a rights-based framework, stating that everyone has the right to the “use of natural resources while promoting justifiable economic and social development.”

Without appropriate enforcement mechanisms, however, these provisions are little more than policy directives. They cannot hurt, but are toothless if the proper constitutional framework is not in place.

*Natural resource funds*³¹

Natural resource funds can take the form of stabilization funds, savings funds or a combination of both. As Svetlana Tsalik explains in the Revenue Watch book, *Caspian Oil Windfalls: Who Will Benefit?*, stabilization funds even out government spending by channeling excess revenues to the fund when commodity prices are high, and transferring revenues back to the budget when commodity prices fall. Stabilization funds can protect budgetary spending from sharp fluctuations resulting from external price shocks. Because natural resources are depletable, some countries channel a portion of these earnings to a savings fund, which can continue to generate wealth through its investment earnings even after the natural resources are exhausted.

The Alaska Permanent Fund (APF), created in 1976 by an amendment to the state constitution and enacted through popular referendum, is a good example of an effective natural resource fund. Public oversight and an engaged citizenry have resulted in wise investment decisions, and consequently the fund has remained financially strong.

The stability of the APF is due largely to its status as a constitutional amendment. In contrast, the Alberta Heritage Savings Fund (AHSF) in Canada was created through the normal legislative process. As a result, the AHSF’s management structure, investment rules and organization are subject to the ups and downs of the political process. The different strategies and priorities of the AHSF and the APF have resulted in significant earnings discrepancies. While the AHSF has declined in value over the last 15 years, the APF has had a real rate of return of over 12 percent over the same period.³²

NRFs function best in established democracies like the United States, Canada, and Norway, which have strong cultures of accountability. A relatively young democracy, Chile, however has established a successful NRF for its state-owned copper industry. Chile’s Copper Fund operates as a stabilization fund; transfers go directly into the budget, and the elected legislature decides how to allocate funds through the budgetary process. Venezuela, on the other hand, has had much less success with its stabilization fund because its ultra-presidential system allows the executive to allocate transfers from the fund without meaningful legislative oversight.

Chad offers another cautionary tale. That country passed a revenue management law for its anticipated oil proceeds from the Chad-Cameroon pipeline project. Although the law requires that 80 percent of the government's oil revenues be dedicated to education, health, infrastructure, and other development projects, the law does not specify where the funds should be spent. In other words, all the investments could be made in one region. In Chad, where ethnic cleavages coincide with geography, inequitable spending could reignite Chad's long running war.

In sum, if Iraq decides to create an NRF, the best way to ensure stability for the fund would be to create it in the constitution, thus protecting the fund from future political pressures. But more importantly, any future NRF must exist in a constitutional structure founded on the principle of checks and balances, both among the various branches of government and between the national and local governments.

Ownership restrictions

Another potential constitutional provision to prevent corruption would limit the ownership rights of any single person, family or entity. This principle finds support in the constitution of the Palestinian Authority, which deems natural resources to be the property of the Palestinian people and explicitly forbids the monopolization of natural resources (Article 20). Ownership restrictions might also have the beneficial effect of forcing antagonistic groups into positions of economic interdependence.³³ Iraqi regulators, however, would have to be vigilant about schemes using "front men" to circumvent ownership restrictions.

Conclusion and Recommendations

As Iraq's National Assembly drafts the country's first permanent constitution since Saddam Hussein over the coming months, lawmakers will be tempted to postpone making difficult and indeed possibly divisive decisions about the administration of Iraq's resource sector. Yet there are great risks in allowing the future permanent government of Iraq to define its own relationship to the country's central source of income. By enshrining safeguards against the abuse of Iraq's oil revenues and public finances in the constitution now, and determining an equitable system for their distribution, the National Assembly can take protect the Iraqi people from Saddam's legacy of spoliation.

Deferring important decisions on the management of oil revenues almost certainly will lead to corruption and conflict, and feed the resentment of ordinary Iraqis, who have long felt dispossessed in a land of potentially tremendous wealth. Iraqis can feel that they have a real stake in the constitution if it provides for transparent and accountable governance, and the management of oil revenues is the most concrete and critical place to set a constitutional precedent. Below are several recommendations for drafters of the Iraqi constitution to help protect Iraq's economic and political future:

- ▶ *Guarantee a transparent and accountable budgetary process.* Any section of the constitution allocating responsibility for developing the Iraqi state budget should explicitly include oil-related income and expenditures as part of the public budgetary process. The legislature must also be able to call the executive, including cabinet ministers, to account for their spending decisions and actions. Any audit commission or oversight bureau should report to the parliament on a yearly basis and should be authorized to initiate investigations of malfeasance, another important mechanism of accountability. The legislature or attorney general also should have the authority to initiate and conduct investigations.
- ▶ *Address the equitable distribution of oil revenues.* The constitution should ensure that both the national government and the provincial and/or local governments have a role in petroleum exploration and development, and in deciding how to spend the resulting revenues. Iraq will have to find a compromise solution somewhere between its historically ultra-centralized economy and a highly decentralized model like Australia's. At the very least, local government officials should have the right to participate in the negotiation of oil exploration and production contracts in their region. At the national level, spending decisions should be made in the national legislature, to ensure the participation of elected officials from throughout the country.
- ▶ *Prevent natural resource funds from becoming "slush funds."* The optimal method for creating an NRF—should Iraq decide to do so—would be through a constitutional provision. If the fund is designed as a stabilization fund, Iraq should follow Norway's or Chile's model and put the elected legislature in charge of the allocation of transferred funds. This approach could help to unify Iraq, forcing parliamentarians to negotiate and reach consensus on expenditures. To the extent that an Iraqi NRF would serve as a savings fund, the fund's income and investment decisions must be subject to public scrutiny, and the legislature and/or judiciary should be empowered to investigate and punish malfeasance.

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Iraq Revenue Watch monitors Iraq's oil industry to ensure that it is managed with the highest standards of transparency and that the benefits of national oil wealth flow to the people of Iraq. Iraq Revenue Watch complements existing Open Society Institute initiatives that monitor revenues produced by the extractive industries.

In many parts of the world, the lack of proper stewardship over oil resources has resulted in corruption, the continued impoverishment of populations, and abuses of political power. By prompting governments to tackle these problems early, the Open Society Institute hopes to help Iraq avoid this plight.

The Open Society Institute currently supports a recently launched initiative, Caspian Revenue Watch, which monitors the development of oil production in the Caspian basin. The goal is to promote transparency, accountability, and public oversight in the management of oil and natural gas revenues.

Iraq faces even greater challenges than the Caspian region. If Iraq is to become an open, democratic society it will need to develop transparent accountable institutions for ensuring honest management of oil revenues.

There is an urgent need for Iraq Revenue Watch given the current occupied status of the country. The Coalition Provisional Authority and the Iraqi Governing Council should establish rules that ensure complete transparency regarding Iraqi oil revenues. So doing will foster a stable, democratic Iraq, and will protect the Coalition Provisional Authority from charges of misappropriation during this period of trusteeship over Iraq's reconstruction.

The **Open Society Institute**, a private operating and grantmaking foundation based in New York City, implements a range of initiatives throughout the world to promote open society by shaping government policy and supporting education, media, public health, and human and women's rights, as well as social, legal, and economic reform.

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