



# Caspian Oil Windfalls: Who Will Benefit?



## Overview and Recommendations

Foreword | Joseph E. Stiglitz

CASPIAN REVENUE WATCH

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For more information, contact:

Caspian Revenue Watch

Central Eurasia Project

Open Society Institute

Tel: 1 212 548 0600

Fax: 1 212 548 4607

[stsalik@sorosny.org](mailto:stsalik@sorosny.org)

[http://www.eurasianet.org/policy\\_forum/crw.shtml](http://www.eurasianet.org/policy_forum/crw.shtml)

<http://www.soros.org>

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# Caspian Oil Windfalls: Who Will Benefit?

## Overview and Recommendations

This publication condenses important conclusions and recommendations from the Caspian Revenue Watch report *Caspian Oil Windfalls: Who Will Benefit?* It also reprints the report's foreword by Joseph E. Stiglitz. The report, written by Svetlana Tsalik, is a publication of the Central Eurasia Project of the Open Society Institute. It analyzes the systems Azerbaijan and Kazakhstan use to manage their oil wealth. It offers recommendations to the governments of Azerbaijan and Kazakhstan, multinational oil companies, international financial institutions, and foreign governments for promoting accountability, transparency, and public oversight in the management of oil and natural gas revenues. The full report includes 10 case studies on natural resource funds in other countries and presents models of citizen oversight to provide information and comparisons for the establishment of effective programs in these two Caspian Basin countries.

# Foreword

It is sad but true that most natural resource–rich countries do not grow faster or perform in other ways better than those with fewer natural resources do. This observation would seem to contradict the basic laws of economics since more natural resources should provide more economic advantages and opportunities. Economists and other social scientists have worked hard to explain this anomaly and to figure out how these countries can maximize the benefits of their abundant natural resources.

Yet, the failures are legion and continuous. Oil-rich Nigeria has squandered a quarter trillion dollars of oil revenues and is deeply in debt. Two-thirds of the population of Venezuela still lives in poverty. Civil wars, fostered in varying degrees by struggles over control of oil, gas, and minerals, have devastated a host of resource-rich countries.

Part of this instability is explained with simple economics. Natural resource wealth can destabilize exchange rates. It can cause currency appreciation that weakens sectors of the economy not based on natural resources by making it difficult for manufacturers to export or to compete with imports. Meanwhile, the natural resource sector of the economy provides substantial revenues, but does not create employment throughout the economy. The resulting unemployment can give rise to political and social instability.

But the most fundamental problems that many resource-rich nations face are political. Control over natural resource wealth provides leaders with little incentive to share power, and gives leaders the means with which to buy legitimacy rather than earn it through elections. Leaders undertake costly investments to buy political support through job creation with contracts often awarded to well-connected insiders. Because rent seeking and state subsidies direct investment to unviable projects incapable of attracting private financing, many of these extravagant projects fail to lessen the country's dependence on natural resource development. The desire by government leaders to control wealth generated by natural resources often discourages the development of democracy and prompts violent conflict and resistance by those who have not benefited from the resource wealth and who feel shut out of centralized, undemocratic political systems.

To avoid these outcomes, political leaders and citizens need to regard their country's natural resources as the nation's endowment. These resources do not belong exclusively to the current government or generation, but to all citizens and generations. The current government and generation are simply trustees. To use these resources for one's own benefit, leaving future generations impoverished, is to steal their patrimony. Leaders inside and outside of government share a responsibility to promote this sense of stewardship in resource-rich countries.

Transparency of information about revenues received and fiscal accounting standards are key to increasing natural resource management and wealth. National accounting frameworks that do not appropriately take account of the depletion of resources are misleading; they prompt governments to think that the economy is becoming wealthier, when it may be becoming poorer. This false sense of wealth leads to bad decisions.

Even more important is information about what the government receives for oil or other natural resources, how this compares with what other countries are receiving, and how the government uses the funds it receives from the sale of natural resources. Governments should recognize that even in more developed countries major oil companies have tried to minimize their royalty payments by under-reporting the effective price of oil and over-reporting their costs. It was only through hard research that such evasion was detected, for instance, in the State of Alaska, and it was only through even harder prosecution that the oil companies finally agreed to pay the more than a billion dollars that they had avoided paying the state.

Companies have strong incentives to maximize profits and the opacity that surrounds oil contracts and payments can lead to abuse. A few oil companies, most notably BP, however, are setting the opposite example, by willingly publishing what they pay. Such disclosure allows citizens in resource-rich countries to become informed about how much the government receives for the nation's natural resources. It is regrettable that this commitment to good corporate citizenship has not been matched by most other oil companies.

Institutional arrangements like stabilization funds are essential to managing wealth derived from natural resources and ensuring that the money is used to replace the natural resource endowment that is being depleted. Stabilization funds in several countries have helped ensure that public funds are available for the rainy day when they are needed. This is especially important because international arrangements like the IMF, set up at the end of World War II to help finance counter-cyclical fiscal policy, have failed to perform the function for which they were created. The result has been that most developing countries are forced to engage in pro-cyclical fiscal policy, at great cost to the economy and society. Countries today recognize that borrowing is highly risky, and that they must rely on their own resources, especially for stabilization purposes.

There is no issue of greater importance than ensuring the long-run prosperity and stability of resource-rich countries by developing ways to use these resources and the wealth they generate well. The approaches explored in this important study provide a framework that will enhance the likelihood of success in what remains a very difficult task.

Joseph E. Stiglitz

# Overview

Azerbaijan and Kazakhstan are on the cusp of a new oil boom. Drillers have tapped vast new oil and natural gas deposits hidden beneath these former Soviet republics. Revenues are flowing into state coffers. Asset managers and dealers of luxury goods are pouring in from abroad. And everyday people are entertaining visions of a higher quality of life, a life free from nagging poverty, a life that offers economic opportunity, good schools and hospitals, and a significant voice in the decision making of their respective governments.

Unfortunately, the people of Azerbaijan and Kazakhstan may never reap the full benefit of the wealth their natural resources can yield. Even if guided by well-intentioned leaders, these countries may not be able to meet the powerful economic and political challenges posed by the revenues derived from oil and natural gas production. Economists call these challenges the “resource curse.” This curse has already hurt oil-rich states such as Venezuela, Nigeria, Iran, and others.

Azerbaijan and Kazakhstan need not follow in their footsteps. The governments of these two Caspian Basin countries can still undertake an array of measures capable of defeating the resource curse. Accountability, transparency, and public oversight can be introduced into the systems used to collect, invest, and disburse state revenues from the oil and natural gas industries. Only when these measures are in place will Azerbaijan and Kazakhstan stand a

chance of using their oil and natural gas revenues to raise living standards for their people, strengthen the private sector, and lay the basis for healthy, long-term economic growth. More openness in state fiscal management may also lead to broader democratic reforms, including improvements in the electoral process, enhancement of the role of parliament, and the development of an independent judiciary and a freer press.

But the road ahead is not an easy one. Accountability, transparency, and public oversight require the creation of checks and balances and a separation of powers among an array of institutions established to oversee the flow of oil and natural gas revenues. They also demand input from civil society and the creation of a powerful sense of public ownership of the revenues. Azerbaijan and Kazakhstan have taken an important step in this direction by creating special funds for managing their oil and natural gas revenues. The chances for success of these funds would be improved by strengthening parliamentary oversight, improving budget transparency, and establishing independent citizens' advisory councils to raise public awareness about and conduct monitoring of the countries' use of oil and gas revenues. Unfortunately, the supervisory councils that currently oversee the oil funds in Azerbaijan and Kazakhstan lack the independence and authority to conduct effective monitoring on their own and parliamentary oversight of the oil funds is lacking.

It is in the economic and security interests of the countries that will increasingly consume oil and gas from these two countries to encourage and even pressure the leaders of Azerbaijan and Kazakhstan to adopt revenue management reforms. The United States has employed its considerable leverage in the region to promote the entry of U.S. oil companies and to influence pipeline routings. To secure those interests in the longer term, it should use its leverage to encourage revenue accountability so that stable governments and prosperous societies may emerge.

The home governments of transnational oil companies can begin by introducing greater accountability and transparency into the international oil and gas business. Multinational oil and gas companies should be required to disclose the entire array of payments they make to the governments and leaders of all oil-exporting states, and they should be encouraged to publicize their production-sharing and joint-venture agreements with the oil states. At the same time, governments should be encouraged to report what they earn from the oil and gas companies and how this money is spent. That will be just as important, if not more so, to the citizens of these countries. The governments of those oil companies that invest in Azerbaijan and Kazakhstan should use their influence within international organizations such as the World Bank, International Monetary Fund, United Nations, and other multilateral donors to make any project support for oil companies or oil-exporting countries conditional upon full transparency of payments made or received.



# The Resource Curse

## **Economic aspects**

Influxes of oil dollars create powerful economic incentives that make it difficult for even well-intended leaders of oil states to use these revenues to promote economic growth and social development. Economists know well that sizeable revenue flows from the oil and natural gas industries tend to starve rather than nourish the overall economies of developing countries. This paradoxical reality is the result of the basic economic aspects of the resource curse, which spawn exchange-rate problems, inflationary pressures, a loss of competitiveness and jobs, futile efforts by the government to use subsidies to prop up unprofitable enterprises, a weakening of the bonds between the state and its citizens, and the accumulation of vast foreign debt.

***Exchange rates and Dutch Disease.*** A large influx of foreign currency from oil and natural gas exports creates demand for an oil state's domestic currency and raises its real exchange-rate value. As a result, tradable goods produced in the oil state become more expensive and less competitive both domestically and on external markets. At the same time, imports become more affordable, thus squeezing domestically produced goods out of the market. This leads to a withering of the agricultural, manufacturing, and other sectors of the oil state's economy, a loss of jobs in these sectors, and development of an even greater economic dependence on the oil and natural gas industries. Oil and natural gas development also tends to monopolize the investment money available in the state's economy, which raises the cost and lowers the volume of loan money available for other industries. "Dutch Disease" is the term economists use to describe the less desirable effects oil and natural gas revenues have on exchange rates, trade balances, domestic production, and the availability and cost of credit.

***Unemployment.*** Economic problems also arise because the oil and natural gas industries are capital- rather than labor-intensive and employ relatively few people. Thus, when industries in an oil state's broader economy contract, the highly specialized and capital-intensive oil exploration and production sectors can absorb few of the laid-off workers. The result is higher unemployment, lower wages, more poverty, and increased numbers of people who are dependent upon state largesse. As in any economy where a downturn occurs, displaced workers find it difficult to be absorbed elsewhere.

***Subsidies and corruption.*** Efforts by the governments of oil states to use the revenues from the oil and natural gas industries as loans to boost the broader economy and promote job creation too often set in motion a disastrous cycle. In many cases, these government loans are awarded on the basis of political patronage and effectively become subsidies that prop up unprofitable domestic enterprises. The subsidies reward inefficiency, poor management, and overemployment in these enterprises, which further erode their profitability. Governments are reluctant to shut down these enterprises, which guarantee political support by providing jobs to

large numbers of workers. When oil prices fall, governments borrow to maintain their spending commitments. This cycle inevitably promotes indebtedness and corruption, drives up the cost of doing business for entrepreneurs outside the subsidy system, forces businesses into the informal economy, and diverts capital from sound enterprises that would thrive in an open, competitive economy.

**Taxes and accountability.** A flood of oil and natural gas revenues also reduces the need for a government to collect income and other taxes from the country's citizens and residents. The reduction or elimination of income taxes critically weakens the relationship between the government and its citizens. It reduces the stake individual citizens have in their government and the incentive to demand government accountability. It also reduces a government's incentive to be responsive to its citizenry and to provide responsible management of public revenues. The inability to tax exposes governments to budget gaps when oil prices fall, leaving them with little option but to borrow against future oil revenues.

**Foreign debt.** The volatility of prices on the world oil and natural gas markets often prompts the governments of oil states to take on unwieldy amounts of foreign debt. When world oil prices are high, the governments of these states tend to spend oil revenues freely, raising popular expectations and dependency upon this spending. When world oil prices are low, these governments tend to take on loans to avoid making cuts in spending that would fuel popular discontent.

### **Political aspects**

The resource curse has a devastating effect on political life. Revenues from exports most often flow to central governments rather than to entrepreneurs spread across the broad spectrum of an economy. Multinational oil companies prefer to work with powerful political leaders, assuming that they can enhance the likelihood that the oil-producing state will fulfill its contractual obligations. At the same time, political leaders stand to lose from any kind of power-sharing that might limit their control over oil contracts. As a result, an expansion of petroleum production in a country often coincides with an expansion of executive power and an evisceration of any effective political opposition inside or outside the government. This symbiotic relationship between the oil companies and the leaders of an oil state exacts a heavy toll on the country's commitment to democracy. Few incentives exist for the oil state's leaders to permit any processes that could challenge their control over oil revenues, such as existence of a real separation of powers, free and fair elections, or freedom of the press.

# Defeating the Resource Curse in Azerbaijan and Kazakhstan

## Domestic factors

Neither Azerbaijan nor Kazakhstan had fully completed the transition from the Soviet one-party, centrally planned system before their current oil boom began. The rapid influx of revenues from their oil and natural gas industries has already slowed the uneven progress these countries have made in developing democratic institutions, free-market economies, and a healthy civil society. A failure to overcome the resource curse risks setting Azerbaijan and Kazakhstan on a development path that has already produced damaging and long-lasting results in countries such as Venezuela, Mexico, Nigeria, and Iran, which were also developing state capacity and their petroleum sector at the same time.

Governments committed to sound management of oil and gas revenues can defeat the resource curse. Azerbaijan and Kazakhstan are no exception. Prudent management of these revenues requires investing in the human resources that can drive the non-oil sector of the economy. This means investing in education, health, and poverty eradication, and improving the business climate for small and medium-sized enterprises. It requires creating and strengthening public sector institutions that can anticipate, monitor, and plan how best to invest government revenues. It also requires a commitment to making government revenues from oil and gas production a matter of public record. Transparency should extend along the entire chain of custody over these revenues, starting with the oil-producing companies, both state-owned and multinational, and ending with the deployment of these revenues for domestic economic growth and social development. The government's commitment to such goals must be encouraged by a vigilant and engaged citizenry, a citizenry that feels a strong sense of ownership of the revenues flowing from the country's oil and natural gas industries.

As a first step in the process of meeting these requirements, governments can introduce accountability, transparency, and public oversight into the system for managing the revenues derived from the oil and natural gas industries. One of the mechanisms for providing the necessary accountability and openness is a fund for saving, investing, and disbursing the revenues derived from natural resources like oil and natural gas. Another useful mechanism is a citizens' advisory council. These mechanisms can be used in tandem.

## Oil funds

Some oil exporting states have established oil funds in an attempt to prolong the wealth-generating potential of oil and natural gas revenues beyond the lifetime of the reserves themselves and to overcome domestic-currency appreciation and the temptation to spend and borrow in binges. In its most basic form, an oil fund amounts to a foreign-currency investment account owned by the state. Laws or regulations require the government to deposit revenues derived

from the oil and natural gas industries into the fund; and laws and regulations prescribe how the government may invest and disburse these assets. Oil funds usually serve one or both of the following functions: “Savings funds” set aside a portion of oil and gas revenues for the future or for current development needs while “stabilization funds” act as a fiscal shock absorber engineered to cushion the budget from turbulence caused by volatility in the world price of oil. This stabilization mechanism automatically diverts windfall revenues into the fund when world prices exceed a preset trigger and directs a regulated flow of funds into the state budget when the oil price drops below the trigger.

Some economists argue that oil funds are no more effective than other mechanisms for mitigating the effects of Dutch Disease and the other economic problems that accompany influxes of oil and natural gas revenues. An oil fund, however, can be an effective political instrument. It can be a manifestation of a compact between a government and its citizenry. It can give citizens a sense of ownership of oil and natural gas revenues and can help them force the government to treat these as public monies, not private income to be veiled from public scrutiny. An oil fund can force governments to plan the investment and disbursement of these revenues. And it can be a source of information to a country’s parliament and citizens about how well the government is managing their revenues. These functions can foster the key component of all good public-revenue management: an educated, active, and organized citizenry capable of demanding government accountability.

Azerbaijan and Kazakhstan have taken a positive step toward good revenue management by establishing oil funds to help manage the revenues derived from their oil and natural gas industries. These funds, however, suffer governance flaws, including a lack of accountability and transparency. Moreover, the governments’ commitment to transparent revenue management should extend along the entire revenue chain, beginning with disclosure of the terms of contracts the government and oil companies have entered into.

### **Citizens’ advisory councils**

An independent citizens’ advisory council is one way of organizing public oversight of revenues derived from the oil and natural gas industries. Citizens’ advisory councils were created by law in Alaska after the *Exxon Valdez* oil spill in 1989. These councils were the result of negotiations between the oil companies and citizens and were codified in government law to ensure their funding, independence, and access to facilities for the life of the oil operation. The councils—whose voluntary boards of directors include representatives of environmental groups, native settlements, fishermen’s groups, and chambers of commerce—provide direct citizens’ oversight of oil industry operations in certain regions to minimize ecological damage and the danger of a large-scale disaster.

Advisory councils in Kazakhstan and Azerbaijan could play a similar role in monitoring and publicizing information about the social impact of their country’s hydrocarbon devel-

opment. If funded by an endowment created by a broad range of donors, and if they include members of both government and civil society, such councils can serve an important intermediary function. They can help manage the unreasonably high public expectations of immediate improvements in living standards, while also channeling information back to government about likely public reactions to the government's expenditure priorities.

### **International actors**

It is in the long-term economic and security interests of the United States, the European Union member states, and other major importers of oil and gas to see Azerbaijan and Kazakhstan evolve into stable, prosperous, and friendly allies. In the economic realm, defeating the resource curse in Azerbaijan and Kazakhstan will help regularize the flow of oil and natural gas onto the world market. The *National Energy Policy* report of the National Energy Policy Development Group, headed by Vice President Dick Cheney, outlines a plan for encouraging diversity of oil production to minimize the potential for market instability. The plan identifies the Caspian Basin countries as a significant source of supply. Similarly, the European Union Energy Policy anticipates increased reliance on Caspian Oil. In the security realm, defeating the resource curse in Azerbaijan and Kazakhstan will contribute to the creation of stable governments and reliable allies in this volatile but strategic corner of the world.

For these reasons, the home governments of the major investors in Azerbaijan and Kazakhstan—the United States, Britain, Italy, France, Norway, and Russia—should encourage the governments of Azerbaijan and Kazakhstan to introduce transparency, accountability, and public oversight into the mechanisms they use to manage revenues derived from their oil and natural gas.

Unfortunately, since September 11, efforts to obtain the cooperation of the governments of Azerbaijan and Kazakhstan in the war on terrorism have dampened the pressures on these governments to respect democratic processes and human rights and construct the institutions necessary for a modern state. Taking advantage of this shift in emphasis, the governments of Azerbaijan and Kazakhstan have clamped down on media freedom and persecuted political opponents. It is likely that such autocratic and repressive practices will, as they have elsewhere, create a fertile breeding ground for terrorism because they allow dissidents no other alternative for registering their complaints. The high expectations that the people of these countries have for a dramatic improvement in living standards, if unmet, may erupt in violence. Such violence often triggers disruptions in energy supplies and human rights abuses as governments attempt to stifle unrest. By continuing to support the governments of Azerbaijan and Kazakhstan, the United States and its allies in the war on terrorism risk creating an impression of complicity in these governments' abuses.

This need not be. Azerbaijan and Kazakhstan will always look to the United States and to Europe for political and financial support. One U.S. policy aim has been to secure the polit-

ical and economic independence of these countries, and that goal continues. As oil and natural gas flows increase in volume from Azerbaijan and Kazakhstan to Russia, Iran, and China, this energy linkage will bring closer political ties, which may not always be in the national interests of the United States or of the European Union. Hence, it is in the interest of the United States and the European Union to encourage the formation of open societies capable of choosing their models of political and economic development.

With the support it has given the two countries in the past, the United States and its allies have gained sufficient leverage on the leaders of Azerbaijan and Kazakhstan to guarantee the use of military bases and obtain overflight rights as well as achieve other, longer-term, security-enhancing goals. Increased pressure by the United States and its allies for improved government accountability is unlikely to sever ties that have developed since these countries' independence.

# Recommendations

The following section summarizes policy recommendations from the full Caspian Revenue Watch report directed to the governments of Azerbaijan and Kazakhstan, to transnational oil and gas companies active in these countries, to international financial institutions, and to foreign governments about what each can do to increase accountability over the use of public revenues generated by oil and gas development in Azerbaijan and Kazakhstan.

## Recommendations for the Government of Azerbaijan

In order for Azerbaijan to make effective use of the revenues it will garner from development and export of its oil and natural gas reserves, the country's leaders should undertake reforms that improve the transparency and accountability of the major institutions responsible for managing these revenues: the state oil fund (SOFAZ), the state-owned oil company (SOCAR), and the budgetary process. The following recommendations, in summary form, follow from the analysis of Azerbaijan's system of managing oil and gas revenues presented in the full Caspian Revenue Watch report. A more detailed treatment of the recommendations can be found in that report.

## **Recommendations concerning the Azerbaijan State Oil Fund (SOFAZ)**

- ▶ Clarify the SOFAZ mission and objectives so that it is possible to determine what expenditures and investments fall within the Fund's mandate and which fall outside it.
- ▶ Adopt a medium- and long-term expenditure policy for SOFAZ that takes into account the expenditure priorities identified in the State Program on Poverty Reduction and Economic Development. Hold public hearings to understand citizen preferences about SOFAZ spending priorities.
- ▶ Adopt rules specifying the relationship between the budget and SOFAZ in the event of an external oil price shock.
- ▶ Improve SOFAZ accountability by adopting a parliamentary law on SOFAZ. Such a law should increase parliament's role in oversight by requiring parliamentary approval of spending from the Oil Fund, and also allowing parliament to elect its own members to the supervisory council without the president's approval. It should require all Oil Fund expenditures to pass through the consolidated unified budget.
- ▶ Give the SOFAZ supervisory council independence and real powers of oversight, including the authority to control its own meeting schedule, conduct its own inquiries, subpoena documents and expert witnesses, and publish its findings and recommendations.

## **Recommendations concerning the government budget and the State Oil Company of Azerbaijan (SOCAR)**

- ▶ Improve accountability in the state budget process by providing parliament with an adequate research capacity and greater time for consideration of the budget, and providing opportunities for public comment on the budget.
- ▶ Improve budget transparency by requiring that the Ministry of Finance provide information to parliament and the public about the basis for the draft budget's revenue and expenditure estimates, as well as greater line-item detail about proposed expenditures. Provide an explicit statement of budget priorities and how these are translated into planned expenditures. To facilitate the tracking of expenditures, the budget should include detailed (program and line-item) budget classifications. If actual expenditures differ sharply from planned expenditures, a revised budget should be prepared. The



budget, as well as a version that is easily understood by nonexperts, should be published for public discussion. More detailed reports on budget execution should also be made available.

- ▶ In the budget, disclose any oil-backed loans obtained by the government or SOCAR that will become the obligation of future generations to repay.
- ▶ Initiate a new review of the country's compliance with the International Monetary Fund's code of good practices for fiscal transparency, last completed in 2000, and allow publication of the results.
- ▶ Establish an agency comprised of *ex officio* government and civil society representatives with responsibility for monitoring government expenditures consistent with the priorities established in the Poverty Reduction Strategy Process.
- ▶ Overhaul reporting requirements for the state-owned oil company, SOCAR. The government of Azerbaijan should require SOCAR to submit to external audits and publish financial information in line with international accounting standards.
- ▶ Volunteer to become an early signatory to the templates for reporting oil and gas revenue receipts being developed by the Extractive Industries Transparency Initiative (EITI). The EITI, a British government-led coalition of governments, extractive companies, and nongovernmental organizations, aims to increase transparency of payments by companies to governments as well as transparency over revenues by those host country governments.

### **Recommendations on engaging civil society**

- ▶ Build public trust and set realistic expectations about Azerbaijan's oil and natural gas revenue management by encouraging public discussion of the country's economic development.
- ▶ In line with the standards of the Council of Europe and the jurisprudence of the European Court of Human Rights, and to encourage discussion about Azerbaijan's revenue management strategy, retract once and for all the August 2002 decree on state secrets, which puts the responsibility on journalists rather than the government to keep secrets, requires reporters to divulge sources, and has overly vague content restrictions.

- ▶ Improve the environment for civil society by making public the NGO registration procedures required by the Ministry of Justice, allowing registration to take place in offices outside the capital, and consistently implementing existing law on procedures of notification for registration denial.
- ▶ Adopt a law on public access to public information held by the government, as recommended by the Committee of Ministers of the Council of Europe in 2002.
- ▶ To improve public engagement regarding the environmental impacts of hydrocarbon development, introduce relevant legislation and develop procedures and infrastructure to implement the Aarhus Convention, which Azerbaijan has ratified and which came into force in October 2001. The Aarhus Convention guarantees citizens access to information, public participation in decision making, and access to justice in environmental matters.

## Recommendations for the Government of Kazakhstan

If Kazakhstan is to use its finite natural resources as a springboard for long-term economic growth, it must demonstrate a commitment to transparency, fairness, and good governance in the management of its oil and natural gas wealth and create favorable conditions for development of the economy beyond these industries.

Kazakhstan's leaders should initiate and nurture public discussion about the government's strategy for using its oil and natural gas earnings to promote long-term economic growth and improvement of the nation's health, education, and social protection infrastructure.

### Recommendations concerning the National Fund

- ▶ Adopt a medium- and long-term expenditure plan that clarifies how the National Fund (NF) savings portfolio will be used to combat poverty, reform the education system, and address the country's environmental challenges. Hold public hearings to gauge public opinion on spending priorities.
- ▶ Build checks and balances into oversight of the NF. Replace the presidential decrees that now govern the Fund with an oil fund law giving parliament a voice in expenditure policy, a guaranteed right to information about the Fund, and greater access to its super-

visory council. To put limits on spending pressure, set caps on how much can be withdrawn from the NF in a given year.

- ▶ Resist pressure to invest the Fund's assets in the domestic oil and natural gas sector. Similar investment strategies in other countries have undermined the competitiveness of the domestic energy industry, resulted in corruption and waste, and drained financing away from more viable projects.
- ▶ Improve the Fund's accountability by giving the oversight council real powers of oversight: the authority to set investment benchmarks, determine its own meeting schedule, conduct its own inquiries, subpoena documents and experts, and publish its conclusions.
- ▶ Improve transparency of the Fund. As is done in Azerbaijan, publish the full annual report of the NF and the auditor's report. Quarterly reports should also be made available. The National Bank should make available to the public income projections for the Fund and any expenditure plans.
- ▶ Require any transfers from the NF to be recorded in the budget and approved by parliament.

### **Recommendations concerning the state budget and state oil, gas, and mining companies**

- ▶ Strengthen parliamentary engagement with the budget by bolstering the research capacity of the parliamentary committee on budget and the audit committees. Provide information in the budget about assets accumulated in the various development and social protection funds, including the National Fund. If actual expenditures differ sharply from planned expenditures, a revised budget should be prepared. Strengthen the capacity of the external auditor and introduce an annual published audit of budget execution. Provide opportunities for public comment on the budget.
- ▶ Disclose terms of the production-sharing and joint-venture agreements for oil and gas development that the government has entered into, as is currently done in Azerbaijan. Commit to eliminating, where possible, confidentiality clauses in new contracts the country enters into so that these contracts become part of the public record. Have new production-sharing or joint-venture agreements ratified in parliament, as is done in Azerbaijan.

- ▶ Require the state-owned oil and gas company, KazMunaiGaz, to undergo external audits and to publish financial information in line with generally accepted international accounting standards.
- ▶ In the budget, disclose any oil-backed loans obtained by the government or by KazMunaiGaz, which will become the obligation of future generations to repay.
- ▶ Volunteer to become an early signatory to the templates for reporting oil and gas revenue receipts being developed by the Extractive Industries Transparency Initiative (EITI). The initiative aims to increase transparency of payments made by extractive companies and received by host governments by creating templates for companies and governments to report what they pay and earn.

### **Recommendations on engaging civil society**

- ▶ To improve public engagement regarding the environmental impacts of hydrocarbon development, introduce relevant legislation and develop procedures and infrastructure to implement the Aarhus Convention, which Kazakhstan has ratified and which came into force in October 2001. The Aarhus Convention guarantees citizens access to information, public participation in decision making, and access to justice in environmental matters.
- ▶ Foster an environment for public discussion of a government revenue management strategy by curbing the persecution of journalists, which has intensified in recent years. To strengthen its commitment to essential human rights and effective citizen oversight, Kazakhstan should ratify the two fundamental conventions on human rights, the International Covenants on Civil and Political Rights and on Economic, Social and Cultural Rights, which have been ratified by over 140 countries.
- ▶ In compliance with international standards, adopt a law on public access to public information held by the government, and ensure that laws on freedom of expression and information, including on the media, comply with international and comparative standards, in particular with Article 19 of the Universal Declaration on Human Rights and Article 19 of the International Covenant on Civil and Political Rights. These recognize the right to freedom of opinion and expression through any media.

- ▶ Reinstate the National Nature Protection Fund, which until its abolishment in 1999, was used to pay for accident prevention and oil spill emergency response. Use pollution penalties paid by extractive companies for environmental allocations rather than for general budget expenditures.

## Recommendations for Foreign Oil and Natural Gas Companies

It is in the interest of foreign oil and natural gas companies to help the citizens of Azerbaijan and Kazakhstan monitor their governments' use of oil and gas revenues. These companies can begin by disclosing their production-sharing and joint-venture agreements with Azerbaijan and Kazakhstan and by revealing how much they pay the governments of these countries. BP and project partners for the largest oil and natural gas fields in Azerbaijan have already revealed their production-sharing agreements as well as the agreements for construction of the Baku-Tbilisi-Ceyhan pipeline. ChevronTexaco, ExxonMobil, AGIP, TotalFinaElf, Royal Dutch/Shell, and Lukoil should also disclose their contracts for producing oil in Kazakhstan and their payments to the government of Kazakhstan.

Companies that do not disclose this information act against their own bottom line. Increasingly, companies are being asked to pay for tasks such as building schools, clinics, and roads, which are normally performed by governments, and which are not among the companies' core competences. At the same time, the veil of secrecy that surrounds company payments to governments creates a permissive environment for large amounts of money to disappear. Often, these amounts far exceed what companies are asked to spend on community development. If citizens had access to information about how much their government earns from oil and gas development, they could hold their own government to account over missing payments, and free the oil companies from having to pay for services that government should be providing.

Moreover, by concealing payments, companies leave themselves exposed to accusations that they have underpaid the state and are to blame for continued poverty. If the regimes or other political circumstances change, they will be vulnerable to revisions of the terms of their contracts. The companies' best protection against such exposure is a public record detailing how much was paid, to whom, and when. Disclosure will shift the responsibility to the individuals who receive and allocate the revenues. Disclosure will also allow civil society to take up much of the burden of coaxing governments to manage their revenues properly.

To help citizens hold their governments to account over receipts from natural resource development, oil and gas companies operating in Azerbaijan and Kazakhstan should:

- ▶ Disclose the terms of production-sharing and joint-venture agreements entered into with state or state energy companies, as has already been done in Azerbaijan.
- ▶ Identify the consultants and other third parties engaged to provide services connected with government negotiations, exploration and production operations, and other activities. The oil and gas companies should also disclose payments to these third parties.
- ▶ Report social development spending, which usually takes place at the local government level where the absence of budget transparency leaves room for abuse.
- ▶ Establish an endowment for the creation of citizens' advisory councils to monitor and report on the social and environmental impacts of petroleum development. A first step might be to arrange a study tour to Alaska for a task force of budget watchdogs and government representatives to learn how Alaska's Regional Citizens' Advisory Councils operate. That visit and the information gained would provide the basis for drafting a blueprint for creating such councils in Azerbaijan and Kazakhstan.
- ▶ Empower citizen advocates with the tools to advocate for good governance with regard to revenue management. Provide training on budget analysis, project monitoring, and the economics of petroleum-led development for NGOs and journalists.

## Recommendations for Foreign Governments

It is in the interest of the home governments of the major investors in Azerbaijan and Kazakhstan—the United States, Britain, Italy, France, Norway, and Russia—to increase accountability in the use of public revenues derived from oil and gas exports. Because many of these countries' oil companies will be in the Caspian Basin for many years to come, their position will be more secure if it can be demonstrated that their presence has contributed to improvements in the economic and human development of Azerbaijan and Kazakhstan.

- ▶ Home governments of the major oil and gas companies operating in Azerbaijan and Kazakhstan should use their domestic regulatory powers to require oil and natural gas companies to make public the taxes, royalties, production-sharing fees, bonuses, and other forms of payment to the governments of the countries in which they operate.

- ▶ The European Union should use the implementation of its Partnership and Cooperation Agreements with Azerbaijan and Kazakhstan to emphasize the importance of revenue transparency and fiscal accountability to the public.
- ▶ The Organization for Security and Cooperation in Europe (OSCE) should designate public participation in the government budgetary process a programmatic priority through its efforts to further member compliance with OSCE Human Dimension Commitments.
- ▶ The United States should provide leadership for the Extractive Industries Transparency Initiative by pressing for full disclosure of payments by companies and receipts by governments, and by holding open the option for a regulated approach if voluntary disclosure fails.
- ▶ The diplomatic community should promote citizen oversight by facilitating the granting of refugee status and speaking out against persecution of watchdogs, whistleblowers, and journalists who report on mismanagement and corruption. Foreign aid should be embargoed when governments are directly responsible for cracking down on investigative journalists.
- ▶ Governments should emphasize the importance of revenue transparency in the course of diplomatic dealings with the governments of Azerbaijan and Kazakhstan. Governments that dispense foreign aid to these two countries should fund training and other programs that aim to build the capacity of civil society to monitor oil revenues and budgets.

## Recommendations for International Financial Institutions and Donors

The International Monetary Fund (IMF), the World Bank Group, and other financial institutions should use their leverage to promote accountability and transparency in Azerbaijan and Kazakhstan. Although Kazakhstan has paid off most of its assistance loans, it will continue to depend on multilateral donors for project financing, which creates opportunities for conditionality. The European Bank for Reconstruction and Development (EBRD) and the International Finance Corporation have funded several projects in the energy sectors in Azerbaijan and Kazakhstan and are now poised to help finance the Baku-Tbilisi-Ceyhan pipeline.

- ▶ The World Bank Group, IMF, EBRD, Asian Development Bank, and the export credit agencies that lend to Azerbaijan and Kazakhstan should require these governments, as a condition for receiving further loans, to:
  - ▶ disclose all revenues received from the exploitation of oil, natural gas, and minerals;
  - ▶ produce and make public financial reporting by the state oil and gas companies, with that reporting meeting the requirements of generally accepted international accounting standards;
  - ▶ introduce improved accountability mechanisms in the oversight of their resource funds;
  - ▶ commit to set aside a portion of expenditures for poverty alleviation;
  - ▶ disclose all oil-backed loans obtained; for Kazakhstan, encourage the government to disclose, to the extent possible, details of production-sharing and joint-venture agreements entered into. Require disclosure of any new contracts for oil and gas development.
  
- ▶ The IMF, which produces a Code of Good Practices on Fiscal Transparency and a survey to assess compliance with these standards, should include an assessment of how transparent and accessible the budgetary process is to the public. It should assess the extent to which government budget documents are readily available to the public in a timely manner and whether there has been an open discussion of the budget. The IMF's annual Article IV consultations, the country-specific assessments which guide IMF lending, should include an assessment of the transparency of government oil and gas revenues.
  
- ▶ The IMF and the World Bank Group should facilitate payments disclosure by governments and companies by creating templates for such reporting, as advocated by the Publish What You Pay campaign and the Extractive Industries Transparency Initiative. The campaign and initiative aim to increase transparency of payments made by extractive companies and received by host governments by providing templates for companies and governments to report what they pay and earn.
  
- ▶ Donors should make training and education of civil society budget watchdogs in Azerbaijan and Kazakhstan a priority. Local groups are woefully underprepared to conduct independent analysis and oversight. Training in budget monitoring, fiscal policy, and the economics of petroleum-led development should be provided. Such capacity building should become a priority for the OSCE through its Economic and Environmental



Dimension, which seeks to promote economic prosperity among member states to reinforce international security. Training could also be integrated into the World Bank's Global Development Learning Network. The IMF already provides fiscal training to government officials through the IMF Institute and should expand such training to civil society budget watchdogs.

- ▶ Donors should promote coordination and an exchange of experiences between revenue watchdogs throughout the world by providing grants to organizations to organize information exchange, training, roundtables, and joint advocacy for budget activists from different countries.

## **Caspian Revenue Watch**

The Caspian Revenue Watch (CRW) is a program of the Open Society Institute's Central Eurasia Project, which sees the transparent use of revenues generated by the sale and transport of Caspian natural resources as an issue of great importance for regional development and the promotion of civil society. The Caspian Revenue Watch aims to generate and publicize research, information, and advocacy on how revenues are being invested and disbursed and how governments and extraction companies respond to civic demands for accountability in the region. CRW also supports projects that build the capacity of local advocates to monitor government revenues. By promoting transparency, civic involvement, and government accountability, CRW seeks to help ensure that existing and future revenue funds are used to benefit the public by reducing poverty, reforming education, and improving public health.

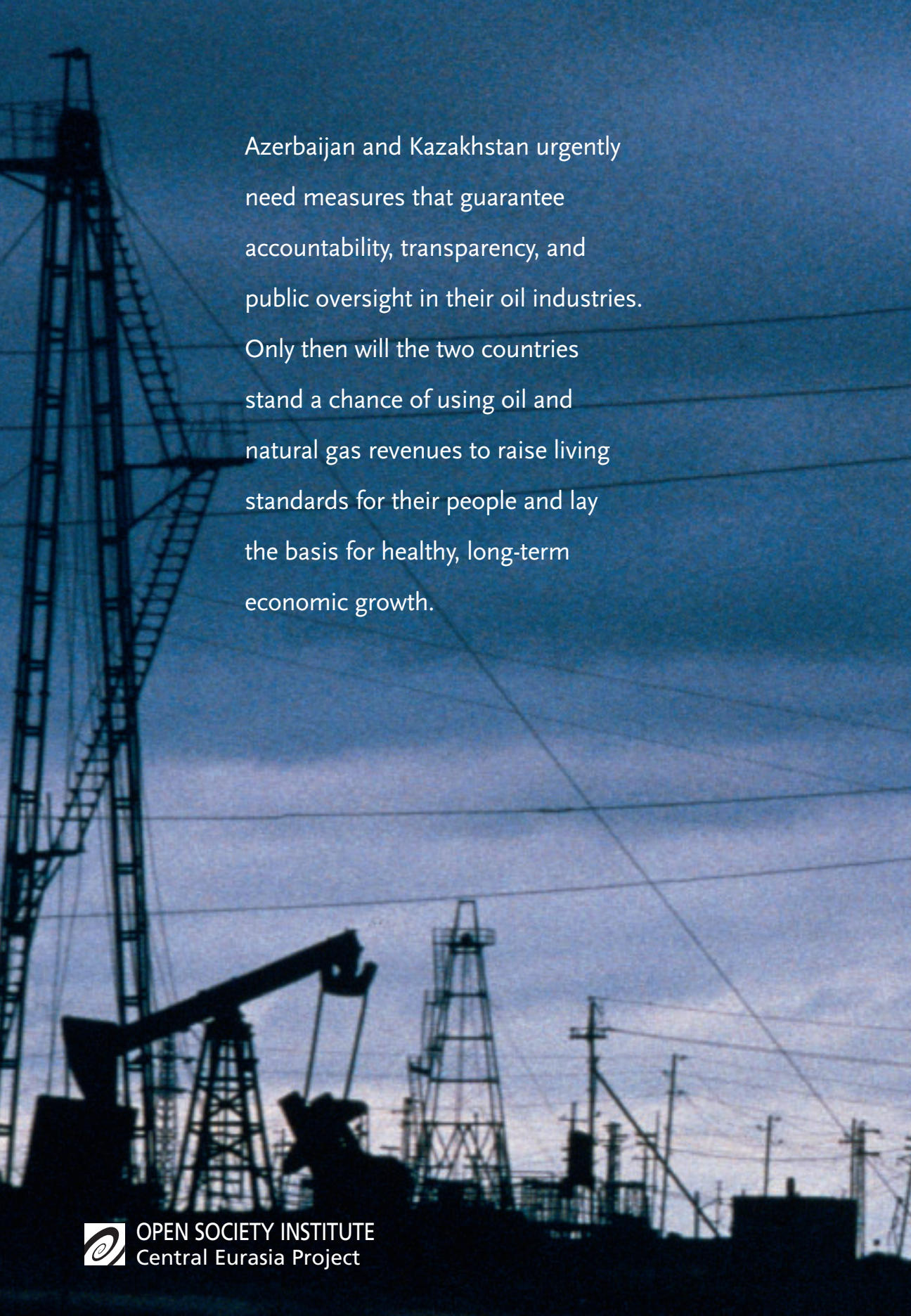
## **Central Eurasia Project**

The Central Eurasia Project (CEP) of the Open Society Institute acts as a policy center, grant-making program, and OSI liaison for Soros foundations and programs in the South Caucasus, Central Asia, Mongolia, Turkey, Afghanistan, and the Middle East. It promotes public awareness about policies and developments in the region through its website, EurasiaNet, the Open Forum meeting series, and the Eurasia Policy Forum, which helps develop policy and advocacy initiatives. CEP awards grants to local nongovernmental organizations and international groups that promote human rights and civil society. CEP provides support to Soros foundations in Armenia, Azerbaijan, Georgia, Kazakhstan, Kyrgyzstan, Mongolia, Tajikistan, Turkey, and Uzbekistan. It also awards grants relating to Iran, and is exploring initiatives in Turkmenistan, the Middle East, and North Africa.

## **Open Society Institute**

The Open Society Institute (OSI), a private operating and grantmaking foundation based in New York City, implements a range of initiatives 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. To foster open society on a global level, OSI aims to bring together a larger Open Society Network of other nongovernmental organizations, international institutions, and government agencies. OSI was created in 1993 by investor and philanthropist George Soros to support his foundations in Central and Eastern Europe and the former Soviet Union. Those foundations were established, starting in 1984, to help former communist countries in their transition to democracy. OSI has expanded the activities of the Soros foundations network to other areas of the world where the transition to democracy is of particular concern. The network encompasses more than 50 countries with initiatives in Africa, Central Asia and the Caucasus, Latin America, and Southeast Asia, as well as in Haiti, Mongolia, and Turkey. OSI also supports programs in the United States and selected projects elsewhere in the world.



The background of the page is a photograph showing the silhouettes of an oil field against a clear blue sky. In the foreground, a large oil pumpjack (jack-o'-lantern) is visible on the left. In the background, several oil derricks and power lines stretch across the horizon. The overall scene is industrial and suggests the energy sector.

Azerbaijan and Kazakhstan urgently need measures that guarantee accountability, transparency, and public oversight in their oil industries. Only then will the two countries stand a chance of using oil and natural gas revenues to raise living standards for their people and lay the basis for healthy, long-term economic growth.

