



REVENUE WATCH

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Opening the Books: Transparent Budgeting for Iraq

This report, the fifth in a series by Iraq Revenue Watch, evaluates the level of transparency in budget reporting by the Coalition Provisional Authority. On the eve of the transition to a new Iraqi government, the report finds that although Coalition Provisional Authority financial procedures and documents have improved, they still fail to meet internationally recognized standards for fiscal decision-making and reporting. The report calls upon the CPA and the Governing Council to make further improvements in accordance with these standards. Budgetary transparency and accountability can help assure that Iraq does not revert to the tyranny of secrecy practiced under Saddam Hussein.

Introduction

One of the defining traits of democracy is control by the people of how governments collect and spend public money. Such control requires comprehensive and accurate reporting about public finances and opportunities for public participation in government spending decisions.

As the Coalition Provisional Authority (CPA) prepares to transfer political and fiscal sovereignty to an Iraqi interim government in June 2004, it has an opportunity to bequeath a positive legacy. The CPA, working together with international institutions, must lay the groundwork for Iraqi democracy in substantive ways, with the creation of transparent budget-making processes a priority.

The CPA, together with Iraq's Ministries of Finance and Planning in October 2003 issued a 2004 budget that included two-year projections. It is the first full-year budget produced by the CPA, which last year issued an emergency budget for July-December 2003. This report examines the budget and processes used by the CPA, with a particular focus on how well they meet external and internal standards for transparency in financial management.

Last year, Iraq Revenue Watch produced the first of its reports on the transparency of the budget and budget-making processes of the CPA.¹ Recognizing the extraordinary challenge of providing even the most rudimentary reporting and procedures in a war-ravaged nation, the first Revenue Watch report prescribed the bare necessities for sound financial reporting in future budgets. This year's budget document is a step forward in the development of financial reporting practices.

While the CPA has made progress over the past year, current financial presentations do not yet meet internationally recognized practices for transparency. The budget lacks key information about state-owned enterprises, financing for sub-national governments, and contingencies that pose significant risks to Iraq's public purse.

The report recommends the development of opportunities for public input and calls for increased action on the part of audit institutions. As a constitution for the country is drafted in the next 18 months, there should be a meaningful effort to institutionalize democratic control by the people of Iraq over their country's resources.

The first part of this report describes the 2004 CPA budget and remaining gaps in fiscal transparency. The second part summarizes best practices for financial management and transparency laid out by international financial institutions and how the CPA and the Governing Council can make progress in meeting them. The final section provides recommendations on improving fiscal transparency and increasing Iraqis' understanding and control over their land and resources.

Iraq's 2004 Government Budget

Iraqi ministries in July 2003 were asked to prepare budgets for the coming year and to defend them at the Ministries of Finance and Planning hearings. The consolidated budget was presented to CPA Administrator Paul Bremer and the Governing Council for approval. The 2004 budget and supporting documents are available on the CPA website in English and Arabic.²

The 2004 budget includes some economic and fiscal policy information, a description of the budget process, a brief statement of risks, a review of the revenue sources for the government, and summary data about each ministry's expenditures and staffing levels. Supporting spreadsheets for each ministry are also available.

In broad terms, the budget predicts 2004 gross revenues of \$12.8 billion and a deficit of \$590.9 million.³ Iraqi government revenues primarily derive from the sale of oil. In the new budget, oil sale proceeds account for more than 90 percent (\$12 billion) of the projected gross revenues.⁴ Revenues from the sale of oil, along with certain other revenues, are deposited in the Development Fund for Iraq (DFI), created pursuant to United Nations Security Council Resolution 1483.⁵ Funds are held by the U.S. Federal Reserve Bank, and distributed pursuant to the decisions of the CPA acting through the Program Review Board, a Coalition-dominated body.⁶

The budget only has resources to pay for government operating expenses, as well as certain obligations incurred by the previous government.⁷ These costs roughly match the operating revenues generated by oil and other minor sources such as Iraq's dysfunctional tax system. A portion of the budget—approximately \$625 million—will be available for nation-building projects, such as a national census and infrastructure to hold elections.

The 2004 budget document is a significantly more substantial document than the one for the July-December 2003 period. The improvements include the following:

- ▶ More consistent publication of minutes of the Program Review Board, albeit at times delayed by weeks
- ▶ A statement of strategic priorities in the budget, although sketchy
- ▶ Brief narrative detail for some major budget line items
- ▶ Reporting of personnel levels by ministry in the budget
- ▶ Some multi-year projection information.

The CPA now makes a number of important documents available through its website in addition to the budget document.⁸ These documents represent substantially more disclosure than had been available in the previous year, showing that the CPA has made progress in improving the transparency of the budget process and reporting documents. The budget, orders, memoranda, and other procedural documents give some indication of the financial structure of the government. However, several key issues have been overlooked.

Off-budget Accounts

The reported operating budget is not the only source of public sector spending in Iraq.

- ▶ The \$18.4 billion of funds appropriated by the U.S. Government in the Iraq Relief and Reconstruction Fund (IRRF) are considered “off-budget” and therefore outside the scope of influence of the Iraqi budget-making process. The uses of these monies are not reported in the Iraqi budget, but are reported separately to the U.S. government. Given that these expenditures are the main source of funds for Iraq’s reconstruction and pose risks to the Iraqi budget in case of cutbacks, they must be reported in the Iraqi budget as contingent expenditures pending receipt of funds from the IRRF. Information about projects for which the money will be used should be included, since they will likely be administered by the Iraqi government.
- ▶ Other funds from non-Iraqi sources, such as the Natural Resources Risk Remediation Fund (NRRRF) are not included. The NRRRF, established by the United States in September 2003, includes funds for addressing emergency fire fighting, repairing damage to oil facilities and related infrastructure, and preserving oil distribution capability. In 2004, the Fund will spend \$500 million in Iraq. An additional \$100 million will be spent by the U.S. Army Operations and Maintenance Fund on supporting the new Iraqi army.
- ▶ Iraq’s many state-operated enterprises (SOEs) are included only insofar as they receive or remit funds to the general government—their gross expenses and revenues are not incorporated in the budget because they are supposed to be stand-alone enterprises. Since these SOEs provide no annual reports, it is difficult to assess the value and the cost of the quasi-fiscal activities that they undertake. These enterprises are significant—employing up to 500,000 Iraqis, they are nearly half the size of the formal government. Only a handful of these nearly 200 state-owned enterprises transfer revenues to the government, leaving a large gap in fiscal transparency.
- ▶ Direct U.S. and Coalition expenses for military force support and related costs are not included, although they amount to approximately \$3.6 billion dollars monthly.

Risks to Iraqi Budget

While revenue and expense estimates for the operations of the Iraqi public sector are complex, more is known about them than about the capital investment required for the reconstruction of Iraq. As detailed in a recent report by the Congressional Budget Office,⁹ estimates of the capital construction costs for Iraqi infrastructure vary widely, from as little as \$16 billion to as high as the \$55 billion estimated by the World Bank in its October 2003 assessment, depending on the standards to which the nation's core infrastructure is to be restored.¹⁰ These infrastructure demands will have important effects on the financial situation of the country for many years to come.

Contingent liabilities also pose a significant risk to the Iraqi budget. Contingent liabilities are costs that the government will incur if particular events take place. Assumptions about the extent to which Iraq will have to make repayments on its outstanding foreign debt are an important potential liability for the government. The budget assumes annual payments of some \$200 million for this purpose beginning in 2005, which may be significantly less than Iraq will in fact pay. The nation's total outstanding debt is a matter of uncertainty and dispute, with estimates ranging from \$45 billion (exclusive of Gulf War-related payments to Kuwait) to as high as \$383 billion.¹¹ Neighboring country creditors claimed they provided funds as loans, while Iraq's former regime treated them as grants. The extent to which these amounts may be forgiven by sovereign governments and foreign financial institutions is a major variable in the nation's economic outlook. And, of course, should donors fail to provide promised aid, the nation will have to assume additional international debt as part of its reconstruction program, and repayment requirements would grow.

Macroeconomic data about the status of the nation's economy remains shrouded in the fog of post-war recovery, just as it was unintelligible before the war due to state secrecy. For example, the CPA budget's report of declines in the nation's per capita GDP and its rate of private capital formation are difficult to verify. The World Bank estimates that Iraq's GDP declined by 31 percent in 2003, but projects that GDP will increase by about 33 percent in 2004.¹² A significant effort to track price changes, perhaps through collection of costs for a market-basket of goods consumed by a number of families, would at least allow for some assessment of inflationary pressures.¹³ Information about public- and private-sector employment in Iraq should be included as well.¹⁴ There is little question that Iraq is blessed with vast natural resources—with the second largest proven oil reserves in the world, and what was once one of the region's best-educated and productive populations. Currently, however, Iraq's political and economic infrastructure is barely functional and the potential vitality of its economy is difficult to measure or report.

Absence of Audit Institutions

A continuing challenge to ensuring fiscal accountability in Iraq is the absence of audit institutions. The CPA has spent 5.6 billion Iraqi oil dollars from the Development Fund for Iraq without any independent auditing. The International Advisory and Monitoring Board (IAMB) was finally created in October 2003 but has not yet undertaken any audits. The 2004 budget appropriates \$3 million for the Board of Supreme Audit, an office that previously reported directly to Saddam Hussein. Its audits were top secret and available in only three copies which were delivered to Saddam Hussein. Although the office lacked independence, it may still have staff with technical competence. It is imperative that this office be provided with adequate resources, staff, authority and technical assistance to ensure that Iraqi oil dollars are used for the benefit of the Iraqi people.

Unclear Status of State-Owned Enterprises

Information recently made available about the many state-owned enterprises (SOEs) that employ more than half a million Iraqis has been related only to their potential privatization. Profiles of some 35 SOEs appear on the CPA's website as part of its "Business Opportunities in Iraq" section.¹⁵ Recent CPA documents indicate that leasing of the assets of more than a dozen SOEs is underway and is expected to expand, with most of the bidders either foreign firms or Iraqi firms in partnership with foreign firms. The long-term implications of these leases and the privatization of the SOEs are critical financial and policy matters for the nation, and little information has been made available outside the bidding community.¹⁶ Transparency will be needed to ensure that there is competitive bidding for state assets and that privatization provides maximum revenues for the state. The recent privatization of Iraq's air transport industry with no public bidding shows that there is a danger of valuable state assets being given away to well-connected insiders.¹⁷

Although gathering accurate information about Iraq's nearly 200 state-owned enterprises will take time, it is important that whatever information is available is reported. This is one of the central recommendations of the International Monetary Fund (IMF) Code of Good Practices on Fiscal Transparency. State-owned enterprises often undertake quasi-fiscal activities, such as providing products to the public at below market costs or taking on commercial debt. An absence of reporting carries several risks. According to the IMF manual:

First, where quasi-fiscal activities are sizable, the budget balance ceases to be a reliable indicator of the government's financial position, complicating the design of fiscal policy. Second, official government revenue and expenditure statistics do not accurately reflect the actual size of government. Third, quasi-fiscal activities can generate implicit contingent liabilities. This would happen, for example, if the government directs a public financial institution to guarantee a loan which could impair its profitability

and ultimately require a capital injection from the government. Finally, because quasi-fiscal activities often have redistributive effects, it is important that they be subjected to public scrutiny.¹⁸

Future Iraqi budgets should include information about the assets tied up in state-owned enterprises, about the liabilities these enterprises take on, and about the products or services they provide to the Iraqi government or the public. This can be done through annual reports provided by the enterprises and a consolidated report on government financial assets.

Few Signs of Reducing Oil-revenue Dependency

Revenue sources included in the 2004 budget are more diverse than in the 2003 budget, but the public sector remains extraordinarily dependent on oil sale proceeds. Having oil provide 90 percent of Iraq's revenues now and in the future—and no plans to privatize the oil sector any time soon—makes oil production rates and prices the epicenter for virtually all the revenue side risks for the planned budget. Assumptions about production levels of 1.6 million barrels per day (rising to 2.4 million in 2005) and oil prices of \$21 a barrel are critical. For example, a drop of only \$1 below projected oil price levels reduces government revenues by nearly 5 percent. The budget does not provide any contingency plans for different oil price scenarios. Rather, it states, "Should anticipated revenues be lower than expected, either expenditures would need to be reduced, or other revenue sources identified." Given the volatility of oil prices and Iraq's fiscal dependency on the sale of oil, more detailed planning for financing potential deficits will be needed.

The only other major revenue streams documented in the budget are a modest 5 percent "reconstruction levy" imposed on all non-humanitarian goods imported into the nation and revenues from state-owned enterprises from the sale of Oil for Food programs.¹⁹ User fees are slowly imposed over the next few years, a modest personal and corporate income tax is included (with yields growing over the succeeding two years), and some excise taxes and luxury taxes are included in the budget, even if not yet levied. These are estimated to bring in \$340 million in 2004, but it remains to be seen whether the CPA and the interim Iraqi government will succeed in collecting these taxes and fees.

Partial Reporting of Expenditures and Staffing Levels

Expenditures broadly balance the revenues projected and no deficits are assumed for 2005 and 2006. The budget lacks a baseline comparing ministry spending levels between 2003 and 2004 (and 2003 levels were included in the prior document only for the final six months of the year), so trends cannot yet be determined.²⁰ While the budget does include staffing levels for the government, it excludes the approximately 500,000 workers—as well as the gross expenses and revenues—of the vast state-owned enterprises, changes in which can have enormous economic effect on the nation.²¹ Together with the 1.1 million government workers budgeted

for the ministries, public sector employment is approximately 1.6 million (for reference, the total population between the ages of 15 and 64 in Iraq is approximately 14 million). Staffing costs make up about 15 percent of projected expenses in 2004.

About 25 percent of the budget is dedicated to the provision of a food ration for each Iraqi citizen. The budget estimates that rations will cost \$4.9 billion in 2004. However, only \$3.5 billion is budgeted. The rest of the money is expected to come from the use of residual Oil for Food items in 2004. The Oil for Food program has been dissolved and its assets and files transferred to the CPA. Given the dependence of so many Iraqi households on the food rations, the CPA should provide more detailed information on how the \$1.4 billion funding gap for Iraqi food rations will be filled.

A Closed Budget Process Dominated by CPA Decision-makers

The 2004 budget for the government of Iraq was the most important financial document issued by the CPA. The budget was prepared by the Ministries of Finance and Planning under the auspices of the CPA and was approved by the Iraqi Governing Council and CPA Administrator L. Paul Bremer. According to the CPA, the budget was based on submissions made by the Iraqi government ministries working under budgetary guidance provided for them by the CPA in July 2003. After a series of internal ministry hearings with the staffs of the Ministries of Finance and Planning in September, the budgets were consolidated and recommendations made to the Governing Council and CPA administrator for final approval in October 2003. Public engagement was not reported as part of this process. Given the continuing controversy over the legitimacy of the current Iraqi government, this omission is all the more serious.

Best Practices for Budget Transparency

Various international institutions have described best practices for sound financial management, especially its most critical element, transparency.²² Guidelines established by the Organization for Economic Cooperation and Development (OECD) and the IMF offer particularly detailed information that Iraq can use. The OECD guidelines²³ reflect the best practices for national governments while the IMF guidelines include reporting for sub-national units as well.²⁴ Iraq's future development may well depend on obtaining financial support from OECD members and the IMF itself, both of which will likely use the standards cited here when assessing Iraq's fiscal stability.

The IMF Code lays out four basic areas of budget transparency: clarity of roles and responsibilities, public availability of information, open budget preparation and execution, and assurances of integrity. The IMF Manual offers detailed specifications for each of these areas, and compliance with them is the subject of *IMF Reports on the Observance of Standards and Codes*.²⁵ It is readily apparent that the 2004 budget for Iraq was not designed to meet the high standards set by the IMF. However, applying these standards to the 2004 budget will give the Governing Council and successor bodies some sense of the requirements that the international financial community will expect the government to meet in future budget presentations.

The following is a brief summary of the major components of the IMF Code and how the current budget documents for Iraq address them.

Clarity of Roles and Responsibilities

- ▶ The government sector should be distinguished from the rest of the public sector and from the rest of the economy, and policy and management roles within the public sector should be clear and publicly disclosed.

The 2004 budget does not fully address this requirement. While the structure and functions of some elements of the government are clear, even a reading of all supporting documents on the CPA website does not disclose the responsibilities of different levels of the Iraqi government, nor the full nature of the government's role with non-government public sector bodies (such as the off-budget, state-owned enterprises or a central bank). Finally, the government's role in the private sector is not fully addressed. This includes information about the regulatory role of the government in the financial and other sectors, as well as the government's role as supplier and purchaser in major markets.

- ▶ There should be a clear legal and administrative framework for fiscal management.

While there are no laws yet established for the nation under provisional governance, the CPA has promulgated rules on the budget-making processes²⁶ and the role of certain administrative bodies in much of the process. Taxes and fees are now based on published rules set out by the CPA administrator. Ethical standards for government employees should be set to meet the highest international standards, reflecting the *International Code of Conduct for Public Officials* as adopted by the United Nations in December 1996 or those best practices established by the OECD.

Public Availability of Information

- ▶ The public should be provided with full information on the government's past, current, and projected fiscal activity.

The 2004 budget does purport to cover all budgetary expenditures to be made by the government for the year, and it offers a look ahead at the next two years, as suggested by the IMF Code and IMF Manual. It does not offer sufficient information about the prior year—chaotic as that may have been for the government of a nation emerging from a state of war—so there is no comprehensive basis for comparison or specification of policy changes implicit in the budget. Contingent liabilities—major hidden fiscal risks that the government may face—are not mentioned, other than the potential for debt repayments. Yet even on this critical topic, there is little detail about the potential magnitude of such demands or the consequences of default. The risks due to further disruptions in oil sales, changes in the international price of oil, renewed hostilities, or the failure of donors to deliver on promised aid do not appear in the budget planning.

The IMF Code and the IMF Manual both specify the need for reporting on the status of sub-national governments. The 2004 budget makes little mention of them even though they are to receive \$783.6 million in subsidies from the central government each year up to 2006. The IMF Code recommends that “Where sub-national levels of government are significant, their combined fiscal position and the consolidated fiscal position of the general government should be published. Sub-national levels of governments should also report publicly on their extra-budgetary activities, debt and financial assets, contingent liabilities, and tax expenditures, and on the quasi-fiscal activities of public financial institutions and non-financial public enterprises under their control.”

- ▶ A commitment should be made to the timely publication of fiscal information.

Since political sovereignty will pass from the CPA to an Iraqi interim government this year, no commitment or timetable could be made in the 2004 budget for future publication of documents about the financial position of the government. However, the CPA should leave behind a template and timetable for budget reporting that the interim government can use. At a minimum, as the transitional government assumes power, the CPA must provide it and the Iraqi public with a balance sheet on the expenditures and revenues from the beginning of the fiscal year up to the time of handing over power.

A commitment to continued reporting will lay the groundwork for checks against future abuse and will also facilitate aid from international donors and lenders.

Open Budget Preparation, Execution and Reporting

- ▶ Budget documentation should specify fiscal policy objectives, the macroeconomic framework, the policy basis for the budget, and identifiable major fiscal risks.

The new 2004 budget contains statements about the policy objectives of the government, and other documents made available by the CPA offer some insight into the fiscal rules adopted by the CPA. There is, however, no macroeconomic data in the budget, perhaps understandable in a nation where much of the economic infrastructure is still in ruins. Analysis of the basic

macroeconomic indices is critical, however, for establishing the credibility of the financial management process. Thus, there should be statements about efforts to support the Iraqi currency, the trade balance Iraq expects to run with other major trading partners, the state of labor markets, and the CPA's general approach to the management of price inflation.

Importantly, the budget does not include adequate description of the financial risks facing the nation. These include the broad categories of risk covered in the IMF Manual: variations in forecasting assumptions, contingent liabilities, uncertainty about the size of specific expenditure commitments, and other items not included in the budget. At least two of these are of such magnitude that they deserve detailed analysis: first, the price of oil and the nation's production capacity and second, the level of debt repayment to be required of the nation by its creditors. The budget ignores other important risks as well, such as the cost of national security, the condition of the state-owned enterprises, and the exchange rate condition of the new Iraqi dinar.

- ▶ Budget information should be presented in a way that facilitates policy analysis and promotes accountability.

In broad terms, the 2004 budget does address some of these issues. It offers gross expenses and revenues for the central government (although not for its state-owned enterprises). The budget also has some general statements about the functions of the ministries and the objectives of the government. True financial accountability would require more detailed statements of what the government seeks to achieve at the various ministries, including specific goals for major program areas. The functions and financial status of the vast state-owned enterprises need to be specified and included in at least some fiscal presentations, as well as those of the sub-national governmental bodies. Reports should be in some internationally-recognized form such as the IMF's *Government Financial Statistics (GFS)* to facilitate acceptance in the financial community. The International Federation of Accountants has also published (through its Public Sector Committee) a governmental reporting standard that could be used.²⁷

- ▶ Procedures for the execution and monitoring of approved expenditures and for collecting revenue should be clearly specified.

There is no statement of the accounting system being used by the government, but it is assumed to be cash rather than accrual. Under cash accounting, income is counted when payments are actually received, and expenses are counted when actually paid. Under the accrual method, revenues and expenditures are counted when an obligation is incurred regardless of when the money is actually received or paid. Ideally, the categories of expenditures should reflect the United Nations *System of National Accounts* and the IMF GFS, mechanisms with which other international financial institutions will harmonize over time. The process by which tax

administration will be restored is unspecified, and remains a crucial procedure requiring definition and clarity if the new government is to move from the corrupt enterprises of the Hussein regime to more transparent state revenue collection. National tax administration is not clearly separated in the budget documents. Rules regarding procurement have been promulgated by the CPA, but it is not clear if they meet international standards such as the United Nations *Model Law on Procurement of Goods, Construction and Services*. Perhaps most importantly, at this time, there is no functional internal budget audit process (nor any external process, as discussed below) in accordance with what would be recommended by bodies such as the International Organization of Supreme Audit Institutions. The IAMB finally has been created but has not yet announced its audit plans, and the internal audit office of the Hussein regime needs to be reconstituted as a credible and independent agency.

- ▶ There should be regular fiscal reporting to the legislature and the public.

In the temporary structure of the governance of Iraq, such reporting could be made on a regular basis to the Governing Council (since there is no formal legislative body). The CPA makes no commitment on regular reporting to the Governing Council or to the Iraqi public. There should be some regular reporting during the year on the status of the budget, as well as a final, year-end reconciliation of spending against the government's specified goals. Reports reflecting the IMF *General Data Dissemination System* would offer the most credibility.

Assurances of Integrity

- ▶ Fiscal data should meet accepted data quality standards.

There are few accounting details in the budget as it is currently presented, and expense and revenue trends are not presented for the period during which the Coalition has been in control of the nation's resources. The published reports on the status of the Development Fund for Iraq are representative of this issue. They lack details, time series, and descriptions of fund uses, making them ineffective tools for monitoring resource allocation policies. Major categories of expenditures of funds from the DFI should be presented as part of the budget, along with expenses funded from other sources. Particularly large contracts should be identified as well, and included in the budget rather than in separate documents.

- ▶ Fiscal information should be subjected to independent scrutiny.

The CPA should demonstrate its commitment to fiscal transparency by cooperating fully and promptly with the IAMB, which was mandated by UN Security Council Resolution 1483. Fiscal transparency has suffered in Iraq due to the CPA's delays in authorizing the creation of the IAMB, and its continued sluggishness in approving Iraqi observers and selecting an auditor.

The earlier the IAMB's auditor can begin functioning, the easier it will be to establish sound audit practices in a sovereign Iraq. The restoration of a fully independent and functional central audit office, with a clear mandate to publish regular and comprehensive audit findings, is also a critical step in restoring financial credibility for the new government.

Conclusions

Budgets in both developed and developing nations too often are designed to allocate resources for the benefit of the powerful rather than helping the majority of citizens understand what has become of the wealth they have produced. In the case of a nation in crisis like Iraq, time pressure and exigencies of post-war recovery make the presentation of comprehensive, transparent budgets by the government to the people even more unlikely.

Yet it is exactly at this moment that the budget can play its most important role in supporting the growth of democracy. The more Iraqi citizens understand that the second largest proven oil reserves in the world belongs to them and not to the government, the more determined they will be to seek accountability from that government.

Open and participatory budgeting is essential not only for the existence of effective democracy, but for the sound financial management of the nation. The international financial institutions upon which Iraq will depend for financing will demand clear and comprehensive presentations of the country's economic and fiscal position as a condition of economic aid. Furthermore, market-based enterprises will be loath to make investments in Iraq unless they can assess the country's financial stability.

The 2004 budget is an improvement in transparency from the 2003 budget, and is an important break from the secrecy imposed by Saddam Hussein. There are, however, large gaps in fiscal transparency and participatory budgeting that should be filled in subsequent years. This report has identified the following as problem areas:

Little consolidated reporting and substantial off-budget fiscal activity

Significant amounts of spending in Iraq bypass the budget process and are not reported in the budget. These include the \$18.4 billion appropriated by the U.S. Congress for reconstruction in Iraq, the billions to be channeled through multilateral trust funds managed by the World Bank and the UN, and the activities of Iraq's large number of state-owned enterprises. The accounts of the Development Fund for Iraq are reported separately by the CPA. There is currently no consolidated reporting that encompasses all of the public funds that are being used for Iraq's reconstruction. Iraqis have the right to know what is being spent on their country's reconstruction and how it is being spent.

Lack of reporting by state-owned enterprises

Iraq has 192 state-owned enterprises employing half a million people, yet little is reported about what services or products they provide. These SOEs may engage in quasi-fiscal activities, such as the provision of public goods at subsidized prices or borrowing on external markets which produce distorted indicators of the government's finances. The potential privatization of some of these enterprises will also require transparency to ensure that the government receives fair compensation.

Insufficient information about liabilities and other budget risks

Iraq is targeted to end the year with a modest deficit, but this is based on the optimistic assumption that several key conditions will not change. It assumes that oil prices will remain high and that insurgent attacks will not disrupt the flow of oil. It envisions that war reparations and the claims of creditors will be minimal. It counts on donors abiding by their commitments to provide aid for reconstruction. And it assumes that renewed hostilities will not break out in Iraq. If any of these conditions fail to hold, Iraq's budget picture will be very different. The budget must provide alternative scenarios reflecting these possibilities, along with an explanation of how potential deficits would be financed.

Lack of spending oversight

At the time of writing, \$5.6 billion had been spent from the Development Fund for Iraq without any audits. The urgency of reconstruction needs when combined with an absence of oversight creates conditions ripe for abuse. Although the IAMB has been created, it has not yet begun to audit, and is due to be dissolved at the end of the year.

Absence of public information and engagement about the budget

The budget and supporting documents were published on the CPA's website in English and Arabic, which is an important step in budget transparency. But since the internet is only accessible to a minority of Iraqis, much of the public remains in the dark about the budget. Publication of the budget in the press and greater coverage by reporters will be an important step in building public trust in the government's fiscal policies.

What was acceptable as an emergency budget and financial management process for a nation still in the throes of war one year ago must now give way to documents and procedures fit for a democracy. It is incumbent on the CPA and the Iraqi Governing Council, as temporary stewards of the resources of the Iraqi people, to present information to the Iraqi public in a form they will be able to use. Since it is in the interest of the new Iraqi government to become a part of the world financial community, which will demand sound financial reporting before giving Iraq the capital it desperately needs, laying the groundwork for sound fiscal management is critical.

Recommendations

Key recommendations on how fiscal transparency in Iraq can be improved are summarized below.

- ▶ *Mandate an Open Budget-making Process:* The new constitution must include provisions for an open and participatory budget process, involving the legislature in an active debate about the nation's revenues and their allocation. The best source of information about important decisions for most members of the public will come from what the media reports about the debates among contending parties.
- ▶ *Educate the Public about Government Budgets:* The critical issue in creating public demand for government financial accountability—demand that is the nation's greatest protection against future tyranny—is education. The CPA has invested in sponsoring town hall meetings and “national agenda dialogues” to educate the public and stimulate debate about the value and appropriateness of democratic institutions. Public education—and dissemination of information both directly and through the growing independent media—about how the government is managing Iraqi resources is equally indispensable.²⁸

Even in the aftermath of war, more than a dozen major Iraqi universities are operating, educating a new generation of young people to understand the world as their parents too often could not. Over one million Iraqis work for the government and its agents, making them well-suited to participate in debates about key issues of public policy, such as where their nation's money comes from and where it goes. And thousands of Iraqi physicians, attorneys, journalists, and educators give the nation a strong base for expanded active participation in the political process. In a nation with few broadly respected institutions remaining that are not connected with the former Hussein regime or identified with the occupying forces, it might be worthwhile for the new government to work with some of the nation's religious institutions in a program of civic education.

- ▶ *Make Budget Information Accessible and Intelligible:* Budget documents should be designed for the people of Iraq, not simply for the CPA and other U.S. government entities. Current CPA documents are technocratic and, while helpful for policymakers, are not accessible to the vast majority of the Iraqi people. Moreover, the CPA's reliance on on-line dissemination of information limits access to only those few Iraqis with internet access. Prior to their adoption, easily understandable versions of draft budgets should be printed in the media, along with accompanying narrative explanation.

- ▶ *Use the Media to Inform the Public about Fiscal Policy Choices:* Since the overthrow of Saddam Hussein’s government, the print media has proliferated in Iraq. Many newspapers, however, have limited readership and face control by parties and other factions. A major challenge for the press in the years ahead will be improving the professionalism of reporting, retaining readership, and achieving independence. As the media develops in Iraq, it should step in to play the important role of making fiscal choices accessible to Iraqi citizens in order to promote dialogue and informed choices by voters.
- ▶ *Make the Budget Decision-making Process Broader and More Inclusive:* Budget development and decisions should not only include directly elected (or chosen) representatives of the people in some future democracy, but also representatives of whatever form of civic society develops in a free Iraq. There is no evidence of any meaningful public participation in the current budget process, and Iraqis are likely to continue to have low expectations about shaping their nation’s future. Recently established “democracy centers,” created by the CPA to provide gathering places for discussing principles of democracy could also serve as “town halls” to host discussions about budget priorities.
- ▶ *Create Donor-supported Non-governmental Organizations to Analyze and Disseminate Budget Information:* Analogous groups have been created in dozens of developing nations around the world,²⁹ and could be built around an existing Iraqi organization with resources and credibility.
- ▶ *Get Government Commitments for Fiscal Reporting:* A commitment should be made by Iraq’s interim government to the timely publication of comprehensive fiscal information. This information should be made available in Arabic and Kurdish and distributed widely among major segments of the population. Opportunities for public comment on draft budgets should be made available.
- ▶ *Create Reporting Templates:* The CPA should produce budget reporting templates that approximate the standards established by the IMF or the OECD, and provide these to Iraq’s interim government.
- ▶ *Provide Comprehensive Information about the Development Fund for Iraq:* A clear statement of the financial status of the Development Fund for Iraq should be covered in the budget document, including the status of the Fund, projected receipts and expenses, major categories of uses, and large contracts to be signed.

- ▶ *Address Risks and Contingency Planning Issues:* More detail about contingent liabilities and other risks to the budget should be reported, such as how the budget might be affected by changes in the oil price or disruptions in the export of oil, renewed hostilities, increased debt payments or reparations, and the failure of foreign aid to materialize. Greater detail should be provided on how potential deficits might be financed.
- ▶ *Include Consolidated Reporting:* The budget of Iraq should include a consolidated report on fiscal activity in Iraq, with detailed information about spending by international donors, about the activities of sub-national governments, and about state-owned enterprises.
- ▶ *Develop Audit Institutions:* An audit process must begin functioning in Iraq. The country's state audit institution should become an independent entity with adequate resources. The IAMB should make public its plans for an audit.

Notes

1. <http://www.iraqrevenuewatch.org/reports/o8o5o3.pdf>
2. <http://www.cpa-iraq.org/budget/budget2004.html>
3. The budget shows an operating deficit for the first six months after the war (the period of June-December 2003) and 2004's deficit being covered by surplus funds from Iraq's Oil for Food program.
4. In this report, financial data is presented in U.S. dollars. The 2004 budget is based on an exchange rate of 1,500 New Iraqi Dinar (NID) per \$1 U.S.
5. Established under United Nations Security Council Resolution 1483, the Development Fund for Iraq (DFI) is the repository of funds from various sources including the uncommitted balances of the Oil for Food program, the commitments of foreign governments, and oil sale proceeds. The use of some portion of these funds is incorporated in the budget, although the status of remaining funds (estimated at over \$8 billion as of February 2004) is unclear. A financial status report on the DFI is now available through the CPA website, offering balances, sources and uses, and some general information about disbursements.
6. At this time, there is only one voting Iraqi member of the 11-member PRB.
7. These include, in accord with UN Security Council Resolution 1483, the payment of 5 percent of all oil revenues to Kuwait as reparations for the war waged by Iraq against it, as well as interest payments on other foreign debts incurred by the Hussein regime.
8. These include documents on: Policies on Payment of Public Sector Pensions and Benefits; 1st Quarter Supplemental Budget Reports to Congress; Transition to New Iraqi Dinar Financing; Policy on Public Security Sector Survivor Benefits; Development Fund for Iraq (DFI) Status Reports; Restrictions on Hiring Iraqi Civil Servants; Procedures for Settling of Outstanding Obligations of Budgeted and State-owned Enterprises; Salary Reform Proposals; Data on New Currency; Salary Information; and Budget Letters to Ministries.
9. Congress of the United States, Congressional Budget Office, *Paying for Iraq's Reconstruction*, January 2004.
10. The survey was conducted as a collaboration among the World Bank, IMF, and the United Nations, and includes data from the CPA as well the institutions' independent assessments of Iraq's needs. It is one of the most comprehensive estimates to date. <http://www.imf.org/external/np/oth/102103.pdf>
11. The accounting firm Ernst & Young has been retained to sort out how much Iraq owes and to whom, a process that is complicated by the absence of signed loan commitments between Iraq and neighboring creditors. "Iraq Appoints Ernst & Young on Tracing Debt Source," Reuters, March 16, 2004.
12. <http://web.worldbank.org/WBSITE/EXTERNAL/NEWS/0,,contentMDK:20154836~menuPK:34466~pagePK:64003015~piPK:64003012~theSitePK:4607,00.html>
13. A small-scale consumer price survey of nine food items and four fuel items was begun recently by the CPA, but it will take time to become comprehensive.
14. Unemployment has been reported as high as 28 percent, with underemployment at comparable levels.
15. See http://www.cpa-iraq.org/business_center.html
16. Indicative of the tension around this issue, the CPA web-site reports that "The lack of Iraqi political will is limiting significant re-structuring of SOEs." See http://www.cpa-iraq.org/economy/weekly_updates/state_owned/Jan-Feb.html
17. See *Controlling Iraq's Skies: The Secret Sell-Off of Iraq's Air Industry*, Iraq Revenue Watch, report No. 4.
18. *IMF Manual on Fiscal Transparency*
19. This figure can be compared to published reports of misappropriation of as much as 20 percent of these funds under Saddam ("Hussein's Regime Skimmed Billions from Aid Program," New York Times, February 29, 2004).
20. Further, enormous structural changes in the presentation of the two budget documents make comparison meaningless; for example, in the 2004 budget, 83 percent of all ministry expenditures are channeled through the Ministry of Finance, while in 2003, the Ministry of Finance handled only 23 percent. In addition, the 2004 budget reflects more than 25 ministries, many of them extremely small. A table in the 2004 budget document reports operating expenditures by output area with some comparative 2003 data, but once again so few of the categories are comparable that few meaningful conclusions about policy changes can be drawn.

21. For example, it has been reported that the state electricity enterprise recently laid off as much as one-third of its workforce; nowhere could this information be found in CPA budget documents.
22. Other standards with applicability to some portions of Iraqi financial management include those developed by the Public Sector Committee of the International Federation of Accountants (IFAC), and the internal accounting control guidelines and international standards for government auditing issued by the International Organization of Supreme Audit Institutions (INTOSAI). In addition, fundamental principles of official statistics have been promulgated by the United Nations Statistical Commission to help assure the integrity of official statistics.
23. *OECD Best Practices for Budget Transparency* was drawn up by the Secretary based on the request of its members in 1999. Its most recent version was published in May 2001.
24. The *Code of Fiscal Transparency* was adopted by the Interim Committee of the Board of Governors of the International Monetary Fund at its fiftieth meeting on April 16, 1998. The *Revised Code of Good Practices on Fiscal Transparency* was last updated on February 28, 2001. References to the IMF Code are to this revised document. The IMF has also published a more detailed *Manual on Fiscal Transparency* to explain the Code, a document hereinafter referred to as the IMF Manual.
25. <http://www.imf.org/external/np/rosc/rosc.asp>
26. These are in the form of regulations, orders, and memoranda issued by the CPA. For example, Coalition Provisional Authority Regulation Three established the Program Review Board to approve all expenditures.
27. <http://www.ifac.org/>
28. In a review of the budget dissemination process in another developing nation, the International Budget Project identified some key steps that can help a nation's people participate in, and eventually control, decisions about their nation's financial future. Some of these are applicable to supporting the development of democratic participation in Iraq. Institute of Economic Affairs, *Budget Transparency: A Kenyan Perspective*. (<http://www.internationalbudget.org/resources/library/Kenyatransp.pdf>)
29. Such organizations include the Institute for Economic Affairs in Kenya, the Public Private Finance Institute in Albania, the Center on Budget Accountability in India, and the Economic Development and Research Center in Armenia. Many are working together with the International Budget Project of the U.S.-based Center for Budget and Policy Priorities.

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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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