

OIL FEDERALISM IN IRAQ: RESOURCE CURSE, PATRONAGE NETWORKS  
AND STABILITY. CASE STUDIES OF BAGHDAD, KURDISTAN AND THE  
ADVENT OF ISIS

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## **DEDICATION**

To my inspiring parents.

To my loving wife Guli, and our wonderful daughters, Banu and Besha



## **ACKNOWLEDGEMENTS**

I thank Allah Almighty, whose book commences with the command, “Read;” and his prophet, who taught me at a young age to “seek knowledge from the cradle to the grave.”

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## **LIST OF ABBREVIATIONS**

EITI: Extractive Industries Transparency Initiative  
IOC: international oil companies  
ISIS: the Islamic State of Iraq and al-Sham (aka ISIL, Islamic State of Iraq and the Levant, and IS, the Islamic State)  
ITP: Iraq-Turkey Pipeline  
KRG: Kurdistan Regional Government  
OPEC: Organization of Petroleum Exporting Countries  
PSC: Production Sharing Contract  
SOMO: State Oil Marketing Organization  
TSC: Technical Service Contract

## **ABSTRACT**

OIL FEDERALISM IN IRAQ: RESOURCE CURSE, PATRONAGE NETWORKS AND STABILITY. CASE STUDIES OF BAGHDAD, KURDISTAN AND THE ADVENT OF ISIS

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Petroleum wealth is the lifeblood of Iraq, with the potential to promote prosperity, or become a curse that destabilizes the country and interrupts its economic and political development. The management and sharing of petroleum wealth has been at the center of economic, political and security developments in Iraq since the country's invasion in 2003. This study analyzes Iraq's experiment with *petrofederalism*, the influence of different actors (e.g. international oil companies and ISIS), and the emergence of Iraqi Kurdistan as a *petroregion*. Using case study method, it demonstrates how patronage politics exacerbated resource curse in Iraq and resulted in instability.

## **CHAPTER 1: IRAQ'S PETROLEUM POLICY AND TRANSITION SINCE 2003. GOALS AND CONTEXT OF THE STUDY**

Like many other petroleum-rich countries, Iraq has, for most of its post-colonial history, been simultaneously rich and dysfunctional. In 1920, Iraq's modern borders were demarcated by Western colonial powers after World War I and the carving up of the Ottoman Empire at the Treaty of Sevres. Iraq fell under British mandate, which created a monarchy that gained independence in 1932. The monarchy was overthrown in 1958 and replaced with the Iraqi Republic, which was mostly under military rule until 2003. Since the country's inception, oil has been a major factor in Iraq's political, social and economic affairs. Ironically, oil helped build the country, only later to contribute to its destruction. For example, petrodollars helped Iraq build the best universities in the Middle East, but also financed the arming of multiple state institutions of repression. Oil revenues raised living standards, but also entrenched the wealth and power of the monarchy and the subsequent military and single-party dictatorships. The U.S.-led invasion of Iraq in 2003 has resulted in a new political system where political parties compete in elections, and federalism offers sub-national groups more autonomy. Moreover, the advent of ISIS has resulted in a terrorist

organization controlling and ruling extensive territory and generating enormous oil revenues.

With the fall of the Saddam Hussein regime in 2003, however, new dynamics of power, influence and policymaking emerged, amid electoral competition, decentralization of power in the form of federalism, and the return of international oil companies (IOCs). Political competition ever since has taken the civilian form of parties and elections, as well as violent forms of sectarian warfare and insurgencies. Absent Saddam and his Baath Party's overpowering force, ethno-sectarian divisions and violence emerged. This research project studies Iraq as a case of a transitioning, petroleum-dependent state whose political and economic systems are undergoing major changes. These changes are constantly evolving and are a multi-national concern as ISIS controls a significant share of Iraq's oil revenues at the time of the completion of this dissertation. The dissertation investigates the factors that shaped the changes and developments in Iraq's petroleum sector since 2003, and tries to analyze their impact on the country's development, stability and its endurance as a unified state.

Resource based wealth simultaneously offers opportunities and poses challenges to countries where petroleum is found. If managed efficiently, they could spur competitive advantage and economic growth. However, states often fail to harness the natural resource, and go down a path of authoritarianism, conflict and economic stagnation, as manifest by recent events in Iraq. The rise of

ISIS in light of Iraq's instability may be more dramatic but it is not without precedent in other oil and gas rich countries.

The policies of the post-2003 Iraq regime shaped the country's future trajectory towards the complex situation we see today. Although Iraq shares the characteristics of many other resource rich states, such as heavy economic dependence on oil revenues,<sup>1</sup> the country is different in that it has a competitive political system where political parties, ethnosectarian groups and geographic regions vie for power and influence.

Before 2003, Iraq was a monarchy and then a military and one-party dictatorship. Since the United States and coalition forces invaded Iraq in 2003, the country has formally adopted democracy. Elections have empowered ethnic and national groups to organize as political blocks. Iraq has held multiple national and local elections since 2003, where political parties from different backgrounds competed. Elections accentuated the ethnic and sectarian divides within the Iraqi society, which culminated in sectarian violence in 2006-2007. Moreover, federalism has been enshrined in the country's constitution, which recognizes the Kurdistan region and its sub-national government. Key to Kurdistan's push for power devolution from Baghdad is the right to manage the petroleum resources found in the Kurdish region. The Sunni region under ISIS control is another example of a subregion exerting its own political direction. The

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<sup>1</sup> Oil revenues have constitute half of Iraq's GDP and more than 90% of government revenue (see section below on oil dependence).

Kurdish, Sunni and Shia regions all manifest political and administrative rifts, weak government institutions, riddled with corruption.<sup>2</sup>

Another landmark development since 2003 has been the return of many international oil companies (IOCs). The foreign oil companies come from more than a dozen countries, including the U.S., Europe, China and the Middle East. They seek to explore for more oil, boost production and tap into Iraq's 140-145 billion barrels of proven oil reserves, much of which is located in the south and north of the country. Iraq nationalized its petroleum industry in 1972, and the return of IOCs into the Iraqi petroleum sector is a significant geostrategic move for Iraq and the energy industry. The Kurdistan Regional Government (KRG) and the federal government are in dispute over the right to explore and produce the country's oil and gas resources, and over the role that foreign oil companies should play. Control over the resources generated from this foreign investment in oil fields is a point of serious contention between Baghdad and regional governments.

Moreover, the country and the petroleum sector suffer from continued violence and criminal activities such as oil smuggling and sabotage, including by ISIS and militias associated with political parties in different regions. Oil smuggling, in particular, is an undertaking with a long history in Iraq. The

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<sup>2</sup> According to Transparency International's Corruption Perceptions Index and World Bank's Governance Indicators. Governance and corruption, among other characteristics of governance, are discussed further later in the chapter.

Saddam regime masterminded oil smuggling during the years of U.N. sanctions that banned the formal export Iraq's oil (1990-2003). After the fall of the regime, however, smuggling operations have become less hierarchical and more devolved, involving state and non-state actors such as corrupt politicians, militias and crime networks. Today, ISIS taps into an existing oil smuggling network to sell the crude it extracts from the oilfields in has captured Iraq and Syria.

### **Goals of the Study**

Iraq's energy industry and resources are putting the different regions of Iraq on drastically different trajectories, suggesting that state fracture is imminent. This study seeks to contribute to the public policy literature, and to serve as a basis for policy-oriented recommendations in Iraq's petroleum sector for both national policies, if Iraq survives as a nation state, and for regional government, especially Kurdistan. The study will also attempt to further knowledge on resource-dependent states, transitioning states, and the influence of corruption and patronage networks. Further, it will explore the role of devolution of power, or decentralization, in petroleum dependent states.

The focus of this research is the nexus between corruption and political transition in petrostates. On the one hand, petroleum wealth has the potential to fund Iraq's reconstruction and the development of its economic and human

capital. On the other, the myopic competition among ethnic and sectarian rivals over petroleum revenues may undercut Iraq's prospects for political and economic transition and its stability as a reliable oil exporter. This research seeks to address these policy challenges by studying the key actors who shaped Iraq's recent petroleum policy – governments, the petroleum industry, and the public.

From other contexts, we have a good understanding of how resource wealth contributes to economic stagnation (Auty 1993), authoritarianism (Ross 2001) and conflicts (Collier and Hoeffler 2005b) through rent seeking and concentration and agglomeration of power and wealth. Hence, there are plausible explanations of why countries dependent on natural resources fail to reform and democratize (Karl 1997). Such political and economic problems associated with resource-dependence are collectively referred to as “the resource curse.”

However, there are gaps in the literature that this study seeks to address. Our understanding remains limited as to how petrostates undergoing economic and political transition deal with their natural resources, and the effects of resource wealth on such transitions. Moreover, studies on the effects of policy decentralization and fragmentation on petroleum policymaking and wealth distribution remain inadequate. Finally, while the effects of corruption and patronage in slowing down economic and political development are well studied



(della Porta and Vannucci 1999; Johnston 2005), their influence on shaping petroleum policy merits further investigation.

These dynamics and factors come together in Iraq and influence its economic lifeblood: petroleum. To sum up, it is the goal of this study to a) describe the complexity of the petroleum policy in contemporary Iraq, b) identify the key factors that contributed to shaping that policy since 2003, and, as mentioned earlier, c) analyze the regional variations in policymaking by contrasting the federal Iraqi government and the Kurdistan Regional Government. In particular, these policy dynamics are studied to identify how accountability is maintained in the interactions among international oil companies (IOCs) and the governments, and the latter with the public (Bridge and Le Billon 2013).<sup>3</sup> These internal dynamics may have significant implications for international oil markets and the hope that Iraq would develop into a stable oil exporter. These dynamics affect the possibility for the petroleum industry, both domestic and foreign investors, to have a stable source of oil products.

The link between policy dysfunction and corruption in the oil sector also requires better understanding. Analysis of Iraq's oil industry and policy is often based on economics interest, legal arguments and identity politics (Blanchard

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<sup>3</sup> The focus on these three actors – government, oil firms and civil society – is borrowed from Bridge and Le Billon (2013). The authors discuss the relationships among these actors: contracts regulate the IOC-government relation; the country's political system regulates the relation between government and society; and corporate social responsibility in the main channel of interaction between IOCs and the society.

2009; International Crisis Group 2012). Such analyses do not adequately explain why elected politicians are willing to incur sizeable economic losses to their government revenues through prolonging policy conflicts and indulging in oil smuggling. Conflict at the national stage is often a sideshow and opportunity for corruption and illegal self-enrichment at the local level.<sup>4</sup> Indeed, corruption in the government and the military facilitated the ISIS incursion (Chayes 2014; Cockburn 2014) as well as its oil smuggling operations.

### **Political Transition and *Petrofederalism***

Iraq may be a unique case, where a petrostate is simultaneously undergoing decentralization, transitioning and fracturing. Iraq's politics and constitution lays the framework for federalism and a shift toward capitalism and democracy. *Oil federalism*, or *petrofederalism*, is at the core of reshaping post-invasion Iraq. Oil wealth concentrated in Baghdad allowed for the emergence of a centrally managed economy and a military regime, able to co-opt or quell any dissent. The post-invasion vision for a democratic Iraq, shared by the United States and some of the post-Saddam Iraqi factions, focused on stripping away some of Baghdad's political and economic powers in the form of federalism,

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<sup>4</sup> A member of the Kurdish parliament said that if it were not for the conflict with Baghdad, the Kurdish oil minister should be called to parliament for questioning (Awene Newspaper, May 14, 2012). Hence, the rivalry between Baghdad and the KRG is hampering accountability. Moreover, reports emerged that ISIS has been selling oil to Syrian, Turkish and Kurdish smugglers at a discounted price, hence fueling the conflict in the region. Local politicians are often involved in the illegal trade in oil (see for example Daragahi and Solomon 2014).

mainly in the management of the country's petroleum resources. The decentralization of the petroleum policy in Iraq, a major petrostate, would be unique in the Middle East, since oil federalism also falls across ethnosectarian lines. Another major emerging challenge facing Iraq's petroleum sector, and potentially the broader Middle East oil and gas sector, is ISIS's capture of oilfields in Iraq and Syria. State control of petroleum resources and infrastructure has been the hallmark of power and rule in this region. Yet, ISIS, a non-state actor and a terrorist group, is in control of, and generates massive revenues from, oilfields in Iraq and Syria.

Shedding light on the political and economic dynamics of petrostates has important implications for other resource rich states. For example, oil federalism maybe the midway between state partition (as happened in Sudan) and brutal crackdown on political and geographic dissent (as in Iraq under Saddam). Also, in Libya, oil-rich regions are calling for federalism.<sup>5</sup> Moreover, as manifest by ISIS, massive oil revenues can fall into the hands of a terrorist group. In the aftermath of the Syrian uprising and consequent civil war, the country's oilfields have fallen in the hands of different factions at different times. By August 2014, ISIS controlled 6 of Syria's ten oilfields including Omar major facilities and at

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<sup>5</sup> Hendrix, Steve. 2012. "Post-Gaddafi Libya Confronts Its Diversity." The Washington Post, April 1.

least four Iraqi fields including Hamreen, bankrolling millions of dollars.<sup>6</sup> These dynamics are drastic departures from the norm of the past century, where a monarchy or a military junta single-handedly owned and managed these countries' petroleum resources. With the hope of broader applicability, one objective of this study is to better understand Iraq's specific petroleum policy environment and the politics around it, without which reform and remedial measures against harms of resource curse will be futile.

The research will also contribute to a better understanding of petroleum policy. The multidisciplinary approach of this study allows the researcher to draw a more accurate map of a complex policy, across formal and informal, public and private, national and foreign, national and subnational factors and interactions in Iraq since 2003. Policymaking and patronage calculations of leaders are often seen as different rather than complementary. Patronage may be an addendum to policymaking and institutions (Lande 1977), but it remains an important aspect in the calculation of rulers and power wielders. Finally, the resource curse literature focuses on the flow of oil revenues and governments,

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<sup>6</sup> The situation remains fluid as this chapter is being drafted. ISIS had also captured Ajeel, a large oilfield, but the Iraqi forces recaptured it late August 2014. For more, see for example *Fueling ISIS Inc.*, by Daragahi and Solomon (2014) in *Financial Times*. Before ISIS, Al-Qaeda offshoot Jabhat Al-Nusra took control of Omar oilfield. Kurdish group YPG also controlled some of the Syrian oilfields. According to *Iraq Oil Report*, ISIS could have been making up to \$1 million a day from smuggling Iraqi oil alone (Hussein et al. 2014). Moreover, the *New York Times* quoted Iraqi officials saying that ISIS stole \$400 million from Mosul's branch of the central bank (Nordland and Rubin 2014).

without much attention to the petroleum industry itself. This study captures the roles of international oil companies, their dealings with oil-rich regions, and how they affect and react to national policymaking.

### **The Case Study Method**

This study employs the case study method, which enables the researcher to maintain a holistic view of the unit of analysis and its context (Yin 2003). The cases are the petroleum policies of Iraq's federal government and that of Iraq's Kurdistan Regional Government (KRG). In each case, oil contracts and policy pronouncements are studied, and key informants from government, petroleum industry, local and foreign subject matter experts, and civil society organizations are interviewed. The analysis also tracks the developmental stages of Iraq's petroleum policy since 2003 through publically available government and media sources (see chapter 3 on methods for more details).

### **Oil: The Centerpiece of Iraq's Modern History**

Oil has defined Iraq ever since the black substance gushed from the ground in commercial quantities. Oil wealth shaped the country's development under different regime types — a British protectorate, monarchy, military rule and single-party rule. Iraq's oil wealth attracted foreign involvement at the turn of the 20<sup>th</sup> century where a British oil company reaped much of Iraq's natural resources wealth. After a wave of nationalization of the petroleum sectors, Iraq

took partial and later full control of its oil and gas resources, sacking all foreign companies. Since 2003, international oil companies are back into the country's petroleum sector for the first time in 40 years, as service providers (with the federal government) and partners (with the Kurdish government). The management of oil and gas is slated to shape Iraq's political and economic trajectory in the near and distant future as well.

### **Border Delineation and Ethnosectarian Grievances**

Iraq's oilfields were key to how the wider region's borders were drawn between France and Britain in 1916, the victors of WWI and heirs to the Ottoman Empire. Western companies explored, developed and exploited the oil discoveries in Mesopotamia as early as 1918 (Yergin 2008). After the fall of the Ottoman Empire, the British turned the provinces of Mosul, Baghdad and Basra into modern-day Iraq in 1920, and installed a monarch and a pro-British government. That Iraqi government awarded the Iraqi Petroleum Company (IPC)—a British owned energy company--long-term concessions to explore and produce oil in almost all of Iraq's territories. These concessions lasted until the end of the 20<sup>th</sup> century. Under the terms of the concession, the IPC could determine the levels of output and export, and set prices. In return for such a generous concession, Iraq would receive a meager 24 cents per barrel (Kadhim 2011). In effect, the foreign oil companies controlled Iraq's petroleum resources and wealth, and only paid the Iraqis a small fraction of it. The Iraqi government

for five decades until 1972 was not involved in or knew about the oil production figures or revenues.

Such financial exploitation by the British fed Iraqi nationalist and anti-colonial sentiments, which culminated in the nationalization of the British-owned Iraq Petroleum Company (IPC) on June 1, 1972. Saddam Hussein, then Iraq's vice president, was seen as the architect and champion of oil nationalization. Saddam took nationalization cues from Venezuela as well as neighboring Iran. No foreign oil company played any major roles in Iraq's petroleum sector until the fall of the Saddam Hussein regime in 2003.

Nationalizing Iraq's oil sector as vice president in 1972 was Saddam Hussein's main ticket to the presidency in 1979. Soon after that, he started an eight-year war with Iran that was funded mainly by Iraq's petroleum revenues. Bankrupt and in debt, Hussein invaded Kuwait in 1990 and took control of its oilfields. Saddam's control of so much of world oil reserves became a concern to the region. The ensuing Gulf War of 1991 resulted in the destruction of both the Iraqi military and its oil infrastructure.

The invasion of Kuwait also resulted in comprehensive financial and trade sanctions imposed on Iraq by the United Nations Security Council in 1990, which banned the export of Iraqi oil. However, the Hussein regime devised an intricate oil smuggling scheme that evaded the sanctions and helped the regime stay in power (Volcker, Goldstone, and Pieth 2005), as will be discussed further below.

Moreover, monopolistic access to oil revenues allowed the regime to maintain power, through co-opting the society with social services and coercing opposition into submission or destruction by the security apparatus. Although the Baath regime came with a promise of inclusiveness, with time it became increasingly sectarian (Sunni) and nationalistic (Arab). Even before the Baath Party, there were Sunni-led attempts to “dissolve Shi’i particularism in a philosophy of Arab nationalism” (Marr 2003, 42). Iraq’s Kurds have been fighting Baghdad’s authority for self-rule since 1919. One of the current Kurdish ruling parties, the Kurdistan Democratic Party, started fighting the Iraqi government in 1961. Different Iraqi regimes, most notably the Baath regime, also indulged in social engineering and demographic changes, most notorious of which was “Arabization” and later ethnic cleansing of many Kurdish-dominated towns, including oil-rich Kirkuk. After the Iraq-Iran war started, Shia Kurds, known as Failis, were exiled to Iran (Natali 2008). Upon the Shia uprising in 1990, southern marshes were drained and hundreds of thousands were displaced and resettled, including into Kirkuk (Marr 2003). Iraq’s Shia and Kurds felt marginalized and deemed the regime illegitimate. These ethnosectarian grievances were accentuated by geography – the oil-impoverished center was empowered by oil produced mainly in the northern oilfields in Kirkuk and southern oilfields in



Basra. Today, Kirkuk and other towns are considered “disputed territories,” claimed by both Baghdad and the Kurdish government.<sup>7</sup>

Post-Saddam Iraq opened the door for decentralizing petroleum policymaking powers (or oil federalism). Indeed, Shia parties were initially supportive of decentralization and devolution of Baghdad’s power to the provinces and regions. However, upon consolidating power in Baghdad, their enthusiasm for federalism has abated. Conditional to being part of the new Iraqi government after the fall of the Baath regime in 2003, the Kurdish political parties demanded that the Kurdistan Regional Government (KRG) have a say in managing the oil and gas resources found in its territories. Iraq’s constitution of 2005 laid the foundation for federalism and power sharing among Baghdad, the KRG and other oil-producing provinces on decisions pertaining to the exploitation of Iraq’s petroleum resources.

### **The Return of International Oil Companies**

In addition to oil federalism, the return of international oil companies and are the key changes in Iraq’s post-Saddam petroleum policy. Toward the latter years of his regime, Saddam Hussein started re-inviting foreign oil companies back into Iraq. But it was only after the toppling of his regime in the 2003 invasion that foreign oil companies made a substantial comeback to Iraq’s energy

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<sup>7</sup> Article 140 of Iraq’s constitution pertains to resolving these disputed territories that suffered from deliberate demographic manipulation. The article mandates “normalization and census [that] concludes with a referendum in Kirkuk and other disputed territories to determine the will of their citizens.”

sector since its nationalization. Iraq's contemporary oil policy could be moving toward reversing nationalization. Iraq needs foreign investment to revamp its oil industry – boost production using new technologies and explore hydrocarbon resources (Al-Shahristani 2012). Iraqi policymakers disagree, however, on how much control foreign oil companies should be given.

### **Developing Iraq's Petroleum Sector: Challenges and Constraints**

ISIS has geographically divided a country already fractured across ethnic, sectarian and political lines. However, the ISIS incursion was an additional factor to an already complex conflict over oil policy, power politics, federalism, and border delineation between the Kurdish regional and Iraq's central governments. Prime Minister Al-Maliki's second term (2010-2014) was exclusionary, especially after the full withdrawal of U.S. troops. The rift with the Kurdish government deepened, and the Sunni parties felt increasingly sidelined. These conflicts have exacerbated the uncertainty and instability around Iraq's petroleum sector.

Despite the potential to transition to an oil-rich prosperous democracy, challenges and constraints facing the development of Iraq's petroleum policy put Iraq on a trajectory toward the resource curse and great political instability extending to the possibility to fracturing of the state. Iraq suffers from chronic dependence on oil, for the economy and government revenue. Moreover, other major debilitating challenges facing Iraq and its energy sector include a

governance deficit, the dispute over managing oil, and criminality. These challenges are intertwined with historical ethno-sectarian disputes over power, internal border delineations and the role and influence of foreign oil companies.

### **Deepening Dependence on Oil**

Ever since oil was discovered in Iraq, the country's government coffers and the economy at large have become increasingly dependent on oil revenues. Dependence on oil began when Iraq started regular oil production in 1935. Between 1935 and 1950, during which Iraq was a monarchy, government revenues rose from a meager 1 million British pounds a year to 6.8 million pounds. For fear of its full nationalization, the Iraq Petroleum Company (IPC) agreed to a 50-50 profit sharing agreement with the Iraqi government in 1958. As a result, Iraq's oil revenues jumped to 84.6 million pounds that year, a twelvefold increase. Between 1959 and 1970, the IPC provided an average of 80.4% of Iraq's revenues (Kadhim 2011).

This overdependence became particularly destabilizing when sanctions were imposed on Iraq. Unable to sell oil and lacking income diversity, the sanctions damaged Iraq's economy Iraq remains today highly oil-dependent (See Figure 1. Iraq's oil dependence is revisited and more fully developed in chapter 6). Revenues from oil exports account for over half of Iraq's GDP, according to

World Bank data on Iraq. However, revenues from oil sales yield more than 90% of the government's revenue.<sup>8</sup>

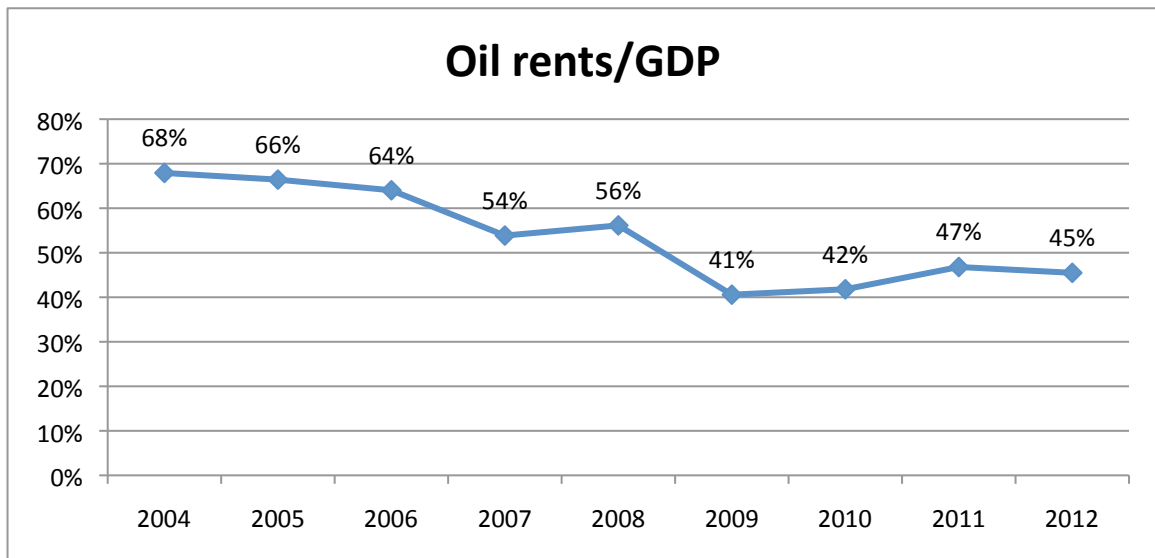


Figure 1: Oil Rents as Percentage of Iraqi GDP (Source: Data from the World Bank)

### Geography and Infrastructure

Except for the opening to the Persian Gulf in the south, Iraq is a landlocked country. Iraqi Kurdistan, which seeks economic independence through oil sales, is completely landlocked. Iraqi sells oil from southern fields via tankers through the Persian Gulf. In the north, oil is transported via the Iraq-Turkey Pipeline or trucked to the Ceyhan Port in Turkey and then to

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<sup>8</sup> Revenue Watch Institute - Iraq - Extractive Industries. In 2011, petroleum revenues accounted for 95% of government revenues (International Energy Agency 2012).

international waters through the Mediterranean. Due to decades of war and sanctions, Iraq's oil industry infrastructure is weak and fragile. Repairs and upgrades need capital investment and technology, some of which have been extended by international oil companies.<sup>9</sup> There are also disputes over internal border delineation, especially between the KRG and the federal government. Many oilfields lie on disputed territories and have complicated the Erbil-Baghdad dispute over oil management (See chapter 4).

### **Corruption and Criminality**

In addition to physical constraints, government inefficiency, corruption and smuggling are the critical challenges to the development of the country's petroleum industry. These are major concerns for international oil companies as well, on whom Iraq's oil sector's revival relies. Government corruption facilitates the diversion of government revenues into private hands as well as into the coffers of political parties and patronage networks. Smuggling allows militias, insurgent groups and crime syndicates to amass illicit wealth (See Chapter 6). The takeover of oilfields and refineries in Iraq and Syria by ISIS in 2013 and 2014 poses a significant threat to an already fracturing Iraq.

Iraq as a country suffers from high levels of corruption, and the oil industry is at the heart of grand corruption. Iraq ranked at 171 out of 177 countries on Transparency International's Corruption Perceptions Index in

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<sup>9</sup> Infrastructure and export constraints will be further discussed in chapter 5.

2013.<sup>10</sup> Oil revenues make the bulk of the economy and almost all of the government's revenue (which was a \$100 billion in 2012). In addition to government coffers, the industry-government interaction accounts for generating a significant revenue stream. Therefore, access to any piece of this multibillion-dollar value chain is the ultimate prize for political parties, crime networks and insurgent, and terrorist groups (such as ISIS).

Some oil importing countries and international governmental and nongovernmental organizations have pushed for more transparency in the international oil trade. The Extractive Industries Transparency Initiative (EITI) is an organization that aims to promote transparency in the interaction of oil firms and oil states. It maintains a set of standards of transparency adopted and overseen by multiple stakeholders such as governments, oil companies and civil society organizations. EITI standards require the disclosure of company payments of and government receipts from oil sales, licensing information, production data, and financial transfers to local governments.<sup>11</sup>

Incidentally, Iraq is a signatory to the EITI. In December 2012, the organization declared Iraq to be "EITI compliant," making the country the largest petroleum producer to achieve that status. Moreover, the Kurdish oil law

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<sup>10</sup> See Iraq's profile at Transparency International's Corruptions Perceptions Index (2013) at <http://www.transparency.org/country#IRQ>

<sup>11</sup> For more details on requirements and reporting procedures see the "EITI Standards" (2013), available at [https://eiti.org/files/English\\_EITI%20STANDARD\\_11July\\_0.pdf](https://eiti.org/files/English_EITI%20STANDARD_11July_0.pdf)

of 2007 enshrines the transparency principles of EITI.<sup>12</sup> Other Iraqi institutions, such as the Integrity Commission and the Board of Supreme Audit, also attempt to keep the energy sector in check. Nonetheless, corruption in the petroleum sector is perceived to remain a major problem and “more responsible than insurgents for breakdowns in the oil sector,” according to a senior U.S. official quoted in Iraq in 2006.<sup>13</sup> After ISIS captured large territories in Iraq, it tapped into a network of corrupt officials, businessmen and smugglers to sell oil from fields it controlled.

Moreover, security and stability remain key challenges to rehabilitating the petroleum industry. Oil facilities and pipelines continue to be targeted by insurgents, terrorists, militias and smugglers. Oil became the epicenter of illicit wealth by corrupt officials and businessmen, cash-thirsty militias, and ISIS and other anti-government insurgents and tribesmen. Iraq’s reliance on trucking due to sabotaged pipelines, the absence of production measuring and export metering, and fuel subsidies all came together to create incentives for and facilitate smuggling operations (Williams 2009; Wahab 2006).

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<sup>12</sup> However, the KRG does not consider itself bound by Iraq’s institutional commitments to EITI, according to an interview with Qubad Talabani, KRG representative to Washington in April 2010. Indeed, when KRG and Baghdad had a dispute over reporting sales figures to EITI, the KRG retained third party auditors. KRG oil revenue figures from 2010 were eventually included for the first time in the 2013 EITI Iraq report (see <https://eti.org/news/iraq-discloses-details-about-50-billion-oil-sales-2010>).

<sup>13</sup> Quote by an unnamed senior U.S. official in Iraq, speaking to the authors of The Iraq Study Group report, 2006.

There is a significant tradition of oil smuggling. Saddam Hussein created an elaborate oil smuggling network to evade UN-imposed sanctions during the 1990s (see section below). The Iraqi federal and regional Kurdish governments also accuse each other of corruption and oil smuggling and cheating each other off of oil revenue (Waleed and Khalid 2010; Van Heuvelen 2012a; Van Heuvelen 2012g).

In summer 2014, the Islamic State of Iraq and al-Sham (ISIS) group took over several Iraqi oilfields and banks. The group controls more than half of Syrian oilfields as well. Through trucking crude and fuel from Iraq and Syria, ISIS could be producing about 50,000 barrels of oil a day and making up to \$3 million a day, according to news reports and government officials.<sup>14</sup> This level of wealth in the hands of an insurgent group is unprecedented, and would help ISIS with recruiting as well as resisting its enemies. For example, ISIS can buy more weapons and ammunition. Moreover, economic hardship and high levels of unemployment resulting from war and mismanagement allow ISIS to recruit more fighters.<sup>15</sup>

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<sup>14</sup> See for example Hussein et al. 2014; Daragahi and Solomon 2014; Mufson; "ISIS' Black Gold," CNN.com

<sup>15</sup> In personal conversations, it was said that even fighters from secular Kurdish parties joined ISIS. Although I have not seen any credible reports on this matter, the chatter was deemed credible since the Kurdish government has not been able to pay salaries of its security forces regularly since the January 2014 budget cut that resulted from political rift with Baghdad.



### **The Absence of Petroleum Policy Framework**

Iraq lacks a comprehensive legal framework for its energy sector that regulates contracts and revenue distribution. The Iraqi constitution has ambiguously laid the foundation for managing hydrocarbon. The two main constitutional articles related to oil maintain that “Oil and gas are owned by all the people of Iraq in all the regions and governorates”<sup>16</sup> (article 111), and that “The federal government, *with* the producing governorates and regional governments, shall undertake the management of oil and gas extracted from *present fields*, provided that it distributes its revenues in a fair manner in proportion to the population distribution in all parts of the country” (article 112, emphasis added). The ambiguity in the latter article lies mainly in the meanings of “with” and “present fields.”

Another key issue in Iraq’s post-Saddam oil policy is federalism. Federalism has significant implications for ownership and control of the country’s petroleum resources. The rights and privileges that the constitution grants regions were intentionally made vague to satisfy all sides’ needs. The constitutional principles need to be translated into laws and regulations. However, Iraqi policymakers have so far failed to do this; hence, Iraq still lacks a federal oil law. In the absence of a comprehensive national hydrocarbons law,

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<sup>16</sup> A “governorate,” or province, is an administrative division in Iraq. There are 18 governorates in Iraq, each with a provincial government. Governorates can organize into a region. The only region in Iraq is the Kurdistan region, governed by the Kurdistan Regional Government (KRG). Governorates and province will be used interchangeably throughout the paper.

the Kurdish regional parliament passed a regional law that grants the KRG the competence to sign petroleum contracts with oil companies.

According to its interpretation of the Iraqi constitution, the Kurdistan Regional Government (KRG) espouses the right to explore, develop and export the petroleum found in the Kurdish region independent of Baghdad, as long as the KRG shares the region's petroleum revenues with Baghdad. According to such an understanding, the KRG adopted the industry favorite model contract of production sharing contracts (PSCs) to fast track the establishment of a domestic oil industry. The KRG has signed more than 40 PSAs without seeking approval from Baghdad (Crisis Group 2012). However, according to the federal government's interpretation of the constitution, KRG oil deals are illegitimate. First, Baghdad posits that only the federal government represents all Iraqis and thus solely has the authority to contract out Iraqi oil. Second, the contract model signed by the KRG gives oil companies a stake in Iraq's oil, which is a sovereign property. But the KRG has been willing to fight for independent policy making in its energy sector. The KRG wants to use its oil policy to achieve fiscal, and by extension political, independence from Baghdad. Many in Baghdad, however, still favor a strong central government, the only governance model that the country has known since its creation (see Chapter 4). This legal and institutional vacuum has exacerbated the uncertainty and instability of Iraq's petroleum sector and the economy that depends on it.

### *Oil Contract Models*

KRG's Production sharing contracts (PSC) differ from Baghdad's technical service contracts (TSC). In the TSC model, the oil companies are mainly service providers, for which they get compensated. In the case of PSCs, however, the oil companies are investors, and receive a share of the profit if they strike oil (Tordo, Johnston, and Johnston 2010). Moreover, the companies can list the reserves they find as owned holding, which helps raise their stock share prices (see International Crisis Group 2012). Federal officials see ownership sharing with oil companies as infringement on sovereignty, and therefore, they caution that PSCs could give oil companies a greater stake in the Iraqi oil sector.

Hence, Iraq has at least two opposing petroleum policies that differ with regards to competence over oil and gas management, the right to sign contracts and sell oil, and the role of foreign oil companies. Policy and political disharmony in the oil sector has resulted in two parallel frameworks that compete to the bottom rather than to the top. The federal and regional governments accuse each other of corruption, smuggling and waste (Waleed and Khalid 2010). The divergence of petroleum policy between Baghdad and the KRG has resulted in a "hybrid oil sector [with] hybrid standards of transparency," as a reporter put it (Van Heuvelen 2012a). That is, each government is unilaterally adopting policies and procedures that suit it rather than complying with good governance practices. Accountability and devolution

of power are at the heart of any federal structure. A national hydrocarbon policy could allow for shared power between the federal government and the KRG, allowing them to hold each other accountable. However, the lack of a unified policy and agreement over a hydrocarbon framework that regulates Iraq's most important industry has created opportunities for corruption and expanding patronage. However, such vagueness could be precisely what serves both Baghdad and Erbil's desires.

### **Iraq's Resilient Legacy of Power, Patronage and Corruption**

In Iraq where politics is fragmented, rule of law is weak, and oil rents dominate the economy, political competition has become less about adopting best policies, but more about achieving the greatest access to wealth and state resources. Thanks to nationalization of the petroleum sector, the Baathist government became the main and only recipient of oil rents (see the following section). And since only through the government can Iraq's oil wealth be accessed, political parties, factions and militias after 2003 have been vying for a slice of the government pie. Although loyalty to people's sectarian or ethnic identities matter, this research argues that creating dependencies through patronage is the effective tool for winning voter support in Iraq. By accessing government offices and wealth, political factions can dole out patronage jobs and wealth to win and maintain the support of their followers and sideline or

oppress their opponents. This practice is expected to grow further with political consolidation should the rest of Iraq follow Kurdistan's trajectory. A State Department report on governance in Kurdistan affirmed that "membership in some political parties conferred special privileges and advantages in employment and education" (Department Of State 2012). Absent a meritocratic system, creating patron-client relationships is the dominant modus operandi of political parties in power.

The practice of patronage as a means to wield power and influence is a legacy of the Saddam Hussein regime. Indeed, many of the constraints and challenges highlighted earlier did not emerge in a vacuum. However, the structure of the patronage system has transformed since 2003 – patronage has changed from a national hierarchical structure to local decentralized networks. Corruption has become the most convenient mechanism through which to reach the state's deep pockets. Furthermore, unlike Saddam Hussein, no single party since 2003 has been able to practice Saddam's level of oppression and brutality at the national level to succumb opponents to submission. Despite some use of the security apparatus by al-Maliki and the Kurdish peshmarga to quell opponents, cooptation has been more feasible and effective than coercion in post-Saddam

Iraq as a means of wielding power.<sup>17</sup> Even ISIS, which violently crushed all opposition, has to deal with rising resentment of the population they rule from lack of services and jobs.<sup>18</sup> The initial positive reception by some Sunni-dominated towns, who saw ISIS as a savior from a sectarian Shia government, may wane.<sup>19</sup>

The mission of politics and policy in Iraq, therefore, becomes to maintain these patronage linkages, be it through legal/formal or illegal/informal means. In other words, if power is the goal, then building patronage networks is the mission. Access to state resources is the means through which to nurture the

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<sup>17</sup> This chapter is being written in October 2014 where the Islamic State of Iraq and Sham (ISIS) has recently captured large swaths of Iraqi territory. ISIS has the support of some of the Sunni Iraqi minority population, who voice grievances of violence and their marginalization by Iraqi Prime Minister Nouri Al-Maliki. According to Ali Khedery, a U.S. diplomat who worked closely with Mr. Al-Maliki, the Sunni revolt against the central Iraqi government stems mainly from Al-Maliki's attempts at ruling Iraq through a one-man, one-party (Khedery 2014). Al-Maliki has used state institutions, such as the police and the judiciary, to go after his political opponents, such as the arrest warrants for former Vice President Tariq Al-Hashemi and Finance Minister Rafi Al-Isawi, both prominent Sunni leaders.

<sup>18</sup> Such domestic pressure for more revenues may also explain the rationale behind ISIS march toward Iraqi Kurdistan in September 2014, which surprised the Kurdish government and many observers. ISIS's acceptance by the Sunni population hinged on its anti-Shia rhetoric and promised march toward Baghdad. Yet ISIS's need to capture more oilfields given its increased need for cash could explain its the military shift toward Kurdistan.

<sup>19</sup> Some reports have emerged about some popular resistance against ISIS in Mosul. The longer ISIS holds on to cities and towns, the more the need to provide for the people. For example, see (Hawramy and Moslawi 2014) Hawramy and Moslawi, "Iraqis Living under Isis Rule in Mosul Begin to Show Resistance." *The Guardian*, August 1, 2014.

networks of patronage. Corruption, crime and weak governance facilitate and exacerbate this enterprise.

### **Saddam Hussein and his Baath Party's: Rule through Cooptation, Coercion and Corruption**

Iraq under the Baath Party (1968-2003)<sup>20</sup>, and especially during Saddam Hussein's reign (1979 – 2003), was ruled through an authoritarian, militarized, single-party political system. As mentioned earlier, revenue windfalls made possible by nationalization of the oil sector financed Iraq's welfare economic system. The regime could afford to subsidize much of the economy, including food, fuel, education and healthcare. The public sector attracted college graduates and offered them secure jobs, high salaries and handsome pensions. Although socialism was one of the mottos of the Baath regime,<sup>21</sup> a private sector thrived under Baathist rule in Iraq, according to Joseph Sassoon, an Iraqi-born scholar who studied the Baath Party archives made available after the invasion (Sassoon 2011). Sassoon argues that the regime was not totalitarian because it did not control the economy. He also argues that Saddam's economic management was myopic, dealing with pressing and immediate issues rather than long-term strategy. Phebe Marr, a prominent historian of Iraq, pointed out that the economy brought about a "stratum of nouveaux riches – mainly contractors,

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<sup>20</sup> The Baath Party first came to power in 1963 but was ousted in a coup. It came back to power in 1968.

<sup>21</sup> Baath Party mottos were unity, liberty and socialism. The full name of the Baath Party is The Arab Socialist Baath Party.

entrepreneurs, and other intermediaries — [who] flourished in a new semiprivate sector that fed off government distribution of wealth” (2003, 164). A number of this new wealthy class related to or had family ties with leading Baathist figures or state officials. This new class was reminiscent of the *Nomenklatura* under the Soviet Union rule — a privileged class who gained power and wealth through government positions and access to exclusive economic opportunities.

Despite the emergence of Iraq’s semiprivate sector, the public sector grew faster and larger. In the 1960s, about 12 to 15 percent of the population were in service provision sectors. By the 1970s, almost a third of the labor force was in the service provision sectors dominated by the government. This trend continued into the 1980s, by which time oil-funded prosperity quickly created “a consumer society dependent on government salaries” (Marr 2003, 164). This legacy of bloated government bureaucracy still lingers and has gone to extremes since 2003. The sanctions during the decade preceding the invasion and subsequent insurgency and civil war impaired the private sector. Hence the legacy of the ruling party able to exploit both the private and the public sectors to maintain a grip on power and wealth.

Thanks to oil nationalization, exclusive access to massive petroleum revenues allowed the Baath Party to co-opt much of the society through opportunities in the private or the public sectors, and to coerce any opposition into submission through a well-funded security apparatus. Sassoon (2011) details



the Baathist reward and punishment schemes. The Baath Party built a system that created incentives for both members and non-members of the Party to support the regime. Tens of thousands of Iraqis received medals, certificates and badges from the regime that designated different status and privileges. Most coveted among these honors and rewards was the “Identity Card of the Friends of Mr. President Leader Saddam Hussein, May God Protect him.” The front of the card displayed personal details of the cardholder. The back had a list of *imtiyazat* (privileges) enjoyed by the cardholder, that included perks such as extra exam grades for the member’s children, acceptance of family members into universities, priority services in the government bureaucracy, and an annual gift of two summer suits and two winter suits presented by the office of the president.<sup>22</sup>

Parallel to those carrots were the sticks – Saddam Hussein’s multiple oppressive security forces and networks of informants. Hussein militarized the Iraqi society during the Iran-Iraq war (1980-1988), and furnished the regime with multi-layered security agencies that ensured the survival of the regime. The lessons that Hussein learned from the numerous coups that peppered Iraq in the 1960s and 1970s included controlling the security apparatus, infiltrating the military and possessing economic wherewithal (Sassoon 2011). He had the

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<sup>22</sup> On a similar vein, a satirical Kurdish TV program in the mid-1990s advised its viewers that in order for their garbage to be collected and for water and power to cut off less often, each neighborhood should ensure that a *masool* (high ranking government official) lives among them, even if by offering him a house.

parallel security and intelligence agencies spy on, and compete with, each other in order for him to maintain control and undercut any conspiracies. When economic sanctions were imposed on Iraq after its invasion of Kuwait in 1990, and against the backdrop of U.S. threats of regime change, Saddam Hussein feared the infiltration of the impoverished army. Therefore, in 1995 he created yet another security layer, the *Fedayeen Saddam* (Saddam's Men of Sacrifice). Meant to crush any potential uprising within the military ranks or the streets, this new paramilitary consisted of Saddam loyalists and reported directly to him (Otterman 2003).

The economic sanctions allowed Saddam Hussein to further centralize the government structure and extend his grip over power and more aspects of people's lives. Saddam Hussein, who was already president and commander-in-chief of the Iraqi military, also appointed himself as prime minister after the first Gulf War. He put in place a food rationing system to deal with food shortages, which in turn weakened the society by increasing people's dependence on him.

Iraq already had a centrally managed economy, but the sanctions allowed the regime to maximize government regulations and further intimidate dissidence. As a gesture of control, Saddam murdered many Iraqi merchants and businessmen in the early 1990s after accusing them of hiking food prices. He also

regulated food and medicine consumption.<sup>23</sup> The Iraqi regime turned resisting the sanctions into a sensational national campaign.

In 1995, the UN Security Council eased the sanctions and allowed Iraq to export some oil to purchase food and medicine, known as the Oil-for-Food Program. This Program armed Saddam with another layer of control: people's food and medicine, which the regime had already rationed. Contrary to the goals of the sanctions, the sanctions regime weakened the public vis-à-vis Saddam and increased their dependence on the regime. Saddam used this added layer of control to nurture his patronage network and starve opponents (Graham-Brown 2000). Even in the Kurdish semi-autonomous region where a level of political competition existed, political parties in control of the government would lure or threaten voters using food rations in order to solicit their votes.<sup>24</sup>

Moreover, the Baath regime was increasingly shrinking into representing the Saddam Hussein family and his Tikriti clan.<sup>25</sup> The Baath Party rule was being replaced by a cult of personality. The "regime bankrupted the country through massive embezzlement of public funds for personal palaces and other

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<sup>23</sup> Few anecdotal examples of this era: the government set a maximum weight to mass ratio control, as conditions for promotions – those overweight will skip promotions. In another case, a television commercial instructed Iraqis to drink only one cup of tea a day. At one point, all sugar products (candy, juices, etc.) were banned from the markets to alleviate sugar shortages.

<sup>24</sup> I was a poll watcher in student and municipal elections during 1998-2001 elections, and became closely aware of such election violations and irregularities.

<sup>25</sup> Tikrit is the birthplace of Saddam Hussein. It lies on the Tigris River in the center of Iraq.

conspicuous and wasteful consumption at the expense of the average citizen” (Iraqi Minister of Planning 2005). Saddam’s sons, Uday and Qusay were rising political figures who controlled Iraq’s security and intelligence forces. Mimicking the Tikriti regional accent would expedite passage through checkpoints and cut red tape.

### **Sanction Busting and Oil Smuggling: United Nations’ Oil-for-Food Program**

When he could not govern through state institutions, Saddam Hussein defaulted to corruption and to nurturing patronage networks for survival. Saddam created an intricate oil smuggling network, which exported large amounts of Iraqi crude oil outside the Oil-for-Food Program, whose revenues went directly to the family’s coffers (Volcker, Goldstone, and Pieth 2005). In fact, Saddam’s eldest son, Uday, headed the oil smuggling enterprise. Buyers of Iraq’s illicit oil sales, and often assistants to the smuggling operations, were none other than its neighbors, namely Syria,<sup>26</sup> Jordan, Turkey and Iran (Wahab 2006). The US Government Accountability Office (GAO) estimated that from 1997-2002, the Baath Regime “acquired \$10.1 billion in illegal revenues, including \$5.7 billion in oil smuggled out of Iraq and \$4.4 billion through surcharges on oil sales and

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<sup>26</sup> In a sin of old foes becoming new friends, Syria, which supported Iran during the Iran Iraq war, had shut down an oil pipeline to Iraq in 1982. In 2001, Syria reactivated the dormant pipeline and became a major customer for illicit Iraqi oil (Arraf 2001).

illicit commissions from suppliers exporting goods to Iraq through the Oil for Food program” (Christoff 2004, 4).

Due to sanctions, Saddam Hussein could not afford to maintain the welfare state and the public control it bought him. By 2003, Iraq’s Baath Party may have lost about 70% of its membership, hence weakening one of the regime’s instruments of power (Sassoon 2011). No longer able to co-opt, he defaulted to repression, using the revenues he generated to lavish and maintain the loyalty of the multiple security and intelligence agencies that ensured regime survival. The public sector was neglected, as was the regular army, which had been the source of coups in the past. Saddam Hussein also reverted to tribal networks to maintain support to his rule, granting their leaders more autonomy to generate revenues in return for keeping their followers in check.

Defections soon hit the house of Saddam. Saddam’s sons Uday and Qusay emerged as strong political players, rivaling others in the system, such as their cousin and brother-in-law Hussein Kamil, who controlled Saddam’s weapons of mass destruction program. Qusay was seen as heir apparent to Saddam Hussein after his elder brother was crippled in a botched assassination attempt. Kamil defected the regime in 1995 and fled to Jordan, revealing many of Iraq’s military industry secrets. These defections resulted from struggles within the ruling family for power and patronage, rather than opposition to the regime, as Marr (2003) argues. Hussein Kamil, and his brother Saddam, who were married to two

of Saddam Hussein's daughters, returned to Iraq and were killed in 1996. Slowly, however, the Baath regime's grip over the government, the economy and the Iraqi society was loosening. Geographically, it no longer controlled the three northern provinces that today constitute the Kurdistan region. The sanctions crippled the economy through hyperinflation, currency devaluation and rising unemployment (Alnasrawi 2001a). Due to the sanctions, GDP per capita, which had peaked at \$4,219 in 1979, dropped to \$343 by 1996<sup>27</sup> (Sassoon 2012). The sanctions also exacerbated people's dependence on the regime, and weakened the state's law enforcement and service institutions. Furthermore, the embargo seriously limited the regime's financial resources, incentivizing it to invest in security institutions that protected the regime, such as intelligence and the *Fedayeen Saddam*. It also neglected service sectors, and many functions of the police were given to local tribes (Baram 1997). Corruption and criminality on many levels of the society and government surged while the regime suppressed any political organization and revolt against it. Meanwhile, the population suffered from hunger and lack of healthcare that resulted in an estimated death

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<sup>27</sup> GDP per capita (in current U.S. Dollars) dropped from \$2,963 in 1979 to \$455 in 1997. By way of comparison, GDP per capita of Saudi Arabia moved from \$12,121 to \$8,674, and Turkey's from \$2,072 to \$4,361 in the same period. (World Bank data analyzed through Index Mundi at <http://www.indexmundi.com/facts/indicators/NY.GDP.PCAP.CD/compare?country=sa#country=iq:sa:tr>).

of half a million children.<sup>28</sup> Through its monopoly of the media and news outlets, the regime ran an anti-Western campaign to diffuse public anger and resentment.

In effect, decades of absolute one-party rule followed by the years under sanctions created a breeding ground for corruption and criminality.<sup>29</sup> Unlike other oil monarchs in the region, Saddam Hussein and the Baath Party had sought to create a socialist, militarized modern petrostate. Neighboring oil-rich sheikhs and kings dispensed state revenues and jobs through tribal networks, encouraging their subjects to think in tribal terms and maintain the upward chain of loyalties from the bottom up (Gause 1994). Saddam Hussein resisted this common regional practice, favoring instead to co-opt, if not outright control, tribal and religious networks and structures under the banner of secular, pan-Arab nationalist Baath Party. The regime wanted loyalty to the Baath Party to transcend and supersede tribal and sectarian loyalties. Akin to the Soviet system of *Nomenklatura*, the regime formed layers and networks of loyalty with different authorities and privileges. However, he reverted to tribalism and religiosity after socialism and Arab nationalism faltered in 1991 and oil stopped flowing (Baram

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<sup>28</sup> United Nations Children Fund (UNICEF)--Results of the 1999 Iraq Child and Maternal Mortality Surveys.

<http://fas.org/news/iraq/1999/08/990812-unicef.htm>

<sup>29</sup> For a discussion of the link between single party rule and corruption, see Shelley (2005a).

1997; Marr 2003, 234–5). A “Faith Campaign”<sup>30</sup> and an alliance with Islamic groups in the region (Baram 2011) helped the regime channel public anger at the West and dampen the public rage at the woes resulting from the regime’s adventures in Iran and Kuwait. Tribes who were neutral during the 1991 uprising against the regime, mainly Sunnis, were given more autonomy vis-à-vis the local security and economy. This contributed to the flourishing of criminality and black markets for scarce goods. Fissures and fractures in the Iraqi society, which became apparent after the 2003 invasion, were in the making during the sanctions years.

Corruption was instrumental to Saddam Hussein’s ability to maintain power. The Baath regime, and in parallel the Iraqi state, was structured hierarchically, with Saddam Hussein at the top. By the end of 2002, the Baath Party had 4 million members (16.5% of the population, exceeding the common communist parties’ less than 10% rate).<sup>31</sup> Despite these staggering numbers, only the top three levels in the party were effectively involved in the execution of Party and government policies (Sassoon 2011).<sup>32</sup> Such a structure was necessary

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<sup>30</sup> Saddam’s Faith Campaign included building mosques and requiring party and military leaders to memorize chapters of the Quran. Saddam Hussein also had a copy of the Quran inscribed using his own blood as ink. Slackman (2001), “Hussein Putting His Mark on Islamic Faith,” Los Angeles Times.

<sup>31</sup> Membership of the Communist Party in the Soviet Union was made artificially scarce. See Bueno de Mesquita, et al (2003, 53).

<sup>32</sup> Sassoon’s (2011) statistics demonstrates that the upper echelons of the Baath party represented only 14.5 % of the total Party affiliates, 2.4% of the overall population. Hence, a very hierarchical party structure.



to maintain Saddam's grip on power. For example, by controlling corruption from the top (Gunter 2013), he became the sole authority able to dole out favors and patronage.

Loyalty to Saddam mattered above ethnic or religious loyalties. Indeed, Kurds, Shias, Sunnis, and Christians loyal to Saddam were all part of the Baath Party and took part in its operations and intelligence apparatuses. As Gunter (2013) argues, compared to the last decade, corruption under Saddam Hussein was both centralized and "honest," strategically serving the interests of the regime. That is, the family and upper echelons of the Baath Party reaped most of the proceeds of corruption, whereas post-Saddam corruption is more "democratic" in which spoils are more widely distributed. Also, corruption under Saddam was "honest" in the sense that results were predictable, whereas post-Saddam corruption is more "entrepreneurial," competitive and unpredictable. The Kurdistan region is comparatively stable partly because of its inclusive politics, where the two ruling parties have been willing to share some power as well as government spoils with the opposition parties.<sup>33</sup> According to Iraqi academic Kanan Makiya, "Iraq transformed from a classic totalitarian state

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<sup>33</sup> Following Kurdistan regional elections in October 2013, the 8th Kurdish government cabinet was sworn in May 2014. The new cabinet is a coalition government includes all political parties with more than one seat in parliament. The previous cabinet, comprising of the two main parties, received harsh criticism from the opposition groups and their media outlets, but observers argue that the two main ruling parties seek to quiet the opposition by including them in the government. Moreover, political parties in Kurdistan are recipients of public funds, as will be discussed in Chapter 6.

to a criminal state” after the first Gulf War of 1991, where “Profiteering, black market trafficking, and sanctions-busting became the principal activity of the Iraqi elite” (*Middle East Quarterly* 2005).

Rather than being replaced or reformed, Saddam and his Baath Party’s legacy survived after 2003. However, the structure and process of that legacy have evolved and fragmented. Post-Saddam Iraqi political parties and factions seem to have picked up where the former regime left off. Corruption for Saddam was a tool of power. Since his ouster, however, corruption has consisted mostly of pillaging public resources for self- and party-enrichment. With consolidation of power, mainly locally, corruption is greasing the wheels of patronage networks and media outlets that are new tools of power in Iraq. In essence, ISIS is not behaving any differently, financing itself through oil smuggling and maintaining power through alliances with local powers.

### **Power, Patronage and Corruption in post-Saddam Iraq**

The U.S.-led invasion of Iraq in 2003 and the political environment that emerged were not conducive to good governance. Compared to the swift military success, the civilian effort to build an inclusive political system and accountable institutions was stymied by ignorance and lack of planning on the U.S. side (Diamond 2005). Corruption in post-Saddam Iraq has been the bane of subsequent governments and a major barrier facing the country’s economic

development and democratic transition. Weak rule of law and accountability, competition over discretionary access to oil rents, and political and administrative fragmentation have resulted in an unhealthy breeding ground for corrupt practices and criminality. The end of the Baath regime also put an end to an already weakened central command of the economy and society. Still a means to wield power and wealth, corruption has become decentralized and competitive. The effective formula to political survival in post-Saddam Iraq seems to be the embezzlement of state assets to nurture patronage networks. When comparing pre- and post-Saddam Iraq governance, informants for this research relayed what could be summarized as: the system used to be corrupt, but now corruption is the system.<sup>34</sup>

Iraq suffers from the many faces of corruption, in both of its public and the private sectors. As a report by Transparency International pointed out, “massive embezzlement, procurement scams, money laundering, oil smuggling and widespread bureaucratic bribery have led the country to the bottom of international corruption rankings, fuelled political violence and hampered effective state building and service delivery” (Agato 2013). Indeed petty corruption and low-level bribery remain common. Bureaucrats use bribery to hedge against the inflation and sharp economic boom and bust cycles expected in

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<sup>34</sup> In the numerous interviews and discussions held in Iraq for this research, corruption is often used to describe anything that is wrong with the government and administration. Therefore, often ‘corruption’ is used to mean and describe and explain inefficiency and mismanagement in the government and the market.

petrostates. To ultimately explain the nexus between corruption and political transition in petrostates, the following sections offer a synopsis of corruption in Iraq and how they affect the policy environment. The subsequent chapters delve into the governance of the energy sector and its major actors, and how patronage politics and corruption contribute to Iraq's resource curse.

### **Iraq's Corruption-Prone Environment**

As discussed above, corruption is a lingering legacy from the Saddam Hussein era that post-invasion Iraq governments inherited. Due to decades of wars and sanctions under Saddam's tyrannical rule, followed by the chaos and disintegration of state institutions that resulted in the aftermath of the U.S. invasion, Iraq has become one of the most corrupt countries in the world. That is, Iraq has the misfortune of suffering from corruption without the necessary means of curbing it. Today, corruption has infested the Iraqi government institutions, society, political parties, and the country's nascent market. Iraqis are familiar, through personal experience or the media coverage, of ubiquitous corrupt practices such as bribery, extortion, nepotism, fraud, and embezzlement. Like in many developing countries, corruption undermines the country's economic and social capital development, and weakens state institutions. Unlike many countries, however, corruption in Iraq is also a matter of national security,

because it exacerbates instability.<sup>35</sup> Hence, corruption in Iraq was often referred to “the second insurgency” (Special Inspector General for Iraq Reconstruction 2009; Borger and Pallister 2006). Indeed, corruption contributed to the military success of the latest episode of insurgency in Iraq by ISIS, which rapidly dominated large territories in Iraq. ISIS did not face much resistance from the Iraqi army, nor a population who had little incentive to see a sectarian and distrusted army defeated.

Iraq continues to rank low on indices that measure quality of governance. Transparency International’s Corruption Perceptions Index – in 2013, Iraq ranked 171 out of 177. On the World Bank’s Control of Corruption index, Iraq scored -1.3 in 2010. Overall, Iraq has fared poorly on the World Bank’s Governance Indicators, which indicate the country’s significantly high vulnerability to corruption (See Table 1). Finally, Iraq scored zero on a scale of 0-100 on International Budget Partnership’s Open Budget Index for 2010, meaning there is “scant or no information” on budget (*Open Budget Index-Iraq* 2010).<sup>36</sup> The index assesses the availability of key budget documents, the comprehensiveness of financial data and the effectiveness of oversight.

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<sup>35</sup> The nexus between corruption and national and international security is a relatively new aspect in the study of corruption and its impacts. For recent works, see Shelley's (2014) and Chayes (2014).

<sup>36</sup> See Iraq’s country profile at <http://www.transparency.org/country#IRQ>

**Table 1: World-Wide Governance Indicators for Iraq (2002-2012)**

Indicator	Country	Year	Governance			Standard Error
			Number of Sources	Score (-2.5 to +2.5)	Percentile Rank (0 to 100)	
<b>Voice and Accountability</b>	Iraq	2002	7	-2.04	0.48	0.18
		2007	8	-1.23	12.50	0.14
		2012	12	-1.13	16.11	0.13
<b>Political Stability and Absence of Violence/Terrorism</b>	Iraq	2002	4	-1.65	8.17	0.31
		2007	5	-2.79	0.48	0.27
		2012	6	-1.93	4.74	0.24
<b>Government Effectiveness</b>	Iraq	2002	4	-1.88	0.98	0.20
		2007	4	-1.59	2.91	0.25
		2012	8	-1.11	13.40	0.21
<b>Regulatory Quality</b>	Iraq	2002	4	-1.99	0.98	0.24
		2007	4	-1.32	7.28	0.24
		2012	7	-1.27	9.57	0.21
<b>Rule of Law</b>	Iraq	2002	5	-1.47	4.78	0.21
		2007	5	-1.92	0.96	0.22
		2012	10	-1.50	2.84	0.16
<b>Control of Corruption</b>	Iraq	2002	3	-1.30	1.95	0.20
		2007	4	-1.58	1.46	0.24
		2012	9	-1.23	8.13	0.17

(Source: Kaufmann, Kraay, and Mastruzzi 2010, Updated for 2012. The scale ranges from -2.5 to 2.5, where higher values correspond to better governance outcomes.)

The bureaucracy and state institutions also remain largely inefficient and prone to corruption. This has reduced confidence in Iraq's nascent market and its promise for an active local and foreign private sector. On the World Bank's Ease of Doing Business index for 2014, Iraq was ranked low, 151 out of 189 economies.<sup>37</sup> On the Failed States Index, Iraq is ranked at 11 (out of 178), only

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<sup>37</sup> With Singapore ranking first in ease of doing business and Chad being last. The Index is a composite that measures 10 criteria, such as the ease of starting a business, registering property, paying taxes, and enforcing contracts. Full ranking can be viewed at <http://www.doingbusiness.org/rankings>

better than countries like Afghanistan and Zimbabwe.<sup>38</sup> Finally, on Legatum Institute's Prosperity Index that measures not only income but wellbeing as well, Iraq was ranked 130<sup>th</sup> out of 142 countries indexed in 2013.<sup>39</sup> Hence, Iraq's oil wealth must be serving purposes other than economic development or stability.

Moreover, corruption in Iraq's public sector is most harmful because it opens the doors for illicit access to the largest cash vault in the country – the oil-rich government. As mentioned before, the government represents half of GDP, but takes more than 90% of oil revenues. This turns the government into an attractive “cash cow” for political parties, patronage networks, militias and crime groups. Government coffers are often reached through legal but inefficient means such as mass employment, procurement and contracting. However, corruption is the main channel that political parties, militias and crime networks, terrorist groups such as ISIS, illegally tap into public funds, through money laundering, embezzlement and outright theft (See chapter 6).

Since 2003, electoral competition has maintained and buttressed Saddam-era structures of a bloated public sector. There is no official and reliable data on unemployment rates in Iraq. By some accounts, however, unemployment among

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<sup>38</sup> The 2013 index ranks Somalia as the most prone to failure and Finland as most stable country. The index captures 12 measures of state stability, such as demographic pressures, group grievances, deterioration of public services, and factionalized elites. Public services is measured at 7.6, on a scale of 1 (best) to 10 (worst). Full list of ranking can viewed at <http://ffp.statesindex.org/rankings>.

<sup>39</sup> Full country profile at <http://www.prosperity.com/#!/country/IRQ>

the youth ages 15-24 is at 18%.<sup>40</sup> According to a World Bank household survey in Iraq, about a third of all Iraqi wagedworkers are employed by the government (30.4%). Although overall unemployment rate in Iraq is at 11%, about half of employed adults work in government jobs that carry pensions and social security benefits.<sup>41</sup> This trend is further accentuated in the relatively stable Kurdish region. In 2011, the Kurdistan Regional Government (KRG) has 1.3 million people on its payrolls, absorbing about two thirds of the regional budget.<sup>42</sup> Hiring people en masse into the public bureaucracy is one way oil-dependent governments deal with unemployment. The government payrolls also include “ghost employees,” even “ghost battalions” (Cockburn 2014), bureaucrats or soldiers who either do not exist or do not report to work, and yet their paychecks are collected (see Chapter 6). Such inefficient employment practices are used to nourish patronage systems that have flourished after the introduction of competitive elections.

Despite a legacy of corruption that Iraq inherited from decades of Baathist rule, corruption in post-Saddam Iraq became ubiquitous, diffused and more

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<sup>40</sup> See United National Development Program’s Iraq page, <http://www.iq.undp.org/content/iraq/en/home/countryinfo/>. For a good discussion of disparity of official and unofficial unemployment figures, see (Wing 2013)

<sup>41</sup> Iraq Household Socio-Economic Survey (IHSES) 2007, World Bank.

<sup>42</sup> Data provided by KRG Prime Minister Barham Saleh in a press conference, Awene Newspaper, January 13, 2011. An updated figure is 1.5 million. See Kurdish channel, Rudaw, interview with KRG Finance Minister, on July 21, 2014 at <http://rudaw.net/sorani/business/200720144> (source in Kurdish).



detrimental, partly due to the rise of political parties and frequent elections. After 2003, not only did corruption persist, it also increased in magnitude and the number of actors. There are few forces to control or hold accountable the corrupt, but many to protect them. Political parties in power, by far the main beneficiaries of corruption proceeds, gained access to government assets and offered their members protection. This dynamic created impunity, and encouraged more corruption. In the presence of weak government institutions, and absence of political platforms, politics becomes merely competition over patronage and spoils.

In Iraq, corruption, and the power and access it grants, creates the incumbent's advantage. The last three consecutive prime ministers have come from the Dawa Party, a Shia faction, which came to power after the oil industry was revived. The two Kurdish parties that came to power in 1992 still rule. Elections were prematurely held in the presence of weak and failing state institutions. Policy platforms were to no avail as a means to rally votes and support, especially since the new political class consisted mainly of expatriates who fled the country decades before. In contrast to policy and services, gaining loyalty mattered more. Looking for a foothold in the new Iraq, political parties indulged in identity politics of ethno-sectarianism rather than policy proposals. Intergroup competition is often paralleled by intra-group competition over

access to state revenues and perks.<sup>43</sup> While petty corruption continued in the public bureaucracy, grand corruption thrived, both in terms of the number of players and the magnitude of money siphoned off. In fact, low level bribery has been dropping in Iraq (*U.S. States Department 2013 Country Reports on Human Rights* 2014).

However, ruling through corruption and patronage requires maintaining a delicate balance. In such a system, inclusiveness matters. The U.S. Inspector General for Iraq Reconstruction said in an interview that “corruption and the patronage it allows has become a means of governing” (Van Heuvelen 2012h). Indeed, Mr. Nouri Al-Maliki, Iraq’s prime minister since from 2006 to 2014 has used both patronage and the security apparatus against his rivals. In 2010, he managed to break down a Sunni coalition against him by making side deals with their leaders and offering them government positions. But since 2011 and the full withdrawal of U.S. troops, Mr. Al-Maliki’s patronage building tactics narrowed and became increasingly sectarian. He also started relying more on the military

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<sup>43</sup> A local Iraqi newspaper reported on “auctions for government positions.” On August 11, 2014, Iraq’s prime minister designate was asked to form the new cabinet, and he asked different political factions to offer nominees for different government ministries. Parties compete against each other for these positions. But the competition starts within the parties first: one politician reportedly paid his own party \$70 million in return for nominating him to the electricity portfolio and another paid \$120 million to be the nominee for defense ministry (Al-Ghad Press, August 19, 2014). One cannot but wonder how such sums were generated in the first place, and what returns they expect in return for such investments! These media reports cannot be independently confirmed, but people asked for verification easily believed their plausibility.

and the judiciary to go after his opponents (see Bertelsmann Foundation's Iraq Country Report, 2014). Indeed, his heavy-handed tactics has reunited the Sunni provinces and parties against him, who started mass demonstrations in 2012. Sunni grievances culminated in their support for the ISIS takeover of major Iraqi cities in summer 2014.

Al-Maliki sought to consolidate power by appealing to the Shia base by portraying himself as their protector from a Sunni counterrevolution and Kurdish secession. However, his main tool, the military, was blunted by corruption. While “ghost battalions” could be used to intimidate political opponents,<sup>44</sup> they could not defend cities against ISIS. The reason was an army marred with “corruption, corruption, corruption,” as an Iraqi retired four-star general put it, where the position of a division commander manning a checkpoint cost \$2 million (Cockburn 2014). On the Kurdish front, his government had already lost the Kurdish vote through the economic warfare – Baghdad had cut KRG’s share of the national budget in January 2014, accusing the KRG for failing to share revenues from oil sales. Exacerbated by intra-Shia rivalry and waning Iran support after the ISIS incursion, Al-Maliki lost his bid for a third term as prime minister. Power wielding through patronage building

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<sup>44</sup> In December 2011, the morning after the U.S. troops withdrew from Iraq, Al-Maliki ordered the arrest of Sunni Vice President Tariq Al-Hashemi and other Sunni leaders on terrorism charges. Tanks were positioned in front of their houses. See news reporting on the incident by the Telegraph (Blomfield and McElroy 2011)

seems to have worked more efficiently for Al-Maliki than through a corruption-infested military.

### **Corruption under Foreign Rule: Exacerbating the Saddam Legacy**

Founding effective and clean state institutions and governance practices

were not a priority for Iraq's new foreign rulers in 2003. Upon the U.S. and UK invasion of Iraq, the Coalition Provisional Authority (CPA) was created to govern occupied Iraq. Led by Ambassador L. Paul Bremer, the CPA administered Iraq from April 2003 to June 2004. The CPA rule, which focused on reconstruction and economic development, was marred with mismanagement and lack of oversight. Audits of CPA's performance indicate the presence of waste, corruption, fraud, and favoritism.<sup>45</sup> The U.N. Oil-for-Food program was very much criticized by the Bush administration for the corruption it was infested with. However, the magnitude of waste and corruption during the 14-month long reign of the CPA exceeded that of the U.N. program that spanned over 6 years. For example, Saddam Hussein managed to secure about \$10 billion in illicit funds out of the Oil-for-Food program between 1997-2002, and the most high profile bribery case involved \$150,000 (Volcker, Goldstone, and Pieth 2005; *U.S. GAO - UN Oil for Food Program...Lessons* 2006).<sup>46</sup> However, within a year of

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<sup>45</sup> Examples of audits and reports on CPA performance include (Special Inspector General for Iraq Reconstruction 2009; Global Policy Forum 2007; "Securing, Stabilizing, and Rebuilding Iraq: Key Issues for Congressional Oversight" 2014).

<sup>46</sup> For more on Oil for food program investigations, see dedicated Wikipedia page [http://en.wikipedia.org/wiki/Oil-for-Food\\_Programme](http://en.wikipedia.org/wiki/Oil-for-Food_Programme)

CPA rule in Iraq, \$8.8 billion went missing (Special Inspector General for Iraq Reconstruction 2009, 155). In one case, U.S. Inspector General for Iraq Reconstruction (SIGIR) tracked \$1.2 to \$1.6 billion that had been stolen in Iraq, possibly by Iraqis, and moved into a safe house in Lebanon (Risen 2014). In another, a CPA comptroller stole \$2 million and took \$1 million in bribes and \$683,000 in gifts (Global Policy Forum 2007).

The CPA lacked meaningful anti-corruption checks and balances. “The CPA appeared to be averse to oversight” of the Development Fund for Iraq (DFI)<sup>47</sup>, which was an Iraqi account at the U.S. Federal Reserve Bank in New York (Special Inspector General for Iraq Reconstruction 2009, 155). Even when SIGIR was tipped off about the billions found in Lebanon, the U.S. government was not enthusiastic about investigating the lead and recovering the stolen monies (Risen 2014). The CPA justified the missing billions of dollars of Iraqi money to the difficult environment of post-invasion Iraq. However, chaotic circumstances of a war zone requires more stringent oversight measures, not less, as the Inspector General maintained. In fact, the CPA started auditing its use of Iraqi funds by contracting an accounting firm on April 5, 2004 – almost a year

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<sup>47</sup> The Development Fund for Iraq (DFI) account contained revenues from sales of Iraqi oil under the oil-for-food program as well as frozen and seized assets of the former regime. The CPA administered spending this money in development projects and running the country.

after DFI's inception and less than three months before the CPA's mandate expired (Global Policy Forum).

Another reason for waste and lack of oversight was that the CPA mostly spent Iraqi, not U.S., funds. The Development Fund for Iraq (DFI) collected \$20.6 billion in revenues. The U.S. had committed \$18.4 billion of U.S. pledges to Iraq reconstruction. However, "the CPA spent DFI monies almost exclusively, since Iraqi monies were not subject to Congressionally-mandated rules for open bidding, nor covered by criminal liability under U.S. or Iraqi law" (Global Policy Forum 2007). When the CPA left, Iraq was bankrupt. Out of the \$20.6 billion Fund, the CPA left only \$2.9 billion for the respective Iraqi interim government. In the same period, it only spent \$300 million of U.S.-appropriated funds. Ironically, American and British contractors pocketed much of Iraqi monies – of the contracts awarded with DFI monies in 2003, 74% went to American firms, 11% went to British firms, and only 2% went to Iraqi firms. About 60% of contracts went to Halliburton alone, mostly under no-bid contracts, according to a report by the Global Policy Forum (2007).

What made oversight ever more challenging was CPA's cash economy. Iraq under Saddam Hussein and to date remains largely a cash economy. Cash outlays were inevitable practices of the early days of the invasion, but persisted until the last day of CPA. Between May 2003 and June 2004, nearly \$12 billion in U.S. currency was flown to Iraq. About \$5 billion of these funds were flown into

Iraq in the final six weeks before the handover of DFI to the Iraqi government on June 28, 2004. One shipment included the withdrawal of \$2.4 billion – the largest disbursement of cash in the Federal bank’s history (*Rebuilding Iraq : U.S. Mismanagement of Iraqi Funds* 2005). The Kurdish government received \$1.4 billion few days before the handover of sovereignty. A Kurdish leader said that the Kurds were owed \$4 billion, but Bremer “had spent part of the \$4 billion, and he had to [send the cash] to keep [the Kurdish leaders’] mouths shut about it” (Paddock and Miller 2005). Once in the Iraqi system, controls were weak. Yet, the controls over the transfer of these whopping sums to the Iraqis were also “inadequate” according to Stewart Bowen, the U.S. special inspector general (Risen 2014).

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Saddam Hussein’s late legacy of patronage and corruption followed by the CPA’s mismanagement of the country created the worst of precedents for Iraq’s new rulers. The size and scale of post-invasion corruption, therefore, should not be surprising. The past decade since Saddam’s ouster, Iraq has not been successful at reforming the structures of authoritarian rule. Violence and cooptation remain the main tools of power, thanks to the flow of oil, high oil prices and Iraq’s ability to buy weapons. However, unlike Saddam Hussein, no party, sect or ethnic group has the monopoly over the country’s wealth and means of violence. Therefore, ethnosectarian fissures and violence have impeded

the country's political and economic progress despite numerous elections, some democratic institutions and ample flow of cash. Against the backdrop portrayed above, one can see that since Saddam's ouster the structure of corruption and patronage wielding has evolved and decentralized, the practice spread, and the harms exacerbated. Subsequent chapters will discuss grand corruption in government and the private sector, money laundering and the situation in the Kurdistan region.

### **Summary of the Next Chapters**

The following chapters will elaborate on and discuss the complex context and issues surrounding Iraq's petroleum policy and the country's transition since 2003, introduced in this introductory chapter. Chapter 2 will review the pertinent literature mainly from the social sciences. In particular, the review will highlight the body of knowledge pertaining to transition to democracy, corruption and transnational crime, social networks, and the resource curse. Chapter 3 outlines the research design. The case study research method is discussed as the best fit to undertake this research. The chapter states the research questions, hypotheses and data collection methods.

Chapter 4 discusses the formal and legal policy framework for Iraq's petroleum sector, describing the laws, pronouncements and official views. It also focuses on oil federalism (or *petrofederalism*), which is the grand shift in Iraq's



post-Saddam petroleum policy. Chapter 5 matches politics to the policy surrounding the management of oil and gas. It also identifies, describes and analyzes the roles and influences of the main actors in the petroleum policy – the federal government, the Kurdish government, international oil companies, ISIS, and regional powers.

Chapter 6 looks at how oil wealth greases the patronage networks and exacerbates resource curse. It analyzes how oil is central to Iraq's trajectories in its transition toward democracy, failure or fracture. It demonstrates how the country suffers from a unique kind of resource curse where oil and patronage exacerbate instability. It also details how the mismanagement of oil wealth ended up feeding the insatiable, corrupt and inefficient government bureaucracy and the interests behind them, resulting in economic stagnation and state fracture. It also demonstrates how the subnational government of Kurdistan developed resource curse. The concluding chapters summarize the main findings and contributions to the literature.

## **CHAPTER 2: REVIEW OF THE LITERATURE**

Given its broad and multivariable nature, this policy-oriented study requires a diverse academic framework that includes political science, history, economics, sociology, anthropology, and area studies. The topic of the study is policymaking and accountability in Iraq's energy sector. Iraq provides a case of a petroleum-dependent transitioning country.

This chapter will briefly review four pertinent bodies of literature that inform this study and its focus. The first section will place the case study within the economic and political transition literature. The following section reviews a body of literature on corruption, with a specific focus on governance and policy in conflict-ridden and authoritarian countries. In the third section, patronage networks will be highlighted. The final section addresses the resource curse thesis, and the political, socio-economic and stability challenges associated with dependence on natural resource. The chapter concludes with the contributions that this dissertation seeks to make to the literature.

### **Countries in Transition**

Since this study is looking at policymaking in Iraq's petroleum sector, it is

necessary to first situate the three fields of study – patronage networks, corruption and resource curse – in the context of countries undergoing political and economic transition. These themes, among others, have come together in Iraq, and continue to influence the country's political and economic trajectory.

Much of the literature on democratic transition seeks to decipher the various factors that put a country on the path toward democracy. Of importance to this study is the role of economic development in promoting democratic behavior. Modernization theory posits that economic development is a *prerequisite* to democratization (Lipset 1959; Lerner 1958; O'Donnell, Schmitter, and Whitehead 1986; Epstein et al. 2006). Others argue that economic development may be correlated with democracy, but falls short of being a causal factor (Putnam, Leonardi, and Nanetti 1994; Przeworski et al. 2000; Robinson 2006). Furthermore, a government could learn to shield its polity from the democratizing effects of economic growth. Such an effect could happen by banning what Bueno de Mesquita and Downs (2000) call “coordination goods,” such as the ability to organize and to access information.

That the Arab Middle East has eluded the *waves* of democracy has puzzled scholars and stirred different responses (Huntington 1993; J. Goldstone 2011). The presence of vast petroleum resources in the Middle East has been a key variable explaining the reform-resistant authoritarian and patrimonial regimes (Ross 2001; Gause 2011). Auty (2012) offers an explanation of economic and

governance failure in the Middle East, arguing that dependence on rents from petroleum exports incentivized ruling elites to prioritize patronage over economic growth. Such an incentive structure, in turn, sustains “patrimonial capitalism” (Schlumberger 2006) and ossifies autocratic but brittle governance. Yet, this literature is slim on describing and explaining the trajectory of transitions once they are underway, especially the transition of oil-rich countries like post-invasion Iraq and of post-Arab Spring Libya. Indeed, Goldstone (2013) cautions against much optimism about the Arab Spring, pointing out that the trajectory of these revolutions is going to be tortuous and prone to reverses.

However, a richer body of transition literature exists from studies of Eastern Europe and the post-Soviet Union countries, including the mineral- and petroleum-rich countries of the Caspian region. Geography, level of central planning, proximity to capitalist economies, and abundance of natural resource wealth are factors and impacts that Auty (2003; 2001) studied in former Soviet Union countries’ transitions. He concluded, “resource-poor countries are more likely than resource-rich countries to engender a developmental political state” (Auty 2003). Rent seeking in resource-rich countries such as Russia and other Caspian Basin countries of Azerbaijan, Kazakhstan and Turkmenistan impede economic reforms and blunt the efforts to create accountable government institutions (Auty 2004; Hayman and Mayne 2010). Rising oil and gas prices retreated Russia’s chaotic transition to democracy and market economy in favor

of consolidating an increasingly authoritarian regime, led by President Putin, that is holding the country back (McFaul and Stoner-Weiss 2008).<sup>48</sup>

Furthermore, Auty (2001) argues that despite civil strife, resource poor countries have had a stronger transition toward growth economies than their resource rich counterparts. Natural resource even negatively affected Russia's economic transition, despite having a comparatively larger and more industrialized economy ("Russia: The Political Economy of Transition in a Mineral Economy" 2002). A comparative case study of transitions in petroleum-rich Kazakhstan and Turkmenistan concluded that "kleptocratic systems are fundamentally unstable" because of elite rent-seeking, corruption and the purging of any person qualified to challenge the sitting autocrat (Hayman and Mayne 2010, 138).

Although the debate continues over the role of economic growth in democratization, there is general agreement that growth from petroleum revenues curtails democratization. Natural resource rents are negatively associated with democracy (Ross 2006 & 2011). Abundant resource rents tend to reinforce the existing system they pour into (Dauderstädt and Schildberg 2006)

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<sup>48</sup> The authors critique the arguments that authoritarianism has helped the development and stability of the Russian economy. In an interview with the Economist magazine (dated July 15, 2006), opposition party leader Grigory Yavlinsky said, "Boris Yeltsin took mistaken steps in the right direction toward democracy; Putin took correct steps in the wrong direction toward an authoritarian petro state" (in Goldman 2008, 172).

rather than drive it toward democracy. Furthermore, in the absence of strong institutions, accountability, and checks and balances, electoral competition unleashes patronage politics (Lust 2009; Auty 2001) and competition over divvying up public resources. Therefore, even when elections take place, they tend to buttress the notion of “survival of the fittest” (Collier 2007) which is the group that has the greatest access to resource revenues. This hypothesis, however, is not adequately tested. Oil wealth helped the consolidation of existing monarchies and military rulers in the Arab states. Except for the transition of post-Soviet mineral-rich countries, there are only a handful of studies of transition in petroleum and mineral rich countries in the Middle East and Africa. In a few Latin America cases, petroleum rents may have encouraged democratization by discouraging the government from capturing and redistributing the wealth of established elites (Dunning 2008).

Another challenge to democratic transition arises from ethnic, religious and regional differences. Democracy has slimmer chances in divided societies (Horowitz 1993; Diamond 2006), especially when one ethnic group dominates others (Hale 2004). Some have cautioned that competition among exclusivist groups will result in a “fractured hierarchy” and instability (Goldstone and Kocornik-Mina 2005). Transition and state building in the long term may as well depend on the workings of informal practices, such as clan politics (Collins 2006).

Rather than consolidate, many young democracies have gotten stuck

along the way, neither consolidating as democracies nor regressing to autocracies. Many prefixes and qualifiers were introduced to describe these “hybrid regimes,” such as electoral, illiberal or pseudo democracies (Diamond 2002). The linear path suggested by the term “transition” seldom fits country realities (Carothers 2002; Goldstone and Kocornik-Mina 2005). Countries often “bounce” in a cyclical pattern between authoritarian and democratic behaviors (Goldstone and Kocornik-Mina 2005).

Corruption could be most harmful during transition, where old structures can reemerge, and reinforced private actors are able to penetrate or capture the state (Wedel 2003; Karklins 2005; della Porta and Vannucci 1999). Corruption is often the vehicle through which illicit wealth is accumulated and spent on patronage networks that help the ruling groups maintain power despite apparent transition. Indeed, as will be discussed further below, much of the corruption literature focuses on aid-receiving developing countries and on former communist regimes, although there are calls to rethink corruption in rich countries (Wedel 2012). Amid weak accountability, privatization and political competition – the two major components of transition to democracy and market economy – are also most corruption-prone aspects of these states. Former ruling elites and power clans exploit the dynamics and institutions of transition and compete over state spoils and monopolies. They create or rekindle alliances based on readily available resources, such as ethnic, clan or familial allegiance.

However, such short-term competitions are most damaging to democracy and economic growth since they also deter foreign investment (as in Russia) (M. Johnston 2005) and prioritize patronage over policy (as in post-2003 Iraq) (Billon 2005). Such myopic rivalries also result in vast inequalities, as in the case of privatizing Russia's post-Soviet economy (Wedel 2001, 2003). During state transitions, "the relationship of power to property is no longer one way" (Wedel 2003, 437). Hence, electoral competition encouraged investment in patronage, which, through corruption, can access state resources to fund such investments. Hence, corruption and patronage building could in fact increase during transition and take on new and more complex forms (see della Porta and Vannucci 1999). The next two sections will further highlight the existing literature on corruption and patronage networks.

## **Corruption**

Corruption harms states, government institutions, societies, and markets. Corrupt acts are diverse, including bribery, extortion, nepotism, fraud, and embezzlement. Although the private sector is increasingly a player, corruption has generally been attributed to governments and public officials, and defined as the "misuse of public power for private gain" (Heidenheimer 2002) or the "abuse of public office for private gain" (World Bank 1997, 8).

Confining corruption to public office fails to capture the complexity of its



impacts. Corruption undermines efficiency and trust in society, and distorts policy priorities. Hence, its harms can “ripple through an entire economy or political system” (Johnston 2005, 24), not only in developing countries, but in advanced economies as well (Wedel 2009a; Wedel 2014). Moreover, corruption extends beyond public office. Elite networks can wear multiple hats and span corporations, universities, high government office, and think tanks. This enables them to exercise tremendous influence yet elude accountability (Wedel 2009a).

Corruption is not an isolated problem. Therefore, its definition and impact ought to be assessed based on its context (Heidenheimer 2002) and severity (Chayes 2014), especially when state and non-state actors are involved (Shelley 2014). In transitioning countries in particular, pinpointing corruption is a challenge partly because the line between public and private, legal and illegal boundaries is blurred (Wedel 2006; M. Johnston 2005). In the rich countries, Wedel (2014) argues, “elite power brokers” can glide across formerly distinct arenas of economics, politics, academia and grassroots. Furthermore, Shelley (2014) asserts that corruption incubates terrorists and transnational crime groups, who are increasingly hard to tell apart given their similar entrepreneurial financing methods. Therefore, traditional anti-corruption measures that are rooted in accounting and transparency have failed in addressing corruption adequately. Such failures necessitate rethinking the complexity of corruption and its actors (Shelley 2014) and reintegrating ethics into the discussion. To that end,

Wedel (2014; 2012) proposes defining corruption as “violation of public trust.”

### **Categories and Impacts of Corruption**

Researchers have categorized corruption on different grounds. Some adopted a contextual and institutional approach (Heidenheimer and Johnston 2001), a state-based approach (M. Johnston 2005), an economic approach (Rose-Ackerman 1999), a risk-analysis approach (Lambsdorff 2007), or a “state capture” approach (Hellman, Jones, and Kaufmann 2003; Wedel 2003). The bulk of the literature, nonetheless, focuses on corruption as a problem inherent to governments and their personnel, operations and interactions (Klitgaard 1991; Shleifer and Vishny 1993; della Porta and Vannucci 1999).

Another approach to categorizing corruption is according to its effects and impacts. Many have found that corruption negatively affects economic development (Mauro 1995; Rose-Ackerman 1999; Shleifer and Vishny 1993). Corruption also undermines social capital and trust within society and its institutions (Shelley 2005a; Rose-Ackerman 2001). Especially since the 9/11 attacks, corruption has come under the spotlight as contributing to violence and terrorism (Naim 2005; Shelley 2005b; Fisman and Miguel 2010). In Iraq, the U.S. Inspector General described corruption and its harms as “the second

insurgency.”<sup>49</sup> In her new book on the “dirty entanglement” of corruption, terrorism and transnational, crime, Shelley (2014) demonstrates the nexus between corruption and state failure and instability. “Corruption,” she writes, “contributes to the emergence and sustenance of both organized crime and terrorism” (16). When state assets are looted and drained, these groups can offer jobs and services, making inroads into the population and channel the anger of the disenchanted youth toward violence and extremism. Chayes (2014) distinguishes between competitive and severe, or acute, corruption. The latter has a high degree of consolidation and coordination at the top, functioning as a system where “ruling networks use selected levers of power to capture specific revenue streams.” For *new* terrorism and transnational crime groups, such systemic, or institutionalized corruption is no longer an “operative tool,” but an environment where they thrive (Shelley 2014, chap. 3). It should come as no surprise, therefore, that in a recent poll of 34 emerging and developing countries, a media of 76% of respondents said that corruption was “a very big problem” in their country, second only to crime (at 83%) (Pew Research Center 2014).

Corruption is particularly harmful to oil-dependent states because corruption is closely associated with patronage and rent seeking. The petroleum industry, in particular, is corruption-prone given the enormous wealth it

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<sup>49</sup> Borger, Julian, and David Pallister. 2006. “Corruption: the ‘second insurgency’ costing \$4bn a year.” The Guardian, December 1.  
<http://www.guardian.co.uk/world/2006/dec/02/usa.iraq>

generates, the numerous loopholes across its value chain (McPherson and MacSearraigh 2007), and secrecy. Oil deals are marred with secrecy between international oil companies and the resource owners/governments, and between governments and their citizenry (Bridge and Le Billon 2013). Compared to subsidies, for example, petroleum rents are easier for rulers to legitimate and hide (Dauderstädt and Schildberg 2006).

Corruption is hard to fight, but there are strategies and institutions that can limit its harms. “Accountability” is one such strategy. It entails top-down managerial responsibility, bottom-up answerability initiated by civil society, and horizontal accountability in the form of institutional checks and balances (Karl 1997, Karklins 2005). The accountability approach has come under criticism for its efficacy in curtailing apparently legal but harmful influence of social networks and powerful elites (Wedel 2012; 2014). Another anticorruption strategy is transparency, which counters secrecy ingrained in corrupt transactions. Transparency stems from the economic approach that values competition and access to information (Rose-Ackerman 1999). For transparency to stimulate reform, however, it must empower those harmed by corruption—the society. Therefore, the third anti-corruption strategy depends on a strong civil society (M. Johnston 2010; Shelley 2005a; Warren 2002).

## Patronage Networks

Studying governments and their policies without due attention to the workings of social networks results in shortsighted and flawed analysis.

Throughout history, patronage has been a tool of governance and rule by leaders of different regime types. Understanding patronage is necessary to understand how governments really operate. It is insightful to look at the interactions among government, citizens and oil companies through the framework of social networks analysis. Such an approach values both the actors and the relations among them, and enables the study of power and influence in policymaking. One particular area where this approach is a good fit is patronage networks.

Patronage involves reciprocal transaction and exchange (Lande 1977).

*Patronage*, or *patron-client relations*, evolve from power asymmetries, where the dynamics of obligation is present (Boissevain 1974, 26). The term “patron” refers to someone who has power, status, authority and influence, such as an employer or a saint, who helps or protects, politically or economically, the weaker client (Scott 1977). Hence, *clientelism* is also used to describe such a network.

The key to the networked nature of such systems is the multidirectional flow of exchanges, which results in a degree of interdependence. Clientelism falls on “a continuum between personal bonds among equals and purely coercive bonds” (Scott and Kerkvliet 1977). In urban politics, client-to-patron flows could translate into loyalty (Tolchin and Tolchin 2010) or votes (Kitschelt and

Wilkinson 2007). Furthermore, as Lande (1977) argues, patron-client relationships cannot exist in an institutional vacuum. They come to exist as addenda outside the boundaries of institutions to remedy their deficiencies and inadequacies. However, a *clique* may be formed toward achieving a goal and yet maintain loose links across different institutions (Wedel 2003). Wedel (2009b) later dubbed such cliques *flex nets* and their members *flexians*. Hence, social networks such as these have implications for governance and democracy.

### **Elections**

Often used interchangeably with clientelism, patronage remains a theme that is studied and redefined in different contexts. In electoral democracies, patronage is “a particular mode of ‘exchange’ between electoral constituencies as principals and politicians as agents in democratic systems” (Kitschelt and Wilkinson 2007, 7). Hence, in contrast to meritocracy, patronage is often identified as a form of or a context conducive to corruption (Heidenheimer 2002; Sanjó 2002). In modern governments, patronage signifies the “the discretionary favors of government awarded to political supporters” (Tolchin and Tolchin 2010, xi). It is possible for a large society to be organized into a small number of clienteles, which could overlap or be mutually exclusive. Also, scaling or pyramiding of clientelism is common, where smaller patrons act as client to ones that are more powerful. Shared and collective goals may scale up as well “by making the private end-goals of the patron the intermediate goal of the clients.”

(Lande 1977, xxi).

### **A Benign Alternative**

Compared to patrimonial and coercive clientelistic relations, patronage is relatively benign, and often functions as an equalizer and facilitator. It allows low status but well-connected individuals to bypass rigid bureaucracies and reach national institutions (Scott 1977). Building patronage networks is particularly of interest in electoral regimes, an example of which known as “machine politics” (Scott 1969). In electoral systems, the coercive authority to maintain compliance is weak, and therefore creating *dependencies* through patronage becomes a necessary persuasion tool for the elected officials (Scott 1969; Tolchin and Tolchin 2010). Unlike military generals whose commands are obeyed, elected officials need the “power to persuade.”<sup>50</sup> Moreover, when patronage politics is rife, party politics is no longer an *interaction* but a *transaction* between voters as principals and candidates as agents. That is, rather than weigh policies and programs, politicians procure votes for the right price (Kitchelt and Wilkinson 2007). In such an environment, accountability is attained not through the success of policies but through fulfilling the supply of patronage, such as employment.

Even when class and ethnic divisions are dominant in a political process, not only do clientelism and patronage persist, they might as well cut across these

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<sup>50</sup> Words of Richard Neustadt, Cited in Tolchin and Tolchin 2009, page 9.

divisions. In fact, clientelistic networks could exist as an alternative to established divisions: much of Europe and the Third World “electoral systems have promoted the growth of new classes of public patrons and brokers, influenced the pattern of public policy, and integrated local clienteles into larger vote-producing coalitions,” (Scott 1977, 493).

### **Influence on the State**

Having traced financial rewards throughout 25 years of American politics and government, the Tolchin and Tolchin (2010) concluded that patronage is here to stay: it is more humane than meritocracy, laws put in place to rein it in are easy to circumvent, and it has conveniently evolved with the new governance landscape bent on outsourcing many functions. Wedel’s book (2009a) chronicles the role “Shadow Elites,” flexible networks of powerful and well-connected influence wielders across national-global and public-private boundaries. Standard analytic frameworks and terms such as conflict of interest and corruption fall short of explaining power and influence in modern and complex societies.

Furthermore, in poorer and transitioning states, informal networks shape and influence the state depending on their level of state penetration and appropriation. Networks of influence could be merely preying on the state and its corrupt elements (partially appropriated states) or occupying public positions and divvying up the spoils (the clan-state). Although such a role of networks



may imply state weakness, the relationship between these networks and the state are more symbiotic than parasitic (Wedel 2003). Crime cartels and terrorists also prey on corrupting and criminalizing state. Shelley (2005b; Shelley 2014) argues that organized crime needs corruption to function and thrive, as mentioned above.

### **Eluding Accountability**

Because these networks are typically informal, with unclear boundaries, they are resilient and adaptable. On the surface, there is nothing legally or administratively wrong with these networks. There is a mismatch between the agility of these networks and the rigidity of the existing accountability institutions. Hence, the appeal of patronage networks to rulers and politicians. Therefore, social networks like flex nets (Wedel 2009b) and new terrorism and transnational crime groups (Shelley 2014) are inherently unaccountable. The coded formal and legal measures of accountability rarely capture the flexible and loose nature of patronage networks (Lande 1977; Ledeneva 2006; Collins 2002; Kitschelt and Wilkinson 2007).

### **The Resource Curse Thesis**

Beginning in the 1990s, social scientists of different disciplines started describing a perplexing phenomenon: compared to resource-impooverished countries such as Hong Kong and Malaysia, resource rich countries like Nigeria

and Algeria lagged behind on many economic and human development indicators. Different phrases were coined to explain this anomaly, such as “the resource curse” (Auty 1993), “paradox of plenty” (Karl 1997) and the “natural resource trap” (Collier 2007a). The adverse effects of natural resource dependence on economic growth, governance, stability, and society have attracted the attention of political scientists (e.g. Karl and Ross) and economic geographers (e.g. Auty) and economists and practitioners with regional expertise (e.g. Collier and Sachs).

Ross (2012) enumerates the distinguishing characteristics of oil revenues: size, source, stability and secrecy. Understanding the nature of oil revenues matter because, as Ross puts it, “Just as people are affected by the kinds of food they eat, governments are affected by the kinds of revenues they collect” (Chapter 2). First, oil revenues are large in scale and result in large governments – compared to others; petrostate governments are 50% larger as fraction of their economies. Second feature is oil revenue’s unusual source. Compared to taxation, oil revenues are easier for governments to collect, which in turn increase their popularity by not taxing their society. It also allows petrostate governments to grow faster than other sectors of the economy, because they benefits disproportionately from resource revenues.<sup>51</sup>

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<sup>51</sup> For example, on average, although the oil sector makes up 19% of the economy in these petrostates, it funds 54% of the state’s budget (Ross 2012, Figure 2.4).

The third characteristic of oil revenues is their instability and volatility. Oil revenues fluctuate. There are three reasons: oil prices change, production rates change, and the nature of contracts between governments and oil companies could smoothen or tighten the revenue distribution during boom and bust cycles. Finally, the energy industry is prone to secrecy, which facilitates corruption and the creation of off-budget accounts (Ross 2012). Anderson et al (2013)<sup>52</sup> demonstrate the linkage between weak institutions and rent seeking in petrostates by discerning that about 8% of “petro rents are converted into personal political rents” into foreign bank accounts. Political risk to the autocratic rulers, such as conflicts or elections, increases such transfers. Secrecy, furthermore, exacerbates volatility of oil prices (McPherson and MacSearraigh 2007) which is seen a challenge to global energy security.<sup>53</sup>

Researchers expanded the study of the resource curse, which was initially seen as mainly an economic phenomenon, and looked at political regimes, investment structures, and predisposition to conflicts. Subsequent research

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<sup>52</sup> To better measure corruption, Andersen et al. (2013) use data from the Bank of International Settlements of foreign deposits in the banks of places like Switzerland and Cayman Islands that often serve as tax havens.

<sup>53</sup> See U.S. Government report in the lead up to the Doss-Frank bill recommending U.S. support to more transparency measures in the global energy trade, *The Petroleum And Poverty Paradox: Assessing U.S. And International Community Efforts To Fight The Resource Curse*. 2008. Report To The Members Of The Committee On Foreign Relations United States Senate One Hundred Tenth Congress Second Session S. Prt. 110-49. Washington D.C.: U.S. Senate Committee on Foreign Relations.

findings, while asserting consequences for economic growth, also associate resource-rich countries with weak democratic development (Karl 1997; Ross 2001), corruption and resistance to reform (Sala-i-Martin and Subramanian 2003; Auty 2004), and civil wars and conflicts (Ross 2003; Ross 2006; Collier and Hoeffler 2002; Humphreys 2005). Other characteristics of these countries include income inequality (Ross 2007) and centralization of power (O'Lear 2007).

An important distinction needs to be made between the *presence* of and the *dependence* on natural resource in a country. While many countries may be endowed with some natural resources, resource curse symptoms appear when the country's economy becomes relatively dependent on rents from these resources. That is, the definition of a "mineral economy" is based on the relative importance of minerals to the economy and not on the scale of the resource endowment. A country would have a mineral economy if at least 10% of its GDP and 40% of its exports come from minerals (Nankani, 1979<sup>54</sup> in Auty 2012).

### **Lagging and Unstable Economic Growth**

The initial negative symptoms of natural resource wealth were seen in the economic performance and growth of resource-rich countries. Empirical studies have shown that many resource-rich countries have not only failed to generate sustainable economic development, but also incurred economic recessions (Auty

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<sup>54</sup> Nankani, G. (1979) "Development Problems of Mineral Exporting Countries," World Bank Staff Working Paper 354, Washington DC: The World Bank.

1993; Sachs and Warner 1997). Compared to the mineral-rich Caspian region countries, Auty (2001) maintained, “the immediate prospects for sustained economic growth with lower income inequality are superior in the resource-poor” countries. Ross (2012) compared all the resource-rich countries in the world to their resource-poor counterparts and arrived at a similar conclusion. The sustained development of resource-poor Asian Tigers compared to the resource-rich countries in Africa and the Middle East is also a case in point.

Synthesizing the literature and testing them empirically, Gylfason (2004) identifies five channels through which resource wealth slows economic growth. They are: Dutch disease (rise of foreign capital), rent-seeking (dwindling of social capital), human capital, investment (saving and physical capital), and financial capital. By negatively affecting these pro-growth channels, natural resource capital has negative consequences for economic development. The Dutch Disease is the main channel through which natural resources negatively affect economic growth (Gylfason 2006; Collier 2007; Humphreys, Sachs, and Stiglitz 2007). The term was first coined by *The Economist* in 1977 referring to the discovery of natural gas in the Netherlands in the 1950s and the ensuing overvaluation of the currency that hurt the tradable sector (Collier 2007b, chap. 3). Although declining resource rents may pressure government to implement economic reforms that would trigger the emergence of a private sector, the mentality of rent-seeking often prevails, averting the rise of a competitive market. Hence, even if such

reforms were to result from natural pressures (i.e. decline of resources), it may not lead to political and economic reform (Schlumberger 2006).

### **Institutions and Governance**

The agency of rent-seeking government is a key factor to explain the resource curse. The political dimension of resource curse is associated with unrepresentative governments with weak state and civil society institutions, often in post-colonial states with a tradition of authoritarianism and myopic policies. Researchers have observed that resource wealth and institutional quality are inversely correlated (Collier 2007; Auty 2004; Karl 1997). Resource curse is “primarily a political/institutional and not an economic phenomenon,” Karl proposes (2007, 256), offering an institutional explanation to the economic symptoms mentioned above. When government coffers can be filled with revenue through “rent seeking,” independent of economic policy or taxation, the state-citizenry relation is delinked (Karl 1997; Auty 2004).<sup>55</sup> Economic rent refers to the unusual profits that resource-rich governments make, which are outside the normal balance of demand and supply (Ross 2012).<sup>56</sup> Rent seeking, therefore, is “the competition for politically protected transfers of wealth” (Bevir 2007, 822). Rents can be sourced from natural resources, foreign aid (geopolitical rent) (Root

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<sup>55</sup> The “rentier state” theory was first coined and developed by Mahdavi (1970).

<sup>56</sup> Ross (2012) gives an example of rent. At the end of 2008, average extraction costs of a barrel of oil ranged from \$1.80 in Saudi Arabia to \$31.40 in Canada. Oil prices, on the other hand, ranged from \$38 to \$53. The difference between production and sale prices was the rent.

2008), and contrived rent (extracted through price and policy manipulating) (Auty 2006, 37). Hence, economic policy in a rentier state prioritizes wealth/rent distribution rather than wealth creation through innovation and work (Dauderstädt and Schildberg 2006). Large rents relative to GDP and its concentration in a handful of agents/ government “carry high risk of igniting elite contests for rent that undermine long-term economic growth and political maturation” (Auty 2012). In such a country, both wealth transfer and policies trickle down from the top according to the priorities of the ruler, regardless of the regime type, be it theocratic, secular or military. And when forced to choose between reform and repression, rent-dependent regimes usually opt for the latter (Noreng 1997).

Governments of oil-dependent countries are particularly difficult to hold to account. Schlumberger (2008) argues that a patrimonial form of capitalism emerges when oil exporting countries pursue political cohesion, where informal institutional rules override formal rules in the interest of elite recipients of rent. According to Karl (2007), there are three governance deficits that pose accountability challenges in petrostates: a) information deficit and the lack of transparency of the oil sector; b) monitoring deficit, which results from overcentralization and state-industry collusion; and c) the public participation deficit, where citizens *are* beholden to government rather than the other way around. Hence, the power dynamic between the government and the citizenry

are skewed in favor of the government. However, when the rent pours into a society that already has strong institutions, resource rents can jumpstart economic development, as in the cases of the United States and Norway (Lederman and Maloney 2007), both of which were democracies at the time of oil discovery (see section on authoritarianism below). Hence, “oil and gas revenues seem to magnify the ability of governments to do both help and harm their citizens” (Ross 2007, 237).

### **Inter- and Intrastate Conflicts**

In the study of civil wars and conflicts, natural resource wealth is often identified as the culprit for both instigating and prolonging wars. Since the end of the Cold War, civil wars have increased dramatically.<sup>57</sup> Between 1990 and 2010, on average oil states were 50% more likely to have a civil war. That rate rises to 200% if narrowed down to middle- and low-income countries (Ross 2012). Moreover, civil wars last twice as long and result in twice as many casualties in regions and countries where petroleum resources are merely present, even if not produced (Lujala 2009; Lujala 2010).

There are two main and competing arguments for explaining civil wars, often referred to with the shorthand of “greed and grievance.” The greed

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<sup>57</sup> From 1989 to 2006, there were 122 armed conflicts around the world; of which 115 were civil wars, and only 7 were international wars (Ross 2012).



argument, advanced by Collier, Hoeffler and Ross among others,<sup>58</sup> stands for explaining civil wars by looking at economic incentives of combatants to join a rebellion, while grievance proponents downplay economic considerations and argue that people rebel over identity. Some economists and political scientists, to varying degrees, agree that greed dimensions of civil wars have been overshadowed in favor of “ethnonationalist” explanations (Ballentine and Sherman 2003; Berdal and Malone 2000). Moisés Naím affirmed that greed is a smaller motivation than profit in civil wars (2005). Collier and Hoeffler wrote a seminal work in defense of greed theory, arguing that natural resources can motivate and finance conflicts (through reducing the opportunity cost of conflict), induce patronage politics (through weakening state institutions), and create shocks (by exacerbating the already volatile commodity market) (Collier and Hoeffler 2002; Collier and Hoeffler 2005b). Shelley and Picarelli demonstrated that terrorists and organized crime groups had no qualms cooperating despite divergent motives goals (2005). Motive was once seen as the main distinction between criminals and terrorists, the former being driven by profit and the latter by ideology. Increasingly, however, according to Shelley’s *Dirty Entanglements* model (2014), this distinction is no longer holding – the two groups are interacting, and their motives, methods and members are increasingly

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<sup>58</sup> See edited title by Berdal and Malone (2000), *Greed and Grievance: Economic Agendas in Civil Wars*. International Peace Academy. Boulder, Colo: Lynne Rienner Publishers.

hard to tell apart. The interests of both *new* terrorism and *new* transnational crime, for example, meet at the destabilization of existing states.

Weak leadership, failed institutions, and patronage-prone rent-seeking contribute to fragility and civil war in petrostates (Ross 2012). Combining greed and grievance, Shankleman (2006) identifies two key links between oil and conflict. First, the competition over and misuse of oil revenues for patronage by the exporting governments invites conflict. Indirectly, moreover, oil could lead to conflict by being an obstacle to economic development and job creation. Second, oil instigates local tensions and grievances in the oil producing regions. That is, inequality and mismanagement of oil revenues within exporting countries stirs up local tensions and grievances in the oil producing areas, where people more often see oil's environmental degradation but not its economic benefits, as in Angola, Sudan and Iraq (Shankleman 2006; Ross 2007). Social/vertical inequality coupled with geographic/horizontal inequality is the main sources of conflict in resource rich countries. When the society is ethnically or religiously divided, such conflicts could take a secessionist nature, as in the cases of Sudan and Indonesia (Ross 2007).

In addition to civil wars, resource-rich countries influence global peace and conflict. Resource rich countries tend to spend larger shares of their national income on weapons and armament (Dauderstädt and Schildberg 2006; Noreng 1997). In studying foreign policy preferences of petrostates, Colgan (2013) coined

the term “petro-aggression,” to argue that petrostates may have a greater tendency toward violence and aggression against their neighbors.

### **Regime Type and Authoritarianism**

Compared to oil-poor states, petrostates have lagged behind in transitioning to democracy. Empirical research has shown that the presence of mineral wealth in a country is associated with antidemocratic properties (Ross 2001; Epstein et al. 2006). Among oil-dependent countries, Norway remains the outlier where oil and democracy coexist because oil revenues are collected by a democratic government with strong state institutions. By virtue of careful macroeconomic management, good governance practices, and specific tools such as a stabilization funds, Norway has managed to fairly distribute its wealth and escape many symptoms of the resource curse (Gylfason 2011).

One explanation of authoritarianism in resource-dependent states is based on rent seeking. Thanks to resource rents, governments in these countries afford not to tax their population, and appease public pressure for accountability through co-optation, such as patronage jobs and subsidies (Ross 2012). The “modernization effect” of economic growth is often missing in resource-rich countries because rent-driven economic growth fail to bring about the social and cultural changes necessary to engender democratic governance (Ross 2001). Moreover, such regimes can afford to spend lavishly on multiple layers of security forces and repress dissent. The failure of Arab countries to modernize

during the oil boom of the 1970s is a case in point. For decades, writes Ross, “the Middle East has had less democracy, and more oil, than any other world region. This is no coincidence” (2012, 63).

Resource rents encourage doling out patronage even in democracies. Democracies often fail to harness resource surplus into diversified investment portfolios; instead, they indulge in extensive spending on large public sectors (Collier 2007). In resource rich countries with electoral systems, political competition encourages wealth and income distribution through patronage politics, which becomes an alternative to public service politics (Collier and Hoeffler 2005a). Other research has observed that oil could have antidemocratic effects in the combination of high government dependence on resource rents and the absence of a wealthy elite (Dunning 2008). To sum up, when a resource-rich state is not compelled to tax its population, it cannot be held accountable. To insulate its government and democracy from this threat, the Norwegian government levies heavy taxes. Indeed, the Alaska model of distributing oil dividends on the population and then taxing it as income is a major prescription against resource curse (see next section). Lack of accountability is a major threat to democracy and economic growth as it absolves the state from investing in the population’s future. By the same token, the citizenry – when not taxed – in turn has little incentive in organizing and being a check on the government.

### **Anti-Resource Curse Policies**

Although many researchers have observed and explained the negative impacts associated with a country's dependence on petroleum wealth, the literature is thin on policy prescriptions to mitigate the resource curse. Many of the reforms seek to infuse transparency and accountability into the natural resource sector, and are directed at governments. Other measures are external, such as the Extractive Industries Transparency Initiative (EITI), which involves disclosure of transactions in the petroleum industry and its relationship with the producing governments. Further, diversification and investment are important strategies to "steadily channel rent away from patronage-driven redistribution into broad-based wealth creation" (Auty 2006, 57). A mechanism to achieve the latter is Savings and Stabilization Funds, a model spearheaded by Norway. Such a Fund encourages saving during boom periods and discourages extensive government short-term spending. An extension of the Funds is the Alaska Model (Ross 2007), where direct distribution from oil funds facilitates greater transparency and accountability by giving citizens a stake in protecting the fund and demanding greater accountability and voice in its management. This model, however, has not been tried in developing countries since functioning financial infrastructure is a prerequisite. These bureaucratic prescriptions, however, miss one fundamental reality: "what is often economically inefficient decision making is an integral part of the calculation of rulers to retain their political support by

distributing petrodollars to their friends, allies, and social support base' (Karl 2007, 207).

### **Contributions to the Literature and Policy**

This research project will contribute to the body of literature surveyed above by studying the case of Iraq as a petroleum-dependent transitioning country. The case study method allows for such a multivariable analysis of factors and influences. The cases selected for this study bring together the issues of corruption, patronage networks and resource curse in the new Iraqi context of transition and fragmentation.

The literature has two main limitations that this study hopes to address. First is the role of corruption, patronage and resource curse on a transitioning country. Second is the role of policy decentralization and ethno-sectarian fragmentation in petrostates.

On states in transition, studies on how petroleum dependence affects countries' transition remain limited outside Latin American and the Caspian Sea region. We seem to know more about the role of foreign aid (Fisman and Miguel 2010; Wedel 2001; Root 2008) than the role of resource rents. Many of the hypotheses proposed in the literature may explain why petrostates do not set off on a transition path. They fall short, however, of explaining transition patterns in Iraq (or Libya), where exogenous factors (such as invasion and regime change)

has put an end to its centralized authoritarianism.

Furthermore, the literature on resource curse and conflict cannot explain the rise of terror groups like ISIS in Iraq. For example, Ross (2003) argues that crude oil is an “unlootable” and “obstructable” commodity that is difficult for rebels to transport and monetize because they require infrastructure and investment. When rebels cannot simply monetize crude through looting, they have the incentive to fight a secessionist war. ISIS’s control of oil infrastructure such as oilfields, refineries, pipelines and trucking contradicts these assumptions and require a fresh look at the link between oil and war.

Since the wave of oil nationalization, the role and global market share of the national oil companies (NOCs) have been on the rise (Marcel and Mitchell 2006). However, there is a form of reverse nationalization under way in Iraq’s petroleum sector, where international oil companies have been invited back into the country, as service providers (to the federal government) and investors (with the Kurdish Regional Government). Unlike foreign aid, where donors are expected to demand some accountability, the power relation is in favor of oil-rich states. There are too many oil companies competing for a depleting resource. In Iraq, and particularly in Iraqi Kurdistan, the petroleum sector is dependent on oil companies. But given their competition over entry to Iraq’s petroleum sector, these companies are beholden to their government counterparts and not the other way around. In fact, politicians often seek to use the IOCs (and the

countries behind them) to promote their domestic political agendas (International Crisis Group 2012). Also, unlike foreign aid, which is often in kind and dispersed, oil revenues from different companies flow directly into government coffers. Such centralization of wealth in the hands of a few politicians in government empower the state vis-à-vis both the oil companies and the citizenry. But there is little known about the power relations between national and subnational governments in decentralized systems. This study will explore these dynamics by studying the power dynamics between Iraq's central government and the Kurdish regional government.

The literature highlights the policymaking myopia of rent-seeking rulers (Ramsay 2011; Ross 2011). While this theory might hold to an extent, it has inadequate applicability to petrostates with electoral competition. Indeed, election cycles encourage patronage building and the consolidation of power by the early winners. Unlike mining diamonds or distributing aid to cronies, however, petroleum contracts are capital intensive and long-term, often spanning over 20 years. When the petroleum wealth is distributed widely, through mass public employment for example, it raises income levels and public expectations as well, which patronage alone cannot meet in the long term. These expectations may translate into pressure on governments toward better policy performance. If unmet, however, rising expectations could destabilize societies. Further, some transparency over petroleum revenues may add to this pressure.



The competition among oil companies, on the one hand, and the competition between national and subnational governments on the other make complete secrecy of resource revenues very difficult. It is comparatively easier for rulers to hide oil information when national oil companies manage the petroleum industry.

A greater gap in the literature is the role of decentralization in states rich in petroleum. Explanations of resource curse include the centralization of wealth and power as a cause for lack of democracy and accountability in these countries (e.g. O'Lear 2007). Decentralization could help democratization if it is not across identity lines (Epstein et al. 2006). Devolution of power, in the form of federalism for example, could encourage economic development and promote good governance and state legitimacy (Ben-Meir 2009). Surprisingly, however, our knowledge remains very limited about how decentralization would affect symptoms of resource curse. There are scarce attempts at explaining the effects of decentralization on other natural resources, such as forest management (Larson and Ribot 2004). If centralization of oil rents has negative consequences for a country's economic and political development, would the counterfactual hold – that is, would decentralization be a positive factor? Ross (2007) addressed this issue, and hypothesized that producing regions should not levy direct taxes or receive shares from the central government. Ahmad and Mottu (2003) also argue in favor of unitary and centralized petroleum policy. They argue against revenue

sharing schemes, such as the one being practiced in Iraq, in fear of distorting national macroeconomic planning, obstructing vertical accountability, and inhibiting the stability of revenue flows for public services. These prescriptions remain mainly hypothetical rather than empirical, and are premised on fiscal and macroeconomic stability of states.

This dissertation explores and describes the implications of decentralizing and fragmenting petroleum policy. Decentralization of power and the multiplicity of actors, if maintained, may undercut the rise of the “predatory political state” (Auty 2006, 39) in favor of more diffused, competitive and potentially benign power centers. This dissertation and its case study of Iraq and Kurdistan bring together the dynamics and insights highlighted in this chapter, which are often studied in isolation. Iraq is a country whose transition is affected by the “resource curse,” the rise of new power networks, amid widespread corruption.

## **CHAPTER 3: RESEARCH DESIGN AND METHODOLOGY**

Iraq's petroleum policy and industry have undergone dramatic changes after the 2003 invasion and regime change. Main among these changes is oil federalism. Although the country's economy and state both remain heavily dependent on oil revenues, the strong central command over the management of oil and gas has fragmented, mainly across regional and ethnic lines between the Kurdish government in Erbil and the federal government in Baghdad. Moreover, the monopoly of the state over the management of petroleum resources and revenues, partly through national oil companies, has also ended with the return of international oil companies, for the first time since Iraq nationalized its petroleum industry in 1976. This study aims to demonstrate the complexities and consequences of this new multi-centered and multi-player petroleum sector and revenue capture.

The research project's main questions are: How has Iraq's post-2003 petroleum policy played out? What can explain the divergence of petroleum policy between the federal government and the Kurdish government? And what are the consequences of such a decentralized and fragmented petroleum policy?

The implications focus on Iraq's post-2003 transition, which spans politics, the economy, governance, human development, and stability. This dissertation also studies the roles and influences of the many players and actors involved in shaping Iraq's post-2003 petroleum policy. To get at plausible answers to these general questions, the dissertation attempts to address three specific research questions:

### **Research Questions and Propositions**

After the invasion of Iraq and the fall of the Baath regime, the country has been in a state of flux. There was an initial consensus for the different ethnic and religious groups cobbled together as a nation to coexist, albeit in a different power sharing structure. The main tenets of new Iraq were enshrined in a constitution that guaranteed elections, federalism and the sharing of petroleum revenues. In particular, Iraq's constitution lays down principles for "oil federalism" in order to deal with dispersed oil resources that do not align geographically with the country's ethno-religious components. In effect, a multi-centered petroleum policy and revenue control has emerged, with the federal government and the Kurdish regional government both developing their energy industries and policies at diverging directions. This dissertation on petroleum policymaking in Iraq in post-Saddam era seeks to show how one state has been dealing with the opportunities and costs associated with oil federalism and its

impact on the functioning and governance of the central and regional governments.

**1. What are the key factors and dynamics that have shaped Iraq's petroleum policy since 2003? And what are their main implications and consequences? How has oil federalism played out?**

Iraq's petroleum policy has been fragmented between the central government in Baghdad and the Kurdistan Regional Government (KRG) in Erbil. The fall of the Baathist regime in 2003 resulted in the collision of the divergent visions for political power on a continuum between strong centralism and a loose confederacy. Decades of exclusionary authoritarian rule exacerbated Iraq's ethnic, religious and sectarian cleavages. Ever since the creation of the Iraqi state from the ruin of the Ottoman Empire, the Kurdish minority has been fighting the central government for more autonomy and political rights. Moreover, Iraq's Shia majority voices the grievance of political marginalization. Iraq's Sunnis have dominated the state for most of Iraq's history, especially after the Baath Party ascended to power in the 1970s. Therefore, Iraqi Kurds have been most adamant about decentralization and a weak central government. Iraq's Sunnis stood on the opposite extreme to Kurds vis-à-vis federalism. The Shia parties have had a wavering stance, advocating federalism initially but with less so as they consolidated power in Baghdad.

One of the main issues of contention in post-2003 Iraq is oil federalism and

the devolution of power to oil producing regions and provinces. Federalism has major implications for the management of the country's petroleum resources.

The national and subnational governments disagree as to who should have the right to explore for and produce oil and gas, and who has the right to represent the country in contracts with foreign oil companies (see Chapters 4 and 5). Thus far, the main government actors in the petroleum sector have been the central government and the Kurdistan regional government (KRG). Given the different near-past histories and experiences with foreign entities, it is expected that the two sides' perceptions of international oil companies will also differ. Hence, policymaking in the petroleum sector is expected to diverge at some level and converge at others.

*Proposition 1:* Power decentralization, competitive elections and abundant petroleum revenues after 2003 have created incentives and opportunities for cooptation more than for coercion as a means of wielding power. This in turn has created incentives to establish and expand patronage networks that can maintain long-term dominance. The need to support these patronage networks is a key dynamic that influences the making of Iraq's central and Kurdistan's regional petroleum policies. Patronage politics undercuts the country's ability to address the resource curse – the dire political, economic, social and stability consequences associated with dependence on petroleum revenues.

In addition to the primary research question above, the dissertation

considers two secondary questions:

**2. How has Iraq's decentralized petroleum policy affected the country's transition toward a more accountable political system and sustainable economy? Specifically, how is accountability established, if at all, in making petroleum-related policies and sharing petroleum revenues? Who holds whom to account in relations between the Iraqi central and the Kurdish regional governments, between these governments and their public, and between the governments and the international oil companies (IOCs)?**

For the sake of analysis, there are three corners in a triangular relationship among the governments in Baghdad and Erbil, the international oil companies (IOCs), and the public (Bridge And Le Billon 2013). Officially, legal and contractual accountability governs the government-IOC relations, and electoral accountability governs government-public relations. Although the government is usually the intermediary between IOCs and the public, IOCs are increasingly investing directly in the local communities where they operate through corporate social responsibility programs of infrastructure construction, employment and scholarships. Moreover, the Iraqi constitution is the basis for regulating the relationship between the federal Iraqi government and the Kurdish regional government (KRG). Moreover, there is reverse-nationalization of the petroleum industry, where the Iraqi and the Kurdish governments rely on international oil companies to rehabilitate Iraq's energy sector. Before 2003, Iraq's oil industry and

policy were centrally managed through the oil ministry and national oil companies. There was not much of an oil industry in the semi-autonomous Kurdish region. In the decade since 2003, however, IOCs flocked to Kurdistan and signed tens of oil and gas exploration and production contracts. Hence, petroleum policy has been decentralized between the federal Iraqi government and the Kurdish regional government.

*Proposition 2:* Because petroleum policy and revenues are no longer centrally managed, there are two, albeit unequal, centers of power and policymaking in the Iraqi oil sector – in Baghdad and in Erbil. Although both governments use patronage networks to maintain power, patronage is nationally decentralized and does not fall under a central hierarchy as it was under the Baathist regime. Competition over access to and management of petroleum between the KRG and Baghdad could result in a level of horizontal accountability between the two power centers.

The potentially positive effects of competition between the national and subnational government could be blunted by patronage politics within both sides. Accountability between Baghdad and Erbil may determine whether the federal and the regional governments adopt smart strategies and design policies aimed at alleviating the negative consequences associated with resource dependence. That is, competition between the governments in Baghdad and Erbil may compel them to adopt anti-resource curse policies. Contrary to this, if



the Baghdad-Erbil relation is weak or collusive, neither side will prioritize investing in accountability and transparency. Furthermore, patronage politics practiced by both sides could alter the incentive structure and undercut the possibility of competitive accountability between Baghdad and Erbil.

### **3. How has the governance of Iraq's petroleum sector affected the country's stability?**

The conflict over petroleum exploration, production and export rights between the federal government and the KRG could raise Iraq's risk profile as an investment destination for the international oil companies (IOCs) as well as its reliability as a stable supplier of world energy. In 2007, the federal government started blacklisting IOCs operating in Kurdistan and barring them from bidding on federal projects. IOCs ended up having to choose between Baghdad and KRG rather than compete. The effect has been that companies have to exclusively work with either Baghdad or the Kurdish government (with a few exceptions including ExxonMobil). Notwithstanding the security and legal risks, IOCs rushed into investing in Iraq, lured by the country's vast and still fully untapped petroleum resources. Iraq's decision to reverse its nationalization policy soon after the invasion and welcome IOCs back into the country is an opportunity that many IOCs may not want to miss. This study also investigates the view from the petroleum industry of major risks associated with their return to the Iraqi energy sector. The power dynamics between IOCs and their government counterparts is

of importance to the development and stability of Iraq's petroleum industry.

And most recently, in June 2014, the Islamic State of Iraq and al-Sham (ISIS) entered the Iraqi scene not only as a political and military actor, but as an oil player as well. ISIS controls large swaths of territory in Iraq, including numerous oilfields. ISIS increased the security risk for IOCs operating in Iraq and the KRG. Indeed many of the IOCs and the service companies they rely on reacted by evacuating many of their staff for fear of kidnapping.<sup>59</sup> These security challenges coincide with disputes over the budget the sharing of oil revenues between Baghdad and Erbil. Baghdad cut the KRG's share of the budget in January 2014, which partly weakened a coordinated response to the ISIS attack.

*Proposition 3:* Given their addiction to petroleum exports for rent generation, Baghdad and the KRG will have to steadily increase petroleum production and export to international oil markets. Both sides also need to cooperate and coordinate in order to address the macroeconomic instabilities associated with fluctuating oil prices. By economic logic, these needs should bring Baghdad and the KRG closer and allow oil federalism to function.

However, internal power and patronage politics within each government may encourage unilateral rather than coordinated policies. Unchecked unilateral

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<sup>59</sup> Clark, Meagan. 2014. "Expats In Iraq Evacuated By Companies, Governments As ISIS Moves South." International Business Times. June 18. <http://www.ibtimes.com/expats-iraq-evacuated-companies-governments-isis-moves-south-1604552>.

action exacerbates corruption, which greases the wheels of patronage networks and weakens government institutions. In the face of serious external threats such as ISIS, patronage and corruption become matters of national security, fracturing the state and undermining its institutions.

The IOCs and the stability of the petroleum industry could suffer from such state fracture and policy failure. Despite the federal and the regional governments' need for investment from IOCs, the competition among the IOCs for a foothold in Iraq put the Iraqi and Kurdish governments on a stronger negotiation position vis-à-vis the IOCs. Therefore, IOCs are beholden to their government counterparts. The IOCs could move toward building cartels and start exerting more leverage against the government. An added risk is the emergence of ISIS and the doubted ability of the Iraqi and Kurdish security forces to provide security for the petroleum industry and companies.

## **Research Design and Methods**

### **Case Study Design**

This research project employs the case study method to address the research questions posed above. As Yin (2003, 1) points out, the case study strategy is preferred (a) when “how” or “why” questions are posed; (b) when the researcher has limited or no control over events; and (c) “when the focus is on a contemporary phenomenon within some real life context.” The research topic at

hand lends itself to these descriptions. Moreover, “the distinctive need for case studies arises out of the desire to understand complex social phenomena... which allows investigators to retain the holistic and meaningful characteristics of real-life events” (Yin 2003, 2). Hence, the case study is a useful way to investigate a phenomenon within its context, although the boundary between the phenomenon and its context could not always be clearly delineated. Another strength of the case study method is that it allows for the use of multiple sources of empirical evidence (Yin 2003, 14). Finally, “one of the often overlooked advantages of the in-depth case-study method is that the development of good causal hypotheses is *complementary* to good description rather than competitive with it” (King, Keohane, and Verba 1994, 45).

The case study research design consists of five components: “a study’s questions; its propositions, if any; its unit(s) of analysis; the logic linking the data to the propositions; and the criteria for interpreting the findings” (Yin, 21). Unlike survey studies, the case study method does not limit the number of variables of interest to the investigation. However, the five stages cited above direct the researcher toward developing preliminary theories and propositions about the subject matter of the study (Yin, 28). But unlike quantitative research methods, case study designs lack specific tools and guidelines, and, as Yin notes, there is no comprehensive catalog for designing case studies. Case studies are often designed on a case-by-case basis, where replication is desirable in order to

make theoretical generalizations.

On the latter note, the case study method is used to generalize rather than to particularize. More akin to experiments than to statistical analyses, the case study generalizes to a theoretical proposition rather than to a population. Hence, the goal of the case study is to “expand and generalize theories (analytic generalization) and not to enumerate frequencies (statistical generalization) (Yin, 10). That is, the prevailing logic of the case study method is that of *replication* and not sampling. Hence, a design can study a single case or a number of cases (Yin, 39-53).

### **Case Selection**

In order to understand the factors that influence policymaking in the Iraqi petroleum sector and account for the differences that exist at the federal and regional levels, this research adopts a multi-case research design. In general, the research project considers Iraq a petroleum-dependent country that is undergoing economic and political transition, and where energy policy is undergoing decentralization. In particular, this study considers two cases: that of the Iraqi federal (national) government and that of the Kurdistan Regional (subnational) Government (KRG). The unit of analysis in each case is each government’s petroleum policy. For this research project, policy is not limited to government pronouncements, such as legislations and directives, but extends to studying what the policy means to different actors, and what actually goes on

before and during implementation—in other words, the “living policy.”<sup>60</sup> Wedel et al. (2005) argue in favor of examining the interactions of “actors, activities, and influences” to understand and evaluate the making and implementation of policy. To that effect, the two case studies investigate how petroleum policy by each government was made, to what ends, and what influences and factors affected policy implementation or lack thereof. This approach is particularly relevant to the understanding of the Iraqi constitution, where the two governments make different meanings of its petroleum-related articles, and have adopted different policies based on their divergent interpretations of the rights that the constitution grants (see Chapters 4 and 5).

Although Kurdistan is part of Iraq, the policy environments of the Kurdish regional government (KRG) and the Iraqi federal government are distinct enough to warrant comparative studies. The KRG is a subnational government in Iraq, and its regional petroleum policy is linked to the national policy through the constitution, national budget and the export infrastructure. The two cases affect each other as well as the national scene.

The context of the two cases is similar at some level yet different at others. Both the Iraqi government and the KRG have relied on petroleum rents since 2003 for more than 90% of their revenues. Different institutions and players on

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<sup>60</sup> Professor Janine Wedel used the term and concept “living policy” during conversations about this research design.

both sides contributed to the making new petroleum policies. Both governments have relied mainly on international oil companies to produce oil and gas. Also, both governments have been elected to office. Finally, the petroleum sectors of both come under attack for corruption and smuggling.

However, the cases diverge on other levels. Although both cases are undergoing economic and political transition since 2003, Kurdistan's transition started earlier in 1991 when the Baath regime's administration and military withdrew from the north under pressure from the United Nations. Therefore, there is a higher degree of power consolidation by the ruling parties. Self-governance has also increased the national appetite for more political and economic autonomy. Moreover, although international oil companies (IOCs) have played a significant role in the petroleum sector since 2003, the Iraqi federal government has inherited a large oil ministry and bureaucracy that include several national oil companies. The KRG, on the other hand, relies on foreign oil companies to develop and produce oil and gas in its region. Furthermore, the views and policies of contracting with IOCs differ between Baghdad and the KRG. Lastly, a single ethnic group dominates the KRG, which has translated into more sociopolitical coherence. The federal government, on the other hand, has broader ethnic and religious representation and therefore deeper fissures. These national and regional variations may undercut the building of effective institutions of oil federalism sought to keep the country together.

Therefore, for analytical purposes this study treats the Kurdish region of Iraq as an independent – yet related – case from the federal government. The Kurdistan region is semi-autonomous, and has been so since 1991. It has a regional parliament and a regional government that exercise significant powers granted by political realities enshrined in the Iraqi constitution. The Iraqi constitution grants the region powers, albeit vague, over petroleum resources and revenue generation (see Chapter 4). The regional government maintains local security forces that are politically independent of Baghdad. Therefore, the KRG petroleum policy was made rather independently, designed and voted into law in the region. External influences were present, as the study shows. The KRG started signing contracts with IOCs in earnest in 2007 without getting approval from Baghdad, and hence Baghdad deems these contracts illegal. The Kurds are represented in the federal government (Iraq's president has been a Kurd since 2005), but they have less influence on national petroleum policy. Hence, each of these two policies, despite some shared elements, is separate enough to be studied as a unit of analysis, given the level of independence at policymaking and implementation.

### **Data and Methods of Collection**

In each of the cases, data from the following methods and sources were collected (See Table 2 below):

***Laws and Proclamations:*** I have collected, studied and analyzed



pertinent data from publically available documents such as the Iraqi constitution, petroleum-related laws and directives, reports, and legal opinions. I have sought legal commentary to understand the different interpretations of the constitution. Collecting this data is important as baseline, and to understand official policy pronouncements.

*Petroleum contracts signed between the government and IOCs:* The Iraqi and Kurdish governments have separate contract models that they use to enter into petroleum exploration and production agreements with IOCs. With the help of policymakers and legal counselors, I have tried to understand and explain the tenets of these contracts and their implications. Contract analysis is important in order to explore power relations between the government the IOCs. Understanding petroleum contracting is also necessary to identify accountability guarantees and possible loopholes for corruption.

*Interviews:* Interviews were an integral part of researching for this dissertation. I conducted more than 50 interviews with about 35 individuals from the public sector, petroleum industry representatives, civil society representatives, and subject matter experts. Other players interviewed include foreign diplomats, such as from the U.S. and Turkish embassies. I also reached people “in the know,” formal and informal actors with knowledge about the workings of the industry, such as journalists, political advisors and an oil smuggler. Interviewing is an important source of data to distinguish between the

*living policy* and official pronouncements. For example, different parties in the country make different meanings of the same constitutional clauses. Through interviews, I gained insight into the key issues pertaining to the petroleum policy as defined by different actors. Interviews help me describe and analyze policy goals, risks and conflicts as seen by the interviewee categories mentioned above. To do these interviews, I travelled to Erbil, Baghdad, Washington, London, and Istanbul.

***Influence and Social Networks Analysis:*** This study acknowledges that policymaking is not always a linear process, and that it can come under various influences. Particularly, this dissertation focuses on the role of patronage networks and their influence in the making of and calculations of Iraqi policymakers. Therefore, it employs a theoretical as well as practical approach to social networks analysis. Social network analysis could result in both quantitative and qualitative data, however no quantitative analysis is performed for this study.

I used a tool developed by Eva Schiffer called Net-Map (Schiffer and Hauck 2010).<sup>61</sup> The tool is an interview based mapping tool that can be used in one-on-one interviews as well as with a small group. I used Net-Map three times with different groups in a manner similar to an interactive focus group. The tool helps to “(1) visualize implicit knowledge and understand the interplay of

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<sup>61</sup> More information on Net-Map at <http://netmap.wordpress.com>.

complex formal and informal networks, power relations, and actors' goals; [and] (2) uncover sources of conflicts as well as potentials for cooperation" (Schiffer and Hauck 2010, 231). This interactive interviewing and mapping tool allowed me to visually demonstrate some of the networks of influence as well as generate insights and perceptions in the participants. These insights are reflected in Chapters 5 and 6.

***Publically available data:*** I tried to access data on Iraq's economic, social and political indicators, including the performance of its petroleum sector. The World Bank shared with me the *Iraq Household Socio-Economic Survey (IHSES) 2007*: a survey conducted by the Iraqi and KRG statistical authorities in conjunction with the World Bank. The Bank also provided me with raw socioeconomic data on Iraq. This and other data sources from government and other international agencies (e.g. UN and the IMF) helped in extracting data on public employment, and variance between employment numbers in Iraq and its Kurdish region. I also consulted indices such as Transparency International's Corruption Perceptions Index, World Bank's Worldwide Governance Indicators, Bertelsmann Stiftung's Transformation Index (BTI), and the Open Budget Index.

***News reports:*** Since this dissertation studies a policy that continues to unfold, I kept abreast with developments partly through the news media. Surveying news reports also helped me identify interviewees and chart a

chronology of key events in the Iraqi petroleum sector.<sup>62</sup> News reports were also helpful in corroborating data collected from interviews and vice-versa. The Iraqi media coverage, especially around election times, highlights corruption and oil smuggling, both foci of this dissertation.

The Institute of Regional and International Studies at the American University of Iraq, Sulaimani awarded me with a research fellowship for the 2013-2014 academic year to study Iraq's and Kurdistan's energy sectors. The fellowship allowed me to bring together policy makers, industry managers and subject matter experts; organize a public panel discussion; and write a report.<sup>63</sup> These private and public meetings were very helpful opportunities to gain insight, discuss this dissertation's propositions and observe the different approaches and languages used by different actors related to the petroleum sector. The Net-Map focus group sessions mentioned above were conducted with the help of this fellowship. I also presented two separate chapters of this dissertation at the Sulaimani Forum, an international geopolitical conference, in 2013 and 2014. In December 2013, I attended the Kurdistan-Iraq Oil & Gas

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<sup>62</sup> I had access through my institution to IraqOilReport.com, a paid news service focused on covering Iraq's petroleum sector.

<sup>63</sup> Wahab, Bilal. 2014. *Iraq and the KRG Energy Policies: Actors, Challenges and Opportunities*. Sulaimani, Iraq: American University of Iraq, Sulaimani. <http://auis.edu.iq/node/1367>.

Conference in Erbil,<sup>64</sup> an annual gathering of government and industry decision makers, which allowed me to attend presentations, receive training in oil and gas management, and interview professionals.

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In sum, it is the aim of this study to contribute to Iraq studies by collecting evidence on Iraq's petroleum sector and the making of relevant policies. In the case of the Kurdish government, its petroleum policy is in its infancy, and therefore data collected in this study should lay the ground for further research. The research is also designed to track complex domestic processes, politics and influences that have shaped the country's main economic sector. I attempted to cover the main bases and triangulate data from the perspectives of government, the petroleum industry, consultants, diplomats and the civil society. Finally, this study might help to compare Iraq and KRG with other countries' experience with reverse nationalization of the petroleum sector.

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<sup>64</sup> Kurdistan-Iraq Oil & Gas Conference, <http://www.cwckiog.com/2013-conference/kurdistan-iraq-2013/conference/>

**Table 2: Data Sources and Collection Methods**

#	Data Source	Collection Method/Strategy	The information/questions sought	Notes
1.	Laws and Proclamations:	Content analysis of publically available data, including the Iraqi constitution, government reports, petroleum-related laws and directives, parliamentary sessions, among other sources.	<p>Collecting this data is important in order to understand policy pronouncements:</p> <ul style="list-style-type: none"> <li>• What do the laws and regulations require?</li> <li>• What are the bases and principles of the laws?</li> <li>• How do the laws regulate the relationships among the government, the IOCs and the public?</li> <li>• What accountability principles and mechanisms are established?</li> </ul>	To understand legal complexities, the counsel of legal and constitutional subject matter experts were garnered.
2.	Petroleum contracts signed between the governments and international oil companies.	The Iraqi federal government and the KRG have made public their model contracts and some of the signed oil contracts.	<p>Contracts are legal documents that regulate the relationship between the governments and the IOCs:</p> <ul style="list-style-type: none"> <li>• What are the power relations between the government and the IOC?</li> <li>• Who controls what/whom and how?</li> <li>• How is revenue shared/companies paid? What is the cash flow mechanism?</li> <li>• What are the loopholes in the contracts that could facilitate corruption?</li> <li>• How each government's contracts differ from the other?</li> <li>• Do contracts include social content (e.g.</li> </ul>	The opinion and insights of contract law and subject matter experts were sought.

			infrastructure, protection of environment, or technology transfer?	
3.	Datasets and Indices (e.g. Iraqi budgets, Iraq Household Socio-Economic Survey IHSES 2007, World Bank Governance Indicators, UNDP Human Development)	Provided to the researcher by the World Bank and accessed via agency websites and university library resources.	<p>Basic socio-economic data and other surveys about Iraq:</p> <ul style="list-style-type: none"> <li>• What is the level of Iraqi and Kurdish governments' dependence on oil revenues?</li> <li>• Is the petroleum industry crowding out other industries?</li> <li>• What percentage of the public is on government payrolls? (Indication of government dependence)</li> </ul>	
4.	Public officials, corporate representatives from the petroleum industry, government and industry consultants, civil society representatives, and subject matter experts.	Interviews and Net-Mapping focus group sessions	<p>To understand the role of key policymakers and decision makers players, and how they make meaning of and contribute to petroleum policy:</p> <ul style="list-style-type: none"> <li>• What is their priorities and goals?</li> <li>• What are the important issues to them? How do they perceive the conflicts, risks, incentives, and problems? Are main risks economic, political, or legal...? How and why?</li> <li>• Which branch of government has more influence on the policy? Why? What is the role of, if any, institutions such as the Commission of Public Integrity, the Inspector General and the EITI?</li> </ul>	The interviewees are allowed first to list and address issues important to them before they are asked to comment on issues important to the study.

			<ul style="list-style-type: none"> <li>• Who are the influencers and key players? How did they become so? Why?</li> <li>• What are the decision-making processes?</li> <li>• What are accountability measures in the petroleum sector?</li> <li>• What are the ways to use petroleum resources?</li> <li>• What is the sources of conflict between Baghdad and the KRG? What could be possible positive/negative/negotiated outcomes?</li> </ul>	
5.	News and industry reports	Media Outlets	<p>Temporal sequencing of key events pertaining to the petroleum policy and sector:</p> <ul style="list-style-type: none"> <li>• Have key players changed over time?</li> <li>• How policies differ or change with change of government cabinets (pre- and post-election)</li> </ul>	



## **Data Analysis**

Upon collection, the data is aggregated into categories, and then into patterns and relationships. Tables, charts, social networks, matrices and other visual representations are used to bring together the multiple sources of data (Creswell 2006).

### *Analysis of the Individual Case Studies*

The study mainly consists of two case studies organized thematically. The cases are the petroleum policies of the federal Iraqi and the Kurdish regional governments. Per each case, it explores policy goals and objectives, players and policy shapers, policy pronouncements and how they are enacted, and ways in which accountability is maintained. These dynamics are analyzed for their implications for political and economic transition, and national stability. This stage is, in Yin's terms, the "literal replication" stage.

### *Analysis Across Cases*

The second component of the analysis is across the cases of Iraq and the KRG, focusing on the factors of the individual cases on transition, stability and the governance of the petroleum industry. The strategy for the cross-case analysis is to use the case descriptions and revisit the theoretical propositions stated earlier. The analysis across cases is the "theoretical replication" (Yin 2003) that observes the similar or contrasting factors and implications predicted by the

study's propositions. Such a design allows the research to explore what might be different about each case and why. Based on the outcome of this research, the initial hypotheses can be either generalized or modified. Techniques used to analyze the data from the cases will include "pattern matching logic," "cross-case synthesis" (Yin 2003) and patterns of social network maps (Schiffer and Hauk 2012).

The cross-case analysis investigates the implications of each case and its implications on the country's petroleum industry overall. That is, do influences that shape petroleum policy in Baghdad and Erbil operate similarly or differently, and if so, what effects do they have nationally? Although I anticipate the influence of patronage networks to persist in both cases, cross-case analysis will help the study explore the implications of nonhierarchical, decentralized patronage networks. The study anticipates that contextual considerations, such as perception of federalism and IOCs, will explain some of these policy divergences. Moreover, while formal mechanisms and institutions of accountability in each case are anticipated to be weak, other rather informal avenues to accountability, or its circumvention, merit study. Further, the internal dynamics within each case and across them have implications for federalism, petroleum export stability, institution building, and patronage politics.

Overall, the case of Iraq is relatively unique, especially in the Middle Eastern context, as a country where policymaking has been formally and

informally fragmented over the country's main economic revenue. It is an opportunity to explore how policymakers reinvent, or in the case of Kurdistan, create petroleum policies. It also seeks to show whether oil federalism has helped the country's transition to accountable governance or contributed to resource curse and the dysfunction of the central and regional governments. The conflict over resources in oil-rich Sudan across ethnic lines resulted in partitioning the country. In post- Qaddafi Libya, the country's oil-rich eastern provinces have voiced interest in greater autonomy.<sup>65</sup> Other multi-ethnic African states, such as Ghana and Ethiopia, may soon join the oil-producing club<sup>66</sup> and face challenges that Iraq has been facing since 2003. Iraqi government's highly hierarchical and centralized past is the main source of the Kurdish backlash against centralization. Iraq's post-2003 attempt at establishing oil federalism is a case that merits a close and multi-pronged study, which is the goal of this dissertation.

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<sup>65</sup> Hendrix, Steve. 2012. "Post-Gaddafi Libya Confronts Its Diversity." The Washington Post, April 1.

<sup>66</sup> See "Who are Africa's 6 newest oil-producing countries?" <http://allafrica.com/view/photoessay/post/post/id/201307120003.html#3>

## **CHAPTER 4: FEDERALISM AND POLICY FRAGMENTATION OF THE IRAQ'S PETROLEUM SECTOR**

This chapter focuses on the formal, institutional and legal framework and structure of Iraq's petroleum policy in the decade that followed the invasion of Iraq in 2003. It also identifies the key issues around the making, development and management of Iraq's petroleum policy and sector. The following two chapters will tie in these formal and structural issues and actors to the informal ones, and analyze the implications of policy fragmentation for the governance of Iraq's oil wealth, and the country's stability and transition to democracy.

### **Iraq's Petroleum Policy Framework**

Governance and management of Iraq's hydrocarbon resources goes to the heart of Iraq's post-Saddam nation building efforts, and will be decisive in determining its economic and political development. Particularly, the ownership and management of Iraq's petroleum resources and revenues could divide Iraq or keep it united. Ever since oil was found in Iraq, the resource has had significant political, economic and social impact on this post-colonial nation. Controlling oil has been the prerequisite for ruling the country. Former Iraqi

President Saddam Hussein understood this, and planted the seed for his ascendance to power and the presidency by championing the nationalization and takeover of Iraq's oil industry when he was vice president. In post-Saddam Iraq, the management of petroleum resources will continue to shape the country's economy, society, and political structure.

Upon the toppling of the Saddam Hussein regime in 2003, the U.S. and British governments and Iraqi political factions embarked on rebuilding and restructuring the Iraqi political and economic institutions. Of paramount importance was the rehabilitation of the petroleum industry, which was crucial to pay for the war effort and the country's reconstruction. In the presence of American and British troops and the absence of an heir apparent to the Baath regime, the different Iraqi ethnic and religious groups, influenced by the occupying forces, were persuaded that rule of law should be the basis for sharing power. Hence, with help and directions the Coalition Provisional Authority (CPA), the Iraqis wrote and voted for a constitution (Al-Ali 2014).

The first attempt at having a constitution was the passage of the Transitional Administrative Law, a temporary law of the land that was written under the auspices of the American-led Coalition Provisional Authority (CPA) and passed by the CPA-appointed Iraqi Governing Council. Differences over how power should be shared among Iraqi ethnic and sectarian constituents became apparent early on, especially on the decentralization of government and

the management of oil. Rather than deal with them, the Iraqi factions agreed to postpone working out these differences until an elected Iraqi parliament drafted the country's permanent constitution. Such deferment of crucial decisions became a habit in Iraqi politics, where facts on the ground kept changing, which precluded arriving at lasting solutions in favor of short-term deals.<sup>67</sup>

Key to Iraq's post-Saddam oil policy was the issue of federalism, which has significant implications for ownership of and control over the country's petroleum resources. Federalism was mainly a demand of the Kurds, who saw federalism as a guarantee to the preservation of Iraqi Kurdistan region's autonomy. Iraqi Kurdistan had enjoyed self-rule since 1991, thanks to the no-fly zones supported mainly by the U.S. Iraqi Kurds were also eyeing control of their own oil and gas resources, which would have been impossible with the existence of a strong central government in Baghdad.

### **Centralization vs. Decentralization, Public vs. Private Management**

There were two major questions around the new management of Iraq's petroleum sector. First, whether Iraq's petroleum resources be managed centrally from Baghdad (as it has been before the invasion), or decentralize it by devolving some powers to the oil-rich provinces. Second, whether the management of Iraqi petroleum sector should remain in the public domain, or denationalize it. If the

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<sup>67</sup> Some of the major issues that are still unresolved and continue to occupy Iraq's politics to date are, in addition to petroleum management, disputed territories including Kirkuk, the armed forces and power devolution to local governments.

latter, then a sub-question would be the role that the private petroleum companies should play. These options for post-Saddam oil ownership and management could be seen as a 4 by 4 matrix of centralized vs. decentralized management of oil, by the public vs. the private sector (see Table 3) (Springborg et al. 2007). During the monarchy and before full nationalization of Iraq's petroleum industry, the Iraq Petroleum Company (IPC), owned by a consortium of Western oil firms, had monopoly over Iraq's oil industry. Hence, Iraqi oil was privately owned and centrally managed by IPC during this period. Oil and gas became public property after Iraq nationalized the IPC in 1972, and established the Iraq National Oil Company. However, management remained centralized through this new Iraqi oil company. Saddam Hussein and his Baath Party used oil revenues to maintain power and international support, dominate the Iraqi state and society, and fund wars against Iran, Kuwait and the Iraqi people (see Chapter 1). After the 2003 Iraq war, policy discussions regarding the nature of ownership and management of Iraq's petroleum resources came to the fore once more.

**Table 3: Policy Matrix for Petroleum Ownership and Management Structure**

	Public	Private
Centralized		
Decentralized		

(Matrix created by author using insights from Springborg et al. 2007, 39.)

After prolonged discussions and deliberations mediated by the CPA, Iraqi policymakers settled, in principle, on public ownership and decentralized management of Iraq's petroleum resources, as laid out in Iraq's constitution. To decentralize public ownership would be to allow oil producing regions and provinces to own and manage the natural resources that lay beneath their feet. The drafters of the constitution agreed, in principle, to maintain public ownership<sup>68</sup> but allow for some devolution of power when it comes to setting policy and managing the petroleum industry (articles 111 and 112 of the Iraqi constitution, further discussed below).

Privatization, a neoliberal prescription, was on the table during the early

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<sup>68</sup>Article 111 of the Iraqi constitution maintains: "Oil and gas are owned by all the people of Iraq in all the regions and governorates."



phases of the invasion, calling not only for fragmentation of Iraq's energy industry but for a larger role for the private sector as well.<sup>69</sup> An investigative journalist argues, having obtained the release of government documents, that privatizing Iraq's energy industry was integral to U.S. and UK pre-war planning (Muttitt 2012). However, it soon became clear that privatization did not mean dialing back the clock to the monopolistic concessions awarded to the Seven Sisters.<sup>70</sup> Rather, oil companies wanted to gain access to Iraq's petroleum reserves and increase the supply of energy to global markets. Iraq's own history with nationalization and the region's tradition of strong national oil industries

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<sup>69</sup> See for example, a report by the Heritage Foundation entitled, "The Road to Economic Prosperity for a Post-Saddam Iraq" 2003, by Cohen and O'Driscoll. There are Iraqi voices that also called for creating public or private share holding oil companies. See for example, Al-Rahim, Basil. 2003. "Notes on Iraq: Reconstruction & Vitalization" June 2; and Mustafa, Sargul. 2012. "Dasturiyat al-qawanin alkhasa al-munadhima li mulkiyat al-mawarid altabi'ya wa al-sanadiq alkhasa bitawzee' iradatiha [The Constitutionality of Laws that Regulate the Ownership of Natural Resources and the Funds Dedicated to Revenue Distribution]." In *Al-Siraa' ala Qanun Al-Naft wa Al-Ghaz wa Ufuq Al-Hal* [The Conflict Over the Oil and Gas Law, and Scope of Solutions], 177-196. Erbil, Iraq: Masalla Organization (an NGO).

<sup>70</sup> The group of petroleum companies comprised Anglo-Persian Oil Company (now BP); Standard Oil of California, Gulf Oil, Texaco (now Chevron); Royal Dutch Shell, Standard Oil of New Jersey (Esso) and Standard Oil Company of New York (Socony) (now ExxonMobil).

would undercut denationalization or full privation of the petroleum industry.<sup>71</sup>

The main question became what role international oil companies ought to play.

In principle, Iraqi lawmakers ended up agreeing on public ownership. In practice, however, the Kurdish production-sharing contract (PSC) model allows foreign oil companies to partially own some of the oil they produce. Foreign ownership of Iraqi oil is one source of disagreement between the federal government in Baghdad and the regional government in Kurdistan (as will be elaborated below). Nonetheless, given Iraq's history with the British-dominated Iraq Petroleum Company, privatization of oil has been generally frowned upon, and seen as infringement of the country's sovereignty.<sup>72</sup>

The Kurds were most adamant to push for federalism to ensure the autonomous status the Kurdish region of northern Iraq had gained since the Gulf War of 1991. Moreover, federalism, according to Iraq's Kurds, guarantees that

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<sup>71</sup> I reviewed and consulted the Islamic Sharia law literature on ownership of natural resources. According to Ali Al-Qaradaghi, a scholar on Islamic economics and finance, minerals are the property of the umma, the populace, represented by the state. The state can act as delegate in managing the minerals for the public good, but cannot grant its total ownership to private parties, although it can offer temporary benefit sharing contracts (Al-Qaradaghi 2010, 3:99). As for taxation, the state can levy one fifth of the mineral revenues, or 2.5% if its extraction incurs a cost. However, despite many of Iraq's ruling political parties being Islamic, I have not come across any argument for nationalization based on these Islamic law provisions.

<sup>72</sup> As it will be elaborated later in this chapter, unlike Kurdish officials and policymakers, Arab policymakers interviewed for this research made stronger associations between oil and nationalism. Iraqi Oil Union, a syndicate of oil workers in Basra, demonstrated against privatization of the oil sector, fearing job losses (See Iraq: Mixing Oil & Blood 2007)

Iraq will not be centrally managed from Baghdad again. Some Iraqi Shia groups initially supported decentralization of power from Baghdad during the writing of constitution, such as the Islamic Supreme Council of Iraq (ISCI). However, the trend among major Shia parties has since increasingly shifted toward centralization (Alkadiri 2010). The divergent views about federalism is at the core of policy tensions over oil – the Kurdish government and parties see federalism as assurance of their autonomy, while the federal government and many Arab parties see federalism as a step toward Kurdish secession and Iraq’s disintegration.

### **The Iraqi Constitution and the Introduction of Federalism**

Iraq’s 2005 constitution enshrines federalism and the separation of powers. The preamble to the Iraqi constitution describes the new system of governance in Iraq as “republican, federal, democratic, pluralistic.” Also, Article 47 calls for establishing the separation-of-powers principle. Furthermore, the constitution recognizes Iraqi Kurdistan’s special status as a region, and sets the formula for the formation of new regions.<sup>73</sup>

The constitution defines what constitutes a region, and delineates the exclusive and shared rights and responsibilities of the federal government, regional governments, and provincial governments. Article 110 identifies the

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<sup>73</sup> Article 117 of the Iraqi constitution states, “This Constitution, upon coming into force, shall recognize the region of Kurdistan, along with its existing authorities, as a federal region.”

exclusive federal authorities, which include diplomatic representation; international treaties and agreements; foreign sovereign economic and trade policy; and commercial policy among others. Article 212 (First) on regional powers states that “The regional powers shall have the right to exercise executive, legislative, and judicial powers in accordance with this Constitution, except for those authorities stipulated in the exclusive authorities of the federal government.” Article 114 of the constitution enumerates the powers shared between the federal government and regional and local governments. On shared powers between the national and subnational governments, Article 115 of the constitution prioritizes the rights of regions and provinces.<sup>74</sup> Hence, unless specified in Article 110 as exclusive federal jurisdiction, regional and local government laws and regulation hold supreme over federal ones. It is important to notice that neither article 110 on exclusive federal powers nor article 114 on shared powers between federal and subnational governments refer to competence over the management of petroleum resources. In a rather unusual precedence of constitutions, oil and gas matters are addressed in separate and dedicated constitutional articles, 111 and 112, as discussed below.

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<sup>74</sup> Article 115 of the Iraqi constitution maintains that, “All powers not stipulated in the exclusive powers of the federal government belong to the authorities of the regions and governorates that are not organized in a region. With regard to other powers shared between the federal government and the regional government, priority shall be given to the law of the regions and governorates not organized in a region in case of dispute.”

## **Federalism, Petroleum Resources and Constitutional Ambiguities**

Iraq's constitution may have laid the foundation for co-governance and power sharing, but on the ground the delineation of powers, rights and responsibilities of Iraq's federal and subnational governments remained all but clear. Since the ratification of the Iraqi constitution in 2005, both the federal government and the KRG have adopted separate interpretations of the document. Rulers in Baghdad and in Erbil have different visions for what federalism and decentralization entail.

Iraqi power brokers have so far been unsuccessful in establishing the legal and institutional infrastructure for federalism to function. These institutions include, among others, courts with competence to deal with disputes between national subnational governments. Most important for Iraq's transition toward decentralized governance are the constitutional articles that pertain to the petroleum sector, namely articles 111 and 112. These articles are essentially vague, and have been subject to opposing and controversial interpretations. The constitutional principles have not been translated into actionable laws and policies, and a constitutional court tasked with interpreting the constitution is yet to be formed.

The constitution addresses ownership and management of Iraq's petroleum resources. Article 111 of the Iraqi constitution declares that, "Oil and

gas are owned by all the people of Iraq in all the regions and governorates.”<sup>75</sup>

Article 112 (First) states, “The federal government, with the producing governorates and regional governments, shall undertake the management of oil and gas extracted from present fields, provided that it distributes its revenues in a fair manner in proportion to the population distribution in all parts of the country” [emphasis added by author]. The cause of ambiguity in this article lies mainly in two parts, what the word “with” means, and what constitutes “present fields.” The joint responsibility is mentioned again in the Second section of Article 112 on setting hydrocarbon policy: “The federal government, *with* the producing regional and governorate governments, shall *together* formulate the necessary strategic policies to develop the oil and gas wealth in a way that achieves the highest benefit to the Iraqi people using the most advanced techniques of the market principles and encouraging investment” [emphasis added]. Policy formulation is, therefore, expected to be a joint effort by the national and subnational governments.

Through Articles 111 and 112, the constitution enshrines some principles: that oil and gas belong to all Iraqis, that federal and regional governments

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<sup>75</sup> A “governorate,” or province, is an administrative division in Iraq. There are 18 governorates in Iraq, each with a provincial government. Governorates can organize into a region. The only region in Iraq is the Kurdistan region, governed by the Kurdistan Regional Government (KRG). Each governorate has a governorate or provincial council and a governor. The Iraqi Kurdistan region has a president, a regional parliament and a regional government. “Governorates” and “provinces” will be used interchangeably throughout this work.

should share power in policy making and managing Iraq's petroleum resources, and that oil revenues should be distributed equitably among all Iraqis. These remain general principles and guidelines, according to which the Iraqi Council of Representatives (i.e. the parliament) should pass specific legislations and regulations. The Iraqi factions and political parties, however, have so far failed to agree on how to interpret these principles into laws.

Power politics and historical legacies color the key issues surrounding the management of Iraq's petroleum resources. Despite constitutional principles, there remain deep disagreements over federalism and power sharing between the central and the regional governments, and among Iraq's main ethnosectarian and political factions. Pertaining to petroleum management is the right and competence to explore and produce oil and gas; award contracts to foreign oil firms; export and monetize petroleum; and collect revenues. Normally, such issues would be regulated through laws, but Iraq's energy sector since 2003 has been developing amid what I describe as a legal vacuum, where these issues remain legally, politically and institutionally contentious and unresolved. Iraq's political and economic development has been under way, based on short-term political deals, existing laws and executive orders. Iraqi Kurdistan remains to date the only formally recognized region, which administers 17% of the national budget sent by Baghdad. The sections below will shed light on these issues.

## **Petroleum Legislation**

Despite numerous elections and different governments formed since the passing of the 2005 constitution, Iraq still lacks a comprehensive national hydrocarbon law and an agreed-upon legal framework that regulates the energy industry. Rather, energy policy has been fragmented between the federal government and the regional government of Kurdistan.

As discussed earlier, federalism is a contentious issue in Iraq, and remains so by developments on the ground, affecting Iraq's breadwinning petroleum industry. Given their experience with previous unfriendly central regimes in Iraq, Kurds feel threatened by the rise of a strong central government awash with oil cash. Shia Arab factions in Iraq were initially in favor of creating a super Shia region in oil-rich southern Iraq, but abandoned the plan in favor of consolidating power in the central government (International Crisis Group 2012; Kadhim 2011). In contrast, Sunni Arabs were categorically opposed to federalism, seeing it as precursor to the disintegration of Iraq. That view among Sunni Arabs is changing, however, fearing imposition from a Shia-dominated central government (Kane, Hiltermann, and Alkadiri 2012).<sup>76</sup>

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<sup>76</sup> See also, in an ABC News/ BBC News/ NHK poll dated March 16, 2009, 91% of Sunni respondents favored a central government, compared to 74% and 18% of Shia and Kurdish respondents respectively. Only 5% of Sunnis thought Iraq should have a regional government structure.



## **Iraq's Federal Hydrocarbon Legislation**

As mentioned above, Iraq's constitution mandates a legislative framework to regulate the country's hydrocarbon industry and to ensure equitable sharing of oil and gas revenues among Iraqi citizens in all provinces. Iraq's federal parliament, formally the Council of Representatives, has received three different versions of a draft oil law. Two of them are rather recent, proposed in 2011, one written by the Iraqi parliament's oil and gas committee and another by the 2010-2014 Iraqi cabinet. These are mainly amended versions of an earlier draft law that dates back to February 2007.

In mid-2006, a three-member Oil and Energy Committee drafted the first Iraqi hydrocarbon legislation framework.<sup>77</sup> The framework was presented to a political negotiating committee comprised of Iraq's different political factions for edits and comments.<sup>78</sup> In February 2007, the Iraqi cabinet (i.e. the Executive

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<sup>77</sup> The three-member committee consisted of three technocrats: Farouk Al-Kasim, Thamer A-Ghadban and Tariq Shafiq. The latter two have been interviewed for this dissertation. Also, The U.S. Department of Commerce helped with the drafting of this law; interview with Mathew Amitrano, Energy Analyst at U.S. Department of State, April 15, 2010.

<sup>78</sup> Tariq Shafiq, one of the drafters of the 2007 draft law and who was interviewed for this research, laid out to Congressional committee the "principal criteria" for the Iraqi national oil and gas law (Christoff, Shafiq, and Saliba 2007, 42):

branch) approved the draft hydrocarbon law and, in July, forwarded it to the Iraqi Council of Representatives (parliament) for a vote. Before the parliament could vote on it, Iraq's Shura Council, a judicial body, reviewed the draft law. Although they endorsed it at the cabinet level, Kurds withdrew their support for the draft law over changes that the Iraqi Shura Council later made to the draft law. For the Shura Council, the changes were semantic, necessary to align the draft law with the Iraqi constitution. To the Kurdish negotiators, however, the changes limited the Kurdish rights over oil and gas found in their region (Christoff, Shafiq, and Saliba 2007), and hence deemed the amended bill unacceptable. Kurds in effect halted the parliamentary deliberations of and a vote on the draft law.

As negotiations over the national hydrocarbon law failed, the Kurdistan regional parliament passed its own oil and gas law later in 2007, and started signing more contracts with IOCs accordingly. The Kurdish law has become the

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One, reconciliation and production capacity growth are a priority; Two, prevent struggle over control of the resource management between the Federal and regional governments to preserve the unity of the country and nation; Three, a strong National Oil Company seeking management and technology services from the international oil companies and the gradual introduction of the IOC's on one or two other areas; Four, the principal policy choice should be unified plans, policy and management running from the center in order to achieve efficiently the production of maximum return which is a condition made by the constitution; Five, reconcile Federal versus regional conflict through a compromise where policy and management by the Federal Government run from the center not only in cooperation with the regions or provinces as required by the constitution, but also in participation on both aspects of the management of the resource, that is to say the development as well as the exploration.

legal basis for the development of the Kurdish energy sector ever since. The federal petroleum industry also developed despite the failure to pass a national petroleum law. The federal government resorted to old laws and rules, an interim registration agreement, and aspects of the draft law to move forward with its oil and gas contracts. The federal government has also developed a body of unpublished Ministerial Instructions (akin to executive orders) that could further complicate future legislative changes (Brimson, Addison, and Thomson 2013). Ongoing political tension over oil, intertwined with power politics and disputed territories, have created inertia toward passing a national hydrocarbons law.

Iraq's legal hydrocarbon framework entails the following aspects and provisions (Blanchard 2009; Brimson, Addison, and Thomson 2013):

a) The establishment of the Federal Oil and Gas Council (FOGC): this federal institution's mandate would be to set national policies and plans that govern oil and gas exploration, production and transportation. The Council would also be responsible for reviewing all contracts involving the hydrocarbon sector. Its members would consist of specific cabinet members, a representative from the Kurdish government, representatives from producing provinces, and industry experts. Since the Sunni Arab provinces are poor in energy resources, this formation structure raised concerns of under-representation with the Sunni groups.

b) Set the criteria for contracting: The law would identify and elaborate on

the qualitative criteria set in the constitution (Article 112) for contracting in the oil and gas sector. The draft law does not mandate any contract models (on models, see section below). The criteria for contracting include guaranteeing Iraqi control over the resources and maximizing economics returns for the country.<sup>79</sup> Hence, the FOGC would have the competence to review Iraqi and Kurdish oil contracts. However, the KRG has categorically refused Baghdad's authority over its oil contracts, seeing such an oversight as diluting its regional powers.

c) Revenue collection: The draft oil law empowers the federal government to collect all revenues from the sale of oil and gas. As part of the national budget, federal expenses, such as defense, would be initially deducted from oil and gas revenues; the rest will then get equitably distributed to Iraqi provinces on a per capita basis every month. The Kurdistan region has received a set 17% of the national budget. In the lack of a national census, Iraq still relies on population figures produced by the United Nations during the oil-for-food program.

Therefore, the 17% remains a figure based on political agreements.<sup>80</sup>

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<sup>79</sup> Maximizing economic returns through central management is goal of the national oil and gas law as communicated by the technocrats who drafted the bill (Al Ghadhban 2012). Also see (Christoff, Shafiq, and Saliba 2007).

<sup>80</sup> Federal deductions, and in January 2014 a complete budget cut, have been a source of dispute between the federal and the regional government. Conducting a census has been complicated by the ethno-sectarian make-up of the disputed territories, such as Kirkuk, where a sizeable Arab population were resettled into the province by the Baath regime. Also, expanding the sovereign expenses reduces the share of the budget to be allocated to the KRG, since the KRG's share is allocated after federal expenses are allocated.

Centralization of revenue collection and distribution was among the recommendations of the Iraq Study Group (recommendation #28) presented to the U.S. administration in 2006 (Iraq Study Group (U.S.) et al. 2006). The State Oil Marketing Organization (SOMO) would make all petroleum sales, although the KRG natural resources minister, Ashti Hawrami, said that the KRG has the right to independently export oil (Van Heuvelen 2012g).

d) Revenue Sharing: According to the annexes to the draft hydrocarbon law, Iraq should establish two funds: “the Oil Revenue Fund” and “the Future Fund.” Amid political bickering, Iraq and the KRG currently spend all of the oil revenues. Although a draft revenue sharing law is on the shelves, deliberating it is pending larger political agreement on roles and responsibilities of the federal and the regional governments of Iraq and Kurdistan. Creating these funds are crucial steps for Iraq to diversify its economy and invest the revenues of a depleting resource to avoid economic volatility associated with oil-dependence. However, such long-term interests are being forsaken for short-term gains (Springborg et al. 2007).

e) Regulating the Oil Ministry and the national oil companies: The framework also sets the basis for separating policymaking and implementation. It requires the passage of two additional laws, one that regulates the oil ministry, and another the Iraqi national oil companies. Currently, the ministry of oil sets as well as implements oil policy. The separation of power between the two – the

ministry as policymaker, and national oil company as commercial entity – is sought to enhance accountability and oversight in the sector. Again, the drafts of these laws have been shelved until a political deal is reached.

The 2007 draft law was amended twice in 2011 resulting in two more versions of the bill, one was proposed by the Iraqi parliament oil and gas committee, and another by the Iraqi oil ministry. The two versions have major differences regarding the decision-making and oversight powers it grants different government institutions. For example, regarding the proposed Federal Oil and Gas Council, which would be Iraq's main policy making body in the energy sector if formed, the ministry's version wants the Council to be part of, and its chairperson *appointed* by and report directly to, the Executive branch (the prime minister). The parliament, on the other hand, wants the Council and its chairman to be elected by and to report to the Legislative branch. The KRG sides with the latter for Baghdad, although, at home, ironically, the KRG prime minister heads the Kurdish regional oil and gas committee that enters into contracts with oil companies. Indeed, careful reading and comparison of the cabinet draft law indicates how eager the federal government is not only to centralize policymaking powers in Baghdad, but also to put them in the hands of the prime minister and the ministry of oil.

### **KRG Legislation**

Kurdish regional parliament's oil and gas law, NO. 28 of 2007 regulates

KRG's energy industry. The law grants the Kurdish government to enter into oil and gas exploration and production contracts and establishes the institutions for managing KRG's petroleum sector, including the Ministry of Natural Resources. The hallmark of the law is Production-Sharing Contract (PSC), set as the model for attracting and dealing with IOCs operating in the region. KRG's main contention with the federal draft law is over control and management of fields in the Kurdistan region.

The KRG wants decision-making autonomy and opposes Baghdad's demand to approve Kurdish oil contracts. However, in principle, the KRG agrees to the principle of *revenue sharing* set forth in the constitution (Blanchard 2009).<sup>81</sup> In the absence of a national hydrocarbons law, KRG and Baghdad disagree on how the petroleum industry should be managed and its revenues shared. Baghdad wants to control the sale and monetization of oil from all Iraqi fields, including those in Kurdistan, through the State Oil Marketing Organization (SOMO), a national company. The KRG, on the other hand, wants a revenue stream that is not under the control of the federal government. Among KRG's aggressive tactics for independent revenue stream have been direct oil sales. The KRG initially agreed that oil from Kurdistan be sold by the federal government through the (SOMO), and indeed did so for a short time. But as disputes over

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<sup>81</sup> KRG officials have reiterated these concerns and contentions on numerous occasions. Then KRG representative to Washington, DC Qubad Talabani detailed Kurdish concerns in an interview with the author in April 2010.

revenue sharing heightened, the Kurdish government started stretching their interpretation of the constitution and regional rights to include direct sale of oil, rather than through SOMO (Van Heuvelen 2012g). Mr. Ashti Hawrami, KRG's natural resource minister, maintained that revenue sharing involved monetized oil, and not the oil itself. This approach granted his ministry the right to sell oil directly and share its revenues with Baghdad.

Although the KRG has an oil law, which could put its industry on a stronger legal footing compared to the federal government, it has been selective in implementing its own oil law. For example, while the KRG has used the law to sign tens of oil and gas contracts, it has ignored other mandates of the law such as establishing Kurdish national oil companies and an oil fund.<sup>82</sup> One explanation of such selective implementation of its own law could be the KRG's outward-looking energy policy, prioritizing contracts with foreign oil companies over building strong local institutions. The KRG may have also benefited from less transparency and rule of law at home in order to avoid Baghdad's and domestic opposition parties' scrutiny.

Kurdish oil minister says that the reason Iraq does not have an oil law is because many in Baghdad do not want to have one. "They want centralization

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<sup>82</sup> Articles 9 and 10 call for the establishment of Petroleum Law The Kurdistan Exploration and Production Company (KEPCO) and the Kurdistan National Oil Company (KNOC), respectively. Article 13 establishes the trust fund. The English version of the law can be found at [www.krg.org/pdf/2\\_English\\_Version\\_Kurdistan\\_Petroleum\\_Law.pdf](http://www.krg.org/pdf/2_English_Version_Kurdistan_Petroleum_Law.pdf)



and they know they cannot achieve that by law... So, by not acting on the law is the best way to just [force] centralization against the constitution,” Ashti Hawrami said in an interview with a reporter. He went on to criticize the federal government’s contracts, “They never consulted the provinces when they signed the deals in the south. They deprived them of any decision-making. And there is no Parliament approval of those contracts either, and there is no law” (Van Heuvelen 2012f).

KRG’s unilateral attempts could have serious implications for oil exports, revenue collection and sharing, and the governance of the petroleum sector. When the KRG started signing oil contracts according to its regional law, 60 Iraqi oil sector leaders and 120 parliamentarians publicly opposed KRG's actions. In return, the KRG commissioned reports by lawyers and consulting firms to point out that its contracts were constitutional and superior to those proposed by the Iraqi government (KRG 2008). Despite these legal battles fought directly and through hired hands, both sides established facts on the ground. Divergent policies and actions toward oil management render coordinating oil sales and revenue sharing particularly difficult, especially once Iraq rejoins OPEC and needs to abide by its quota system. In the absence of coordination and agreement, moreover, lack of transparency and accountability is the high price that Iraq’s energy governance must pay.

## **Competence to Sign Oil Contracts**

One of the core issues in the conflict between the federal and the regional governments over oil in Iraq is the divergent approach to contracting with and outsourcing to international oil companies (IOCs). The Kurdish government adopted the oil-contracting model of production sharing contracts (PSC), while the federal government opted for technical service contracts (TSC). The federal Iraqi government calls Kurdish contracts illegal since they are based on the unconstitutional Kurdish oil law (in Baghdad's view) and grants IOCs the right to own some of Iraq's oil. Kurdish officials, on the other hand, call the federal government's contracts inefficient and incapable of attracting investment and boosting oil production.<sup>83</sup> Hence, oil has been added to an already intricate web

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<sup>83</sup> The KRG claims that the federal technical service contracts (TSC) are inefficient because they do not align the interests of the government and the oil company. Hence, the companies can overcharge the government for their services. Moreover, since they do not share the revenues, the IOC has lesser incentive to better maintain the health of the oil reservoirs. As far as oil exploration goes, where risks are usually higher, the TSCs had limited success in attracting investors (see discussion below and

Table 4 on Iraq's licensing rounds, especially the 4th round).

of issues, tying together grievances related to power, politics, wealth distribution, and geography.

**Despite the lack of a comprehensive national oil law, the federal and the regional governments have both independently signed dozens of petroleum exploration and production contracts with foreign oil companies. Even before the Kurdish regional oil and gas law was passed, Kurdish officials had signed a few contracts with IOCs.<sup>84</sup> Despite Baghdad's repeated disapproval, Ashti Hawrami, KRG minister of natural resources, reiterated the Kurdish understanding of the Iraqi constitution that authorizes the KRG to handle all aspects of oil as long as it is sharing revenues with federal coffers. KRG Natural Resources Ministry has signed 60 petroleum contracts with IOCs that come from around a dozen countries (See and**

for an overview of KRG contracted blocks, its oil and gas industry infrastructure, and IOCs operating its fields). Baghdad has consistently asserted that KRG's oil contracts are illegal, and banned IOCs dealing with the KRG from bidding on federal contracts. On the other hand, the federal government has also been signing contracts with oil firms despite the lack of a national oil law. The drafts of the oil law call for the formation of the Federal Oil and Gas Council (FOCG) where national, regional and local governments share decision-making power and authority over signing contracts. In the absence FOCG, and amid contested sovereignty, the KRG and Baghdad have unilaterally entered into oil

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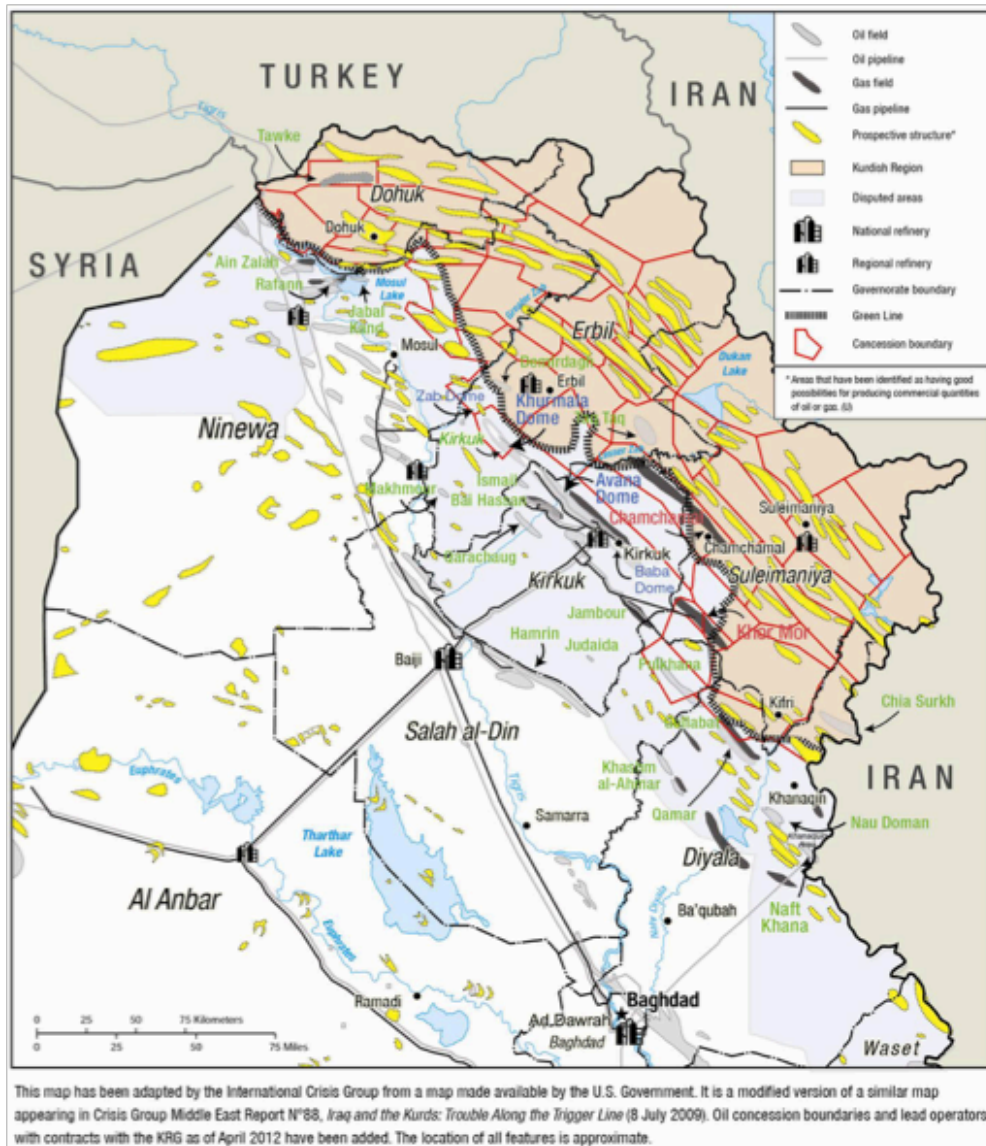
<sup>84</sup> Qubad Talabani told the author that before Hawrami joined the KRG as oil minister to regulate the oil industry, local politicians were independently inviting IOCs to drill for oil. The KRG oil law was necessary in stopping these "oil mafias."

agreements with international oil companies.

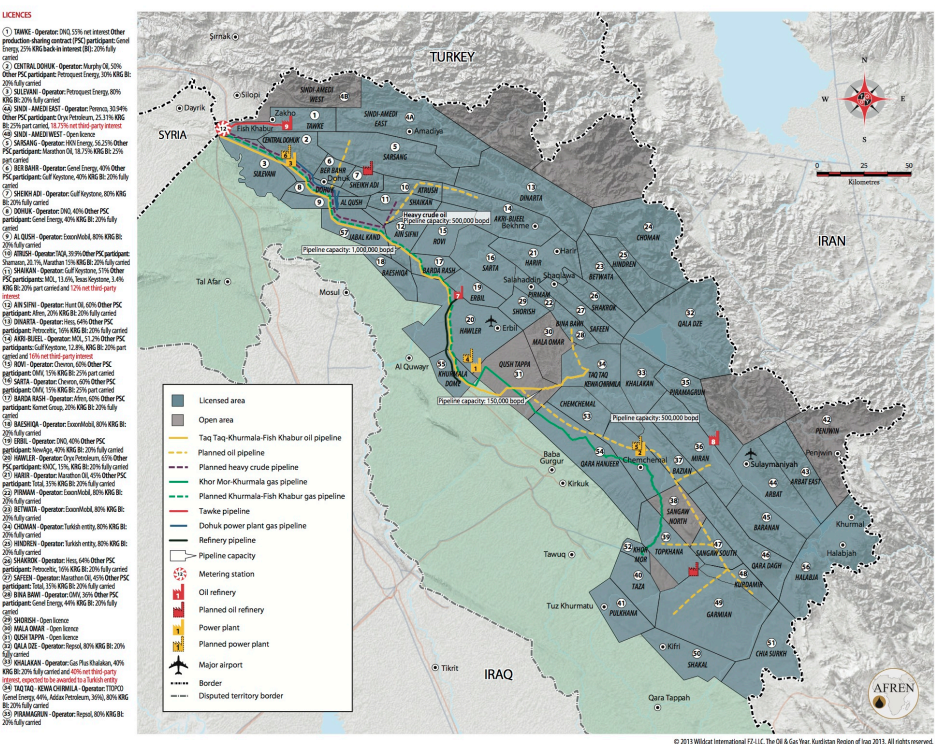
In addition to the legal dilemma, both the federal and the regional contracts have been criticized for their lack of accountability.<sup>85</sup> Baghdad and the KRG may disagree on who has competence over signing oil contracts with IOCs; however, both governments have sidelined the role of the legislatures in their respective governments in overseeing their contracts. Former Iraqi Prime Minister Nouri Al-Maliki and his deputy for energy, Hussein Al-Shahristani, both agree that the Oil Ministry has the competence to sign oil contracts, which become legally binding once approved by the Council of Ministers (the cabinet) (Jiyad 2010). The KRG does not pass its contracts by the Kurdish parliament either. In fact, the KRG signs oil contracts with IOCs by direct invitation rather than Baghdad's process of prequalification and competitive bidding.

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<sup>85</sup> The next chapters will further focus on issues of accountability and transparency.



**Figure 2: Oil and Gas Fields in the KRG, the Petroleum Infrastructure, and the Green Line. (Source: International Crisis Group, N°120, p. 27).**



**Figure 3: Northern Oil and Gas Fields, KRG Concessions, Lead Operators, and Green Line**  
(Source: Afren. Found in *The Oil and Gas Year*, Iraqi Kurdistan, 2013)

Weak checks on the management of the energy sector optimize opportunities for corruption. Even by the set standards, federal oil contracting process lacks accountability and tips the power balance in favor of the executive branch. An analysis of events leading up to the first round of Iraqi contracts by Ahmed Jiyad, an Iraqi scholar with the Centre for Global Energy Studies, indicates that even the Iraqi cabinet ministries were not consulted adequately. Lack of a legal framework and due process in signing oil contracts would result

in too much power vested in the Ministry of Oil (Jiyad 2010). In the case of the KRG, Kurdish officials often argue that there is no need to consult the parliament on every contract, since the contracts comply with the regional oil law. Hence, denying the parliament its oversight duties.<sup>86</sup>

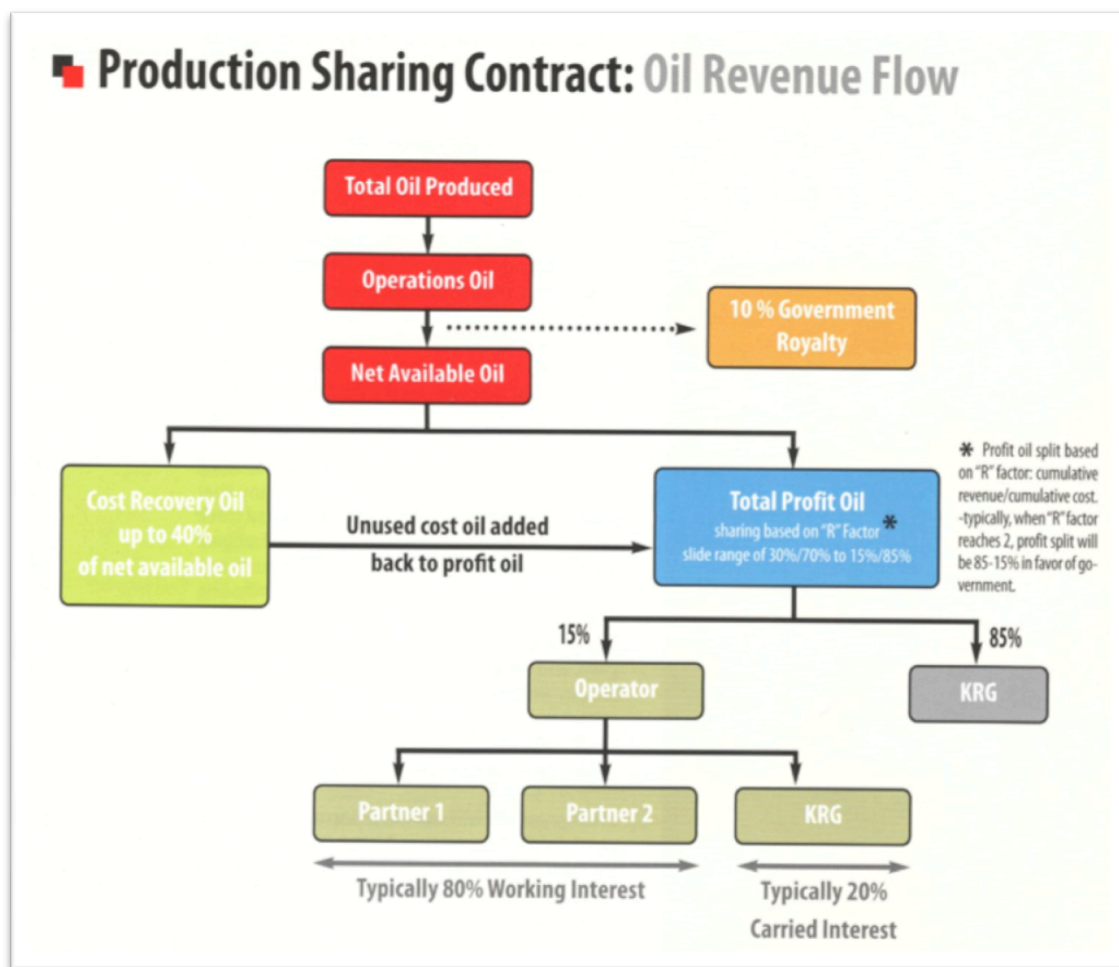
## **Contract Models**

KRG's production-sharing contracts (PSC) model is the industry's favorite. The oil companies are considered investors rather than service providers. Premised on a risk-reward incentive structure, the oil companies alone bare the cost and risk of exploring and producing oil. But once they find oil at commercial quantities, they share oil revenues with the government in the forms of cost-recovery and profits with the government. (Tordo, Johnston, and Johnson 2010). Moreover, the company can book the petroleum it finds as its own reserves. For international oil companies, replenishing with reserves the oil they produce is critical, especially to maintain and boost the company's share prices and stocks. Hence, PSCs give oil companies a greater stake in the local oil sector where they operate.

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<sup>86</sup> In September 2013, Kurdish parliamentary elections resulted in the ascendance of Gorran, an opposition party, which promised a more active role of parliament in overseeing the oil and gas sector.





**Figure 4: Production Sharing Contract Model's Revenue Flow**  
 (Source: *The Oil and Gas Year: Kurdistan Region of Iraq*, 2009, 79. Also available at [www.mnr.krg.org](http://www.mnr.krg.org))

Figure 4 above demonstrates the distribution of oil revenues according to KRG's Production Sharing Contract model between the different stakeholders. These figures and percentages can be altered through negotiations between the KRG and the oil petroleum company. If the oil firm is unable to strike oil, then it



loses its investment and will not be able to recover the cost. When it finds oil at commercially viable quantities, the government takes a 10% royalty from the oil produced. The remaining net available oil will be divided into two main categories: cost recovery and profit oil. Up to 40% of the net oil can be allocated for cost recovery. Profit oil, on the other hand, will be shared between the government and the IOC, on basis ranging from 30% - 70% to 15%-85%, where the government takes the larger share. Moreover, the government has a 20% carried interest in the contracts as an operator.<sup>87</sup> The KRG also receives different bonus payments from IOCs, such as contract signing and oil production bonuses. By end of 2013, the Kurdistan Regional Government had independently signed 60 PSCs with foreign oil companies from more than a dozen different nations. KRG's contracts offer IOCs between 12% and 15% share in the oil the IOCs find (International Crisis Group 2012; Brimson, Addison, and Thomson 2013).

Because it allows the private firms to share the oil, PSCs are closer to privatization and concessions contracts than service contracts (TSCs). Although PSCs are often adopted when the risk of finding oil is high, such as in difficult terrains (Tordo, Johnston, and Johnston 2010), companies in the Kurdistan have had 70% success rate at finding oil (International Crisis Group 2012). PSCs have been an effective political tool to attract investors to venture working despite

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<sup>87</sup> The KRG law requires the establishment of a national oil company that will hold the 20% carried interest in these contracts. This company is yet to be created.

Kurdistan's legal disagreements with Baghdad (See Figure 5).



Figure 5: KRG's Oil and Gas Blocks, with Green Line (Source: International Crisis Group, N°120)

Iraq, on the other hand, signed technical service contracts (TSCs), where the oil companies are retained not as partners but as service providers.

Nationalized oil and gas industries often use international companies through service contracts, where the government retains full control over the oil. TSCs are also used more often to produce oil in explored fields, where oil is already found (Tordo, Johnston, and Johnston 2010). In many of these service contracts, Iraq's national oil companies work with their foreign counterparts.

The Iraqi federal government started signing service contracts with major IOCs in 2009 through bidding rounds preceded by pre-qualifications. The first and second rounds took place in 2009, where petroleum companies were awarded contracts to boost production in brown (i.e. already producing) fields, and produce oil at green (explored but not producing) fields. These were Iraq's giant oilfields (Figure 6). IOCs were required to be prequalified before they could bid dollar values per barrel of oil produced in the fields auctioned by the Iraqi oil ministry. Companies were also required to take an Iraqi national oil company as a local partner, with a 25% operation stake (Blanchard 2009).

A total of ten oil fields were awarded to IOCs during the first and second bid rounds, covering a total of 62.7 billion barrels of Iraq's oil reserves, 43% of Iraq's 145 billion barrel proven reserve. The minimum length of these contracts is 20 years, where Iraq will be spending \$100 billion in capital investment and operation costs (Jiyad 2010) (See also Clark (2010) for details on these companies,

their blocks and shares). According to TSCs, the government pays IOCs a remuneration fee between \$1.15–\$6 per barrel of oil produced, depending on location and cost of production (Kadhim 2011) (See

Table 4: Iraq's Bidding Rounds for Oil and Gas Production . In the first round, IOCs were required to boost production by 10% in already producing oilfields. In the second round, they must start production within 18 months (*Iraq: The Essential Guide to Foreign Investment* 2010).

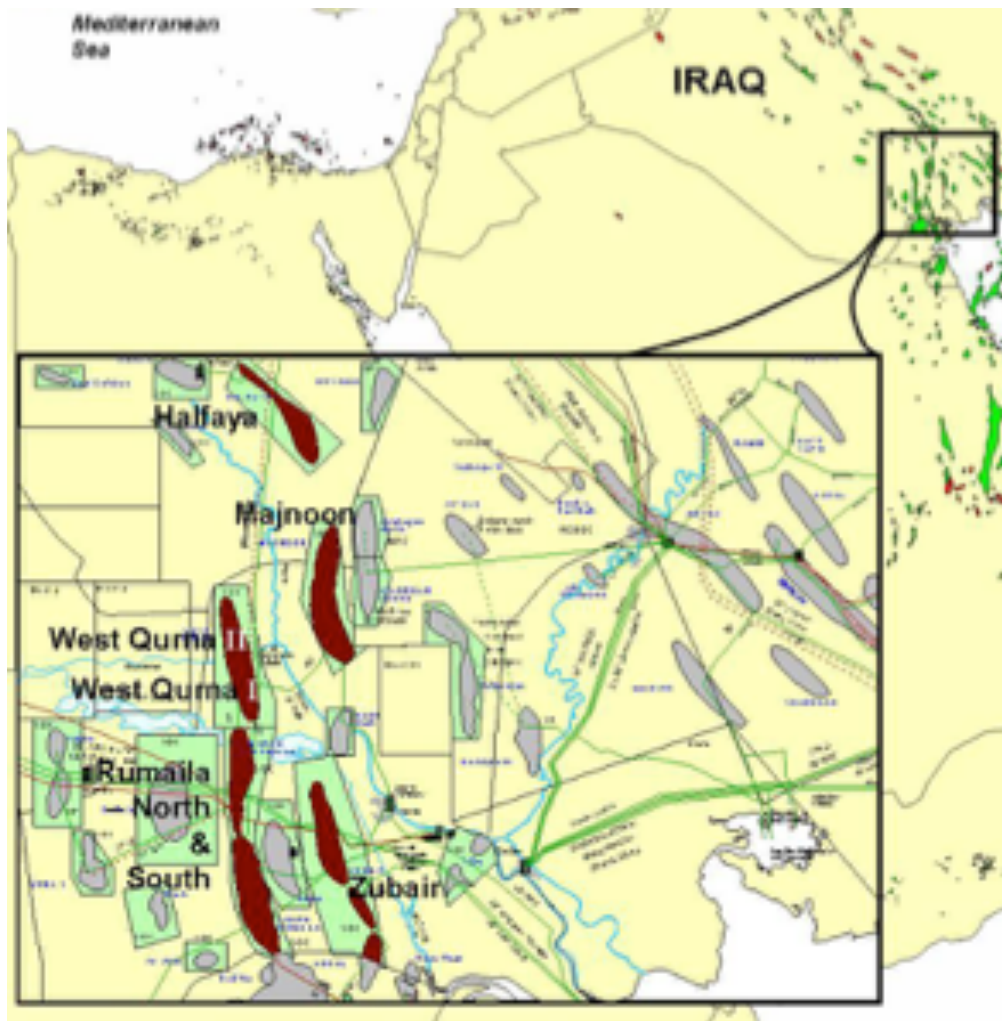


Figure 6: Iraq's Giant Petroleum Fields: West Qurna I, West Qurna II, Zubair, Majnoon, and Halfaya (Source: Clark 2010).

In the third round, Iraq auctioned its gas fields for the first time in Iraq. The bidding round was organized in 2010, where the Iraqi gas fields of Akkas, Mansuriah and Siba were awarded. Shell and Mitsubishi won the sizeable contract to capture Iraq's associated gas in Basra, which along its oil deals, gives Shell the largest petroleum portfolio in Iraq (Smith and Lando 2011). Gas deals

are the bedrock of Iraq's ambitious plans to raise gas production from 2.5 million bpd to 12 m bpd in 6 years. However, Iraq's plans to boost petroleum production may indeed be too ambitious given the country's poor export infrastructure and governance (Jiyad 2010). Iraq held a fourth bidding round in mid-2012, where IOCs were invited not to produce in brown and green fields, but to explore for new oil and gas reserves. Only a quarter of the blocks auctioned were bid on and awarded. The main reason for such a low rate of contracts awarded was the unattractive terms of the service contracts that the Iraqi federal government offered IOCs (Lando 2012a; Al-Khateeb 2013a).

**Table 4: Iraq's Bidding Rounds for Oil and Gas Production (Source: U.S. Energy Information Agency 2013)**

		2009 prod. 1,000 bbl/d	Target prod. 1,000 bbl/d	Target incr. 1,000 bbl/d	Reserves (billion bbl)
Operators					
<b>First bidding round (brownfields), June 29-30, 2009</b>					
Rumaila	BP, CNPC	1,000	2,850	1,850	17.8
West Qurna, Phase I <sup>1</sup>	ExxonMobil, Shell	270	2,325	2,055	8.6
Zubair	Eni, Occidental, Kogas	205	1,200	995	4.0
Missan Group	CNOOC, TPAO	86	450	364	n/a
<b>First round total</b>		<b>1,561</b>	<b>6,825</b>	<b>5,264</b>	<b>&gt;30</b>
<b>Second bidding round (greenfields), December 11-12, 2009</b>					
West Qurna, Phase II	Lukoil, Statoil <sup>2</sup>	0	1,800	1,800	12.9
Majnoon	Shell, Petronas	55	1,800	1,745	12.6
Halfaya	CNPC, Petronas, Total	3	535	532	4.1
Garaff	Petronas, JAPEx	0	230	230	0.8
Badra	Gazprom, KOGAS, Petronas, TPAO	0	170	170	0.1
Qaiarah	Sonangol	2	120	118	0.9
Najmah	Sonangol	0	110	110	0.9
<b>Second round total</b>		<b>60</b>	<b>4,765</b>	<b>4,705</b>	<b>32.3</b>

<sup>1</sup> ExxonMobil was asked by Iraq to choose between this project and its projects in the KRG.

<sup>2</sup> Statoil exited this project in March 2012.

Sources: Special Inspector General for Iraq Reconstruction, Middle East Economic Survey, Iraq Ministry of Oil

### Results of fourth bidding round May 30-31, 2012

	Operators	Hydrocarbon	Location
Block 8	Pakistan Petroleum	Oil/Gas	East central Iraq, 110 km east of Baghdad
Block 9	Kuwait Energy, Dragon Oil, TPAO <sup>1</sup>	Oil	Southern Iraq, 20 km north of Basra
Block 10	Lukoil, Inpex	Oil	Southern Iraq, southwest of Nassiriya
Block 12	Bashneft, Premier	Oil	between Najaf and Muthanna

<sup>1</sup> The Iraqi government has not signed a contract with TPAO and has asked Kuwait Energy to take over TPAO's share.

Source: Middle East Economic Survey, Iraq Ministry of Oil

Gas Field	Operators	Estimated Reserves (Tcf)
<b>Third bidding round, October 20, 2010</b>		
al-Mansuriyah	Kuwait Energy, KOGAS, TPAO	3.3
Akkas	KOGAS, KazMunaiGas	2.1-4.0
Siba	Kuwait Energy, TPAO	0.1
<b>Third round total</b>		<b>5.5-7.4</b>

### Fourth bidding round, May 30-31, 2012

Gas Field	Operators	Estimated Reserves (Tcf)
Block 8	Pakistan Petroleum	Not Available

Source: Middle East Economic Survey

## Oil Export and Monetization Infrastructure

Pipelines in the north and ports in the south are the main transportation structures through which Iraqi oil is exported. Revenues from oil exports account for about 70% of Iraq's GDP and 95% of government revenue (International Energy Agency 2012, 17). Iraq has pipelines that connect its industry to the

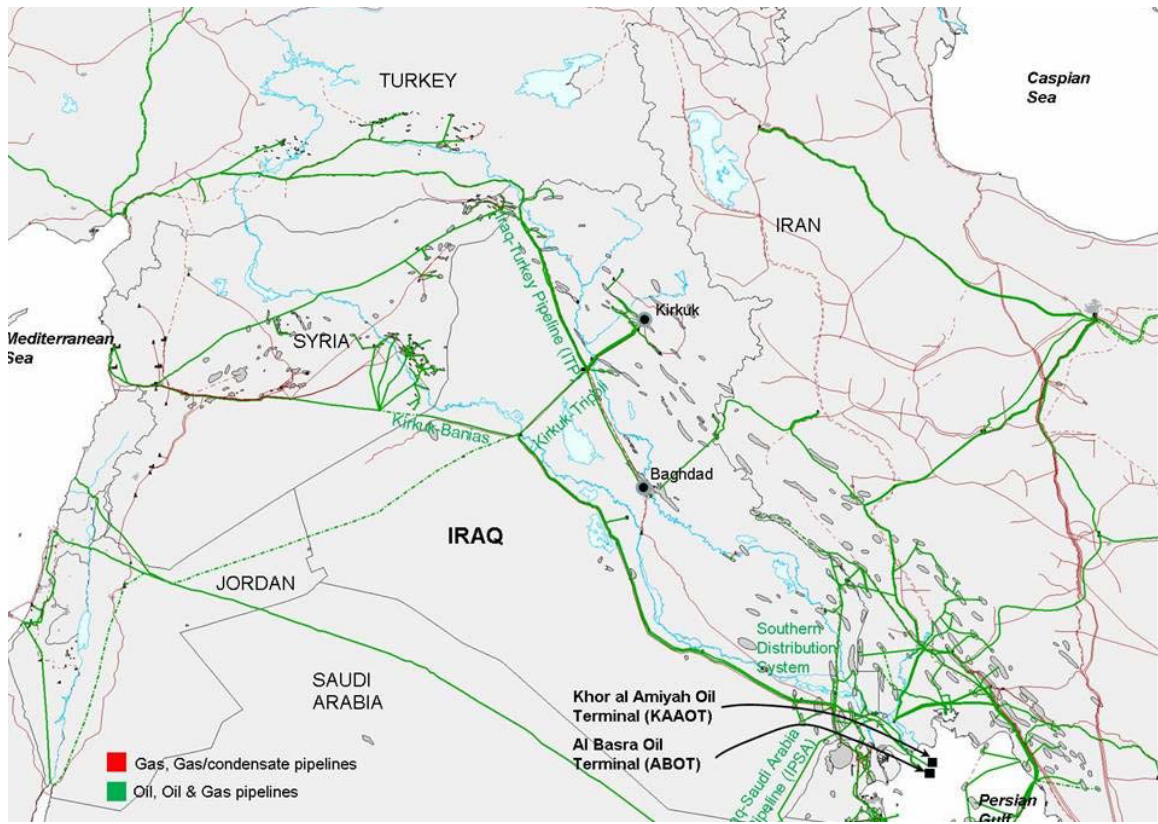


neighboring countries and waterways nearby. The main pipeline is the Iraq-Turkey pipeline that takes oil mainly from Iraq's northern fields to the Turkish Ceyhan Port on the Mediterranean. Until late 2013, Iraqi Kurdistan region did not have any pipeline infrastructure, and much of its oil was exported either through the Iraq-Turkey pipeline or through trucks. To break away from dependence on Baghdad and to make its energy industry more viable, the Kurdish government built a pipeline that connects its oilfields directly to Turkey (see Chapter 5 for more on pipeline politics).

Iraq has five main pipeline systems, a total of 4,300 miles (See Figure 7). First, the 600-mile (970 km) Iraq-Turkey northern pipelines link Kirkuk fields in the north to Ceyhan port in Turkey. This export route consists of two parallel pipelines, in 46 and 40 inches. This pipeline has come under most attacks since 2003, often forcing its shut down and Iraq's reliance on trucking. Sabotage and neglect has resulted in complete shut down of the 40-inch pipeline. Continued sabotage and eventually ISIS's incursion in summer 2014 completely Iraq-Turkey pipeline (Lando et al. 2014). Compared to export through pipelines, trucking is a more costly method of transporting oil. It is also more vulnerable to corruption and crime in the form of smuggling by insurgents and enterprising criminals alike (Glanz and Worth 2006; Williams 2009). Second, the southern oil port in Basra is the country's largest, which transports 1.3 million barrels a day. Iraq has plans to build four more pipelines, at 800,000 barrel per day (bpd) in Basra. These

new pipelines and the construction of new single point moorings boost Iraq's exporting capabilities (IMF 2011; EIA 2012). Third and fourth are pipelines take Iraq's oil to the west and south ports. The Kirkuk-Banias pipelines have been shut down since 2003 due to war and sabotage. The Iraq Pipeline to Saudi Arabia was shut down during the 1991 Gulf war. Iraq's fifth pipeline is the domestic Strategic Pipeline, which connects southern and northern fields so the country can continue export oil in the case of disruption. Iraq's only access to international waters is through Basra Oil Terminal which opens to the Persian Gulf, with the capacity of 1.5 million barrels per day (EIA 2012).

Iraq's pipeline and export infrastructure have been severely affected by war, sanctions and sabotage, and therefore need significant rehabilitation. Continued sabotage followed by ISIS control of swaths of land in Iraq's north completely shut down the Iraq-Turkey pipelines. The Iraqi government is planning to spend \$50 billion on modernizing the pipeline infrastructure (*Iraq: The Mother of All Oil Stories* 2010). Control and authority over these exporting pipelines, except for the new Kurdish lines, fall under the federal government. The Iraqi State Oil Marketing Organization (SOMO) is in charge of the sale of oil and gas, and expects the Kurdish government to sell its oil through SOMO as well.

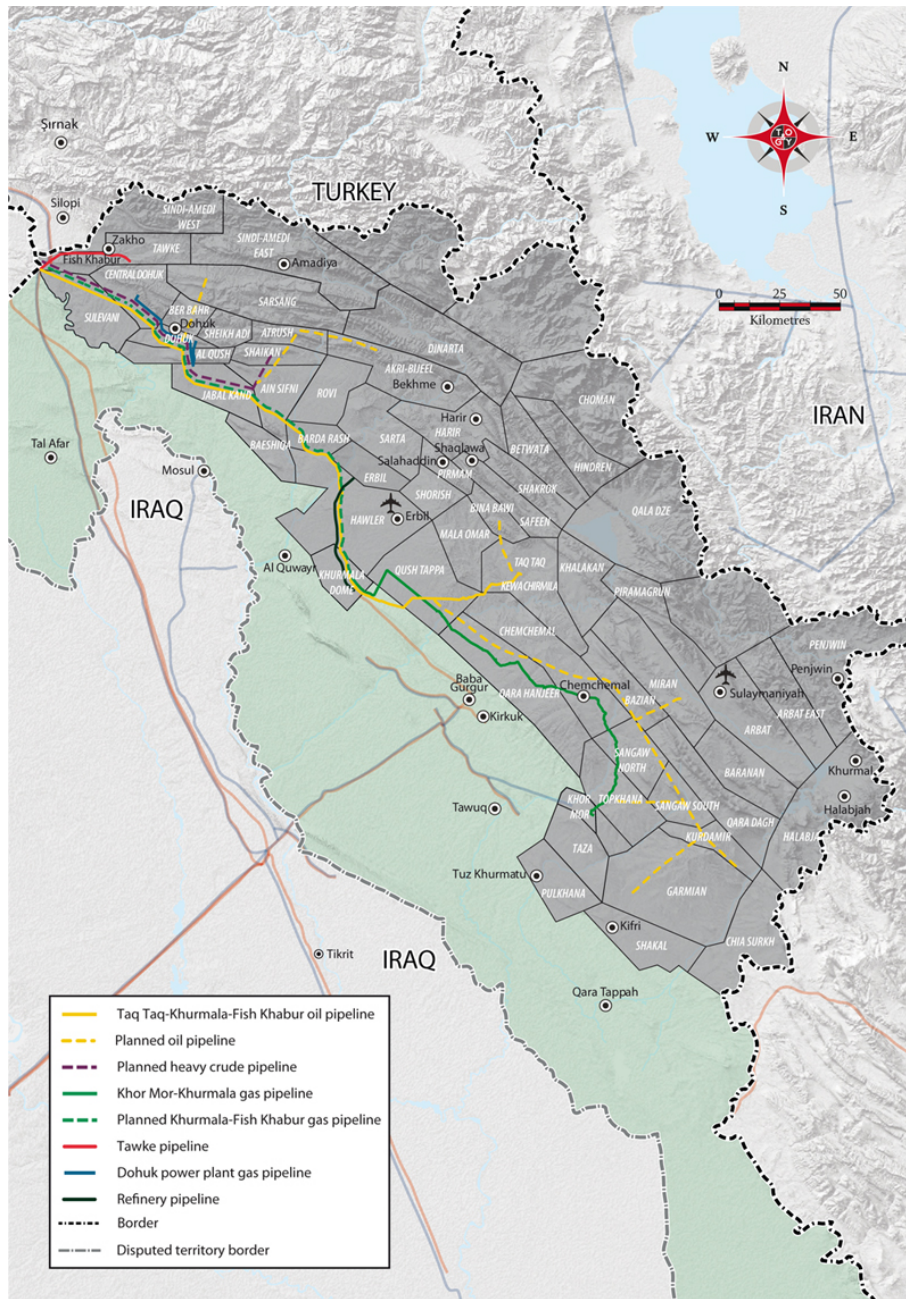


**Figure 7: Iraq's Pipeline Infrastructure**  
 (Source: Deutsche bank, "Iraq: The Mother of All Stories," 2010)

### KRG's Exports

KRG's energy industry will have limited viability without the ability to export and monetize the oil and gas produced in the region. First, without independent export outlets, the KRG's economy and oil industry will remain dependent on Iraq's export infrastructure. The Kurdish government receives 17% of Iraq's national budget, which makes the bulk of KRG's budget. However, this share of the national budget is subject to annual parliamentary approval, and therefore gives the federal government a sizeable leverage over the KRG. Second,

oil companies can recuperate their costs and gain profit only when the KRG can sell its oil, according to the terms of production sharing contracts. Disagreements and numerous failed settlements over revenue sharing with Baghdad have led the KRG to set up its own export pipelines. Toward the goal of economic independence and supporting its local energy industry, and to Baghdad's dismay, the KRG has been developing oil and gas export capacity through Turkey.



**Figure 8: KRG Oil Exporting Pipeline Network (Source: [www.KRG.org](http://www.KRG.org))**

The KRG first started autonomous oil exports first by trucking and later via pipelines. Kurdish crude was transported through a domestic pipeline (from

DNO's Tawke field) and trucking (from Addax's Taq Taq field) to the Khurlama export station and eventually in the Iraqi-controlled Kirkuk-Ceyhan export pipelines (Oil and Gas Journal 2009). In 2012, the KRG embarked on building its own export pipelines that would bypass Iraq's authority, which concluded in late 2013. The Kurdish pipeline passes through KRG territories and links its fields and different stations. Eventually, before entering Turkey, the Kurdish pipeline ties-in with the smaller 40 inch Iraqi-Turkish pipeline after an Iraqi controlled metering system. In December 2013, Kurdish oil entered Turkey independently for the first time.

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The management of Iraq's petroleum resources is at the core of the country's post-Saddam development and transition. Tenets of oil federalism might have been introduced in the Iraqi constitution, but the institutions and legal frameworks necessary for federalism's functioning have not been developed. Rather than becoming decentralized, Iraq's petroleum policy has been fragmented. The fluid political, economic and security situations also encourage myopic and reactive policies and tactics rather than adopting long-term strategies. The oil industries of Iraq and Kurdistan have been contributing and reacting to these changes. Most recently, the ISIS incursion as well as low oil prices brought the federal and regional government closer. Kurdish pipelines, which were built in reaction to Iraq's push back against KRG's petroleum

industry, would allow the federal government to export Kirkuk's oil after the Iraq-Turley pipelines are shutdown.<sup>88</sup> However, the dynamic circumstances and regional and domestic pressures have created different incentives for KRG and Baghdad. Therefore, the federal and Kurdish policies for managing the country's breadwinning industry is increasingly diverging.

Yet, Iraq's oil and gas industry has been growing in the absence of a legal framework that maintains checks and balances. This blunts rule of law. The long-term contracts that Baghdad and the KRG have signed with foreign oil companies create facts on the ground that, coupled with struggle over authority and revenue sharing, undercut the passing of a comprehensive hydrocarbon law. Oil federalism was hoped to hinder the reemergence of an authoritarian central government awash with petrodollars. In effect, however, Iraq ended up with two fragmented and semi-autonomous energy industries. The unaccountability that this fragmentation allows may appeal to politicians and political groups in both governments. Rather than help Iraq, oil has become an addition to an already intricate web of challenges, tying together grievances related to power, politics,

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<sup>88</sup> Indeed, an interim deal between KRG and Baghdad on December 2, 2014 dictates that the KRG would sell 300,000 barrels a day of Kirkuk oil through KRG pipelines in return for Baghdad releasing KRG's share of national budgets and payment to Kurdish Peshmarga fighters who have been battling ISIS (See "Iraq, Kurdistan Agree on Oil Deal" By Matt Bradley, Sarah Kent, Ghassan Adnan. The Wall Street Journal. December 2, 2014).

wealth distribution, and geography.

The political impact of this policy fragmentation on energy governance is highlighted in the next chapter. In practice, oil federalism has resulted in a multi-pronged conflict between Baghdad and the KRG. Sunni provinces, which are generally poor in petroleum resources, have suffered since 2003 for lack of political unity, disagreement over federalism, losing power in Baghdad, and continued violence, most recently by ISIS. The petroleum related dynamics would become further complex once Sunni dominated provinces, like gas-rich Anbar, enter the energy scene. These national conflicts involve numerous actors, formal and informal, national and foreign. Their influence over the development of Iraq's petroleum sector is also the subject of next chapter.



## **CHAPTER 5: PETROLEUM POLITICS: ACTORS, CONFLICTS AND INFLUENCE**

The tenets of oil federalism laid down in Iraq's constitution did not alter the political realities on the ground. State institutions necessary for the functioning of oil federalism – shared management and revenue between the federal government and oil-rich provinces and regions – have not been realized. That is, petropolitics undercut oil federalism. The Constitution was set to bring Iraqi factions together, but the competing goals of the diverse actors shaping Iraq's energy industry and policy resulted in further fracturing. Indeed, Iraq's politicians, especially the rivalry between the Kurdish government and the federal government, put the country's petroleum policy and industry on a diverging trajectory. Indeed, as this chapter will demonstrate, actual governance of Iraq's petroleum sector has come detoured away from what was envisioned in the constitution.

This chapter will discuss petroleum politics, and numerous actors that have actually shaped and influenced Iraq's petroleum policy since 2003 and the ensuing conflicts, especially between the national government in Baghdad and the regional government of Kurdistan in Erbil. Internal conflicts within Iraq has

created opportunities for interference and leverage by private, regional and international actors, which undercut responsible and sustainable management of Iraq's petroleum resources and revenues.

### **Policy and Politics of Petroleum Management: Actors and Goals<sup>89</sup>**

It is a major challenge for the constitution and rule of law to be the basis for managing Iraq's petroleum sector. Oil and gas management seem to coincide with intricate political and power dynamics, and with old and new ethnosectarian grievances. In addition to these internal dynamics, there are regional, geopolitical and industry factors that have influenced the shaping of Iraq's post-2003 energy scene. Key actors, their goals and relations influence the issues surrounding oil management, such as hydrocarbon legislations and institutions that regulate contracting with oil firms, production management and exports.

As a rule, three main types of actors are involved and affect the management of a country's petroleum resources. These are: states, petroleum companies and society. The relations among these actors are regulated and

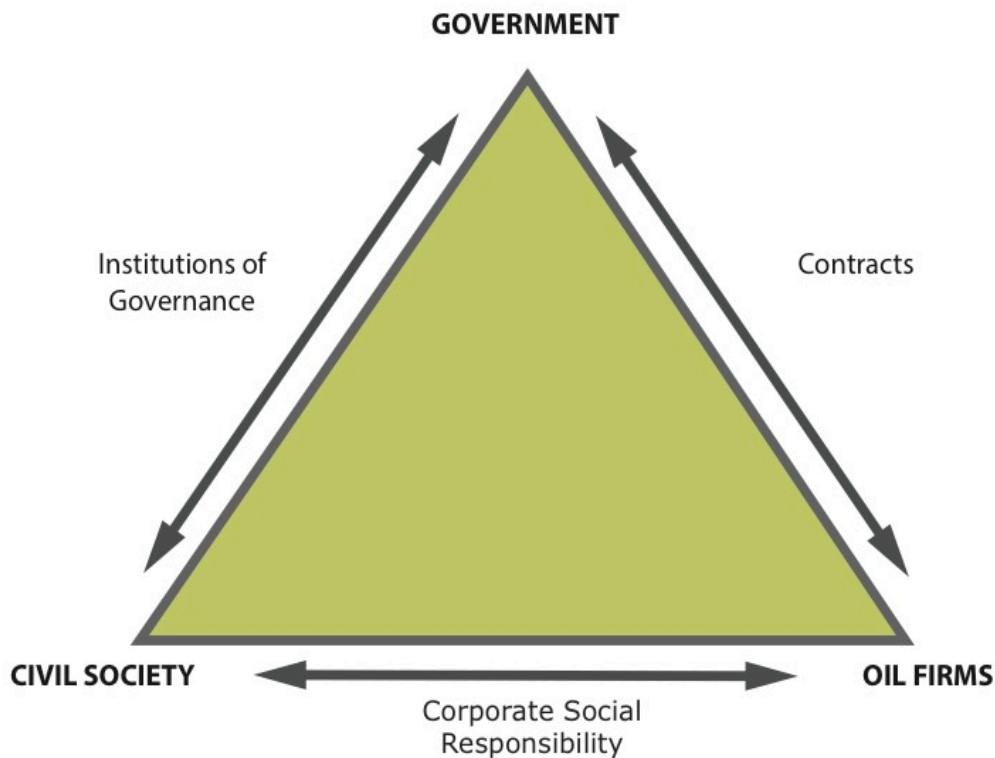
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<sup>89</sup> From this chapter, American University of Iraq's Institute of Regional and International Studies published a report on Iraqi-Kurdish disputes over oil management: Wahab, Bilal. 2014. *Iraq and the KRG Energy Policies: Actors, Challenges and Opportunities*. Sulaimani, Iraq: American University of Iraq, Sulaimani. <http://ais.edu.iq/node/1367>.

dictated by different means. Contracts regulate the relationship between states and petroleum companies. Corporate social responsibility (CSR) is the direct link between companies and the society, where companies provide services to the locales they operate in. Moreover, this direct relationship also involves labor unions that represent workers, environmental and governance NGOs and watchdogs, and journalists who cover the energy sector. A country's political system dictates the link between the states and the population (Bridge and Le Billon 2013) (See Figure 9). There are also local and international citizens groups that oversee the expenditure of state energy resources in some countries, such as the Natural Resource Governance Institute.<sup>90</sup> This is a citizen function different from CSR.

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<sup>90</sup> The organization's website is [www.resourcegovernance.org/](http://www.resourcegovernance.org/)



**Figure 9: Actors and Their Relationships in Managing Petroleum Resources**  
(Source: created by author, adapted from Bridge and Le Billon 2013)

Numerous and more specific actors have shaped Iraq's petroleum policy and industry since 2003. In addition to these main and generic actors mentioned above, I employed a social network mapping tool developed by Schiffer and Hauck (2010) called Net-Map. Using Chatham House rules<sup>91</sup> to encourage open discussions, I facilitated three discussion sessions of petroleum industry executives, government officials, civil society representatives, advisors to the

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<sup>91</sup> Unless expressed otherwise and citation permitted through informed consent forms.

government, and media editors. They were asked a series of questions in a certain order, and were asked to discuss their answers and draw a map (on a large canvas using markers):

1. Who are the actors involved in this policy/contract?

(in the cases presented here, one is about KRG's general petroleum policy, and the other is about a gas deal between Baghdad and Shell Oil)

2. How are they linked?

3. How influential are they?

4. What are their goals?

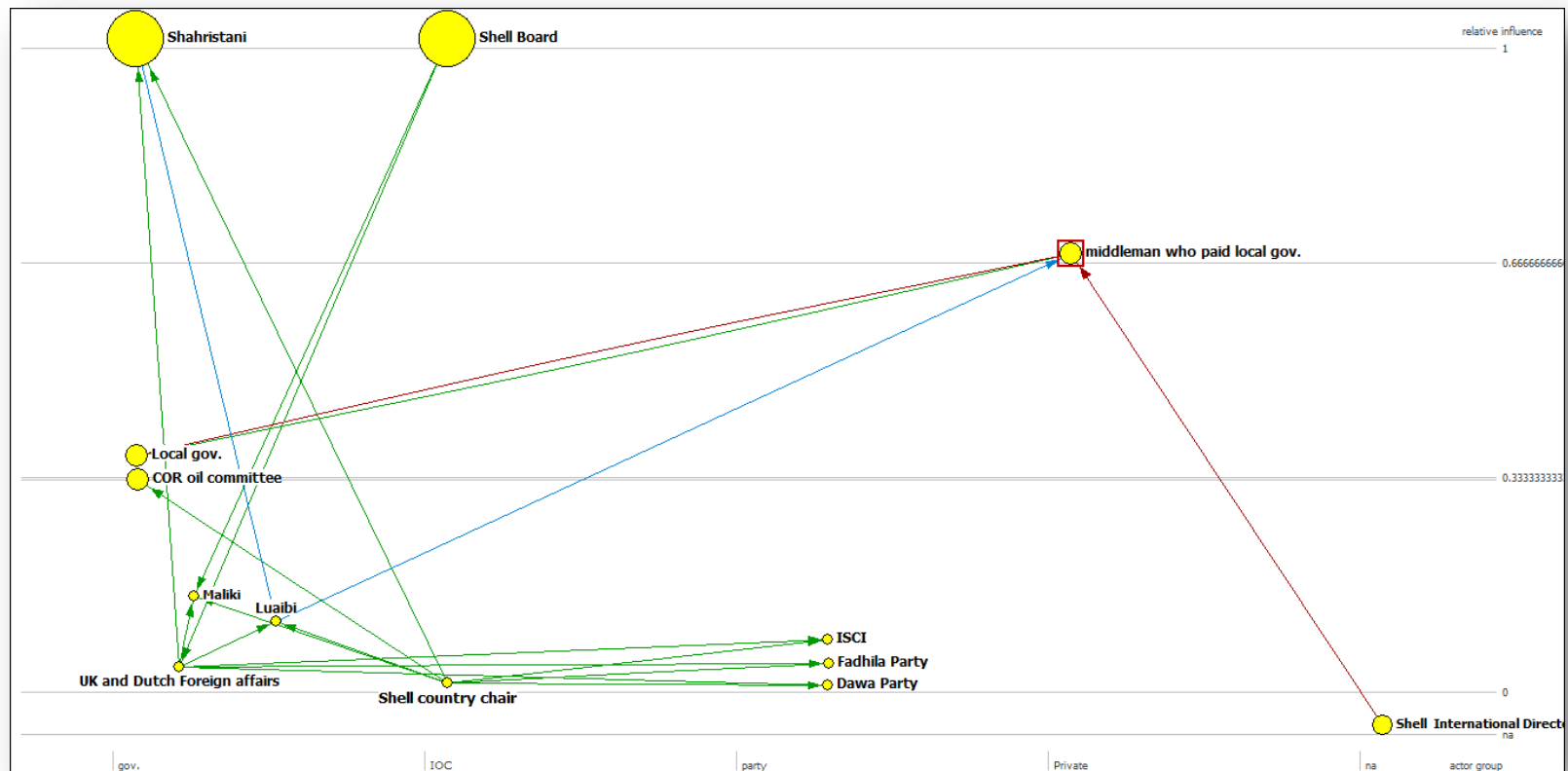
This hands-on method allowed the participants to identify diverse actors and relationships from their different perspectives. In addition to identifying kinds and flows of relationships, the influence of different actors is also gauged in comparison. Two of these sessions were about specific oil and gas contracts by KRG and Baghdad; the other was on Kurdish petroleum policymaking in general. The data and maps have been digitized using a computer program called VisuaLyzer©.<sup>92</sup> The actors and their roles, relationships and goals are discussed below referring to data collected through influence maps, interviews and analysis of events. The sections below will discuss the different actors, their

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<sup>92</sup> See more about the methodology and tools used on the Net-Map manual at <http://netmap.wordpress.com/about/>

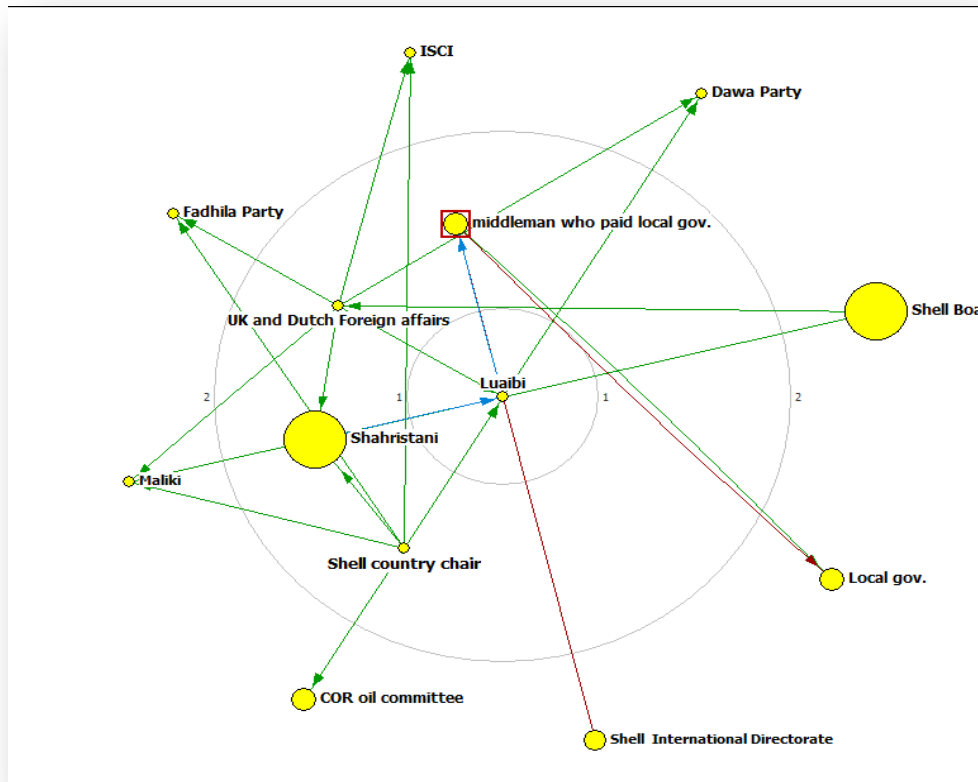
goals and influences on the shaping of Iraq's petroleum policy and industry.

The actions and policies adopted by the federal government and the KRG reflect their divergent visions for the country, especially where oil fits in each side's vision. The federal government and the KRG are the two main rival governments vying for power and control over the management of petroleum resources. This national-subnational rivalry and conflict will have implications for oil-rich provinces, such as southern province of Basra, and for confronting threats such as ISIS.



**Figure 10: Influence Map of Iraq-Shell Gas Contract**

This is a digitized influence Net-Map© created by the author using VisuaLyzer©. The nodes (yellow circles) indicate actors. The X-axis identifies the category of actor (government, international oil company, political party, and private interest). The Y-axis indicates relative influence (from 0 to 1). Relative influence is also identified by the size of the actors. The color-coded arrows indicate relationships and their directions. Blue: formal command, order or authority. Green: lobbying and/or persuasion. Red: informal cash flow.



**Figure 11: Influence map of Iraq-Shell gas deal (centrality of actors)**

This influence Net-Map© uses the same data for the previous map on Iraq-Shell gas deal, but from a different perspective. In this version, the centrality of actors is highlighted – the closer to the center an actor is, the higher its linkages and relationships. The relative influence of the actors is maintained through the size of their nodes.



Iraq and Royal Dutch Shell (with Mitsubishi as junior partner) and the Iraqi government signed a service contract in November 2011 to create a joint venture company called the Basra Gas Company. The new entity would gain exclusive rights for 25 years to capture associated gas from three of Iraq's largest oilfields of Rumaila, West Qurna and Zubair. Crude production generates natural gas as a byproduct. Rather than capture it, Iraq burns, or flares, the gas, which results in environmental damage as well as substantial economic loss--\$5 million a day. The flaring hurts Iraq again since the country has to import natural gas to power electricity generators (Al-Khateeb 2013b; Smith and Lando 2011).

But Shell's deal was surrounded with controversy. Unlike other contracts with petroleum companies, the Shell deal was negotiated behind closed doors rather than through competitive bidding. Moreover, Shell received a commission from the Iraqi government in 2005 to conduct a strategic study and plan for Iraq's natural gas. This study was kept as a secret, and Shell was contracted to implement its own plan. Also, the Shell deal received ample criticism and local opposition when its terms first came to light in 2008. Before the scope was narrowed down to three oilfields, Shell was going to gain an exclusive monopoly to capture and sell gas from all over Iraq. The deal was also negotiated in unbalanced fashion as far as Iraqi and Shell negotiators are concerned. Documents made public through the anti-secrecy website Wikileaks.com demonstrate Iraq's weakness in negotiating deals with such magnitude and

duration. For example, one cable tells the story of the Shell top negotiator in Iraq telling U.S. diplomats that “Iraqis are still novices with regard to international business deals,” and that his company offered them basic economic training (Lando and Van Heuvelen 2011).

The influence maps above highlight some of these key issues from the perspective of the experts and analysts who participated in this Net-Map session. The key actors and the relations among them are demonstrated, with categorizing and weighting the actor’s relative influence. First, the most influential actors were Iraqi Deputy Prime Minister for Energy, Mr. Al-Shahristani and Shell’s Board of Directors. State oversight institutions such as the parliament’s oil and gas committee and the local provincial councils are sidelined. The Iraqi constitution mandates a role for the provincial governments to have a say. The map also demonstrates the lobbying efforts that Shell committed in order to realize this deal (including of leading Shia parties), as manifest by the green arrows. The map also shows the significant role of corruption and secrecy, involving an unnamed middle man who allegedly had the Iraqi oil minister’s blessing (Luaibi) to bribe the local government of Basra with Shell money. The second map distinguishes between influence and centrality in the network. Mr. Luaibi, a bureaucrat serving Mr. Al-Shahristani’s policies, is at the center of action and negotiations for this multi-billion dollar, long-term deal.

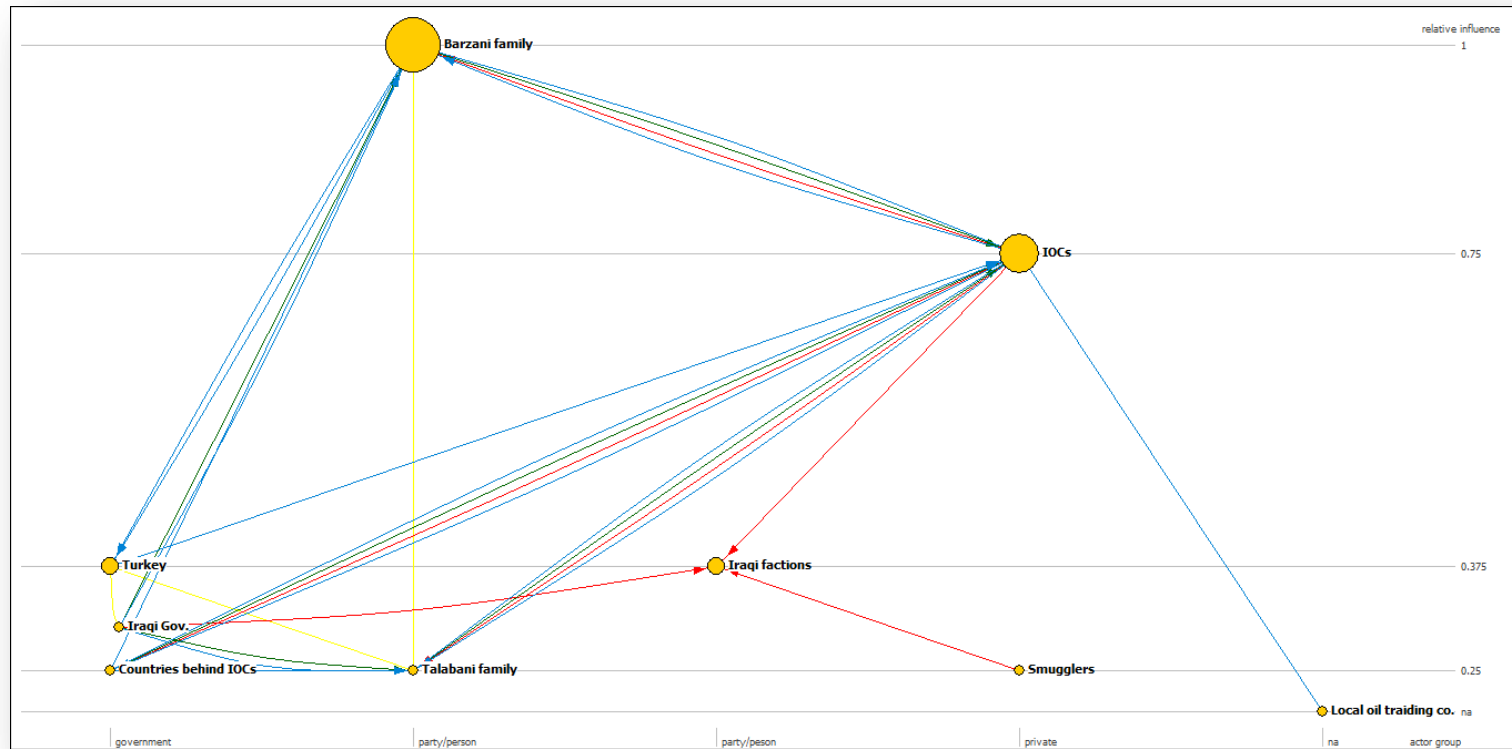


Figure 12: Influence Map of KRG Petroleum Policy

This influence Net-Map highlights the perception of influence regarding the overall shaping of KRG petroleum policy. The nodes indicate actors. Their influence is represented by the size of the nodes as well as the Y-axis. The X-axis represents the category of the actor. The color-coded arrows indicate the type and flow of relationships. Yellow: conflict or rivalry. Red: Informal cash flow. Green: Formal cash flow. Blue: lobbying/ political influence. This particular map is the result of a Net-Mapping session on general Kurdish government energy policy, rather than a specific contract.<sup>93</sup> Similarly, it distinguishes the formal and informal actors, as well as the licit and illicit interactions. The drawers of this map identified the Barzani family as the central and most influential player in shaping the Kurdish government's petroleum policy. The rival Talabani family is perceived as less influential (Note: the respondents insisted that when it comes to oil and gas policy, the two families matter more than the parties they lead, the KDP and the PUK, respectively.) Other actors include international oil companies and the foreign interests associated with their presence. The local industry, represented here by local oil trading firms, is the least influential.

National and regional politics and the associated conflicts discussed below also affect the Kurdish energy calculations and relations. Turkey's disagreements with Iraq's former Prime Minister Maliki brings it closer to the Barzanis and less so to the Talabanis (Jalal Talabani was Iraq's president at the time). This particular map also demonstrated that political parties are the main recipients of illicit cash flows, from IOCs, government agencies, and oil smugglers.

### **Iraq's Federal Government**

Iraq's central government seeks to preserve the unity and centrality of governance and policymaking in Baghdad through control of oil. The federal Ministry of Oil sees itself as the sole legitimate entity in Iraq to make decisions on petroleum management (Al-Shahristani 2012). Until the advent of ISIS, maintaining the upper hand over producing regions has been relatively easy for Baghdad, since the balance of political and economic powers on the ground are

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<sup>93</sup> A special session for KRG's ExxonMobil deal was also conducted for this dissertation. However, the data was inadequate to draw an influence map.

tilted in favor of the federal government. Upon strengthening their grip on power in Baghdad, the Shia parties loosened their interest in federalism, which they espoused before and early after the fall of the Baath party. The main obstacle facing Baghdad's central grip on petroleum policy, however, has come from the KRG (see next section). A second potential challenge to centralization could come from oil-rich Basra.

Basra, Iraq's so-called "oil capital," possesses the economic power to takeaway from Baghdad's central command of the petroleum industry. This is also true of ISIS occupation of parts of oil rich Sunni areas. Federalist tendencies in Basra has ebbed and flowed frequently since 2003. Leaders from Basra have rallied for federalism by collecting signatures and running on platforms to form a region around Basra modeled after the KRG.<sup>94</sup> Ruling Shia parties in Baghdad have undercut Basra's attempts at more autonomy. Another avenue through which Basra attempted to benefit from the oil revenues it feeds into the Iraqi economy is the "petrodollar" budget, a bonus given to provinces that produce or refine petroleum. The petrodollar program was introduced in 2010, as \$1 per barrel produced or refined. Later, the amount increased to \$5 when the

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<sup>94</sup> For an overview and analysis of Basra politics, see two blogs run by Reidar Visser, senior research fellow at the Norwegian Institute of International Affairs: "Basra and Southern Iraq Analysis: Basra and southern regionalism," [http://www.historiae.org/basra\\_initiative.asp](http://www.historiae.org/basra_initiative.asp), and "Iraq and Gulf Analysis," at <https://gulfanalysis.wordpress.com/category/basra-and-southern-regionalism/>

parliament passed the Provinces Law in June 2013. That would have resulted in a windfall to Basra's provincial budget. Prime Minister Maliki sought to reduce petrodollars back to a dollar for the 2014 budget, but he had to succumb to pressure since the petrodollar had support across all Shia parties in Basra (*Inside Iraqi Politics* 2014). Basra's autonomy is often cited in discussions about KRG's autonomy – that KRG's energy industry should be reined in lest it becomes a model for Basra. If Basra were to control its oil and manage its revenues, the federal coffers could bankrupt.

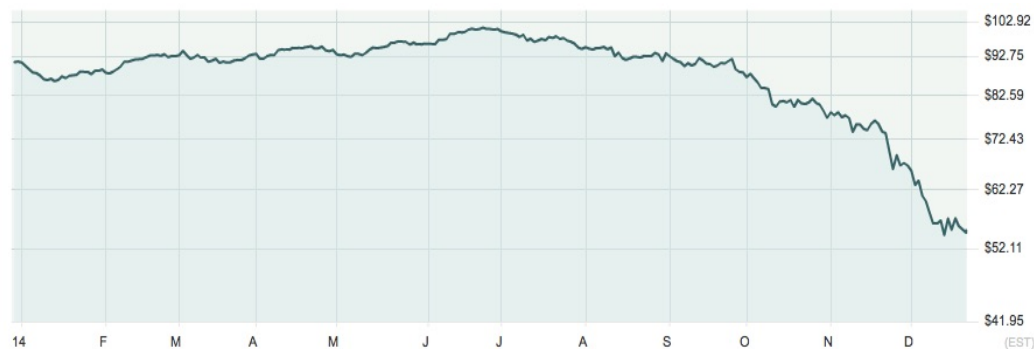
Moreover, ISIS is putting to question the Iraqi federal government's grip on power. ISIS came from Syria and captured entire provinces and cities in northern and eastern Iraq, as the well-equipped Iraqi military melted down. As a result, ISIS is in control of swaths of land, millions of population, and oilfields that generate millions of dollars in revenue (Di Giovanni, Goodman, and Sharkov 2014). The Shia-led Iraqi government, especially under the two terms of Prime Minister Nouri Al-Maliki (2006-2014) failed to represent the Sunni provinces and share power with their political representatives. Powerful Sunni leaders, like Vice President Tariq Al-Hashemi, were chased away. With ISIS in control of much of northern Iraq, the country has in effect been divided into three different entities. The new Iraqi government of Prime Minister Hayder Al-Abadi is attempting to regain its legitimacy through measures such as conciliation with the KRG over oil sales (Osgood and Smith 2014), the establishment of a new

national guard from local communities (Wehrey and Ahram 2014) and paying the salaries of public employees in areas under ISIS control (Sly 2014). But despite the new government's gestures, recapturing the provinces from ISIS may prove lengthy and arduous.

A second goal of the government in Baghdad is to maximize oil revenues (Zulal 2013; Al-Khateeb 2013a; Taha 2013). Because of years of sanctions and wars, the non-oil economic sectors are less attractive to investors compared to the petroleum sector. This resulted in larger dependence on oil for economic rent generation and government revenues. To maximize revenue, Iraq is planning to boost oil production to reach 9 million barrels a day by 2030, according to the International Energy Agency. However, Iraq's strategy of maximum revenue generation is often undercut by Baghdad's tactical inability to perform and implement oil contracts, and to spend the majority of the wealth accrued from oil on security and government operations (Camp 2013).

Yet, another factor that is critical to Iraq's goal of wealth generation is the volatility of oil prices. Oil prices took a nosedive in 2014 – they had been stable at about \$90 per barrel until they started falling to below \$60 by December (Figure 13). Oil prices fell by about 45% due to oversupply and weak economic recovery of importers, as the United States is enjoying record oil production in three decades. Unlike other oil-rich governments like Saudi Arabia and Kuwait, Iraq lacks spare capacity or cash reserves. Therefore, Iraq's 2015 budget is based on

oil selling for \$60 for a barrel of oil, which will result in significant spending cuts and running a large deficit. Iraq suffers from such financial pressures as it wages a war against ISIS (Al-Ansary 2014). Oil revenues make up more than 95% of Iraq's budget. With OPEC refusing to cut its output, prices may drop even further; hurting the oil-dependent Iraqi economy to a degree that boosting its production may have little effect.



**Figure 13: Crude Oil Prices, January-December 2014**

(Source: NYMEX, MarketWatch.com)

Others have described Iraq's post-2003 petroleum policy as "sectarian" since consecutive Shia-led governments focused investment on Shia majority southern provinces (Gfoeller 2013). Iraq's focus has indeed been on southern oil fields in the four exploration and production bidding rounds it has organized to date. But the lack of security and stability in the Sunni areas has also discouraged



IOCs from working in Sunni provinces. Even under Saddam Hussein, the Sunni provinces were not explored as much as southern, Shia-dominated areas. When the Iraqi government invited IOCs to bid for exploration blocks in June 2012, it included some blocks in Sunni areas. However, no IOC bid on blocks in Sunni provinces. Although security is the obvious culprit, the unfavorable contract terms offered by Baghdad also discourage IOCs from bidding on exploration contracts (Lando 2012b; Lando 2012a). Going against its vision of consolidated power in Baghdad, the Shia-led federal government is suspicious of Kurdish oil dealings, and sees them as a step toward secession from Iraq and a model for other oil-rich regions to gain more autonomy from Baghdad. In general, Baghdad views its control of oil as insurance for preserving the unity of Iraq.

### **The Kurdistan Regional Government (KRG)**

The Kurdistan region has quickly emerged as a significant player in Iraq's energy sector. The KRG has sought to build an energy industry from scratch in the shortest time possible. To date, the Kurdistan Regional Government has signed more than 60 oil and gas contracts with international oil companies (IOCs), including majors such as ExxonMobil and Chevron. Most of Iraqi Kurdistan was not explored for oil and gas in the past, so the potential was largely unknown.

In contrast to Baghdad, Iraqi Kurds fear a strong central Iraqi government, and want to maintain decentralization and a level of autonomy through building

a local energy sector.<sup>95</sup> Iraqi Kurds hope to buttress and promote their current level of autonomy from Baghdad. Kurds think that autonomy can only be maintained through access to revenues, and to have exclusive power over decision-making in the region's affairs. In other words, economic independence is the precursor to political autonomy. Many perceive political independence as the long-term goal of the KRG's oil dealings, "a contingency plan" for pulling away from Iraq. The KRG seeks to build the economic capacity for statehood. As one Kurdish energy analyst put it, KRG Minister of Natural Resources Mr. Ashti "Hawrami is not only in the business of building an [oil] industry, but in nation building too," (Zulal 2013). Kurdish autonomy would be deficient if they were "beholden to Baghdad," as Kurdish officials often put it. Kurdistan region has been receiving 17% of Iraq's national budget, which gives the federal government sizeable leverage over the KRG. KRG is quite fearful of the return of a strong central government and sees dividing Baghdad's power over oil management ensures a weaker central government.

Iraqi Kurdish parties and government have, therefore, been on a two-track policy: one that seeks to stay within a federal Iraq where decision-making powers and revenue generation abilities are devolved into subnational governments; and another track that seeks to build the institutional, economic

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<sup>95</sup> Author's interview with numerous Kurdish officials and monitoring of the policy debate, e.g. (Talabani 2010; Zulal 2013; Khalilzad 2010).

and security infrastructure for statehood. Indeed, the KRG with its level of autonomy has so far enjoyed many of the benefits of statehood—a Peshmarga security force loyal to the Kurdish parties, an energy industry that it built. However, the effectiveness of these achievements was tested in 2014: the budget cuts by the federal government demonstrated the fragility of the Kurdish economy, and the ISIS attack on Erbil in summer would have been more catastrophic had it not been for U.S. air support.

The KRG's strategy is to attract Big Oil and tie its security and autonomy to the interest of major international oil importers. It is politically important for the KRG that majors are able to monetize their investment over the long run (Camp 2013). The KRG's pipeline agreement with Turkey, although it has angered Baghdad, is an instrumental step toward creating a viable Kurdish energy industry (See below). The KRG feels under pressure to achieve these goals in a short time, since the window of opportunity is closing on it—on the one hand, Baghdad could get richer and attract more international support, and therefore be able to undercut KRG's energy goals; and on the other, the recent technological developments leading to the shale revolution and to renewable energy may attract investment away from Kurdish oil. The sharp decline of oil prices in 2014 may prove to be a significant challenge for the KRG, one that it has no control

over.<sup>96</sup>

### **KRG vs. Baghdad Views of International Oil Companies**

Moreover, Baghdad and the KRG hold different views of foreign companies. Oil and colonialism are tied to Arab nationalism and the struggle for independence, in Iraq and beyond. For the Kurds, however, oil is a new tool to achieve prosperity and protection for the Kurds. Increasingly, however, oil is linked to Kurdish right of self-determination.

Federal Iraqi officials often voice skepticism of international oil companies as reminiscent of Western domination. Many still remember Iraq's history with international oil companies (IOCs) and the exploitative concessions they exacted.<sup>97</sup> Nationalization of the petroleum industry was central to the Arab nationalist identity promoted by the Baath Party, which ruled Iraq for three decades. The Saddam regime renamed the oil-rich province of Kirkuk to "al-Ta'amim," which is Arabic for nationalization. The Iraqi perceived motives of

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<sup>96</sup> The Kurdish government has considered taking loans from international creditors and use oil as collateral. However, this could exacerbate KRG's budgetary woes since oil prices are likely to fall even further. Indeed, the Saudi minister said that OPEC will not cut production even if oil prices fell to \$20 a barrel (See the BBC report at <http://www.bbc.com/news/business-30585538>)

<sup>97</sup> In a meeting in Baghdad with oil executives and lobbyists, then Iraqi Oil Minister Shahrastani is said to have raised his index finger in the air warning, "Clean games, gentlemen. Clean games" (Coll 2012). A Kurdish member of the Iraqi parliament and its oil and gas committee told the author and others that some Iraqi factions in 2007 saw the passing of the hydrocarbon law as another invasion (B. Hassan 2010; Masalla Organization 2012, 110-117).

U.S. and UK invasion of Iraq in 2003 focus on the country's oil.<sup>98</sup> In an opinion poll of Iraqis, respondents opposed privatization of the oil sector, where 63% of them preferred Iraqi oil companies to develop Iraq's oil reserves rather than foreign companies ("Iraqi Oil Law Poll" 2007).

Moreover, Iraqi Kurds have a different experience with, and view of, the West. Oil wealth funded the Iraqi military and security forces, which the Saddam Hussein regime unleashed on Kurdish villages and towns, including atrocities such as the use of poisonous gas in Halabja in 1988. Western powers denied Kurds statehood at the turn of the 20<sup>th</sup> century after the break up of the Ottoman Empire. Many Western countries also supported Saddam's wars against Iran and his brutal quelling of Kurdish dissent. But the 1990 Gulf War set a new beginning for the Kurdish relation with the Western powers. The Kurds revolted against Saddam's regime, as encouraged by U.S. President George H. W. Bush. To protect Kurds from Saddam's wrath, the United States, England and France created a "safe haven" for the Kurds, a no-fly zone, which became today's autonomous Kurdistan region. In the Iraq invasion of 2003, Kurds came out as a major beneficiary of the demise of the Saddam regime, and solidified the autonomy of their region.

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<sup>98</sup> For example, see this Wikipedia page that collects news stories, quotes, and data about how the motives and justifications for the Iraq invasion: "Rationale for the Iraq War," [http://en.wikipedia.org/wiki/Rationale\\_for\\_the\\_Iraq\\_War#Oil](http://en.wikipedia.org/wiki/Rationale_for_the_Iraq_War#Oil).

These different views of foreign governments and oil companies have affected how the Arab-dominated Iraqi federal government and the Kurdish regional government (KRG) have approached the international oil companies. Compared to KRG's welcoming approach, Baghdad has been more skeptical. For example, although both governments maintain strong oil ministries, the KRG adopted the production sharing contract (PSC) model, which is more appealing to IOCs. PSCs could earn the IOCs large profit margins. They also offer IOCs the right to own some of the oil they produce. More importantly, the IOCs can book a share of the oil reserves of the fields they operate, which is essential to the health of their stocks. Hoping to attract Western money and influence, the Kurdish "smaller, faster, lighter" approach<sup>99</sup> to building a Kurdish energy industry favored the international oil companies more than the federal approach did. Kurds describe IOCs as "partners" who help Kurds benefit from their oil for the first time in Iraq's history. Kurds also see their oil deals as a way to tie Kurdish interests with those of the countries behind the IOCs, such as the U.S., France and Turkey. On the other hand, the Iraqi federal government has signed Technical Service Contracts (TSCs), which preserve the dominance of the state and do not grant such ownership rights to IOCs.

Despite different approaches and disagreements over power and control,

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<sup>99</sup> A trio of adjectives used by Mr. Qubad Talabani in an interview with the author in 2010.

the federal government and the KRG share some goals. They both seek to maximize production in record times, which has negatively impacted the non-oil economic sectors such as agriculture. They both also seek to maximize their control and grip over their respective petroleum industries. Even the KRG, which seeks power devolution from Baghdad, has been reluctant to devolve meaningful powers to the three Kurdish provincial governments. In fact, due to political rivalry, the KRG held its first provincial elections in 2005 and failed to regularly hold it. After postponing it four times, provincial elections in KRG were eventually held in May 2014. It is yet to be seen how much more power the newly elected provincial councils can grab from the KRG.

Maximizing revenue from the sale of oil is also necessary for the early victors of Iraqi elections to maintain power. Given the weak state institutions and the volatility of the political transition, wielding and nourishing patronage networks became of paramount importance. Rather than build policy platforms, political parties embarked on doling out jobs and government contracts to broaden their support. Indeed, the two parties that won the first elections in 1992 still dominate the KRG (See Chapter 6). However, sharp drops in oil prices could create the right pressure needed for institutional and economic reforms that Iraq's stability desperately needs. This pressure may be more pronounced for the

KRG's oil sector given the proximity of its oilfields to ISIS.<sup>100</sup>

Another common feature of oil-related decision making in Baghdad and the KRG is the dominance of individuals rather than state institutions in shaping their energy policies (See Figure 10, 3 and 4 above). None more so than former Iraqi oil minister and later deputy prime minister for energy, Mr. Hussein Al-Shahristani. Mr. Al-Shahristani is a "politician with technocratic support," an Iraqi energy expert described him. The role of powerful individuals in post-Saddam Iraq's energy policy is present in the Kurdistan region as well. Mr. Ashti Hawrami, the KRG minister of natural resources, plays a significant role. Compared to Al-Shahristani, he is "a technocrat with political backing" from the Kurdistan Regional Government, said the energy expert. Whether these two personas lead or simply implement the policies of their respective governments and prime ministers or the political parties behind them could be debated. Nonetheless, the level of power and influence that Mr. Shahristani and Mr. Hawrami wield regarding the energy sector has to an extent personalized the decision making process regarding Iraq's energy sector.<sup>101</sup> In Kurdistan, the Barzani family, which leads the Kurdistan Democratic Party, is perceived as

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<sup>100</sup> Indeed, some oil companies and service providers evacuated their staff in Kurdistan after the ISIS attack on Erbil. See Aljazeera story at <http://america.aljazeera.com/articles/2014/8/8/kurds-iraq-oil.html>

<sup>101</sup> Some have explained the dispute over oil management between Baghdad and KRG (next section) as a clash of two prides and personalities – of Shahristani and Hawrami.



dominating the energy industry (See Figure 3). Government institutions, especially the Council of Representatives in Baghdad and the Kurdistan Parliament in Erbil, have played a lesser role, as have provincial and local governments.

### **Dispute over Oil Federalism**

Realities on the ground are drastically different from the vision set in the Iraqi constitution and the draft national oil law of 2007. The federal government and KRG petroleum policies have diverged and became a source of conflict between the two governments. As discussed in the previous chapter, the authors of Iraq's constitution enshrined, albeit vaguely worded, principles of federalism and shared management of the petroleum sector. Since the parliament has not been successful in translating those principles into laws and regulations, the Kurdish and federal governments have moved ahead with oil contracts and sales according to their understanding of the constitution. The two sides' policies and actions have diverged. In the absence of a constitutional arbiter, i.e. a constitutional court, legality and constitutionality have been seconded to political rivalries and priorities.

The federal government in Baghdad and the Kurdistan Regional Government (KRG) in Erbil adopted significantly different positions and interpretations of the oil federalism principles laid out in the Iraqi constitution.

Although both sides use legal justifications to support their positions, their arguments and goals are essentially political. Baghdad and Erbil have different goals, as discussed above. The rulers in Baghdad want to maintain a centralized grip over the energy industry and Iraq's revenue stream. The KRG, on the other hand, seeks to build a domestic energy industry that would allow it to achieve economic, and even political, autonomy from Baghdad. As far as their legal arguments are concerned, petroleum industry legal experts point out that "neither position is clearly stronger than the other" (Brimson, Addison, and Thomson 2013).<sup>102</sup>

The federal government interprets the constitution in a manner that empowers Baghdad to manage Iraq's petroleum sector and revenues. The federal government's main petroleum policy architect has been Mr. Hussain Al-Shahristani, who was energy minister from 2006 to 2010 and then deputy prime minister for energy from 2010 to 2014. He affirmed in an interview for this dissertation that the constitution makes the federal government "the final authority" regarding petroleum policy. Mr. Shahristani's interpretation of Article 111 – that "Oil and gas are owned by all the people of Iraq in all the regions and governorates" – is as follows: "This joint ownership obviously would mean an

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<sup>102</sup> These oil and gas legal experts from Herbert Smith Freehills LLP, a UK based law firm, made a presentation at the annual Kurdistan-Iraq Oil & Gas Conference in Erbil on December 1, 2013. The author attended and obtained a copy of their presentation. Both governments have also commissioned and retained legal experts to offer opinions on the matter.

authority that represents the whole country would be entitled to deal with [oil and gas]. And that is a government that is elected to represent the whole country – the federal government” (Al-Shahristani 2012). As for Article 112 on joint management and formulation of policy, Mr. Shahristani said, “oil policies should be *discussed* among the federal government and the [KRG] and producing governorates” [emphasis added]. *Discussions* regarding Iraq’s oil and gas policy, Mr. Shahristani continued to explain, ought to take place at a federal entity is the Federal Oil and Gas Council (FOGC), where the Kurdish government and producing regions are represented. This federal entity is mentioned in Iraq’s different drafts of the hydrocarbons law, but the agency is yet to exist.

To the Kurdish government, however, federalism clauses in the constitution grants rights beyond participation in discussions. The KRG holds the position that the constitution grants it the right to develop its oil autonomously. From KRG’s perspective, Article 112 of the Iraqi Constitution separates “present” oil and gas fields, which produced oil at the time the Constitution was ratified, from new fields that would be explored and developed after the passing of the constitution. Moreover, according to the KRG, the federal government and its institutions’ prerogative are limited to setting high level policies, such as setting production targets and negotiating OPEC quotas, rather than managing the hydrocarbon resources (Brimson, Addison, and Thomson 2013). On these grounds, the KRG has passed a regional oil and gas law that

regulates its energy industry. Kurdistan government's Natural Resources Minister Mr. Ashti Hawrami said in an interview that "any new law in Baghdad does not add or subtract from what we have," in the KRG (Van Heuvelen and Staff 2012). Mr. Hawrami maintained that any federal hydrocarbons law that is deemed unconstitutional by the KRG would be null, according to Article 13 of the Iraqi Constitution.<sup>103</sup> These two views on power sharing and decision making fall on two extremes of power devolution and centralism. The road to this extreme divergence has been tortuous. The KRG and the federal government have tried to work out agreements regarding paying oil companies, oil exports and revenue sharing through numerous failed attempts at cooperation and conciliation

The development of KRG's petroleum industry and policy has fast-tracked in three phases between 2007 and 2014. Baghdad's reactions to KRG's measures contributed to the fracturing of Iraq's overall petroleum policy. In phase I, the KRG invited small to medium-size international oil companies (known as wildcatters) en masse to explore the Kurdish region for oil and gas reserves. The KRG also passed a regional hydrocarbon law in 2007, and adopted the industry-favored production sharing contract (PSCs) model. The federal government responded by calling the law unconstitutional and the contracts

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<sup>103</sup> Section 2 of Article 13 of the Iraqi constitution states: "No law that contradicts this Constitution shall be enacted. Any text in any regional constitutions or any other legal text that contradicts this Constitution shall be considered void."

illegal, and blacklisting the IOCs dealing with KRG from bidding on blocks in federally controlled Iraq. Phase II of KRG energy development, an ongoing phase, is consolidation of KRG's energy industry with major oil companies through mergers and acquisitions of the wildcatters. Once deemed commercially viable, major IOCs such ExxonMobil and Chevron started entering the Kurdistan energy scene. At this point, many of the majors, such as ExxonMobil and BP, had contracted the federal government, which mandated boycotting the KRG. The final phase is independent export and monetization, which is crucial for the success of phase II and the long-term viability of KRG's energy industry and economy. IOCs need to export the oil they find in the KRG in order to get paid according to the terms of the PSC. This is the most crucial phase in establishing and sustaining KRG's energy industry.

Being able to monetize oil independently seems to address several other KRG concerns vis-à-vis Baghdad. Baghdad seems to refuse the pillars of KRG oil policy, and took punitive measures against many of the KRG's actions. The federal government considers KRG's regional oil law unconstitutional its contracts illegal.<sup>104</sup> The federal government also made IOCs choose between Baghdad and the KRG – IOCs operating in Kurdistan are blacklisted and cannot bid on fields managed by the federal government. Moreover, when Kurdish

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<sup>104</sup> This particular dismissive stance against Kurdish oil contracts seems to be weakening since Mr. Haidar Al-Abadi took office as prime minister in September 2014.

fields started producing oil in commercial quantities, the central government did not agree to export it. And when Kurdish oil eventually flowed through federal pipelines for the first time in 2009, Baghdad refused to reimburse the IOCs in Kurdistan for their production costs. This forced the KRG to rely on other means, including smuggling, to allow the companies to recover their costs. When the federal government agreed again to sell Kurdish oil in 2011, it soon cut the payments, and the KRG shut down its crude exports in April 2012 (International Crisis Group 2012). In 2014, the federal government accused the KRG of withholding revenues from oil sales (Van Heuvelen 2012c), and cut the monthly allotment (17%) of the national budget that flows to the KRG, which crippled the latter's ability to pay public salaries for two months.

### **The Politics of Petroleum Export and Revenue Sharing**

Generating revenue independently seems to be a panacea for many of KRG's ills with Baghdad. The KRG will be better positioned to honor its contracts with IOCs by being able to pay them not only for their costs but profits too. Moreover, the KRG will cease being beholden to budget allocations from Baghdad, which is leverage in the hands of the latter. Independent revenues also allow the KRG to finance its security forces and pay the salaries of its personnel.

But the right to export oil has been the latest and most crucial episode in the Kurdish-federal governments dispute. Officially, Iraqi oil is sold through SOMO, or the State Oil Marketing Organization. Oil revenues are collected at the

Federal Reserve Bank of New York.<sup>105</sup> After 5% is deducted for Kuwait reparations mandated by the United Nations, the funds are transferred to Iraq's central bank, which is budgeted and distributed to ministries, regions and provinces. Before revenues are shared with regions and provinces, however, sovereign expenses are deducted to, which go to federal agencies and expenses like the cabinet, the parliament and defense.

The KRG's first exports flowed in May 2009 after an agreement with Baghdad through the Iraqi pipelines and by SOMO. Soon after, however, KRG stopped its exports, accusing Baghdad for failing to reimburse the IOCs in Kurdistan for their production costs. The federal government demanded that the KRG pay its contracted companies out of its 17% share of the national budget. The KRG expected Baghdad to pay the oil companies out of sovereign expenses, outside of the KRG's share of the national budget. That is, the KRG did not want to pay 100% of the costs in return for 17% of its proceeds.

In January 2011, the Iraqi and Kurdish oil ministers reached another agreement to resume the export of Kurdish oil through Iraqi pipelines. This time, Baghdad agreed to pay the IOCs for their production costs, but the KRG had to pay them their profits (International Crisis Group 2012). In return, the KRG agreed to open up its books for the federal Board of Supreme Audits (Van

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<sup>105</sup> Iraq holds an account at the Federal Reserve Bank of New York called Development Fund for Iraq (DFI). This account was created soon after Iraq invasion to protect Iraq's revenues from legal claims.

Heuvelen 2012d). Hence, the federal government would get access to the workings of the Kurdish energy sector. KRG's oil exports were at 100,000 barrel per day (bpd) in 2010, but rose to 175,000 bpd in mid-2011 (Van Heuvelen 2012b). The maximum KRG export rate of 175,000 bpd constituted only 5% of national output of 3.6 million bpd. Should KRG's export capacity reach one million bpd, expected by 2015, the KRG might then become a net contributor to Iraq's oil export (International Crisis Group 2012).<sup>106</sup>

The second export deal lasted more than a year, but Kurdish oil exports stopped again on April 1, 2012. The KRG accused Baghdad of not fulfilling the agreement to pay IOCs in Kurdistan, and owing the KRG \$1.5 billion in backlogged payments (Van Heuvelen 2012e). The federal government shot back next day, accusing the KRG of withholding \$5.6 billions worth of crude from sales to the domestic market and smuggling to Iran (Van Heuvelen 2012c). It also accused the KRG of not cooperating with a necessary federal audit. Paying IOCs operating in Kurdistan on one hand, and accountability to Baghdad remain major sticking issues.

The KRG has sought to export crude independently, but the federal government consistently uses its political and infrastructure leverage to curtail KRG efforts. When the KRG planned to build export infrastructure into Turkey,

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<sup>106</sup> See also The KRG Ministry of Natural Resources website, "The Road to 1 Million Barrels," <http://mnr.krg.org/index.php/en/the-road-to-1-million-barrels>



Baghdad entered agreements with Turkey and the EU not to buy Iraqi oil except through SOMO (International Crisis Group 2012). However, Turkey passed a law later in 2011 authorizing the import of oil from countries in the region by truck should national reasons necessitate it. According to the International Crisis Group, the Kurds were betting on a shift in Turkish policy in favor of Kurdish petroleum exports (International Crisis Group 2012). Indeed, Turkish firms have invested heavily in Kurdistan's energy, real estate and construction sectors.

At an oil and gas conference on December 4, 2013, and in the presence of Turkish energy minister, KRG's Natural Resource Minister Ashti Hawrami declared that the KRG has reached an agreement with Turkey to export oil directly through a new KRG pipeline.<sup>107</sup> Kurdish and Turkish companies have built a 78-kilometer pipeline, with one million bpd capacity, that links Kurdish oilfields to the Iraq-Turkey pipelines. The Iraq-Turkey Pipeline (ITP) consists of two parallel lines, one of which is not being used. The KRG attached its pipeline into the unused pipe beyond the federal government's metering station (Osgood and Van Heuvelen 2013). The ITP passes through Kurdish territories before it enters Turkey. Granted, technical capability alone is insufficient for oil to flow, and needs to be aligned with political agreement over the export, sale and cashing of Kurdish oil and gas. The Kurdish pipeline that was announced in

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<sup>107</sup> Iraqi Kurdistan Oil and Gas Conference, Erbil, December 4-5, 2013, which the author attended.

December 2013 exacerbated tensions between the national and the regional governments, and further internationalized a domestic dispute by involving Turkey. Baghdad completely cut off KRG's share of the national budget in early 2014.

In late 2014, the federal and Kurdish governments reached yet another agreement to export oil and share revenues. The military advance of ISIS, the election of a new government in Baghdad and the sharp decline in global oil prices brought the KRG and Baghdad together again. In November, the two sides reached an agreement that allowed the KRG to export 250,000 barrels of oil per day and resume receiving 17% of Iraq's budget. The tables have also turned in terms of export infrastructure. Because the Iraq-Turkey Pipelines fell under and was sabotaged by ISIS, Baghdad needs to export oil from Kirkuk fields to Turkey through the new Kurdish pipelines. The KRG agreed to lift 300,000 barrels of crude from Kirkuk fields as well. The Iraqi government also agreed to allocate budget outside the KRG's 17% for the Peshmarga, which, along with the Iraqi military and militias, is fighting ISIS (Coles and Evans 2014; Osgood and Smith 2014). The deal does not address some of the fundamental issues around oil management, such as passing the national hydrocarbon law or to wind down Iraq's legal measures against the KRG in Iraqi and international courts.

Politics, more than commercial interest, shapes oil export policy in Iraq. For example, Baghdad agreed to let Kurdish oil flow in 2009 through Iraqi

pipelines because it needed the extra revenue from Kurdish oil to meet budget demands. Just as with the recent price falls, oil prices had fluctuated, from \$147 per barrel in mid-2008 to \$30 per barrel sixteen months later. In contrast, Baghdad had initially agreed to Kurdish oil exports following Kurdish endorsement of Al-Maliki's second term as prime minister following the inconclusive 2010 elections. However, Al-Maliki's government had no qualms stopping payments to the KRG since it could meet 2012 budget easily (Van Heuvelen 2012b; International Crisis Group 2012) – oil output was higher thanks for the deals with IOCs with quick turnover, the price of oil had recovered, and its export capacity grew thanks to Basra's mooring stations.

### **Oilfields and Disputed Territories**

Another aspect of the multipronged dispute over oil management is geography. The KRG controls only 3 of Iraq's 18 provinces (Erbil, Sulaimaniya and Dohuk). But the KRG exercises de facto political and administrative powers in Kurdish dominated towns in Kirkuk, Mosul and Diyala provinces. The Kurds have historical claim over these territories, especially the oil-rich city of Kirkuk, which has been the sticking point in many negotiations throughout the Kurdish struggle in Iraq in the 20th century. In 2003, Kurdish forces along with U.S. troops captured the city of Kirkuk, but the Kurdish forces were soon asked to leave the city.

Kirkuk is an oil-rich, multi-ethnic, multi-religion city and province. It

houses Kurds, Turkomans, Arabs, Muslims, and Christians. Under the Baath rule, it underwent ethnic engineering – Kurds were expelled from the city and Arabs from southern Iraq were settled in. Kurds have a historic claim on the city – Iraq’s former president Jalal Talabani called it “the Jerusalem of Kurdistan.” The province briefly fell to Kurdish control in 1991 and 2003, but it remains outside of KRG territories. To address the contested Kurdish and federal claims over Kirkuk and other disputed territories, article 140 of Iraq’s Constitution lays out a roadmap for a settlement that would conclude in a census and a referendum to settle Kirkuk’s administrative (and ethnic) identity.<sup>108</sup> Despite the constitution’s set date – December 31, 2007 – as the deadline for these measures, they are yet to take place. Therefore, Kirkuk and many other oil-rich areas remain as “disputed territories.” After the ISIS incursion into Iraq, Kurdish peshmarga forces took control of the city of Kirkuk, and soon after, KRG officials from the Minister of Natural Resources took over the management of Kirkuk’s oilfields. These land disputes are intertwined with and further complicate the Baghdad-KRG battle over oil management.<sup>109</sup>

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<sup>108</sup> The steps are: (a) normalization, which refers to addressing or reversing the Baath regime’s policies of demographic changes, which Kurds refer to “Arabization of Kirkuk;” (b) a census; and (c) a “referendum in Kirkuk and other disputed territories to determine the will of their citizens.” The article also sets a deadline for these measures to be taken, December 31, 2007.

<sup>109</sup> For analyses that bring together both issues of oil and territory, see International Crisis Group Reports, *Iraq and the Kurds: The Brewing Battle over Kirkuk* 2006; and *Oil for Soil: Toward a Grand Bargain on Iraq and the Kurds* 2008.

The KRG took action unilaterally with regard to disputed territories. In addition to expending human and financial resources in these territories, the KRG strategically invited American, European and Turkish companies to invest in areas that fall into disputed territories, outside KRG's borders. Disputed territories in Iraq are delineated by a "green line" that separates what was the Kurdistan region in 2003, and Iraq proper. The oil blocks that the KRG offered ExxonMobil and Hunt Oil fall alongside the disputed territories (International Crisis Group 2012) (See Figure 14: Northern oilfields including in the KRG, and the green line between KRG from federal Iraq for a map that shows the overlap of oilfields with the green line).

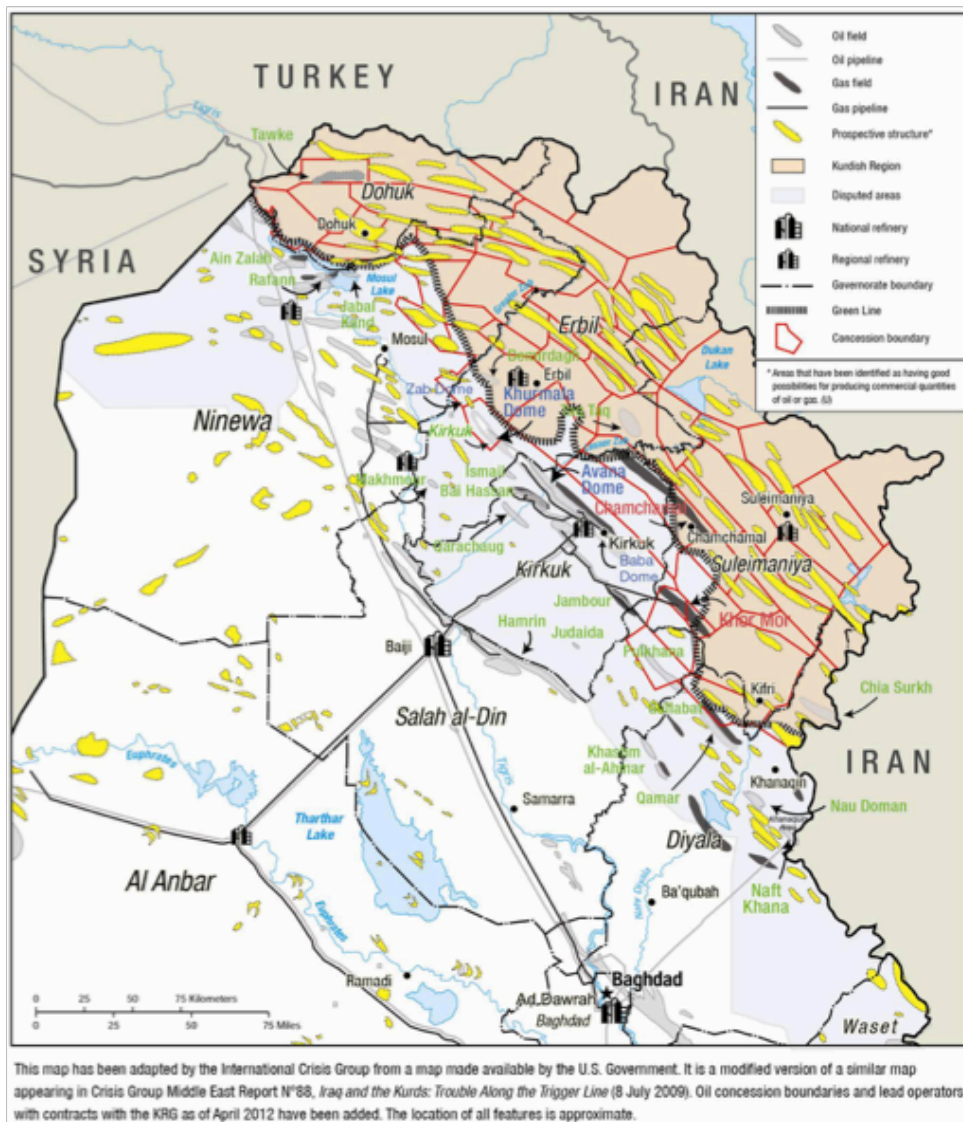
### **Other Actors**

In addition to disagreements over the constitution and export, the oil conflict in Iraq has gained a geopolitical dimension, which involves regional and international powers, and private and corporate interests. Iraq's neighbors, by way of their foreign policy and geography, have a say in Iraq's affairs. As mentioned earlier, the KRG sought to diversify and solidify foreign support by attracting IOCs from different countries. Turkey is a significant player in Iraq's petroleum industry since northern exports pass through its territories, including the KRG pipelines. Most recently, ISIS became a player that affects the functioning of the petroleum industry.

## **Turkey**

With sanctions on Iran and a civil war raging in Syria, Turkey is the only viable outlet for Iraq's northern oilfields, including for Kurdish oil. Turkey exerts influence on Iraq and KRG's petroleum industries through the Iraq-Turkey pipeline. The KRG energy industry received a major boost when Turkey agreed to allow Kurdish oil to pass through.

Turkey's relation with the KRG is complex, however. On the one hand, Turkey wants to see a unified Iraq, since an independent Kurdistan could become a model for Kurdish populated regions in Turkey. Hence, it is important for Turkey to keep Iraqi Kurdish statehood aspirations in check. On the other hand, Turkey's economic development is energy thirsty, and it would serve the country to diversify its energy sources (Okumus 2014).



**Figure 14: Northern oilfields including in the KRG, and the green line between KRG from federal Iraq**  
 (Source: International Crisis Group, N°120, p. 27)

With Turkey's domestic opening toward a solution to its Kurdish issue, coupled with problems between the Turkish and Iraq's federal governments, Turkey's

priorities were shifted in favor of the KRG.<sup>110</sup> Turkey would also welcome Kurdish natural gas for its domestic use, but also to feed the proposed Nabucco pipeline project (International Crisis Group 2012). Kurdish gas could help Nabucco by replacing Iranian gas contributions (Kadhim 2011). From Turkey's ruling AK party's perspective, a rapprochement with Iraq's Kurds could guarantee at least some of Iraq's oil flowing to Turkey, and enlist KRG's support for the Turkish peace process with its Kurds.

Turkey is an important player and influencer of Iraq's energy industry, as an importer of, and as transit country for Iraq's petroleum. Turkey's foreign policy toward Iraq has been shaped by two main goals: maintaining Iraq's territorial unity and defeating or containing the PKK. Turkey takes interest in Iraqi Kurdistan's affairs in particular and in Iraq in general because of its own Kurdish population and the Turkoman minority that lives in Iraq, including in the oil-rich city of Kirkuk. There are Turkoman communities in Erbil and Mosul as well. Turkey has eyed Kurdish claims over Kirkuk with suspicion, since Kirkuk's oil will further buttress KRG's economic independence. To that end, Turkey has been using Kirkuk's Turkoman as its main vehicle of leverage to make sure Kirkuk stays outside Kurdish control (International Crisis Group 2008).

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<sup>110</sup> Interview with Murat Ozelik, former Turkish Ambassador to Iraq, who is known as the architect of Turkish-KRG rapprochement (October 6, 2013).



Turkey also has a sizeable Kurdish population, from which the Kurdistan Workers' Party, better known as the PKK, has emerged. The PKK is a militant group that has been fighting the Turkish military since 1987, often using the Iraqi-Turkish mountainous borders as hideouts and base camps for their operations. Respective Turkish governments and the Turkish military feared an independent Kurdistan in Iraq from being a model for their own Kurdish population.

Turkey's Neo-Ottoman foreign policy orientation of the ruling AK Party, coupled with Turkey's energy needs, smoothed the path for a Kurdish-Turkish rapprochement. The relation between Turkish Prime Minister Recep Tayip Erdogan and Iraqi Prime Minister Nouri Al Maliki also soured, especially after the Syrian civil war. Moreover, the AK Party sought a peaceful resolution to the conflict with the PKK, which has been raging since the mid-1980s, and to grant more rights to Turkey's Kurds. Turkish intelligence agency arrested PKK leader Abdulla Ocalan in 1999, which gave the government the upper hand in negotiations with the PKK. To make peace with its own Kurds, Turkey needs Iraq's Kurds.

Turkey was not gaining much from its antagonistic policies toward Iraqi Kurdistan. As Turkey's former Ambassador to Iraq put it, Turkey had "mortgaged [its] own business in the hands of the central government of Baghdad in order to see that nothing goes to the Kurds." Turkey's relations with

the KRG started warming up, culminating in Mr. Erdogan's visit to Erbil in March 2011 to inaugurate Erbil International Airport (which was built by Turkish companies) and the Turkish Consulate (KRG.org 2011). Turkey is Iraq's and Kurdistan's largest trade partner. Iraq was Turkey's largest export market after Germany in 2012, accounting for \$11 billion in trade (Werz and Hoffman 2014).

Turkey's relation with Iraq and Iraqi Kurdistan has transformed in few years, especially since the withdrawal of U.S. troops from Iraq (International Crisis Group 2012). Ankara's mainstream foreign policy has been to maintain Iraq's territorial integrity, keep Kurdish independence aspirations in check, and contain the KRG's influence as a model for Turkey's own Kurdish population. As late as 2006, Turkey's trade regulating agency issued a special decree banning oil imports from Iraq except through SOMO. In 2007, trucks were not allowed entry into Turkey because they had the word "Kurdistan" written on them. This antagonism against the KRG has quickly transformed into what it seemed as a "catholic marriage" to an Iraqi oil executive (Shakir 2013), cementing the KRG-Turkey commitment and relations.

Key part of Turkish softening of policy toward the KRG was to offer political and technical backing to a Kurdish pipeline that allows the KRG to export directly to Turkey. For Turkey, an oil-exporting pipeline from the KRG offers Ankara leverage over the KRG, and turns Iraq's Kurdish political parties into allies, especially regarding the peace process in Turkey and Turkey's

influence over Kurdish groups in Syria. The economic benefits of the Turkish-KRG oil-based rapprochement may outlive its political gains, even if the AK Party's grip to power in Turkey were to weaken.

Turkish companies are heavily involved in Kurdistan's economic sector, including oil. Turkey is the largest investor and trade partner in the KRG.<sup>111</sup> Turkish laborers, mainly from Turkey's Kurdish regions in the southeast, work in the KRG and remit much of their income back into Turkey. Turkish Genel Enerji has been among the first foreign oil companies to deal with the KRG. After the pipeline deal, Turkish Energy Co, a state-owned company was offered several Kurdish oil blocks (Van Heuvelen 2013). As a Turkish entrepreneur recently put it, "We provide them with security, and they provide us with energy," and that Turkey wants to see Kurdistan's "full economic integration into Turkey" (International Crisis Group 2012). The Kurdish-Turkish deal is in Turkey's strategic interest and will likely continue even if the ruling AK Party were to lose power (Gfoeller 2013; Ozcelik 2013). By loosening its dependence on Baghdad, the KRG may be becoming too dependent on Turkey.

While Turkey would benefit from being an export route for Iraqi oil, it is also eyeing Iraq's natural gas, which Turkey needs for its domestic energy

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<sup>111</sup> It is estimated that 80% of all goods in Kurdistan markets are made in Turkey. Turkish foreign investment in the KRG was \$4 billion in 2011, \$8.4 billion in 2012, and expected to be more than \$12 in 2013 (Overview: Kurdistan Region Economy <http://www.investingroup.org/publications/kurdistan/overview/economy/>)

consumption and industry (Al-Khateeb 2013b; Okumus 2014). For Turkey, KRG oil and gas can decrease Turkey's reliance on Russian and Iranian gas, and position Turkey as an energy hub for Europe. Turkey would want to gain access to all of Iraq's oil and gas, but if stability is elusive in Iraq, the Kurdish region will make for a safe buffer zone. Iraq's oil and gas may have different outlets and buyers, but much of Kurdish oil could easily end up in Turkey. The KRG could potentially provide up to a third of Turkey's energy needs, according to energy analysts (Al-Khateeb 2013b; Zulal 2013). The KRG, on the other hand, seeks an outlet for the oil produced in the Kurdistan region so its IOCs can get reimbursed for their investments. Also, Ankara could strategically use its good relations with Erbil as a vehicle to better its relations with Baghdad, and to bring Baghdad and Erbil closer.

As for the KRG, Turkey is its ticket out of the landlocked region into international markets. With the help of Turkish government and companies, the KRG can export oil independent of Baghdad. The KRG had been acting strategically to attract the Turkish interest. For example, to raise Turkish interests in the region the KRG asked other investors in its oil sector early on to team up with Turkish companies (International Crisis Group 2012).

A rapprochement between Turkey and the KRG might be a winning bargain for both sides, but it could further complicate the possibility settlements between the federal and regional governments in Iraq. A decreased KRG reliance

on Baghdad would also reduce the incentive to pass an Iraqi national hydrocarbon law. Moreover, KRG's oil deals with Turkey could further antagonize Baghdad and result in escalations in the power struggle between the federal and the regional governments.

However, developments since summer 2014 may distort these newly built relations. ISIS is fighting the PKK in the Syrian town of Kobane, where the Kurdish Peshmarga also joined the fight in defense of the city. The PKK had helped Kurdish Peshmarga in Iraq in when ISIS attacked Sinjar. Turkey has refrained from joining the anti-SISI coalition. Turkish peace talks with the PKK was served a dangerous blow over Kobane (Semple and Arango 2014). At one point, Turkey had supported ISIS against Bashar Al-Asad of Syria. Turkish-KRG relations were also tested when ISIS attacked Erbil. While American jet fighters came to the rescue, the Turkish military did not budge, which resulted in an outcry in Kurdistan, questioning the strategic gains of the long-term energy deals with Turkey.

### **The U.S. Government**

The United States of America has been an important actor, with vested interest in Iraq's energy sector. The U.S. is one of the major importers of Iraqi oil,<sup>112</sup> and has interest in the stability of international oil markets. During the

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<sup>112</sup> In 2012, the U.S. bought 19% of Iraq's oil exports, according to U.S. Energy Information Agency (2013).

drafting of the Iraqi hydrocarbon law, the United States Embassy in Baghdad offered advice and technical assistance. The Embassy has also been a mediator between Baghdad and the KRG over oil disputes, often getting both sides to arrive at temporary agreements (Khalilzad 2010). In his investigative reporting, Muttitt (2012) argues that the even before the Iraq war of 2003, Bush administration officials were planning for the return of IOCs into Iraq's energy sector. He also argues that the British and U.S. governments sought to bring more oil into global energy markets, and envisioned a more powerful role for IOCs like ExxonMobil and BP – companies with the necessary technology to boost Iraq's production. Muttitt also argues that Britain and the United States were involved in the shaping of Iraq's post-Saddam energy policy – former oil company executives were involved in composing drafts of the Iraqi hydrocarbons law.

However, internal rivalries between the KRG and Baghdad turned the U.S. and British governments into mediators.<sup>113</sup> It has been the policy of the U.S. government to push for a unified energy policy in Iraq. To that end, the U.S. government has refrained from encouraging U.S. oil firms from investing in Kurdistan in order to avoid exacerbating the conflict between the Kurdish region and the center in Baghdad. But the U.S. efforts to reach an agreement between

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<sup>113</sup> Not just politically, but legally too – disputes between IOCs and the governments in Iraq are arbitrated in the international Commercial Court in Paris of London.

Baghdad and Erbil have so far been futile, partly because some U.S. oil firms have signed petroleum contracts with the KRG, including ExxonMobil.<sup>114</sup> Even before ExxonMobil, other KRG oil contracts were signed, including with U.S. oil companies, against the wishes of the Coalitional Provisional Authority order number 39, which banned the signing of oil contracts before an elected government was in place (Coll 2012, 567).

The Obama administration has adopted a One Iraq policy, which weighs energy policy against preserving Iraq's territorial unity. Washington has been discouraging IOCs to sign oil deals with the KRG before a national hydrocarbon framework is agreed upon. When ExxonMobil decided to sign deals with the KRG, Iraqi Prime Minister Nouri Al-Maliki wrote a letter to Obama asking him to stop ExxonMobil from dealing with the KRG. Although the Obama administration advised companies about the legal and stability risks involved in dealing with KRG without Baghdad's approval, an Obama official reiterated that the U.S. government couldn't stop ExxonMobil from making a decision that the company saw fit. ExxonMobil found KRG's contract terms in particular, and the

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<sup>114</sup> The first American oil company to deal with the KRG was Hunt Oil. The Bush administration discouraged IOCs from signing contracts with KRG without the approval of the federal government. See the Washington Post report on KRG deal with Hunt Oil: [voices.washingtonpost.com—dems\\_administration\\_knew\\_more.html](http://voices.washingtonpost.com-dems_administration_knew_more.html). Also, State Department official Mathew Amitrano (2010) said that the KRG found backchannels to the Bush White House, which helped secure the Hunt Deal. Qubad Talabani said in an interview that the Hunt Oil deal was very important for the KRG because it opened the door for other companies to invest in Kurdistan.

industry in general, more appealing than Baghdad's (Gfoeller 2013). Some in Washington see KRG's actions as irresponsible. ExxonMobil has come north and has so far maintained its contracts in the south as well. The KRG is happy with the Exxon deal and sees it as a vote of confidence and legitimacy for its energy policy.<sup>115</sup>

Regarding U.S. views on the Turkish-KRG relations, realities on the ground have been louder than feeble critical noises from Washington. Washington did not receive the news of the KRG-Turkey pipeline positively. There might be misconceptions in Washington and Ankara about each other, but as Murat Ozcelik, former Turkish Ambassador to Iraq, put it, indications from Washington have not been all that negative. Ozcelik, who advocated better Turkish relations with the KRG, asked rhetorically "why should we hurt ourselves over failed Baghdad policies" (Ozcelik 2013)? The U.S. may eventually come to terms with the warming Ankara-Erbil relations, which Washington sees as too close at the moment. Some in Ankara have seen the presence of ExxonMobil in the KRG as tacit approval from Washington. In its relations with

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<sup>115</sup> Kurdish officials and industry experts relay this point about the strategic significance of ExxonMobil deal with the Kurdish government. For example, Gfoeller (2013) and Levine (2013). Before the U.S. Consulate in Kurdistan opened, a Kurdish official jokingly told a U.S. government official the Consulate won't be needed now that ExxonMobil's is in Kurdistan. A member of the Kurdish parliament said that ExxonMobil is "architect of U.S. policy" (Masalla 2012, 126). Indeed, to demonstrate that KRG policy is more successful than Baghdad's, Kurdish officials point out that ExxonMobil wouldn't have invested in the KRG oil sector if the legal terms were not in order.



the KRG and Iraq, Turkey might be taking the lead on its own terms, rather than taking cues from Washington. Furthermore, the KRG seems to value Turkey's practical political support over Washington's critical rhetoric. Gfoeller told an audience in Washington, DC that in 40 years of his service in the Middle East, "I have never seen a period which American influence has shrunk to this level" (Gfoeller 2014). He said in an interview (2013) that it is in the interest of Turkey to gain access to some of Iraq's oil and gas in Kurdistan if cannot access the entire country's resources. To that strategic end, Turkey can afford to ignore American's reservations.

### **Iran**

Iran may not have been a visible major player in Iraq's oil industry; but it remains a significant actor in general Iraqi politics.<sup>116</sup> Iran favors a strong, Shia-led central government in Baghdad, and wields significant influence with the ruling Shia parties, many of whose leaders were took shelter and received training in Iran during the Baath rule. Iran also received thousands of Kurdish refugees, including fighters and political leaders, during the Iran-Iraq war. Hence, Iran could use its position to limit Iraq's policy options in a fashion that serves Iran's interests in Iraq and the wider region (Ozcelik 2013). Iran also has

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<sup>116</sup> Iran is seen an important power broker in Iraq, having leverage over Kurdish and Arab parties alike, often with the power to pick winners in post-election negotiations. Upon the ISIS incursion, Iranian intelligence and Quds Force, led by Qasim Sulaimani, are helping Iraqi militias and Peshmarga fight back. For more on Iran's influence in Iraq and the wider region, see Katzman 2010; and Filkins 2013.

leverage over the KRG and its two main ruling parties. For example, shunned by Baghdad, the KRG exported or smuggled crude and oil products to and through Iran (Lando 2008; Dagher 2010). Iran may seek to balance Turkish power and influence in Iraq and the KRG.<sup>117</sup> However, Iraq's rise as an energy giant could bolster the independence of Iraqi politicians and weaken Iran's influence in Iraq. Oil revenues could empower Iraq's ruling elite and help them consolidate power, at which point Iran cannot as easily pick winners and exert pressure. Should international sanctions imposed on Iran be lifted, European countries would start investing in the Iranian oil sector. Iran's energy industry may need those investments more desperately should oil prices continue to fall. Geostrategically, Iraq and the KRG could be caught between Turkish and Iranian competition for regional hegemony (Gfoeller 2013). Iran has an attentive ear with parties like the Shia Islamic Supreme Council and the Kurdish Patriotic Union (led by Talabani) of Kurdistan. Sources of this influence include history, sectarianism and geographic proximity. Similarly, Turkey has larger sway with Sunni tribes and parties, and the Kurdistan Democratic Party. Moreover, Iran could become a competitor to Iraq within OPEC over production quotas. Therefore, Iranian influence in Iraq's and the KRG's petroleum sectors and politics is expected only to rise, especially after the rise of ISIS.

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<sup>117</sup> Gfoeller (2013). See Stratfor, Letter from Kurdistan, <http://www.stratfor.com/weekly/letter-kurdistan>

## **International Oil Companies**

International oil companies (IOCs) see Iraq as an opportunity in an industry that is increasingly dominated by national oil companies. IOCs lost access to much of the world's lucrative and easily accessible conventional oil after the wave of nationalization that started in the 1970s. Therefore, IOCs are stretching the oil frontier, looking for oil deep waters and the arctic, or investing in technologies that allow them to access non-conventional oils such as tar sands and shale oil (Bridge and Le Billon 2013). In the Middle East, post-Saddam Iraq is the only country that welcomes IOCs back into its oil sector in any significant fashion (Gfoeller 2013; Coll 2012). Therefore, lack of security and optimal legal and bureaucratic frameworks has not stopped oil firms from entering the Iraqi energy market, even if only to find a foothold.

Iraq's energy sector has attracted national and international oil companies alike. The two kinds of firms are in Iraq for different goals, however. The KRG attracted some risk-taking (like the wildcatters) and mostly private foreign investors into its petroleum sector by offering them generous deals. With increased production and prospects, major oil companies like Chevron and ExxonMobil have also entered the Kurdish energy sector. Baghdad, however, managed to attract the comparatively risk-averse major oil companies, including state-owned ones. Moreover, Iraq managed to get competitive deals since many of Iraq's oil contracts are signed with Asian national oil companies, including

those from China, India, Malaysia and Indonesia (See Table 5 for a list of companies operating Iraqi oil and gas fields). Unlike Western oil companies whose primary interest is profit, the Asian companies are in Iraq for their own long-term energy needs, and hence are more tolerant of security, political and legal risks (*Iraq: The Essential Guide to Foreign Investment* 2010; Bridge and Le Billon 2013). Although they have an interest in a more stable legal and political framework for oil, international oil companies have not exerted extensive influence over Baghdad and the KRG toward reconciliation of their respective energy policies. Alternatively, the political and ethnosectarian power play and disagreement over power sharing in Iraq is too large and complex for the nascent post-Saddam energy industry to exert much influence.

**Table 5: Iraq's bidding rounds for oil and gas fields, and awarded IOCs  
(U.S. Energy Information Agency 2013)**

		2009 prod. 1,000 bbl/d	Target prod. 1,000 bbl/d	Target incr. 1,000 bbl/d	Reserves (billion bbl)
Operators					
<b>First bidding round (brownfields), June 29-30, 2009</b>					
Rumaila	BP, CNPC	1,000	2,850	1,850	17.8
West Qurna, Phase I <sup>1</sup>	ExxonMobil, Shell	270	2,325	2,055	8.6
Zubair	Eni, Occidental, Kogas	205	1,200	995	4.0
Missan Group	CNOOC, TPAO	86	450	364	n/a
<b>First round total</b>		<b>1,561</b>	<b>6,825</b>	<b>5,264</b>	<b>&gt;30</b>
<b>Second bidding round (greenfields), December 11-12, 2009</b>					
West Qurna, Phase II	Lukoil, Statoil <sup>2</sup>	0	1,800	1,800	12.9
Majnoon	Shell, Petronas	55	1,800	1,745	12.6
Halfaya	CNPC, Petronas, Total	3	535	532	4.1
Garaff	Petronas, JAPEx	0	230	230	0.8
Badra	Gazprom, KOGAS, Petronas, TPAO	0	170	170	0.1
Qaiarah	Sonangol	2	120	118	0.9
Najmah	Sonangol	0	110	110	0.9
<b>Second round total</b>		<b>60</b>	<b>4,765</b>	<b>4,705</b>	<b>32.3</b>

<sup>1</sup> ExxonMobil was asked by Iraq to choose between this project and its projects in the KRG.

<sup>2</sup> Statoil exited this project in March 2012.

Sources: Special Inspector General for Iraq Reconstruction, Middle East Economic Survey, Iraq Ministry of Oil

### Results of fourth bidding round May 30-31, 2012

	Operators	Hydrocarbon	Location
Block 8	Pakistan Petroleum	Oil/Gas	East central Iraq, 110 km east of Baghdad
Block 9	Kuwait Energy, Dragon Oil, TPAO <sup>1</sup>	Oil	Southern Iraq, 20 km north of Basra
Block 10	Lukoil, Inpex	Oil	Southern Iraq, southwest of Nassiriya
Block 12	Bashneft, Premier	Oil	between Najaf and Muthanna

<sup>1</sup> The Iraqi government has not signed a contract with TPAO and has asked Kuwait Energy to take over TPAO's share.

Source: Middle East Economic Survey, Iraq Ministry of Oil

Gas Field	Operators	Estimated Reserves (Tcf)
<b>Third bidding round, October 20, 2010</b>		
al-Mansuriyah	Kuwait Energy, KOGAS, TPAO	3.3
Akkas	KOGAS, KazMunaiGas	2.1-4.0
Siba	Kuwait Energy, TPAO	0.1
<b>Third round total</b>		<b>5.5-7.4</b>

### Fourth bidding round, May 30-31, 2012

Gas Field	Operators	Estimated Reserves (Tcf)
Block 8	Pakistan Petroleum	Not Available

Source: Middle East Economic Survey

## ISIS and Smuggling Networks

The spillover of the Syrian civil war into Iraq and the ISIS tapping into Sunni grievances disrupted the development of Iraq's petroleum industry. ISIS now controls much of the Iraq-Turkey pipeline that transports crude from Iraq's northern fields. Many oil companies operating in or near the areas threatened by

ISIS withdrew their staff and halted their operations (M. Clark 2014). ISIS became an actor in Iraq's energy scene not only as saboteur but also as an influencer that controls oilfields, refineries and export routes. ISIS was making up to \$1 million a day from sale of crude in Iraq and Syria (Daragahi and Solomon 2014b; Hussein et al. 2014). ISIS taps into an existing oil smuggling network to sell the crude it extracts from the oilfields in has captured Iraq and Syria. ISIS crude finds its way to Iraq, Kurdistan, Syria and Turkey and even beyond, blunting the international effort to degrade the terrorist organization.

Moreover, smugglers were crucial in helping the KRG in a scheme to monetize some of the crude it produced (see Figure 10) above, where smugglers are identified as actors influencing KRG's petroleum policy and industry). Before it built the pipelines to Turkey, the KRG trucked oil to Iran and Turkey. To avoid backlash from Baghdad, the KRG sold crude to local refineries and traders, who in turn "exported" crude and products (like fuel oil and naphtha) to ports in Iran and Turkey. To the Iraqi government, this was smuggling. These practices, legal or not, maintain a smuggling enterprise that was established by the Saddam's family in during the sanctions of the 1990s and continued during the insurgency and today with ISIS (Chapter 6 revisits smuggling in more depth).

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The dispute over oil has been intertwined with dispute over power, historical Kurd-Arab ethnic tension, land claims and regional influence. Despite

the potential to be a bridge for negotiations, the addition of oil to these complex conflicts has so far exacerbated solutions. The developments on the ground since 2007 have imposed a status quo on the political scene in Iraq, and have further complicated reaching national accord over oil. Absent an agreed-upon national hydrocarbon policy, Iraq is missing current and future opportunities of better deals, more equitable revenue sharing and investing in the future. Politically, a national policy is needed to hold the country together harmoniously. Also, political bickering has created room for corruption and discourages accountability in a sector inherently prone to corruption. Economically, a unified policy would ensure efficiency and stronger position vis-à-vis OPEC and international contract negotiations. For now, however, legal ambiguity and disaccord among political parties in power in Baghdad and Erbil have not stopped them from signing long-term contracts unilaterally and deepening the discord. The multiplicity of influential actors, with varying agendas, weakens Iraq's ability to better govern its energy sector. The next chapter will address the social, political and economic consequences of these legal and political failures in governing Iraq's petroleum industry.



## **CHAPTER 6: RESOURCE CURSE AND CORRUPTION IN IRAQ**

This chapter demonstrates that Iraq suffers from resource curse and endemic corruption. It also discusses how Iraq's oil wealth is squandered through corruption and the nurturing of patronage networks. The Iraqi economy became chronically petroleum-dependent ever since the Baath Party nationalized the natural resource in the mid-1970s. Iraq's wars with Iran (1980-1988) and Kuwait (1990-1991) and sanctions (1990-2003) deepened this dependency, especially for the government whose revenues come exclusively from proceeds of oil sale. The presence of such significant oil wealth has created disincentives for good governance and efficient management of the economy. Rather, it has encouraged rent-seeking and policy myopia instead of policies that stabilize volatile commodity, such as diversification of the economy and countercyclical policies. The prevalence of oil revenues and Iraq's return after the sanction to the major oil exporters club affects the country's political and economic trajectory. Depending on how new Iraq manages its core commodity and export; the country could break up, fail, or become a regional competitor for prosperity and good governance.

Oil wealth could offer opportunities for prosperity, but governments often

squander them. Iraq's oil wealth flows directly into the government coffers and increases its dependence on oil. Iraq's complete dependence on oil has serious political and economic consequences, and the Iraqi government needs to reduce its dependence on oil by investing oil revenues to diversify the economic base. For example, Iraq was once the world's largest palm dates exporter, but today it is a net importer. Moreover, although petroleum exports provide more than half of Iraq's GDP, the petroleum industry employs less than 2% of the workforce. However, sound policies to reverse the resource curse require a level of political maturity and institutional capacity that Iraq simply lacks. Yet, the later these policies are set in place, the harder it becomes to counter the rising government's and the economy's lethargic addiction to oil. Instead, through various inefficient policies and political schemes, most of that wealth is siphoned off to political parties, family-business networks and militias. Dutch Disease, rent-seeking and different kinds of corruption demonstrate that Iraq suffers from resource curse.

The analysis also demonstrates that national and subnational governments are quick to be infected with resource curse but slow or unable to heal from it. Even the Kurdish region of Iraq, which only recently found oil, started to suffer from symptoms associated with oil-dependence, such as corruption, bloated bureaucratic payrolls and economic volatility. However, oil did not pour into a vacuum. Rather, a legacy of an oil-rich welfare state coupled with years of sanctions and civil war loots created a fertile ground for spending

oil wealth in a manner unfavorable to stability and economic prosperity.

Corruption and secrecy pose challenges to any developing country, but more so to an oil-rich one. Iraq has one of the most corrupt governments in the world, ranking 171 out of 177 most corrupt countries on Transparency International's 2013 Corruption Perceptions Index. Citizens and businesses both complain about how their livelihood is affected by corruption, both grand and petty. The budding market economy is slowed down by corruption, and Iraq's anticorruption infrastructure is too weak to put a serious dent in the billions of dollars that corruption costs the country (Cordesman and Khazai 2014).

Patronage politics is the goal of many Iraq's practices. Iraq's corruption is most detrimental because it allows for channeling of public revenues into the coffers of patronage networks of political parties, militias and terrorist groups. Patronage spending in the absence of sound economic policies and strong economic institutions hurts the country's economic growth. They result in myopic policies and lack of meritocracy.

Patronage networks dominate Iraqi politics and government. Post-2003 corruption and patronage are different from that of the Saddam era in that it is decentralized in structure, more predatory in nature, and more participatory, involving diverse actors such as political parties, militias and informal networks. Corruption is also closely tied to crime and instability (Williams 2009). Iraqi ethnosectarian groups share government offices (and the revenues that come

with them) based on an ethnosectarian quota system. For example, the Iraqi Governing Council, created in 2003, consisted of 25 members with 13 seats for Shia groups, 5 for Sunnis and 5 for Kurds. Assyrians, Turkomans and women each received a seat as well. A version of this quota system lives on, in which a group is given a ministry to run which it in turn packs it with supporters. Although the Coalition Provisional Authority institutionalized this patronage prone quota system, the Iraqis themselves might have designed it when they were a Diaspora opposition (Wing 2014). After the 1992 Kurdish elections, a 50-50 power sharing deal resulted in dividing government departments between the two winning parties, the KDP and the PUK. The administrative divide contributed to the Kurdish civil war (1994-1998). In addition to being inefficient, such patronage quotas have been conducive to corruption and conflict.

Dividing ministries in Baghdad may ensure representation, but not power and wealth sharing. Kurds and Shia Arabs have been more successful at consolidating power because their regions hold petroleum resources. Iraq's Sunni population, however, perceives itself as the losers of the 2003 invasion. They have not successfully regrouped or organized with a clear vision for their position in new Iraq. Divisions within, pressure and cooptation of leaders from the new Shia-led government, and the insurgency that inflicted mass losses on their territories have undermined the Sunni Arab attempts at a serious footstep in Iraqi polity.

Iraqi Sunnis have tried fighting Americans alongside Al-Qaeda, then fighting Al-Qaeda, protests, and eventually falling under ISIS. The touted success of the U.S. Surge of troops in 2007 offered the Sunni youth and leadership an alternative that resulted in turning their guns against Al-Qaeda in return for power sharing and a slice of the national pie. The week that the last U.S. soldier left in Iraq in 2011, Prime Minister Maliki's forces attacked and attempted the arrest of the most prominent Sunni leaders in the Iraqi government: then Vice President Tariq Al-Hashemi and Finance Minister Rafi Al-Isawi. Contrary to its promise, the Iraqi government integrated only a small portion of the Sunni youth that took up arms against Al-Qaeda into Iraq's formal security forces. Iraqi Sunni provinces revolted, mostly peacefully as inspired by the Arab spring, starting rallies and sit-ins in December 2012. Mr. Maliki's government ignored their demands and eventually sent in security forces to dismantle the protest camps in December 2013. Within weeks, ISIS forces entered Iraq from Syria, capturing about 40% of Iraqi territories and posed a threat to the federal and Kurdish capitals. Moreover, the poisonous atmosphere between the federal and the Kurdish governments resulted in distrust – Kurdish leaders say they warned Baghdad about the ISIS threat, but Baghdad shrugged it off. Indeed, it was only after Maliki was replaced as prime minister that the Kurdish forces agreed to coordinate with the Iraqi army and Shia militias in their joint fight against ISIS.

ISIS is a serious challenge to Iraq's stability and its survival as a country.

Although accurate data is hard to get by, conservative estimates by analysts at Rand Corporation put ISIS annual revenue generation in 2014 at \$100-200 million (P. B. Johnston and Bahney 2014). ISIS's main revenues come from the sale of oil and criminal activities. ISIS could be making \$1-2 million a day from selling oil to Iran, Turkey and Syria (Abu Haniya 2014; Hussein et al. 2014). ISIS taps into a resilient smuggling network that is facilitated by corrupt government officials, middlemen and porous borders. ISIS controls more about 300 oil wells in Iraq with the capacity to produce 80,000 barrels of crude per day (Di Giovanni, Goodman, and Sharkov 2014), and about 60% of Syrian oilfields. The other major source of revenue for ISIS is criminal activities, such as extortion, kidnapping for ransom, and looting banks and archeological sites. Ransoms alone could have made up to \$20 million (about 20% of total revenues) of ISIS revenues in 2014, according to the U.S. Treasury Department and Iraq Integrity (Di Giovanni, Goodman, and Sharkov 2014). Moreover, ISIS has 8 million people under its control to tax and extort. Aljazeera reported that ISIS makes \$6 million a month from levying taxes and customs of the local population and its businesses. ISIS also owns hundreds of thousands of tons of wheat in Iraq, representing 40 percent of the country's annual wheat production according to the UN. This in turn allows ISIS to create dependencies among the population and dole out patronage, rewarding its supporters.

This final chapter discusses how oil has contributed to the multifold

challenges Iraq faces. It first demonstrates that Iraq and Kurdistan suffer from then resource curse. Then it explains how corruption greases patronage networks. It argues that corruption, patronage and the resource curse affect and are affected by the budding energy industries in Iraq and Kurdistan, thereby elevating risk and instability.

### **Resource Curse: Iraq's Oil Dependent Economy and Government**

Oil revenues are unique compared to other sources of economic wealth. The distinct characteristics of oil revenue, as defined by Michael Ross, color the economy and the political system in oil-rich countries. Ross (2012) points out that oil revenues have four unusual properties: *sizeable* revenues that result in relatively large governments; unique *source* that deepens the economy's dependence on oil; ease of *secrecy* of hiding oil revenues; and *instability* and volatility of production levels and resulting revenues. These unusual characteristics color the form, function and nature of oil-dependent governments. Or as Ross put it: "Just as people are affected by the kinds of food they eat, governments are affected by the kinds of revenues they collect" (2012, 27). The many ways that Iraq's oil revenues have affected the country's economy and government is elaborated in the sections that follow.

The sheer size and scale of oil revenues flowing into the Iraqi government coffers has resulted in a comparatively large government. Iraqi coffers were

estimated before the drop in oil prices to receive an estimated windfall of \$5 trillion in oil revenues until 2035, at an annual average of \$200 billion (International Energy Agency 2012, 11). But unless reforms are adopted, much of that wealth will simply lubricate the functioning of the Iraqi government's 40 ministries and the cash-hungry political parties who control them.

As a fraction of their economies, petrostate governments are on average 50% larger than non-oil states (Ross 2012). Even when comparing petrostates to their resource-poor neighbors, the disparities are obvious. For example, as percentage of their economies, Azerbaijan's oil-funded government is 16% larger than its Armenia's natural resource-poor neighbor, and Algeria's government is a staggering 250% larger than next-door Tunisia (Ross 2012). The Iraqi economy and government are both highly dependent on oil revenues. Oil revenues and the size of the Iraqi government (including its budget, government departments and number of employees) have been simultaneously growing.

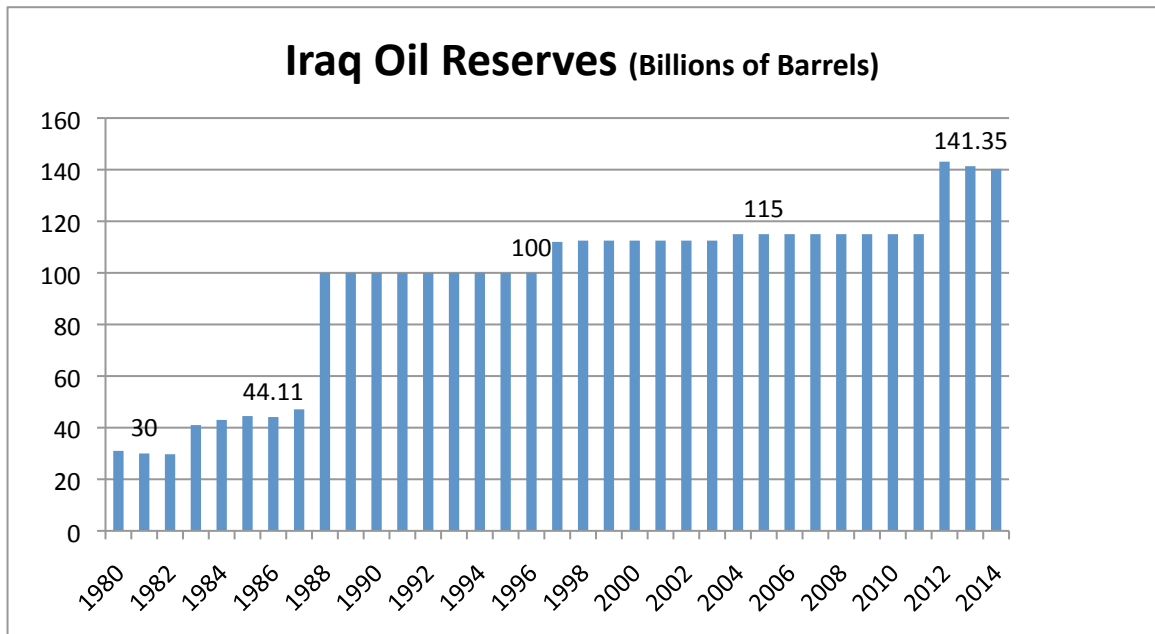
Petroleum is slated to continue to dominate the Iraqi economy for the



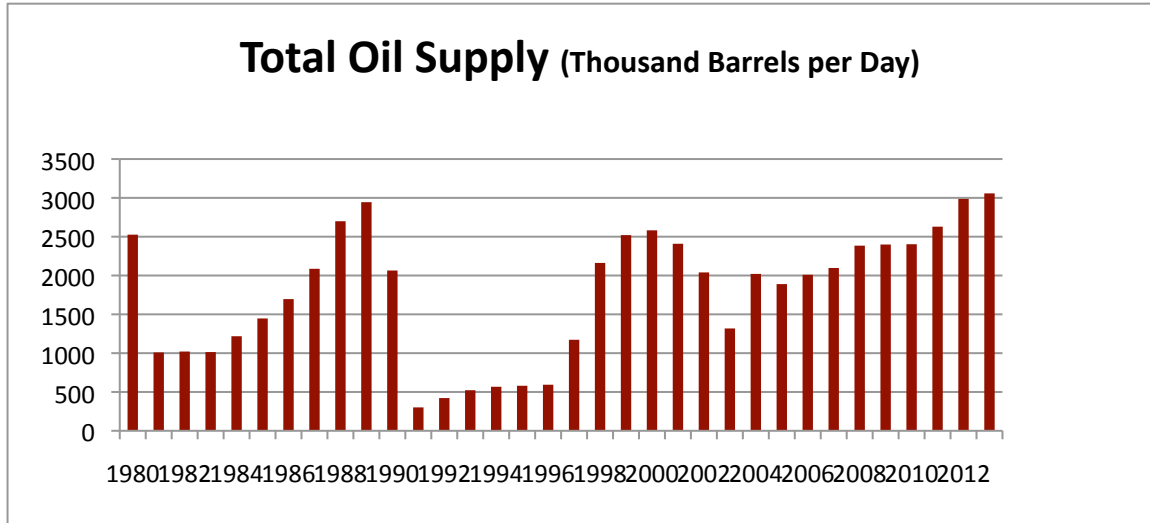
foreseeable future.<sup>118</sup> Iraq holds the fifth largest proven oil reserves and the 13th-largest proven gas reserves in the world. Iraq's crude reserves may rise as many parts of the country open up to petroleum exploration. Iraq is also the world's third largest oil exporter, after Saudi Arabia and Russia, and could overtake Russia's position by 2030. By the year 2035, Iraq is projected to become the largest contributor to global growth of oil supply (International Energy Agency 2012) (See Figure 15 and Figure 16).

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<sup>118</sup> Although the availability of petroleum resources is not geographically balanced, the federal government collects revenues from oil sales and spends them as part of its national budget. Iraqi provinces, regardless of the availability of petroleum, receive a public revenues depending on population size. Regions that house oil and gas fields and refineries receive an additional amount, dubbed petrodollars (as discussed in chapters 4 & 5). The Kurdish region receives a dedicated 17% of the national budget. Since the ISIS incursion, the Iraqi government offices have evacuated the three northern provinces the group captured. This has not meant a budget surplus in government coffers, however, plummeting oil prices as well as funding the army and militias fighting ISIS have dwindled the overall national budget.



**Figure 15: Iraq Oil Reserves (in billions of barrels) (Source: Chart produced using data from International Energy Agency (IEA) Iraq Outlook (2012)).**



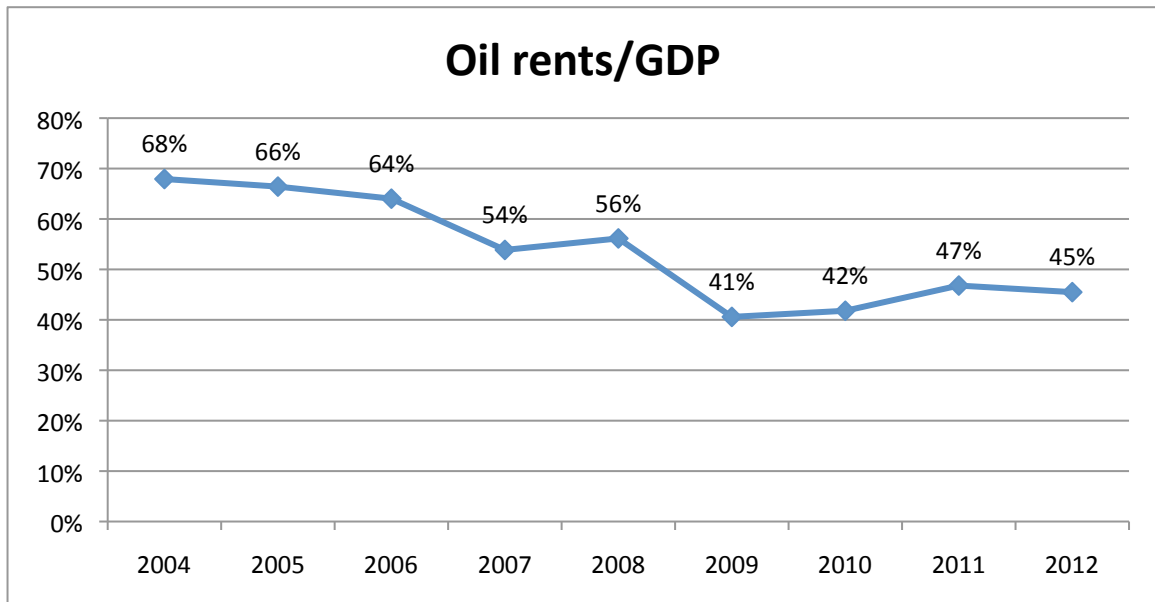
**Figure 16: Iraq's Total Supply of Oil (Source: Chart produced using data from International Energy Agency (IEA) Iraq Outlook (2012)).**

The bulk of oil revenues flow into the government, which in turn has

become the largest employer. Petroleum revenues dominate the Iraqi economy, but the government is the main and most direct beneficiary of these revenues. On average, oil revenues have contributed about half of Iraq's GDP since 2004, when such data started becoming available.<sup>119</sup> However, oil revenues make up about 95% of government revenues. Foreign oil companies receive compensation for their work in Iraq and the KRG, but their remunerations are much smaller compared to the governments' take. One reason is that Iraq's oil is relatively easy and cheap to produce. Hence, the government, as the principal recipient of energy revenues, is the largest beneficiary of the oil economy. Therefore, the public sector dominates the Iraqi economy and is expected to remain so (IMF 2010) (see Figure 17).

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<sup>119</sup> Economic data, especially that concerning oil production and sales, were considered state secrets under the former Baath regime.  
[https://www.cia.gov/library/reports/general-reports-1/iraq\\_wmd\\_2004/chap2\\_annxD.html](https://www.cia.gov/library/reports/general-reports-1/iraq_wmd_2004/chap2_annxD.html)



**Figure 17: Oil Rent as Percentage of Iraqi GDP (Source: Chart made using World Bank Iraq data, 2014)<sup>120</sup>**

Although the Iraqi economy at large is oil-dependent, the Iraqi government is even more deeply so. Not only is the Iraqi government the largest sector in the Iraqi economy, it is also disproportionately benefiting from the country's natural riches. Oil revenues account for more than half of the Iraq's GDP. But petroleum revenues accounted for 95% of government revenues in 2011 (IEA 2012). For the decade since 2003, the government has accounted for more than half of the economy – average government total revenues and total

<sup>120</sup> These figures are updated for 2014 and were provided to the author by the World Bank. The figures are updated and drastically different from previous versions of the World Bank data on Iraq. For example, average oil rents as percentage in Iraq was estimated at an average of 86% in the 2013 version of the dataset. The World Bank says that the changes are due to review of Iraq's GDP figures.

expenditures have accounted for 52% and 55% of GDP, respectively. Also, on average, the government's annual approved budget has accounted for 37% of GDP (See Table 1 below). Therefore, the Iraqi private sector is at a disadvantage to the government as a beneficiary of oil revenues. That is why the government, rather than the market, dominates the economy.

The oil-rich government, therefore, becomes the ultimate prize for politics. Through corruption, political parties, militias, criminal networks, and businesses compete to exploit and access government assets. Indeed, as discussed later, the Iraqi political leadership has been quite creative in transferring state revenues to pay their clients, such as through government contracting, public hiring, and party financing. Peace and conflict, or political satisfaction and lack thereof in Iraq can be correlated with such access. Exclusionary policies of respective Iraqi governments have been a major source of political and military turmoil in the country. One example is the Baathist regime exclusion of Kurds from seeing the fruits of oil from northern oilfields such as Kirkuk. Another example is the oil-poor Sunni provinces that have been relatively deprived of oil revenues since 2003. These provinces have been in turmoil partly because they are not sharing the country's wealth. Iraqi Kurdistan's autonomy has allowed it to establish a domestic energy sector and generate oil revenues. The Sunni provinces, however, remain in turmoil, and have most recently fallen to ISIS.

The dependence of Iraq's economy and government on oil is projected to

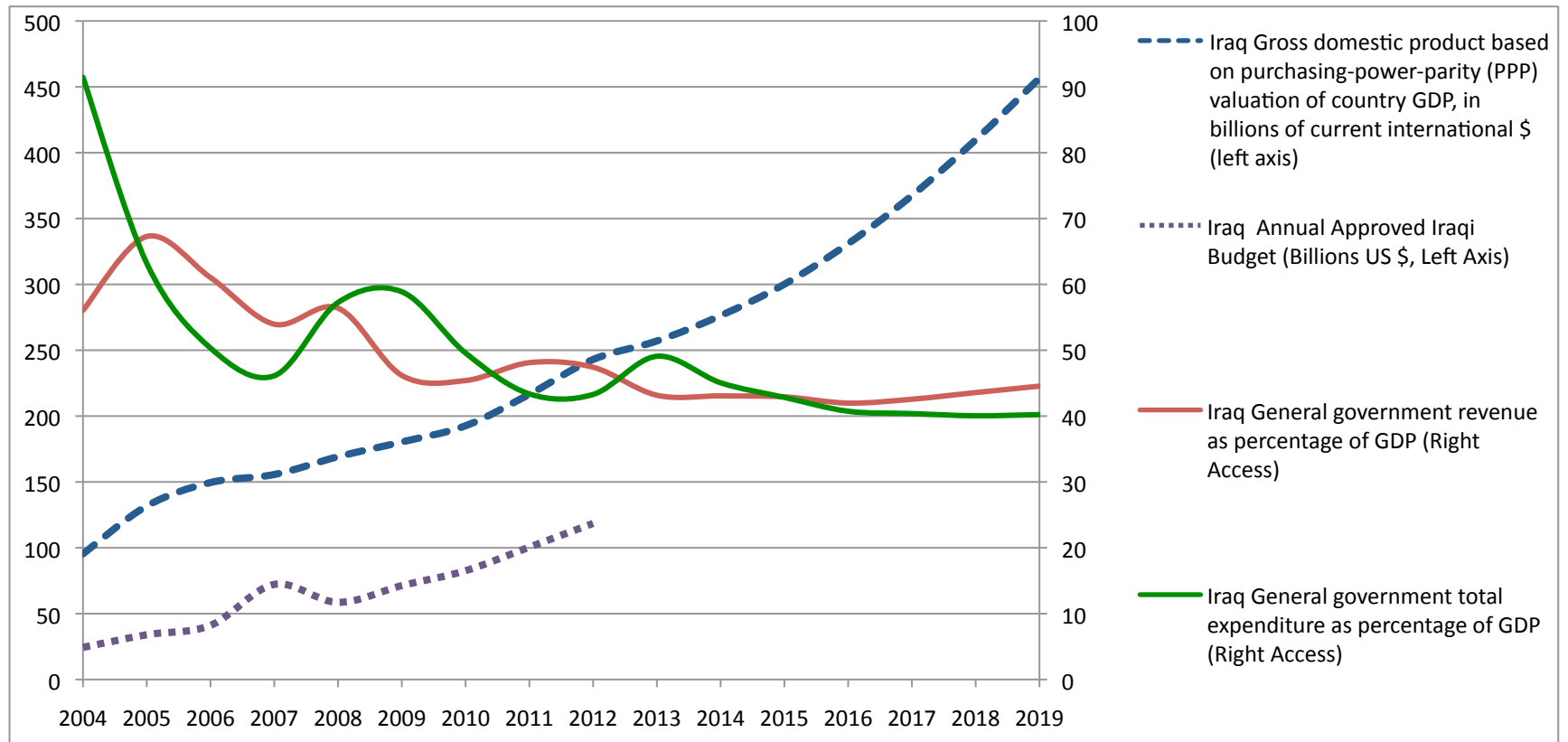
continue. Table 7 and Figure 18 below demonstrate a few trends. First, the government budget has been rising alongside the rising oil-dependent economy (also see Figure 19: Iraq's Approved National Budgets (2005-2013). This indicates that the government has persisted to be the main beneficiary of oil revenues, growing alongside the economy. In other words, the economy and the government's oil dependence have risen together. Also, the government has been spending all of its income, rather than investing or saving. Hence, the Iraqi market and the non-petroleum sectors have remained secondary and only indirectly benefiting from energy sector. As a result, secondly, the government has continued to dominate the economy. Government expenditure between 2004 and 2013 averaged 55% of Iraqi GDP, and is projected to remain relatively high (at 40%) until the end of the decade. Over the same period, the average for public expenditure to GDP in the Middle East and North African region is about 30% (The World Bank 2014). Again, regardless of how fast the economy will grow, the government is and remains the main beneficiary compared to other sectors of the economy. In the absence of diversification of the economy through strategically investing oil revenues, the government, rather than the market and industries, remains the largest part of the economy. Finally, comparing government revenues to government expenditure figures, we can see that the government does not save, which is an essential countercyclical policy for any oil-dependent economy. The share of investment spending is also small, especially given the

dire needs for reconstructing a country that suffered years of war and sanctions. For example, government documents show that 71% of the 2008 budget was spent on operation and management of the government (*Government of Iraq Federal Budget Process 2008*). That is, the majority of the government revenue is spent on running the government and its bloated public sector rather than rebuilding the country or planning investment for the future.

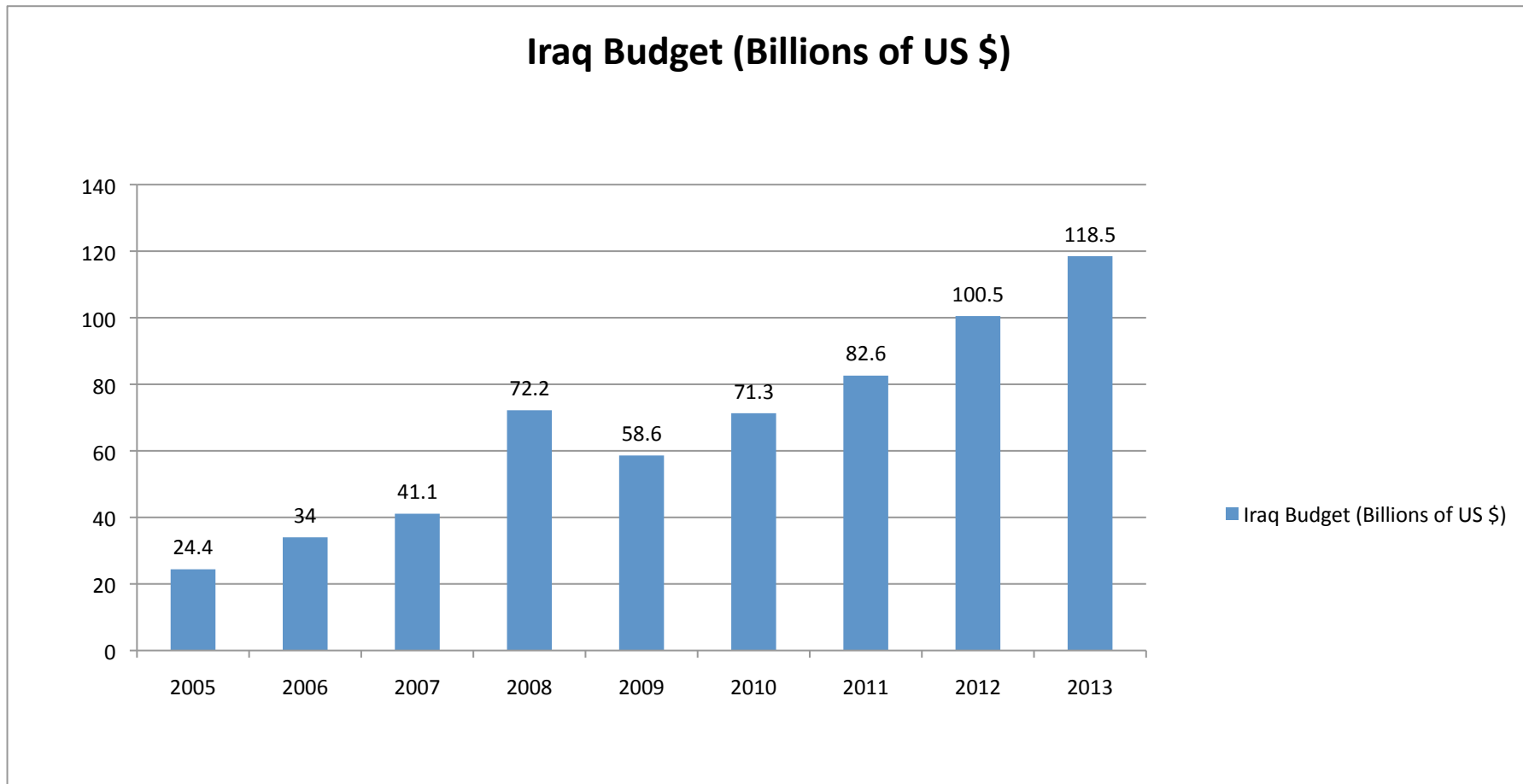
**Table 6: Iraq's Recent and Projected GDP; Percentage of Government Revenue and Expenditure of GDP (Source: Data from International Monetary Fund, World Economic Outlook Database, April 2014; Iraq Budget Data from Bloomberg, Reuters, and Iraq Business News)**

Subject Descripto r	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
GGDP (PPP) in billions of current international \$	95.3 6	131. 72	149. 56	155. 64	169. 17	180. 37	192. 67	216. 52	242. 98	257. 04	276. 30	300. 13	330. 89	367. 44	409. 80	456. 55
General governm ent revenue as % of GDP	56.0 52	67.2 74	61.0 4	53.9 56	56.3 99	46.1 8	45.3 96	48.1 14	47.4 18	43.1 64	43.0 68	42.9 22	41.9 72	42.5 62	43.5 72	44.5 5
General governm ent total expenditu re as % of GDP	91.4 5	63.2 05	50.3 29	46.1 22	57.2 54	58.8 79	49.5 75	43.3 69	43.2 86	49.0 82	45.0 57	42.8 41	40.7 35	40.3 8	40.0 45	40.2 24
Iraq's Annual Budget (Billions US\$)	24.4	34	41.1	72.2	58.6	71.3	82.6	100. 5	118. 5	24.4						





**Figure 18: Key data on Iraq's economy, government revenues and expenditure**  
 (Source: Graph constructed using data and projections from the World Bank and the IMF)



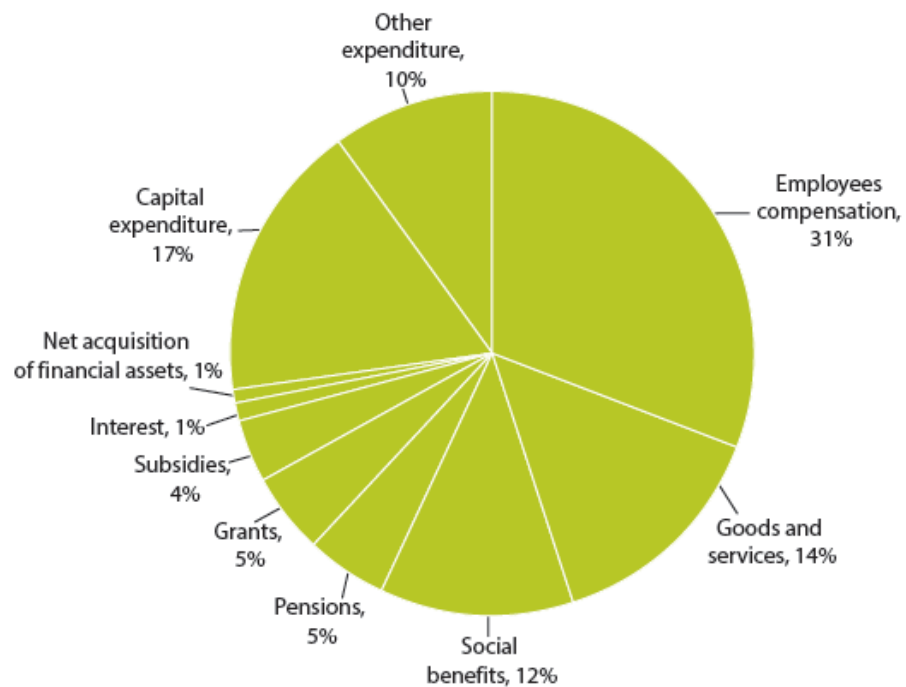
**Figure 19: Iraq's Approved National Budgets (2005-2013)** (Source: Data on Iraqi budget collated from Bloomberg, Reuters, and Iraq Business News)

## **Public Expenditures and Employment**

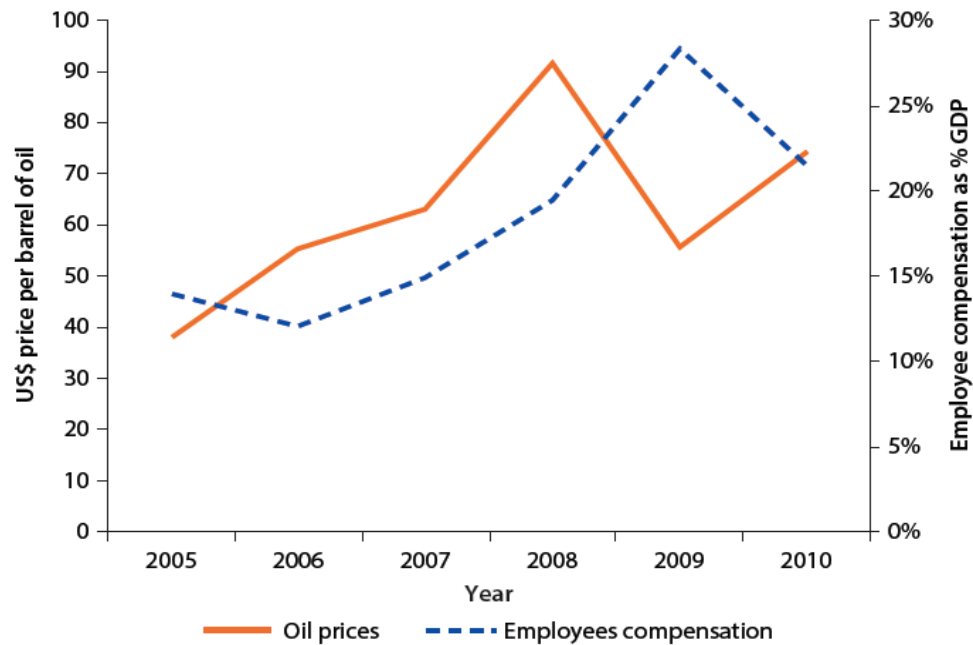
Much of the Iraqi government's oil based revenues are spent on public sector employment as public payrolls constantly expand. Although Iraq's GDP has been rising, thanks to increased oil production and high oil prices (until the late 2014 oil price drop), the government's take has remained persistently high (at half of GDP as explained above), which is spent on operating and managing the government operations rather than investments and infrastructure. Hence, the impact of oil-driven economic growth will not translate into transformative development and reconstruction if larger budgets simply meant higher operating costs and inflated salaries for public sector employees.

Given its nature, the oil sector cannot absorb the increasing demand for employment. Therefore, much of government revenues pour into Iraq's bloated and inefficient public sector. The energy industry is capital and technology (not labor) intensive (Ross 2012; Bridge and Le Billon 2013). The energy industry could be characterized as an "enclave," which, unlike industry and agriculture sectors, has little learning or ripple effects on the rest of the economy (Ross 2012). Although petroleum exports provide more than half of Iraq's GDP, the oil and gas sectors account for less than 2% of total direct employment. Instead, oil revenues have enabled Iraq to establish and maintain "one of the largest public sectors in the world relative to its population" according to the IEA. As a percent of GDP, Iraq's wage bill has also been rising much faster than many of its neighbors (see Figure 22). Between the mid-2000s and 2012, the public sector workforce has more than doubled, and with it the associated wage bill as a share of GDP, from around 15% to 30%. The World Bank estimated wages and compensation to have accounted for about one-third of Iraq's public expenditure between 2005 and 2010, with nearly 40% of its going to the ministries of Interior (police) and Defense (The World Bank 2014) (See Figure 20). Iraq's wage bill and employee compensation have also been rising along with government's oil revenues (See

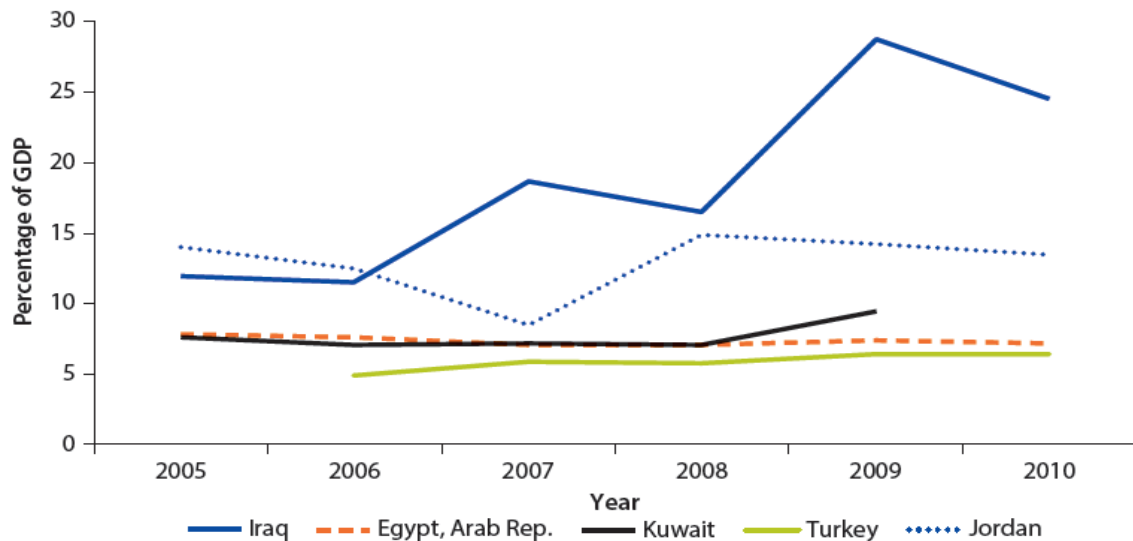
Figure 21).



**Figure 20: Economic Composition of Public Expenditure, Average (2005-2010)**  
(Source: The World Bank, "Republic of Iraq Public Expenditure Review: Toward More Efficient Spending for Better Service Delivery," 2014, p. 24)



**Figure 21: High Oil Prices/Revenues Translate into High Wage Bill (2005-2010)**  
 (Source: The World Bank, "Republic of Iraq Public Expenditure Review: Toward More Efficient Spending for Better Service Delivery," 2014, p. 25)



**Figure 22: Iraq's Wage Bill as Percentage of GDP in Comparison**  
 (Source: The World Bank, "Republic of Iraq Public Expenditure Review: Toward More Efficient Spending for Better Service Delivery," 2014, p. 25)

Mirroring the national scene, the Kurdistan Regional Government (KRG) spends 70% of its budget on salaries and pensions to about 1.5 million wage earners.<sup>121</sup> This should not be surprising, since the KRG budget is simply a carbon copy of Iraqi budget. In fact, the Iraqi government and the Kurdish government have both created new ministries to absorb the demand for public jobs. Even the smaller Kurdish government created 40 ministries, like its federal counterpart. Thus, the government is using public employment to address unemployment and increasing wages to raise public income. In other words, the government's policy of boosting GDP per capita income is to hire more people into public jobs and raise their salaries frequently as the oil-based economy grows.

Despite these staggering figures, the public sector and services remain inefficient. The Iraqi government still has not been able to provide continuous electricity and power cuts remain frequent throughout the country.<sup>122</sup> A 2014 World Bank report stated that the Iraqi "health system is in deep crisis" (The World Bank 2014, xvi). One reason, the report explained, is that the Iraq government has not yet transitioned from the sanctions era to take responsibility

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<sup>121</sup> These figures have been often reiterated by Kurdish government officials. For example, see Kurdish channel, Rudaw, interview with KRG Finance Minister, on July 21, 2014 at <http://rudaw.net/sorani/business/200720144> (source in Kurdish).

<sup>122</sup> In the author's hour-long interview with the Iraqi deputy prime minister for energy in December 2012, there were two power cuts.

from the health care from the United Nations. Fuel shortages and consequent price fluctuations have also persisted since 2003. As one observer put it, despite government spending of \$600 billion, the status of services in 2013 is equal to that of 2004 (Al-Khateeb 2013a).

### **Instability and Volatility**

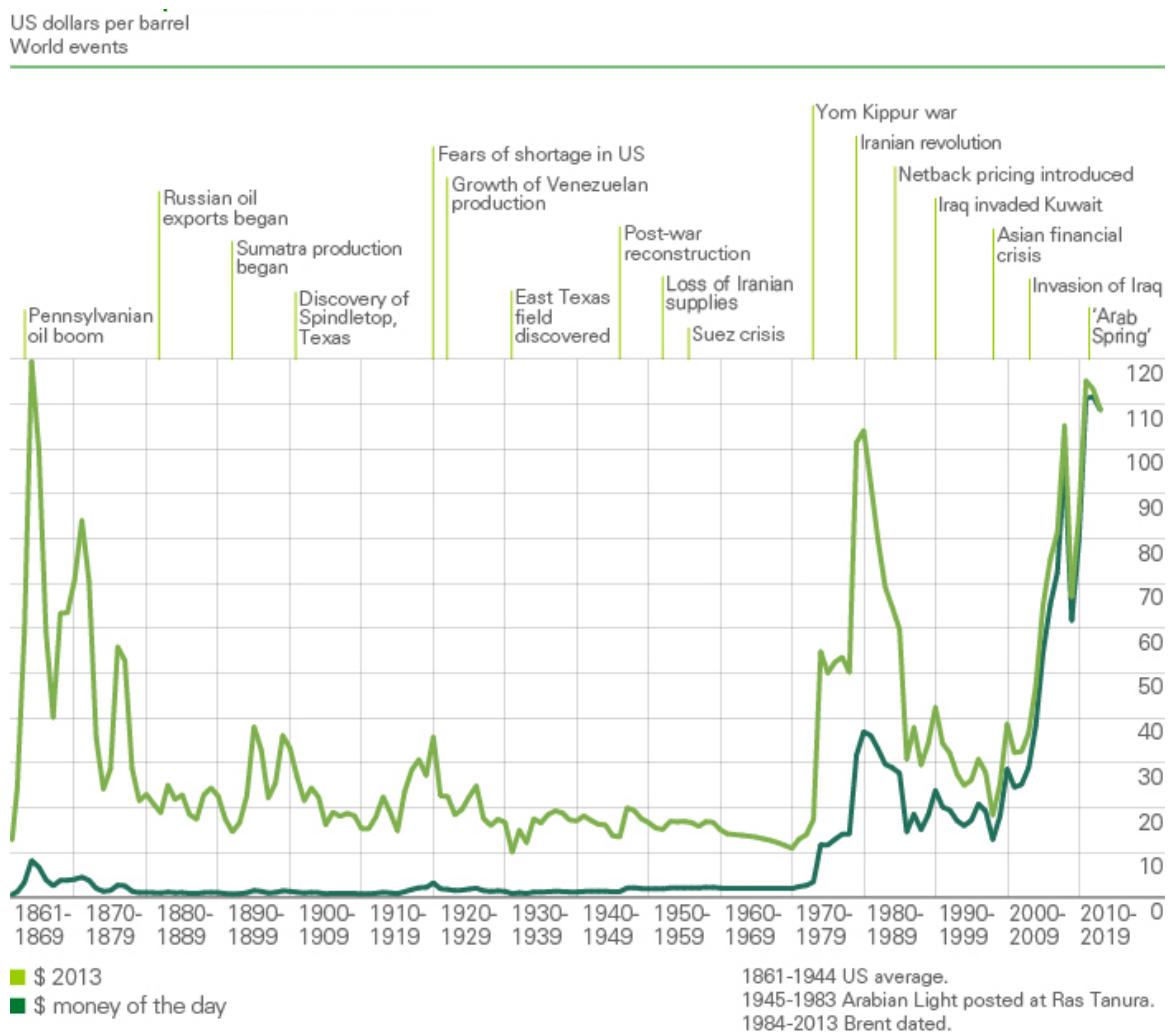
Petroleum dependence can destabilize countries and their economies. Oil prices are volatile; they are subject to factors not only of demand and supply, but also geopolitical risk and speculation. When a country's economy is closely linked to oil revenues, price fluctuations or supply disruptions can be catastrophic. When an oil embargo was imposed on Iraq after its invasion of Kuwait in 1990, Iraq went from being a middle-income country to a poor country within months.<sup>123</sup> Today, the Iraqi government is facing major difficulties operating the government and fighting ISIS since international crude prices fell by about 50% in 2014.

Price fluctuation has been a symptom of energy markets especially since many petrostates nationalized their energy industry (Bridge and Le Billon 2013; Ross 2012). Looking at crude oil prices since 1861, real prices have continued to

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<sup>123</sup> The sanctions banned Iraq from oil sales, trade, financial transactions, international flights and financial transactions. Because Iraq relied on imports for its food security, the blockade bumped food prices 200% to 1800% between August and November 1990. In a testimony before U.S. Senate Committee on Foreign Relations on December 5, 1990, the CIA declared that the embargo had shut off 90% of Iraq's imports and 97% of its exports, thus disrupting the economy and creating hardship for the people (For more on impacts of Iraq sanctions, see Alnasrawi 2001; Alnasrawi 1994; Weiss 1999;).

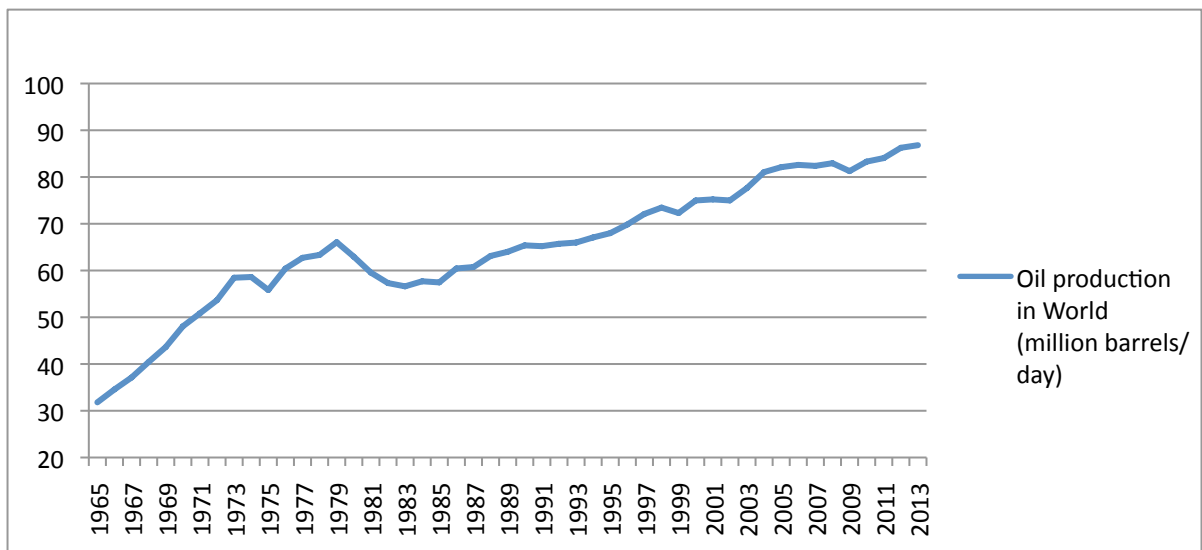
fluctuate. In a matter of one year, in 1861, the price of oil plummeted from \$10/barrel to 99 cents/barrel. Between 1935 and 1969 changes in oil prices averaged a mere 5.6% annual rise, but increased by 26.5% since 1970 (Ross 2012). Since the early 1970's, when the wave of petroleum nationalization took momentum, crude prices have been ever more volatile (see Figure 23 below).



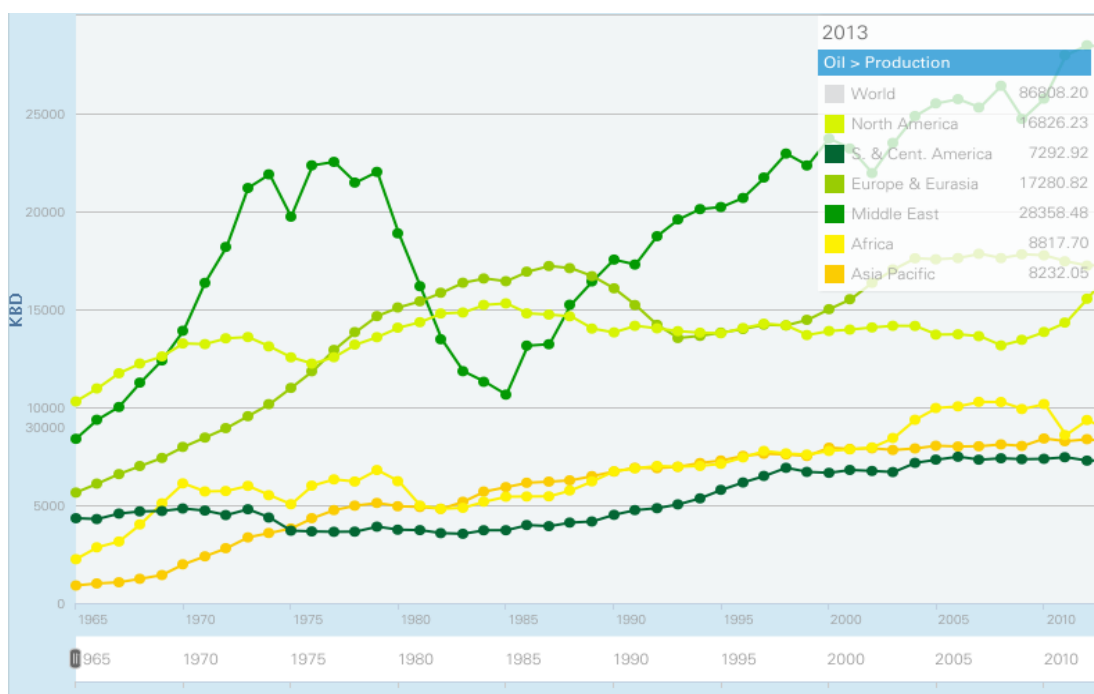
**Figure 23: Crude Oil Prices 1861-2013 (Source: BP Statistical Review of World Energy 2014)**



Among the reasons for price fluctuation is the inelastic but fluctuating production levels paralleled by steadily rising demand for energy. Global oil production has been consistently rising since the mid-twentieth century (see Figure 24). While some countries like Yemen and Bahrain have run out of oil, others, such as the United States, found new oil reserves thanks to new technologies such as shale revolution and horizontal drilling. Therefore, countries and regions have contributed inconsistently to the overall global oil production increase (see Figure 25).



**Figure 24: Global Oil Production 1965-2013 (Chart constricted using data from BP Statistical Review of World Energy 2014)**



**Figure 25: Global Oil Production by Region (Source: BP Statistical Review of World Energy 2014)**

The implications of heavy dependence on oil for fiscal policy and institutions are twofold. First, government revenues and expenditures will be subjected to the volatility of international crude prices. Second, the dependence of government on oil rents to fund the budget blunts the authorities' incentive to build strong, transparency and accountable budgetary institutions (The World Bank 2014). As with many other petrostates, Iraq's oil production has been extremely volatile. Since 1980, due to three wars and decade-long sanctions that included a ban on oil exports, Iraq's production levels oscillated dramatically (see Figure 26). Coupled with price fluctuations, Iraq's varying production capacity has resulted in an unruly and volatile economy. And since the

government budget is tightly linked to revenues from oil, government spending has oscillated as well, resulting in economic disruptions.

Due to sharp changes in international oil prices, Iraq's budget has also been fluctuating (see Figure 16 and Figure 19 above). For example, in July 2008, a barrel of oil sold for \$145/barrel. Only five months later, oil prices plummeted to \$40/barrel. Within few weeks at the end of 2014, world crude prices fell by half. The Iraqi government develops its budget with anticipated oil prices, which is a medium term and inherently unstable budgeting strategy. Price shocks have often disrupted the Iraqi economy and undermined the government budget since 2003.<sup>124</sup>

Oil dependence and weak institutions can also create leverages and vulnerabilities. Iraq's economic dependence on oil made it vulnerable to sanctions, which were used against it in 1990 by the United Nations. More recently, as part of the ongoing dispute over the management of oil and gas between the Kurdistan regional government and the Iraqi federal government, the latter cut the 17% budget share of the Kurdish government. As a result, the Kurdish government immediately lost its ability to pay public salaries or fund projects. Indeed, both the Iraqi and Kurdish governments have become addicted

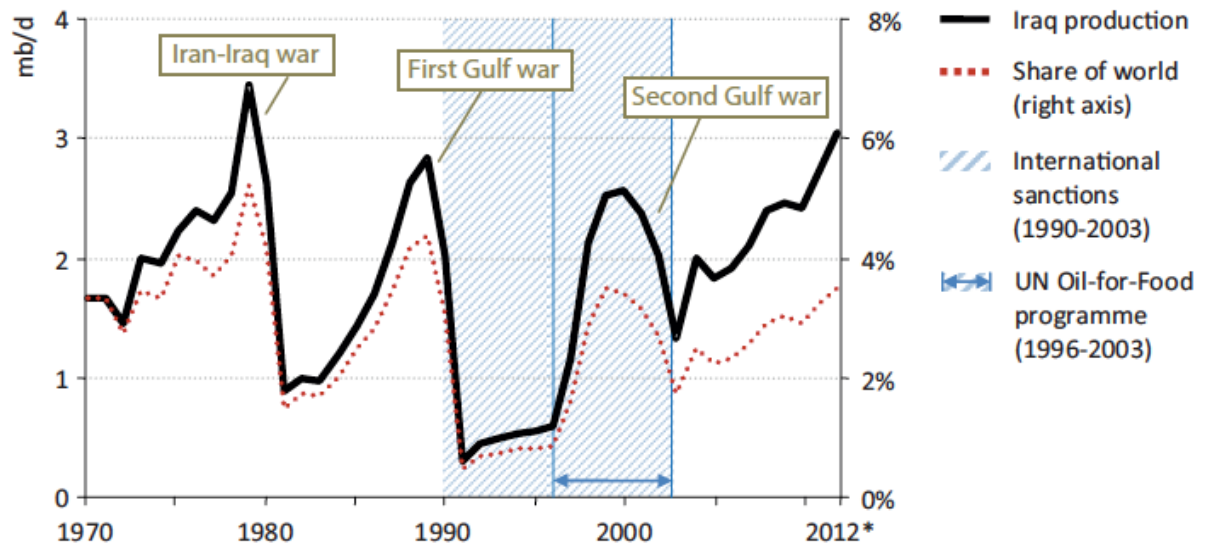
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<sup>124</sup> One could take a drive around major Iraqi cities in 2008, including in Kurdistan, and notice unfinished and abandoned building skeletons. The government simply ran out of money to finance projects due to oil prices lower than projected in the budget. The oil price crash of 2014, coupled with the fight against ISIS, foretells more financial woes.

to oil revenues since 2003 in record times. Rather than inoculate against revenue volatility, they have become vulnerable to higher economic risk and shock, which have destabilizing political and economic effects, as manifest in Kurdistan's inability to pay salaries, which in turn hurt its war against ISIS. The main antidote against such vulnerabilities would be to de-link the budget and oil rents, as Norway does, but such a policy is yet to be seriously considered.<sup>125</sup> Iraq's weak institutions and corruption exacerbate the state's management of the economy. In addition to the revenue lost to corruption, Iraq's budget execution rates are at the 50-60% range. Despite these vulnerabilities, Iraq's "fiscal institutions are ill-equipped to deal with the complexities of an oil-dominated budget" (The World Bank 2014, xiii).

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<sup>125</sup> Government officials and reports give lip service to better management of petroleum revenues. However, serious policy discourse is yet to be heard about wealth management in Iraq and Kurdistan. Efficient management of oil wealth and economic diversification were discussed in an interview with chief advisor to Iraqi prime minister Mr. Al Gadhban (2012) and a report by Kurdistan government's ministry of planning entitled Kurdistan Region of Iraq 2020: A Vision for the Future (2013)



\* Based on first five months.

Figure 26: Iraq Oil Production 1970-2012 (Source: Iraq Energy Outlook 2012, 21)

### Dutch Disease

The phrase refers to a situation where natural resource exports result in amassing large foreign currency reserves, resulting in a stronger domestic currency, which then results in higher production costs. Inflation at home raises the prices of domestically produced goods and reduces the competitiveness in manufacturing and agriculture, potentially to a degree that it would be cheaper to import than to produce. The phrase was coined by the *Economist* magazine in reference to the decline of the manufacturing sector in the Netherlands after the discovery of natural gas in 1959.<sup>126</sup>

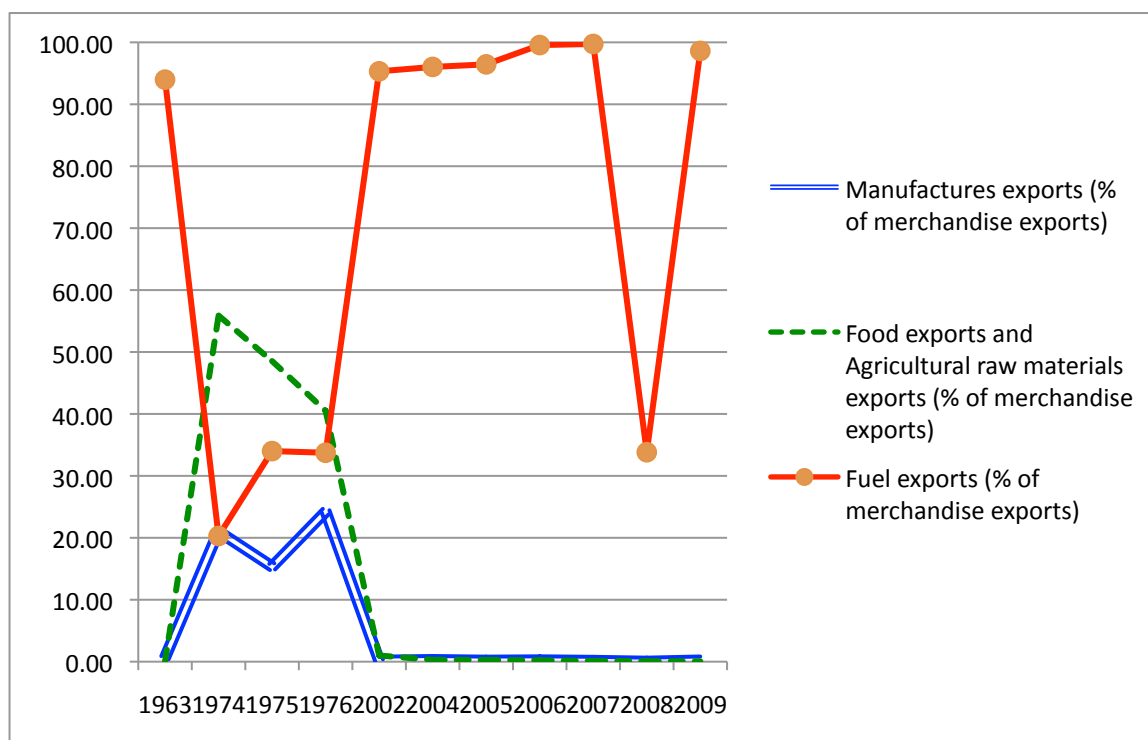
<sup>126</sup> "The Dutch Disease" (November 26, 1977). *The Economist*, pp. 82-83

The Dutch disease argument may not strongly fit the Iraqi and the Kurdish cases, since Iraq did not sustain a strong industry before or after oil was found. Iraq's agriculture sector, however, allowed the country to enjoy food security and self-sufficiency. Iraq was once the world's largest exporter of palm dates. But the instability and destruction that accompanied coups, counter coups, revolutions, sanctions and wars pushed the respective Iraqi governments to deepen their dependence on oil as the main source of revenue. Iraq's manufacturing and agriculture exports have systematically diminished since the mid-1970s when Iraq's petroleum industry was nationalized by the Baath regime. In 1974, food and agriculture products accounted for more than half of Iraq's exports; by the last year of the Baath regime, they accounted for less than 1%. In the meantime, fuel exports jumped from 20% to 95% of Iraq's exports (See Figure 27 and Table 7 below).

**Table 7: Iraq's Export Sectors (1963-2009) (Source: data from The World Bank Development Indicators (2014))**

<b>Iraq's Exports (Select years)</b>	1963	1974	1975	1976	2002	2004	2005	2006	2007	2008	2009
Manufactures exports (% of merchandise exports)	0.64	21.03	15.34	24.21	0.16	0.26	0.17	0.22	0.14	0.01	0.18
Food exports and Agricultural raw materials exports (% of merchandise exports)		55.89	48.54	40.52	0.99	0.30	0.27	0.22	0.12	0.08	0.06

Fuel exports (% of merchandise exports)	93.98	20.29	34.00	33.73	95.32	96.03	96.45	99.56	99.74	33.82	98.62
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**Figure 27: Iraq's Export Sectors (1963-2009)** (Source: graph constructed using data from The World Bank Development Indicators (2014))

### *Manmade Dutch Disease*

According to Dutch Disease analysis, petroleum resources crowd out local industry in favor of imports. Such analysis, however, precludes the agency of actors and influencers, suggesting that Dutch Disease is a natural phenomenon. Governments need to address trade imbalance caused by petroleum exports

through policies and regulations that promote economic diversification and protect local industry. However, corruption could be a cause for hampering efforts to diversify oil dependent economies. Kurdistan's agriculture sector is a case in point. Rather than raising productivity, Iraqi and Kurdish markets have become import dependent, even for the majority of basic food staples.<sup>127</sup> In an interview, researcher and business consultant Christine van den Toorn detailed how she came across powerful local Kurdish politicians with heavy involvement in the food import business have systematically "stunted" agriculture and food industry projects (2014). Similarly, the governments in Iraq confiscated (or rented at low price) agriculture lands and granted them to oil companies for exploration. In the oil rich province of Basra, for example, land seizures could have reduced agriculture production by about 40%, which resulted in significant desertification (*Inside Iraq Politics* 2014). Such crowding out of the non-oil domestic economic sectors is manmade Dutch Disease.

### **Rent Seeking**

Another explanation of Iraq's oil dependence and inability to diversify its economy is rent seeking, or rentierism. Economists use the term "rent" to denote

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<sup>127</sup> A 2009 USAID study of Iraqi Kurdistan showed that 80% of Kurdish food needs were imported (often of substandard quality) although 35% of Iraqi Kurdistan land is arable (according to calculations of agriculture data provided by KRG Ministry of Planning (<http://www.krso.net/documents/54/agri3.pdf>)). The USAID report notes that the KRG Ministry of Agriculture had 13,320 employees in 2008 (which has grown substantially since then). By contrast, however, "the California Department of Food and Agriculture has 1,892, and the Arizona Department of Agriculture has approximately 320" p. 4.



the abnormal profits that many natural resource industries produce, and call rent-seeking government behavior “rentierism” or “rentier states” (Mahdavi 1970; Beblawi and Luciani 1987; Chaudhry 1994; Gylfason 2006). The World Bank measures “Oil Rents as percentage of GDP” as a development indicator, and defines oil rents as “the difference between the value of crude oil production at world prices and total costs of production.”<sup>128</sup>

In Iraq, oil production costs are low, and therefore the rents that the government accrues are sizeable. It costs the federal Iraqi government between \$1.15 and \$7.5 to produce a barrel of oil, depending on oilfield location, and then sold at manifold at market prices<sup>129</sup> (International Energy Agency 2012). The Kurdish government allows the international oil companies to recuperate their costs and offers them a profit as a percentage of oil sales. Compared to other countries, cost of oil production in Iraq is among the lowest—in 2008, extraction costs per barrel averaged at \$1.8 in Saudi Arabia and \$31.4 in Canada (Ross 2012). Cost of Iraq’s oil production is lower than in Angola, Norway and the United States, and much lower than offshore oilfields. Iraq’s low oil production costs bring sizeable returns on investment (ROI) to the government that surpasses the profits of any other sector without employing a significant capital

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<sup>128</sup> This definition can be found at

<http://data.worldbank.org/indicator/NY.GDP.PETR.RT.ZS>

<sup>129</sup> Average price for 2014 Western Texas Intermediate (WTI) has been \$100.45 per barrel, according to U.S. Energy Information Agency, <http://www.eia.gov/forecasts/steo/report/prices.cfm>

or human resources. A state like Iraq – where the economy and the government are rent-dependent, where the economy and the labor force are detached from the source of rent – is called a rentier state (Mahdavi 1970; Beblawi and Luciani 1987). Because the petroleum sector offers the Iraqi government the highest returns on investment without much institutional or labor commitment, it absorbs much of government investment resources, and crowds out other sectors.

Hence, oil dominates the Iraqi economy not only for somewhat natural reasons, such as the Dutch Disease, but also due to failure in policy, such as measures to avoid rent seeking. Oil wealth creates disincentives for broadening and diversifying the economic base. Because oil allows the government to generate large revenue with minimum capital and institutional capacity, the oil sector has distracted the Iraqi and Kurdish governments from investing in the non-oil sectors. For example, although Iraq fares poorly on international rankings such as governance performance and ease of doing business, its contracting policies for oil and gas has been revamped and procedures relatively expedited. For example, the Iraqi government has been far more efficient in boosting oil production than electricity generation. Furthermore, the KRG has been quick to pass a regional oil and gas law in 2007 according to which the Ministry of Natural Resources (MNR) has been formed. The Ministry functions as a one-window shop for all matters related to oil and gas industry, including

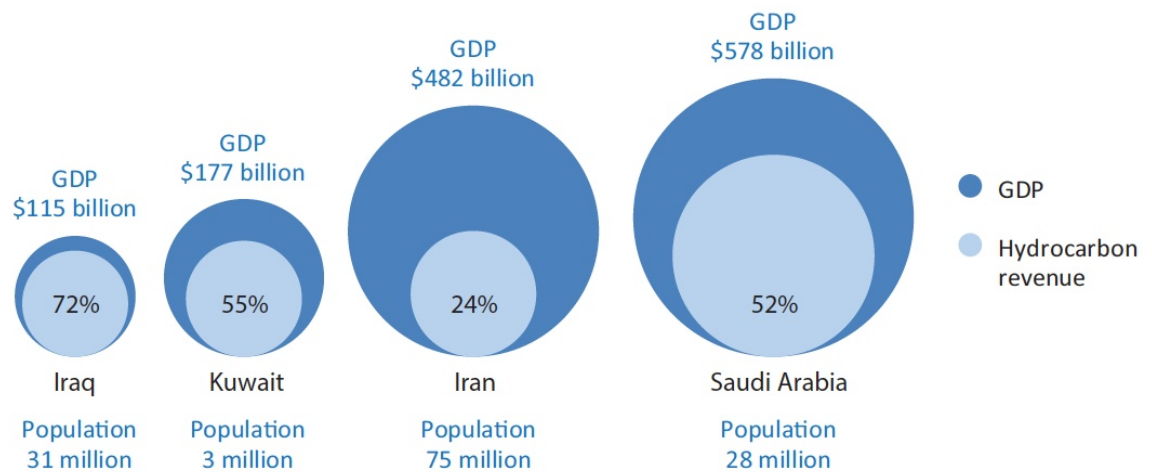
contracting, licensing and overall management. Compared to other ministries, MNR staff is more professional. By so doing, matters of oil gas are efficiently handled and the foreign oil companies are insulated from the red tape of the otherwise less functional and streamlined parts of the bureaucracy. The KRG has also been selective in implementing its own oil law – the KRG acted quickly to create the new Ministry of Natural Resources and sign oil contracts to bring in oil revenues, but it is yet to implement other provisions of the same law that address oil revenue management, such as creating a wealth fund and several national oil companies.

Furthermore, since 2003, Iraq and KRG's energy industries have heavily relied on foreign oil firms. This in turn has further delinked the oil sector from the local economy. In Saudi Arabia, for instance, where a national company manages the energy industry, oil makes up 90% of revenues, but employs only 1.6% of the country's workforce, 0.35% of the population (Ross 2012). In Iraq, with foreign, not national, oil companies have increasingly dominated the oil scene, the employment benefits from oil sector is not expected to rise. In the KRG, employment in the oil sector would be much smaller, since no national Kurdish oil company exists yet.<sup>130</sup> But even when oil is nationalized, it will not

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<sup>130</sup> The author has attended meetings where the Kurdish government's interest has been voiced in surveying the existing and demanded workforce in Kurdistan's energy sector. But no data is yet available as to the percentage of locals in the Kurdish oil and gas sectors.

have the same employment effects as agriculture or industry sectors. Also, unlike industry and agriculture, the oil sector does not provide significant “backward linkage effects,” where some companies procure their needs from or sell their products to other companies (Ross 2012). Petroleum’s value chain could be profitable if a local industry existed. For example, oil companies could use local subcontractors for services or feed crude to oil refineries. However, until recently, Iraq relied on neighboring countries for refined petroleum products, such as gasoline, in the absence of local refining capacity. Except for some security and catering services, international oil companies rely on other foreign subcontractors for services. In summary, never short for excuses, Iraq has afforded to throw money at every problem, meanwhile sinking deeper in oil dependence (see Figure 17: Oil Rent as Percentage of Iraqi GDP).



**Figure 28: Oil Dependence of 4 Major Middle Eastern Petrostates (Source: IEA Iraq Energy Outlook (2012))<sup>131</sup>**

### Corruption and Secrecy

Another symptom of oil wealth is the ease of which revenues can be hidden, manipulated and exploited. The energy industry is prone to monopoly by nature, involving few government offices that receive tremendous amounts of money. Oil-funded governments can maintain popularity by being less transparent about revenues but boast about expenditures. Due to lack of transparency, the public will not know the spending to revenue ratio (Ross 2012). Furthermore, there are numerous opportunities for corruption and secret deals along the petroleum value chain (McPherson and MacSearraigh 2007).

According to Sheikh Sabah Al-Saedi, former head of Iraqi parliament's

<sup>131</sup> As noted above, the World Bank has reviewed and modified its data for Iraq. Therefore, the percentages of oil revenues to GDP have decreased, averaging at 54% between 2004 and 2013. However, the figure is helpful for comparison purposes.

Integrity Committee, corruption in the oil sector takes four forms. First is the smuggling of crude and oil products by criminal cartels and terrorists. Second are biddings and contracts for petroleum and for the numerous business and services involved around oil exploration and production, such as drilling, security and catering. Third, oil sales by the Iraqi State Oil Marketing Organization (SOMO) and the opaqueness regarding pricing and the choice of buyers. Al-Saedi described corruption in oil sales as the “most dangerous,” because it takes place despite Iraq’s commitment to EITI. Lastly, discounted oil sales to Jordan at \$20 per barrel is wasteful, especially since the decision was made by the cabinet and not the parliament (Al-Saedi 2014).

### **Greasing Patronage Networks: Milking Iraq’s Oil Revenues**

For lack of control and full consolidation of power, Iraq’s new elites and factions compete for a slice of the national revenue pie. They get creative at exploiting the government. Some schemes are legal: such as mass employment, increasing the number of government ministries, and regulating party financing. Others are illegal: contract rigging, ghost employment and double dipping, and oil smuggling. Regardless of how large Iraq’s oil-funded budget can grow, so many siphoning off channels will cut it dry. This also creates incentives for

politics to remain to be about spoils rather than policies.<sup>132</sup>

### **Grand Corruption in the Iraqi and Kurdish Governments**

Corruption during the Baathist rule in Iraq was systemic and organized in a top-down fashion, and was instrumental to regime survival. That legacy persists in post-invasion Iraq, albeit in a less organized and centralized fashion. Rather, corruption, which concentrated in the top echelon, trickled down into the bureaucracy and the society. The Oil-for-Food program was the “biggest corruption in history” parliament integrity committee’s head Al-Saedi said, which lingered in the Iraqi government after the fall of the Baath regime. Al-Saedi compared corruption in Kurdistan and Baghdad. Corruption in Kurdistan is like that of the former regime--limited and concentrated, where the budget does not get stolen, thanks partly to a strong political opposition. In Baghdad, however, “there seems to be a political deal not to fight corruption, or to cover it up,” he said.

Corruption has come to serve multiple purposes. At the highest levels of the states, spoils are extracted from the government coffers and diverted into private and party pockets. In turn, the illicit wealth finances and maintains support networks, media outlets and militias. Since so crucial to political survival, elites and political groups use their power and leverage to create a

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<sup>132</sup> After the Iraqi elections of 2014, Iraqi newspapers circulated reports about politicians bidding, in millions of dollars, for government ministries.

policy environment that allows them to continue their embezzlement of state assets. Others may be used as down payment for entering the market and create businesses. Some of it may flee the country. Therefore, corruption in Iraq has been described as institutionalized (U.S. Inspector General for Iraq, in Heuvelen 2012) and systemic (Transparency International, in Agato 2013).

Patronage is doled out through government ministries. Large-scale corruption takes place where large sums of money exchange hands. And that would mainly be the Executive branch of the government, to which Iraq's oil revenues flow. Iraq's national ministries, which are 40 in number, often function as routing centers through which state assets and privileges are channeled to political parties and cronies. There is a desire for personal control through buying loyalty rather than rallying behind policy platforms. One particularly worrisome tendency is Al-Maliki's attempt to "assert his personal control through clientelist networks within the security apparatuses, even going so far as to create new [government] bodies accountable only to him" (Bertelsmann Foundation 2014, 6). In effect, the prime minister turned the Iraqi military into his personal or party's militia. Hundreds of such recruits and high-ranking staff in government, including the prime minister's office, provided fake university degrees in order to qualify for their positions. Instability has been the result and cause of corruption, and has allowed corruption "to become entrenched and spread throughout [state] institutions... The proliferation of criminal elements



and vested interests throughout the bureaucracy” acts as a parasite that paralyzes the government (ICG 2011).

In addition to receiving a share of the national budget through government office, Kurdish political parties have a line item in the Kurdish regional budget. Since 2009, about \$11 million a month has been allocated to fund Kurdish political parties, of which the two main ruling parties, the KDP and PUK have each received the two main Kurdish parties received about \$4 million (*Political Party Funds’ Issue in the Kurdistan Region-Iraq* 2014, 6–7). We know these numbers since 2009 when party financing became transparent. Before then, the two parties simply took and offered money from the budget at whim. Also, the Kurdish government also has departments of NGOs, through which NGOs are funded (through salaries until 2009 and projects since) (Mahmood 2014).

In addition to instability, corruption is also crippling the Iraqi economy and cutting it short of its potential. Corruption is particularly prevalent in four major areas in Iraq: oil production, public contracts, government services, and employment (Sassoon 2012). According to one study, oil smuggling cost Iraq nearly \$7 billion between 2005 and 2008 alone (Agato 2013). Defense and security contracting have also been a source for illicit income to officials. In 2008, for example, Iraqi Integrity Commissioner Judge Radhi declared corruption cases in the ministry of defense worth \$4 billion, and in the ministry of interior worth \$2 billion. One telling example of a flawed procurement contract was the purchase

of fake bomb detectors for \$85 million in 2008 (ICG 2011).<sup>133</sup> In another case demonstrative of inefficiency and possible corruption in public services, the federal government spent \$27 billion between 2003 and 2011 on the electricity sector, but supply only increased by 1000 Megawatts (Agato 2013). By way of contrast, the Kurdish government increased electricity generation by 2000 Megawatts with \$1 billion only. Overall, despite spending about \$120 billion on reconstruction by 2010, the rebuilding effort could only restore what was destroyed and looted during the invasion, according to Sassoon (2012). Or as the Director of Iraq Energy Institute pointed out, the status of development in Iraq in 2013 is the same as 2004 and 2005, despite government spending of \$600 billion in national budget (Al-Khateeb 2013a).

### *Petty Corruption*

Corruption in Iraq is visible and comes in many forms, including petty corruption. Like many developing countries, Iraq suffers from corruption in the form of bribery in its bureaucracy. Petty bureaucratic corruption, however, pales compared to the billions of dollars lost to political graft, as highlighted above. The Iraq Knowledge Survey, organized jointly by the United Nations and Iraqi and Kurdish authorities, found that 11.6% of respondents experienced bribery in their contacts with public bureaucrats. More importantly, the survey pointed to significant regional variation—29.3% of citizens reported paying bribes in

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<sup>133</sup> The machines were in fact designed to detect golf balls.

Baghdad, compared to 3.7% in Kurdistan. This indicates that the federal government has more corruption than the KRG. Moreover, spotlighting corruption in the Kurdish media and the emergence of a strong opposition have created disincentives for petty corruption in Kurdistan. The survey findings also point out the most corrupt government institutions. Police was found to be the institution most likely to request bribes, followed closely by tax and land registry departments (*Iraq Knowledge Network Survey* 2011). Moreover, a U.N. report on Iraq's public sector maintained that most of the corrupt are neither caught nor punished, partly because corruption is hard to detect and investigate. For example, in 2011, bribery and embezzlement accounted for only 4% and 5% of all criminal cases under investigation by the Commission of Integrity, respectively. More easily found offenses make the bulk of investigations. For example, offenses such as "falsification" of documents and "exceeding authority" accounted for 33% and 19% of all investigations, respectively (*Corruption and Integrity Challenges in the Public Sector of Iraq: An Evidence-Based Study* 2012, 273).

### **Bodies with no Soul: Iraq's Anti-Corruption Infrastructure**

Iraq has made some progress in establishing the legal and institutional infrastructure of fighting and controlling corruption. The main institutions are the Board of Supreme Audit (est. 1920 and reconstituted by CPA), Commission of Integrity (est. 2004 by CPA), Inspectors General (est. 2004 by CPA), and the Iraqi judiciary. Iraq also became signatory to the United Nations Convention

against Corruption, and the Extractive Industries Transparency Initiative (EITI). Moreover, the Iraqi and Kurdish parliaments both house public integrity committees.

However, Iraq's anti-corruption institutions are nascent, politicized and too weak to combat corruption of the scale and ubiquity highlighted above. The weakness stems mainly from the Executive's attempts to undercut oversight and maintain supremacy over other branches of government. Part of the governance failure in Iraq can be attributed to the weak judiciary, especially Chief Judge's "slavish obedience" to the prime minister (Cordesman and Khazai 2014).

According to a report by the International Crisis Group (2011), Iraqi Prime Minister Al-Maliki used legal and procedural tactics to stop the parliament from questioning his ministers. Moreover, he used old Saddam-era laws that grant ministers the right to offer immunity to their staff and block corruption investigations. Al-Maliki's opponents in parliament also used similar tactics, such as selectively calling ministers close to Al-Maliki for questioning. Al-Maliki has also been reported to be systematically dismissing anti-corruption officials (Glanz and Mohammed 2008). In another incident in 2009, gunfire broke out when anti-corruption investigators and Iraqi security personnel tried to arrest nine senior officials at the Iraqi trade ministry.

When corruption allegations and cases become a tool for political vendettas, anti-corruption efforts and institutions lose credibility. Therefore, a

culture of impunity regarding corruption is emerging in Iraq. As Iraq's Commissioner of Public Integrity Rahim Al-Okaili told a reporter, "the reason for the massive corruption in Iraq is the belief by the corrupt that they are shielded from prosecution by the protection afforded to them by their political parties and sects" (Dagher 2009). That impunity continues to date. As the Iraqi parliament's chief corruption fighter explained, the intensifying corruption may only be explained by an agreement among Iraqi political parties that corruption must continue (Al-Saedi 2014). Life for anti-corruption champions is marred with peril – one former Commissioner of Public Integrity has fled the country (judge Radhi Radhi), and another (Al-Okaili, quoted earlier) resigned in protest to his office's inability to exercise power.

The Iraqi media does tackle corruption occasionally, but at a cost. Media outlets have mushroomed in Iraq since the fall of the former regime. Much of the media remains partisan and sectarian, however, and independent media is scarce (Bertelsmann Foundation 2012). Despite training for investigative journalists, reporters often exercise self-censorship for fear of reprisals. Much of the Iraqi and Kurdish media are partisan and sectarian, owned or financed by influential political parties or powerful political personalities, according to analyses by Committee to Protect Journalists and the Press Freedom Advocacy Association, an Iraqi NGO (Abdulla 2014; Hatim 2013). Freedom House and Reporters Without Borders rank Iraq very low in terms of press freedom. Indeed, Iraq has

been among the most dangerous places for journalists – since 2003, between 140 and 230 journalists are estimated to have been killed (“Freedom in the World: Iraq” 2012). Some reporters who covered corruption have been harassed or assassinated, including in Kurdistan (Abdulla 2014). Moreover, there was an arrest warrant for the chairman of the Integrity committee at the Iraqi parliament for defaming Al-Maliki (ICG 2011). Nor is the nascent civil society mature or adequately empowered to pressure the state toward good governance. Even in Kurdistan, which enjoys relative stability, the civil society is weak vis-à-vis the government. In a move that resulted in simultaneously promoting and co-opting nongovernmental organizations, the Kurdish government created an office that managed and financed NGOs. What helped to put a spotlight on corruption in Kurdistan has been the emergence of a strong political opposition party – Gorran – and an increasingly vocal and vibrant independent or competitive media.

Amid weak accountability, impunity is the result. An Iraqi-American advisor to the U.S. Embassy in Baghdad described corruption in post-2003 Iraq as a cancer. He told a reported that the leader of a parliamentary block once boasted to him, saying, “I am a thief, and everyone knows it. I have stolen millions of money. I admit it and I am proud of it” (Al-Khderi 2014).

### **Double Dipping and Ghost Employees and Soldiers**

One explanation of how Iraq’s oil wealth has resulted in corruption and

inefficiency rather than prosperity in Iraq could be the phenomenon dubbed “ghost employment,” a spoils system through which political parties channel public funds to their cronies and supporters. Employees who are on government payroll but either do not exist or do not report to work are often referred to as “ghosts.” They fraudulently collect paychecks. Payrolls can be inflated in terms of the number of employees as well as the salaries. Sometimes, people’s names are put on payrolls without the requirement to show up to work. In other incidents, either the employees no longer exist or their identities are forged. For example, a report by the Special Inspector General for Iraq Reconstruction (SIGIR) entitled “Hard Lessons” estimated that 20 to 30 percent of Iraq’s Ministry of Interior staff (which includes police) were “ghosts” and that corrupt Iraqi officials collected their salaries (2009, 198). In an interview, an Iraqi statesman related a story of a military unit of 300 members, none of whom were privates. Rather, they all held some higher military rank in order to boost their wage rates (Abu Bakir 2011).

In the Kurdish region, the government’s approach to solving the unemployment problem has been to hire young college graduates into government offices en masse. During the double sanctions – by the United Nations and the Iraqi regime, which Kurdistan suffered between 1991 and 2003, employment opportunities were very scant in the absence of a private sector. Government jobs became valued prizes. Therefore, “the government stepped in

and provided jobs so people could eat and gain self-respect” as a Kurdish government report recounts (*Kurdistan Region of Iraq 2020: A Vision for the Future* 2013). These prized opportunities allowed the parties in power to dole jobs out selectively to broaden their base of support. In the 1990s, one needed a clearance from one of the two Kurdish ruling parties to get a government job. The opposition parties often complained that none of their members held any public jobs.

Since the fall of the Baath regime and the lifting of sanctions, the government opened the doors of employment wide open, while rewarding high-ranking positions to their loyalists. But public employment en masse has taken a heavy toll on the economy. The Kurdish government spends up to 75% of its budget on about 1.4 million employees who receive artificially high salaries for little work. Although it is a heavy burden on the budget, the attraction of a government jobs and the stability and benefits that come with it make it very hard for the private sector to attract qualified workers (*Economic Development Assessment Kurdistan Region* 2009, 91). However, about half of the people on the Kurdish payroll are ghosts (F. Hassan 2014), hence their heavy toll on the budget.

In fact, getting a government job immediately after earning a college degree is seen as an entitlement, forcing the private sector to hire the cheaper and more efficient foreign labor. There have been numerous demonstrations by young college graduates demanding jobs of their governments. On local media



outlets and in coffee houses, one can hear stories of how there are more staff members than clients in some government offices.<sup>134</sup> The Kurdish government has also been renting residential homes and turning them into government offices to house the ever increasing number of bureaucrats.<sup>135</sup> Some double dippers and ghost employees work in political party offices while their wages come from government coffers. Others can enjoy a second job. The government's approach to create jobs and quickly has been to further bloat the public bureaucracy and increase red tape. And if efficiency is not a priority, then reporting to work will not matter. A similar practice but on grander scale has also been recorded, where the government buys or rewards certain individual's loyalty by appointing them to high ranking government jobs (e.g. ministers, advisors, director generals) for one day and then put them to retirement immediately. This way, these individuals can collect 70-80% of their position's salary for life.

In Baghdad, Muqtada Al-Sadr's block ran the Ministry of Health. But the ministry was turned into a racketeering front for Muqtada's militia, the Mahdi

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<sup>134</sup> A Facebook post circulated in Kurdistan showed a picture of the railroads management office, although there have been no trains in Kurdistan since 1991.

<sup>135</sup> In an anecdote shared with the author, the government hired and assigned 5 people to call for prayers at a mosque in the town on Diyana near Erbil. One of the employees was Christian! The call for prayer takes place five times a day, and could take a few minutes. The task has often been a civic activity that worshippers have done voluntarily. But it has become an opportunity for Ministry of Religious Affairs to "create jobs."

Army, according to a U.S. Military officer advising the Iraqi Government on corruption matters during 2006 and 2007 (Interviewed on June 15, 2014). The ministry's Facility Protection Service was the main vehicle that the Mahdi Army used to inflate the budget and put hundreds of militiamen on government payroll. Some ministry officials appointed themselves about a 100 bodyguards, most of whom existed only on paper. The Iraqi Ministry of Health felt like a "mafia fortress" when visited, the military advisor said.

### **Markets and the Private Sector: When corruption is more than a business cost**

Corruption and related economically inefficient practices have significant consequence for Iraq's transition toward a diversified market economy. Petty corruption becomes a real challenge when it discourages foreign investment into Iraq. Business bribery in the country is high. According to the World Bank-IFC's Business Enterprise Survey of 756 companies working all over Iraq in 2011, 64% of medium-sized firms said they were expected to offer a "gift" in order to win government contracts. In the oil-rich province of Basra, the rate was 100%, signaling that bribery is a norm in the interaction with the government procurement offices.

Businesses surveyed also indicate that "practices of the informal sector" come second to electricity on the list of top ten constraints to doing business. Specifically, 62% said corruption is a major obstacle to conducting business, and

that a bribe is solicited in 33.8% of transactions with the public sector (*Enterprise Surveys: Iraq* 2011). According to another analysis of Iraq's business environment, deals in the electricity sector worth billions of dollars were cancelled due to corruption at the Iraqi ministry (*2011 Foreign Commercial Activity In Iraq* 2012).

Moreover, businesses are either forced to or choose to partner with members of the local authorities or powerful families. In an interview, a Kurdish businessman said that some form of arrangement with local political power wielders is necessary. The local partners often do not invest any monies into the business, and their main role comprises of obtaining permits, expediting the functions of the bureaucracy and undercut any obstacles that may arise. The Kurdish businessmen said that partnerships with local power wielders is similar to lobbying in the developed economies, where companies seek to shield themselves and garner favorable policies.<sup>136</sup> However, unlike lobbying, which could carry significant operational cost, political parties and individuals often demand up to half all profits. In Kurdistan, business corruption is organized (Zulal 2013) while in the rest of Iraq it is still messy and unconsolidated. Furthermore, corruption in Kurdistan could inflate the cost of projects, while in

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<sup>136</sup>Interview with the CEO of one of the largest holding companies in Iraq.

Baghdad and elsewhere in Iraq they hamper investment projects.<sup>137</sup> Businesses understand that without the ruling party or family's partnership, no serious business can see the light.<sup>138</sup>

### **Money Laundering: an annual \$40 Billion enterprise**

Because of corruption, up to \$40 billion could be leaving Iraq annually. As mentioned above, neither the CPA nor the Iraqi government has invested in establishing effective and accountable financial institutions, including banks. The Iraqi economy remains a cash economy. Iraq's Board of Supreme Audit looked into the \$1 billion transferred weekly out of Iraq through currency auctions and concluded that about 80% of it was money laundering operation, siphoned off abroad illegally (cited in Special Inspector General for Iraq Reconstruction 2009). Iraq's Chief Justice Medhat al-Mahmoud declared that "financial corruption" continues to burden the Iraqi government and economy, unencumbered by any system to deal effectively with the problem (Bertelsmann Foundation 2014). Iraqi anti-corruption officials believe that the banking industry is involved in

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<sup>137</sup> When in Baghdad for data collection for this research, the following anecdote was offered to illustrate different functions of corruption in Baghdad and Erbil: a federal government official visits the house of his counterpart in Erbil. The host pointed to a new highway from the his house's windows and said, "do you see that new road? I won the contract for it, subcontracted it and pocketed enough money to build this nice house." When the Kurdish official visited his friend's home in Baghdad, the host asked, "do you see that bridge over the Tigris?" "No, what bridge?" the Kurdish official exclaims. "Well, there was a contract I won to build a bridge, but instead I build myself this nice house."

<sup>138</sup> The dynamics of business-party/family relationship is detailed further in the next chapter.

widespread money laundering (SIGIR, 485). Some money leaves Iraq as a safety net for politicians, or laundered to foreign lands, to neighboring countries and beyond.<sup>139</sup> In the early years following the Iraq invasion and amid Kurdistan region's construction boom, local newspapers reported on mega housing projects being merely money-laundering schemes. Therefore, and due to instability elsewhere in the country, real estate prices in Erbil, Kurdistan's capital, exceeded that of Dubai. Compared to the rest of the country, development projects and business opportunities in Kurdistan discourages the flight of resources and encouraged the circulation and laundering of monies within the region. Business partnerships mentioned earlier is another way through which illicit monies are cleaned up. Indeed, some of the political parties have upgraded their business enterprises. For example, in Kurdistan, a political party officially owns one of the largest companies.

### **Oil Smuggling and Organized Crime**

Crime comes in many forms in Iraq, but most harmful could be the resilient oil smuggling. According to one study, oil smuggling cost Iraq nearly \$7 billion between 2005 and 2008 alone (Agato 2013). The Islamic State of Iraq and al-Sham (ISIS) that occupied parts of Iraq and Syria made about \$1 million a day from the sale of oil from oilfields it captured in Iraq in 2014 (Hussein et al. 2014). Coupled with kidnapping for ransom, extortion and protection monies they

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<sup>139</sup> Some of Iraq's new political elites hold dual citizenship and are repatriates to Iraq.

charge, ISIS has become a multimillionaire terrorist group with the capacity of sustaining itself for an extended period. Rather than reinvent the wheel, ISIS simply had to tap into the oil smuggling craft perfected through years of sanctions, conflicts and porous borders.

Corruption facilitated and is facilitated by the prevalence of organized crime groups in Iraq. The line between Iraqi militia, the insurgency and crime groups is often blurred (Wahab 2006; Williams 2009), since the moneymaking tactics used by all is similar – kidnapping, blackmail and smuggling (Shelley and Picarelli 2005). For example, Earlier in 2006 when the political group associated with Muqtada al-Sadr joined the Iraqi government, their share of government offices included the ministry of health. The group's armed wing, the Mahdi Army, infiltrated the ministry and turned into a racketeering business diverting medicine into the black market, appointing militiamen as security guards, and blackmailing families for ransom in return for the return of the bodies of their killed ones (U.S. Military Advisor to Iraq Gov. 2014). This trend traces back to the Saddam era too. Despite enjoying generous privileges such as cash bonuses for carried out missions and preferential access to public services, a number of Saddam's Fedayeen elite force joined the underground economy and engaged in smuggling weapons to Saudi Arabia and robbing travelers crossing the borders (Kevin Woods, James Lacey, and Williamson Murray 2006).

Thanks to past legacy and recent chaos, as Phil Williams observed, Iraq

has become “a magnified Sicily – with oil.” On top of insurgents’ and criminals’ hit list are corruption fighters in the ministries (Williams 2009, 4) and reporters. Corruption fighters are obvious targets. Their murder, therefore, can go particularly unnoticed amid the chaos and the carnage in Iraq. However, the contribution of corruption and the lure of oil to the rise of ISIS may render Sicily’s example remote in both time and size.

## **CHAPTER 7: CONCLUSION**

This dissertation has focused on Iraq and the central role that petroleum has played in shaping the country since its invasion in 2003. It concludes at the end of the pivotal year of 2014, amidst upheavals not seen before in the modern history of Iraq and the wider the Middle East.<sup>140</sup> Despite a constitution that enshrined principles of shared management and revenue of Iraq's petroleum resources by the national and subnational governments, the politics of oil has contributed to a fractured country and society whose government is rife with corruption. The federal government's authority barely reaches beyond Baghdad. Iraq's economy has been ebbing and flowing along with the international oil prices.

Although oil exports have generated billions of dollars in revenue, the country is far from stable and prosperous – rule of law is weak, security is in tatters, and basic public services like reliable healthcare and electricity are in dire shortage. In summer 2014, the world's largest and richest terrorist group, known best through its acronyms of ISIS or ISIL, took over about 40% of Iraq's territory,

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<sup>140</sup> The Financial Times reported on January 2, 2015 that the death toll of more than 100,000 people in 2014 makes the year one of the bloodiest in the modern Middle East's history.



including several oilfields and agriculture lands. Oil has been the primary commodity that allowed for these dynamics.

Specifically, this dissertation highlights the agency of national and local policymakers and influencers, including individuals, patronage networks and ethnosectarian groups. It describes the shaping of Iraq's petroleum policy and its consequences from the vantage point of an insider, through observation, discussions and public forums. The dissertation chronicles the major stepping-stones toward the Iraqi status quo, mainly its state fracture and rising dependence on oil. The dissertation also witnesses the birth of a *petroregion* – Iraqi Kurdistan. Although Saddam's legacy was in no way conducive to good governance, the context, structure and political processes have resulted in a country with little resemblance to Saddam's Iraq. The focus on domestic politics is necessary to understand how and why petrostates and petroregions emerge. After all, the only touted success story of a petrostate escaping resource curse is Norway, not through World Bank advice or EITI membership, but rather through the country's accountable policies and institutions.

Indeed, Iraq suffers from resource curse. But Iraq's oil curse is unique and its complexity has put Iraq on tortuous trajectories. Oil proceeds dominate the economy and make almost all of government revenues. Such dominance has resulted in public and social dependence on the government and the ruling political parties, which in turn is adverse to the country's transition to

democracy and competitive economy. Moreover, oil is fueling conflicts, between the central government and the Kurdistan Regional Government (KRG), and between them and ISIS. Indeed, the conflict and dispute over the management of oil and the sharing of its revenues have complicated an already intricate web of issues, including grievances over power and the economy, ethnosectarian divide and land disputes. Seen as a cure to resource curse, Iraq's experience with federalism has failed to bring about accountability and prosperity. Mismanaged oil has led to state fracture, government dysfunction, corruption, and terrorism financing.

Although oil has been central to recent developments in Iraq in the past decade, the consequences have been different from other petrostates. Petroleum revenues finance authoritarian states that are able to co-opt or coerce their citizenry into submission, through a combination of strong security institutions and economic welfare (see Ross 2012 for example). In Iraq, no single party or ethnosectarian group has managed to consolidate such powers and capabilities at the national level. Instead, power has been decentralized into smaller, local patronage networks that exploit state resources to maintain widespread support. For example, single parties exert control over geographic and administrative enclaves such as Erbil in Kurdistan and Sadr City in Baghdad. These patronage networks are the primary vehicles for the distribution and the trickling down of oil revenues. The higher level of economic development and stability in the

Kurdish example could encourage other oil-rich provinces, primarily the southern province of Basra, to follow suit and pursue more autonomy.

Competition among these entities on one hand, and among international oil companies for a foothold in Iraq, on the other, have resulted in a level of transparency in the petroleum sector that did not exist in Iraq before (nor in many neighboring petrostates). Iraqi political parties continue to hold regular elections, which do not often translate into significant policy changes. Mr. Nouri Al-Maliki was at the helm of the government for 8 of the past 11 years. Moreover, despite all political, legal and security conundrums, Iraqi oil production and sales continued to rise.

The need for oil revenues unites all Iraqis. The flow of oil has not been uniform, however. Iraqi oil has been sold legally and formally, as well as smuggled. All sides, including ISIS, need to generate oil revenues in order to grease the wheels of their patronage and support networks. Rather than govern, Iraq's leaders have been systematically diverting or outright looting state coffers. No wonder after expending billions of dollars of oil revenues, Baghdad looks like the largest village<sup>141</sup> in the world and the Iraqi army crumbled before ISIS.

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<sup>141</sup> This was my personal perception when I last visited Baghdad in December 2012. A brief rain filled Baghdad streets with water. One would drive miles without seeing modern buildings. Sadly, a survey that ranks cities according to quality of living ranked Baghdad the worst city in its 2014 index (<http://www.mercer.com/content/mercer/global/all/en/newsroom/2014-quality-of-living-survey.html>).

## ***Petrofederalism and the Iraqi Resource Curse***

Iraq is a clear case of a petrostate suffering from the numerous risks associated with natural resource dependence. But Iraq's oil curse is more complex, and unique, given its transitioning regime and economy on one hand, and its experiment with oil federalism on the other. The country can be seen as an experiment with oil federalism, a system that could alleviate the negative consequences of resource curse. The results have not been positive or conclusive. As this dissertation demonstrates, Iraq's national and subnational governments and regions suffer from the many symptoms of the resource curse, including economic volatility and violent conflicts.

Much of the resource curse literature describes the phenomenon as naturally occurring. For example, Dutch Disease is the expected outcome of a stronger currency in petroleum exporting countries. But resource curse is also the result of choices made by agents of power. Iraq's ailing economy and polity did not develop in a vacuum. Rather, the Baathist legacy, the mismanagement by the Coalition Provisional Authority, widespread corruption, and the unaccountable energy policies contributed to Iraq's resource curse.

Iraq's constitution laid out the principles of oil federalism, or *petrofederalism*, in the hope that Iraq can escape the resource curse. Oil federalism would allow for sharing the power of the purse and policy. One reason petrostates become authoritarian is the concentration of wealth and power in the

hands of a small elite that is, therefore, able to stay in power through a combination of subsidizing social welfare and violently suppressing dissent. Oil federalism, in theory, would create different centers of power by devolving authority and distributing wealth to subnational governments. Such decentralization is expected to result in checks and balances and competition toward good governance.

Although the availability of petroleum resources is not geographically balanced in Iraq, the federal government collects revenues from oil sales and spends them through the national budget. In theory, Iraqi provinces, regardless of availability of petroleum, should receive a share of public revenues based on the size of the population. Regions that house oil and gas fields and refineries receive an additional amount, dubbed petrodollars (as discussed in chapters 4 & 5). The Kurdish region receives a dedicated 17% of the national budget, in return for contributing to the national share of oil sales.

In practice, however, Iraq's oil federalism did not lead to stability or accountability. Rather, it resulted in policy and geographic fracturing. A decade into Iraq's transition, to which oil has been a central factor, Iraq is unstable, its society and government are divided, and much its massive oil revenues have been squandered. Moreover, within weeks in summer 2014, the world's richest terrorist group managed to capture about 40% of Iraq's territories, including its second largest city, northern oilfields and agriculture lands. Since the ISIS

incursion, the Iraqi government evacuated the three northern provincial governments that the group captured. This has not meant a budget surplus, however. Plummeting oil prices as well as funding the army and militias fighting ISIS have dwindled the resources of the overall national budget.

Faced with frequent elections, without commanding overwhelming force or having exclusive access to oil revenues, Iraq's post-Saddam parties and factions needed to invest in patronage networks. Iraq's state institutions have been too weak and corrupt to be the vehicle for implementing development policies. Spending oil money to create jobs and establish a social welfare system needed time, patience, know-how, and stability, none of which the country's new political leadership had. Therefore, Iraq's political parties, ethnosectarian groups, militias and families competed for access to the government, which are the main beneficiary of oil revenues. In effect, different political parties used their share of government offices to dole out patronage jobs and siphon off state revenues to personal and party coffers. Corruption and criminality greased the wheels of this enterprise. These dynamics and incentive structures resulted in a vicious cycle, spinning corruption, patronage wielding and staying in power in a direction opposite to political, institutional and economic reforms.

Ironically, patronage politics is what the KRG, the Shia-dominated federal government and ISIS have in common. The abundance of petroleum revenues in the Iraqi political landscape since 2003 has resulted in competition, not for

platforms, but for loot and spoils. Staying in the game of power is expensive. Political factions maintain election machinery, numerous media outlets and a militia for protection. Even ISIS has a strong media and Internet presence. These activities are expensive. In traditional petrostates like the Gulf monarchies, it is alleged that the royal families skim a certain percentage of petroleum revenues, while the rest flows into government coffers where it is budgeted with some level of efficiency and acumen. The effect is a level of authoritarianism associated with political stability and economic welfare. In post-Saddam Iraq, it seems that every ethnic, sectarian, familial, or terrorist patronage network needs a cut in Iraq's petroleum revenues. All are milking the big, fat oil-rich state. In practice, the goal of those in power has been to shape Iraq's petroleum and economic policy in a fashion that nourishes these networks. Iraq's federal government, the KRG and ISIS have had noticeable success in monetizing oil, legally or illegally, formally or otherwise.

In a way, the machination of patronage networks has become Iraq's economic system. Almost one third of Iraq's public spending consists of wages and compensations distributed through Iraq's bloated bureaucracy (Chapter 6). Despite being a smaller economy, the Kurdish government has also mimicked the Iraqi institutional set up – they both have 40 government ministries. The most patronage prone of wage earning ministries are those of defense and the interior, which together receive 40% of public wage budget allocations (The World Bank

2014). If the KRG is any indication to where Iraq at large might be heading, time and stability may exacerbate hiring the public en masse – the KRG spends about 70% of its budget on salaries and wages for about 1.5 million public employees, much larger rate than Baghdad's. Iraq's ministries function as vehicles to siphon off public funds into private and party coffers.

### **Trickle-Down**

Through these extensive patronage networks, however, a sizable portion of Iraq's oil revenues trickles down to the population. Despite significant money laundering and capital flight, much of the oil revenues are expended domestically. This trickle down, however, is far from uniform – it has resulted in relative stability in Kurdistan, consolidation of Shia power in the south, and, its lack to the rise of ISIS in the dominantly Sunni provinces. The state, thus, became a revenue distribution vehicle rather than an enforcer of rule of law and regulator of the economy. No surprise, then, that loyalty to the party or sect, as the patron, takes precedence over loyalty to the country, as manifest in Maliki's near-win of a third term in office despite his national failures, and that of the well-equipped military he commanded to defend swaths of Iraqi land from ISIS.

Again, the level of downward revenue transfer depends on and contributes to the level of stability and consolidation of power. The Kurdish region's economy has benefited the most from oil revenues since the political elites in power feel relatively confident of their grip on power. The Kurds may



seem united from a distance, but interparty rivalries run deep and date back to years of intra-Kurdish civil war (Chapter 1). The two major ruling Kurdish parties have been consolidating power since 1991. They have exclusive monopoly over the region's armed and security forces, have captured much of the economy and have been in control of the government since the first Kurdish elections in 1992. In other words, with time, the interests of a large majority of the population, including a rising business class, depends of their tenure in power. At this point, transparency may not matter since the clients hold their patrons, not the state, to account to deliver jobs and perks. In other words, with time transparency won't matter – people may elect the corrupt *because* they can deliver.

In Baghdad and federally controlled provinces, the government has little economic progress to show for despite spending about half a trillion dollars since 2003. The Shia parties who dominate the southern provinces are still vying to buttress their grip on the levers of power and the economy. Part of this endeavor is investing in armed militias.

Sunni provinces, however, were the underdogs. On the one hand, the federal government paid little financial attention to the economies of these provinces. Also, Sunni leaders with the ability to create and maintain significant patronage were hunted down, either through de-Baathification or anti-terrorism laws. Tribal leaders, who once turned against Al-Qaeda, soon became

disenfranchised as well, as Baghdad reneged on pledges to integrate the Sons of Iraq into the Iraqi military. Unlike the KRG, they lack a local energy industry that allows them to generate revenue independently. No wonder they accept, or at least, tolerate ISIS. Similar to the KRG and the federal government, ISIS needs a steady flow of cash in order to maintain its military offensive, suppress people under its rule and maintain recruitment. Maintaining these patronage networks and dependencies through transfer of state assets has undercut actual governing.

### **Petrostate and *Petroregion*:**

Like national governments, the resource curse can blight subnational governments as well. This dissertation highlighted the case of the Kurdistan Regional Government's petroleum industry and the transformation of its economy into one of rent-extraction and distribution. It is extraordinary how quickly oil rents transformed the Kurdish economy. Within a decade, the KRG's public sector grew exponentially; its bureaucracy expanded, and vested elite powers consolidated. The KRG became what can be called a *petroregion* that behaves like the better-studied petrostates that suffer from resource curse. As oil flowed, Kurdish institutions lagged behind, unable to deal with and account for revenue windfalls. Continuous flow of oil revenues allowed for excessive spending. Economic policy was watered down to project management. Indeed, the KRG has often acted like a nation state and enjoyed some perks of statehood,

such as foreign representations, international trade and oil sales, and bilateral agreements (such as the pipeline and energy supply deal with Turkey). While enjoying these benefits, the KRG did not assume many of the responsibilities associated with a well-governed state — there have been little investment in developing KRG's institutions. As manifest by the dispute over oil sales, the KRG's economy was brought to its knees by Baghdad's budget cuts and there were no significant countermeasures in KRG's arsenal. It would take the KRG decades to dig itself out of the dependencies it has created — the economy's dependence on oil and the population's dependence on the government.

The politics and divisions surrounding oil have inhibited the state's ability to design and implement policies needed in order for oil wealth to contribute to prosperity. The actions of the past ten years are the result of a myopic vision of Iraq's new rulers. Corruption and patronage politics inhibit the nation's ability to establish accountable institutions and policies that would address the resource curse. Even if a window of opportunity for reforms opened, the problems already created would be hard to reverse. For example, it would take tremendous effort, time and political courage to responsibly dismantle the militias or shrink the bloated public sector.

Iraq's woes simultaneously caused and were exacerbated by oil dependence. Oil dependence resulted in economic and political problems whose solution requires government intervention. These problems, in turn, weaken the

government and blunt incentives for reform. Indeed, oil at the heart of Iraq's multidimensional conflicts. The oil addiction was to be expected. But the presence of oil has weakened the state and disabled it from functioning and governing. Although they remain oil-cursed, the oil monarchies have taken some measures toward revenue stability, such as sovereign wealth funds. The likelihood for Iraq to adopt anti-curse policies, however, is remote.

There can be two ways to look at oil federalism and resource curse in Iraq. First, oil federalism failed to mitigate the resource curse in Iraq. The fragmentation of Iraq's petroleum policy and industry into at least two major power centers, the federal government and the KRG, did not result in viable good governance policies and institutions necessary to address the various harms collectively labeled under resource curse. Oil can lead to resource curse in strong and stable states, such as the Gulf monarchies. In Iraq, however, a weak and fractured state is inflicted.

Alternatively, Iraq's lingering problems of corruption and petropolitics undercut the implementation of oil federalism. That is, the widespread corruption and patronage networks exacerbated the resource curse and undercut the functioning of oil federalism envisioned in the Iraqi constitution. Both Baghdad and Erbil seek independent policy devoid of checks and balances and accountability. For example, the Kurdish government has not sought to influence the federal energy policy. The divergence of oil policy and lack of a national

framework has been beneficial to politicians and political groups in both governments. Hence the incentive to undermine oil federalism.

### **Instability and the Advent of ISIS**

Iraq's oil has contributed to problems more acute than what the resource curse literature predicts. Iraq's corruption and resource curse have become national and international security threats. The billions of dollars in oil revenues that flowed into Iraq since 2003 did not only contribute to state failure but also to the rise of ISIS, a terrorist group that may destabilize the whole region. Kurdish and Shia-dominated provinces have been relatively more stable compared to Sunni areas partly because Sunni leaders were not able to create and deliver to patronage networks.

The quick and strong rise of ISIS as the world's richest and largest terrorist organization is directly linked to Iraq's oil story. Sunni regions are oil-poor and Sunni leaders have had little access to the national revenue pie. Despite conflicts, Baghdad and KRG have managed to negotiate deals whenever it was a clear win-win situation, such as shared oil sales during low oil prices. Not the Sunni, who have little leverage against Baghdad.<sup>142</sup> The political and economic disenfranchisement of Iraq's Sunni provinces resulted in public grievances

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<sup>142</sup> Weeks before ISIS entered Iraq from Syria, the son of a prominent Sunni tribal leader told me that the only language Baghdad understands is that of a machinegun. He was reacting to Baghdad's aloofness to yearlong protests in major Sunni cities.

conducive to accepting ISIS. Moreover, the corruption in the Iraqi government and security forces blunted their ability to stand up to ISIS. Oilfields under ISIS control allow the group to generate revenues to maintain its campaign of terror. Therefore, ISIS poses a unique challenge to the Iraqi petrostate.

Corruption and patronage infected all the major joints of the Iraqi government and undermined the effectiveness of its security forces (see Chapter 6). Iraq's military crumbled against ISIS, and was defeated without serious confrontation. Iraq's security forces were more of a paper tiger – *ghost* soldiers made it seem larger and stronger than it actually is. Because of patronage politics, sectarianism and loyalty were more important in appointment of military leaders than military acumen let alone patriotism. Moreover, the soldiers were sent to the Sunni provinces to crush protests, not to fight a guerilla war. They had little incentive to protect a society already hostile to them. Indeed, Iranian and American intervention ultimately protected Baghdad and Erbil against ISIS's momentum.

Furthermore, ISIS is a formidable enemy. Although its fighters are estimated to be in the tens of thousands, they mainly derive strength from controlling territory and revenue. Documents recently declassified show that ISIS maintains a strong organizational structure that resembles any company or organization. Financially, like ISIS itself, the group's revenue generation has been evolving too, from reliance on petty crime in 2005-2006, to mafia-style protection

rackets in 2007-2008, to oil producers and smugglers since 2009 (Shapiro and Jung 2014). Therefore, ISIS does not need to financially depend on foreign largesse. Because it controls large swaths of territory, ISIS is able to extract revenues domestically. Investigators have estimated that ISIS could be making \$100 to \$200 (P. B. Johnston and Bahney 2014), even \$800 million (Di Giovanni, Goodman, and Sharkov 2014) a year from a diversified portfolio of economic resources that include oil smuggling, extortion, taxation, theft, and the capture of local products. U.S. Department of the Treasury's Undersecretary for Terrorism and Financial Intelligence described ISIS as the "the best-funded terrorist organization" the U.S. has "ever confronted" (Di Giovanni, Goodman, and Sharkov 2014).

Oil is undermining Iraq's stability and transition to democracy and good governance. The revenue generated from the formal sale of oil allows the government to avoid reforms and accountability. It also offers the parties and factions tremendous opportunities for illicit enrichment and patronage wielding. The patronage and corruption exacerbated by easily accessible oil revenues hurt the economy and blunt the efforts to fight ISIS. ISIS, similar to other groups in Iraq, also cashes on oil through smuggling to sustain itself for a prolonged fight. Kurds would not have fought ISIS if it did not attack Kurdistan. Baghdad has not been adequately serious in fighting ISIS either. Unless ISIS were to pose threats to Kurdish and Iraqi federal oil revenues, the KRG and Baghdad may have little

need to roll back ISIS.

Much of the literature on conflicts and natural resources did and could not predict the rise of ISIS, a group able to hold land and generate revenues from oilfields. The literature focuses on well-equipped petrostate militaries fighting secessionist guerillas (Shankleman 2006; Berdal and Malone 2000; Ballentine and Sherman 2003). Not in Iraq, where corruption resulted in a hollowed military and a divided government. What is needed, however, is a better understanding of the resilience of oil smuggling on one hand, and the fragility of patronage-based governments. Smuggling networks, trucking and corruption made illegally accessed oil easy to monetize. Policy failures to equitably share oil revenues on one hand, and weak and corrupt policing on the other, contributed to the continuation of oil smuggling out of almost all of Iraq's porous borders. Due to these smuggling networks, non-state actors are as influential as the state. Despite oil wealth and American military hardware, patronage and corruption rendered the Iraqi security forces quite brittle. ISIS represents a "new terror" group (Shelley 2014). Unencumbered by religious creed, ISIS's pragmatism made it adopt sound business and administrative practices, such as revenue diversification, payrolls, and not destroying the population that it extorts (Shapiro and Jung 2014; Di Giovanni, Goodman, and Sharkov 2014). Ironically, ISIS's revenue sources are more diversified than Iraqi and KRG economies.

These political, legal and security risks have serious consequences for the



long-term sustainability of Iraq's petroleum industry and the foreign companies it relies on. Foreign oil companies, many of whom need to abide by anti-bribery laws at home, have to navigate Iraq's corruption. They can be beholden to corrupt officials with unstable jobs. Elections could bring new players to the scene that may open old books, motivated either by revenge or desire for reform. With the incursion of ISIS, many oil companies pulled out their staff from Kurdistan. The line of defense for oil companies is to be on solid legal grounds and diligently navigate the political complexities of Iraq.

A recipe for Iraq out of its oil curse is less obvious. Many Kurds see oil as the elixir to achieving the long-held dream of statehood. But if the KRG were to become an independent state tomorrow, it would be a petrostate, lacking accountability and strong institutions. The common threat of ISIS and low oil prices may bring Erbil and Baghdad closer. The conflicts surrounding oil, that this dissertation highlights, need solutions firmly positioned on solid legal and political grounds, and that would be inclusive of Iraq's Sunni provinces. Moreover, Iraq's transition to democracy should focus less on elections, which garner deceptive domestic and international legitimacy. Instead, accountability — of leaders, institutions, parties and the economy — should be the yardstick for progress. The competition between the KRG and the federal government has already resulted in relatively larger transparency in oil dealings. Opposite to state failure and fracture, accountability derived from the national-subnational

accountably envisioned in oil federalism may still be the most viable alternative against Iraq's resource curse.

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