

AIDING, TRADING OR ABETTING?

THE FUTURE OF TRADE, AID AND SECURITY

6

MANAGING REVENUES FROM
NATURAL RESOURCES AND AID
BUILDING TRANSPARENCY,
ACCOUNTABILITY AND STABILITY



IUCN
The World Conservation Union



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**“WE DO NOT
WANT THE
DUTCH DISEASE
PLEASE.
WE ARE NOT
INTERESTED IN
PARADOXES OF
PLENTY, CRUDE
AWAKENINGS
OR ENDING UP
IN THE BOTTOM
OF THE BARREL
EITHER.”**

*President Fradique de Menezes,
São Tomé e Príncipe, 2004¹*

1. INTRODUCTION

Natural resources and foreign aid revenues can play a crucial role in improving the security of populations in poor countries. After more than a decade of decline, many commodity prices, especially oil and minerals, rebounded at the end of the 1990s. Likewise, foreign aid flows have begun to edge up again in real terms. Well-managed, these financial flows could dramatically improve the lives of some of the poorest and most conflict-affected populations in the world.

However, when the tiny island state of São Tomé e Príncipe discovered oil in the late 1990s, President Fradique de Menezes was right to be concerned about how his country would manage the sudden influx of oil money. Somewhat paradoxically, many of the world’s most conflict-prone countries possess valuable mineral and agricultural resources. These countries, often highly dependent on natural resources and foreign aid, tend to rank lower on the UNDP’s Human Development Index, suffer higher levels of corruption and worse governance than countries with more diverse sources of wealth. This pattern, commonly referred to as the ‘resource curse,’ links natural resource wealth to stagnation and conflict rather than economic growth and development.²

Natural resource revenues are rarely, if ever, the sole source of conflict: identity, ideology and history are all important factors. Nevertheless, natural resources have played a key role in many cases of deteriorating governance, widening income disparities and worsening corruption.

Poorly managed revenues (more accurately called ‘rents’) from natural resources tend to nurture predatory political systems, whose elites have a strong financial interest in staying in power, even if it is by repressive and authoritarian means. In other words, governments find more immediate and lucrative rewards from capturing and redistributing rent (including to themselves) than from encouraging wealth creation and economic growth.

When commodity prices are high, governments face pressure to spend the proceeds from the natural resource windfall quickly—often to satisfy powerful interest groups eager to see tangible benefits. A rise in export earnings during boom times tends to appreciate the real exchange rate (i.e., the local currency becomes more expensive) making other exports uncompetitive. This effect, commonly known as the ‘Dutch disease,’ does not necessarily have a symmetrical effect during price slumps. Meanwhile, large ‘unearned’ natural resource revenues do not automatically trigger re-investment or create employment. This makes the economy even more reliant on that commodity and vulnerable to recessions caused by fluctuations in the prices of commodity exports.

States that are highly dependent on natural resources tend to be unaccountable to citizens demands owing to their reliance on resource rents over tax revenues. Natural resource rents also prove attractive to outside groups, spurring and funding conflict. If natural resources are concentrated in a particular region of a country they may strengthen beliefs among disaffected groups that secession is an attractive option. Aid (another 'unearned rent') can also undermine accountability if governments become more responsive to the demands of donors than those of their citizens. Likewise, aid projects create winners and losers and so can widen inequities and create grievances.

The problem of natural resource revenue management is vividly demonstrated in Angola, where an IMF audit in 2001 confirmed that over \$900 million per year of the country's oil revenues—roughly a quarter of the state's yearly income—had gone missing since 1996.³ Equatorial Guinea, despite valuable offshore oil deposits which spurred some of the world's fastest economic growth (60 per cent in 2001), has an HDI rating 93 places below its GDP per capita position.⁴ In Nigeria, Angola and the Democratic Republic of the Congo natural resource wealth has failed to generate development and has instead helped to entrench deep-seated corruption that retards growth and fuels conflict.

Those countries that have trouble managing natural resource revenues also tend to experience difficulties making the most effective use of aid. Poor management of natural resource revenues and aid

contribute to ongoing poverty and underdevelopment. And poor countries are most at risk of violent conflict. Research indicates that lower levels of GDP per capita are associated with a higher risk of violent and more prolonged conflict. All else being equal, a country with \$250 GDP per capita has a 15 per cent risk of experiencing war in the next five years. At a GDP per capita of \$5,000, the risk of civil war falls to less than one per cent.⁵

With the deadline for the Millennium Development Goals less than a decade away, relatively high commodity prices and current proposals to front-load aid to Africa mean that revenue management is more crucial than ever. The challenge for resource-rich countries is to manage natural resource revenues in an equitable, transparent and accountable way, and to ensure they are carefully invested to meet the needs of the country in a way that breaks the cycle of direct dependence on natural resources. Similarly, there may be lessons from natural resource revenue management for aid policy (and vice versa); in particular to improve aid absorption and utilization.

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2. IMPROVING REVENUE GOVERNANCE: REVENUE MANAGEMENT LAWS

One way to improve revenue management is through the creation of formalized, legally-codified revenue management procedures. Resource-rich countries around the world have adopted such measures for two key reasons. First, they help to stabilize the income a country receives from its commodity exports—saving when prices are high, spending when they are low. Second, they can isolate resource revenues from short-term political interests and embed structures for the long-term, prudent management of revenues.

Typically, these revenue management laws stipulate that revenues be paid to an international account under the administration of an oversight body and a certain annual percentage be devoted to development projects, transfers between regions, and so on. Specific oil revenue management laws have been drafted, with varying degrees of success, in several conflict-affected countries: Azerbaijan, Iraq, Sudan and Timor-Leste as well as Chad and São Tomé e Príncipe.

After three decades of hostilities opposing northern and southern factions, peace negotiations and the consolidation of President Deby's regime in the 1990s made it feasible for oil companies to develop oil fields in southern Chad. With some prompting from the World Bank, the Chad government passed an oil revenue management law in 1999 that stipulated how it would manage and spend direct oil revenues. However, the project failed to ensure that strong institutions were in place before oil revenues started flowing. The outcry over arms purchases with oil money led the World Bank and the IMF to threaten to exclude Chad from its debt-relief program. There have since been continuing problems over the monitoring of oil revenues as well as government interference in the domestic oversight committee.

With two recent coup attempts in 1995 and 2003, São Tomé e Príncipe's potential oil wealth has raised great concern for the future of the tiny archipelago. The 2004 Oil Revenue Management law provides extensive guarantees in terms of transparency, accountability and governance. The law creates a fund that directly receives all oil revenue, which is held by an international custodial bank. All financial information is to be made transparent, fund withdrawals are done on an annual basis only with a ceiling determined by future production potential, and borrowing against present or future oil revenues is prohibited. Despite this exemplary framework, the Prime Minister and government resigned in June 2005, arguing that the President had negotiated and signed new Production Sharing Agreements without proper consultation.



A gold miner in the Democratic Republic of the Congo shows his takings.
(c) Amelia Bookstein

Aid trust funds

The level and allocation of aid is an important component of aid effectiveness. Aid trust funds constitute a financial instrument through which funds are collected from donors and allocated to recipients in a supposedly independent fashion. Such trust funds can smooth aid flows, help generate future income and time disbursements to domestic needs rather than donor priorities.

Recovery in post-conflict situations requires large and rising levels of assistance during the first half-decade, rather than the 'boom and bust' often characteristic of 'CNN-driven' crisis management. Part of the donations immediately made after the signature of a peace agreement can be 'saved' for future use. However, in practice, trust funds have often retained close ties with donor interests, such as donor priorities and preferential home-country contracting.

Such mechanisms, which inherently reduce a government's control over its revenues, are controversial among those who see them as an attack on state sovereignty. In Azerbaijan and Chad, the success of revenue management laws has been somewhat curtailed by continuing political control over the revenues and poor transparency. Whilst revenue management funds can be useful they are no substitute for sound management of a country's national budget. Ironically, resource funds seem to work best only where they are not needed; that is, when sound economic policies are already observed and resource revenues represent only a small part of government revenue.

3. STABILIZING REVENUES FROM NATURAL RESOURCES

A key element of improving the management of natural resource and aid revenues is to make them more predictable and reliable. In theory, revenue management funds and aid trust funds can help to achieve this by providing a continuous income during lean times. There are also international mechanisms, such as the IMF's *Compensatory and Contingency Financing Facility* (CCFF) and the EU Flex's instrument which help countries ride out slumps in the price of their commodity exports. For reasons explained in the first brief (on conflict-sensitive trade) in this series, neither has proven particularly effective.

Historically, the most common way that governments have tried to stabilize prices was by maintaining buffer stocks that could be expanded or reduced during times of low and high prices respectively. However, speculation by private investors, expensive

storage costs and free-riding by other countries make such policies difficult to sustain.

Another method for stabilizing revenues is price agreements based on either producer cartels or pacts between consumers and producers. Stabilization of prices by imposing variable export taxes or tariffs, marketing boards and domestic stockpiles is also possible. Finally countries can try and use of risk instruments like forward contracts to hedge the future price of commodities. None of these approaches has proven outstandingly successful and price stabilization has somewhat fallen out of favour in recent times. Nevertheless commodity price volatility remains a serious problem and there is an urgent need to reopen the debate on what can be done to tackle it.

4. IMPROVING TRANSPARENCY AND ACCOUNTABILITY

The basis of accountability is transparency. A lack of transparency not only increases the risks of corruption and embezzlement, but also of inequity, distrust and false expectations. By contrast, transparency can consolidate democratic debate by providing accurate figures upon which stakeholders can negotiate, plan and ensure accountability.

Transparency can be supported at the international level through corporate revenue disclosure rules, international norms of public and private financial governance, capacity-building assistance, and international auditing and reporting. The IMF and the OECD's Development Assistance Committee (DAC) constitute the two elements of international transparency for resource revenues and aid, respectively. The IMF provides valuable information on resource revenues through its Country Reports, the information for which is mostly provided by the country's central banks. DAC provides aid statistics on aid flows (and other resources) to developing and transition countries.

Three complementary initiatives are now underway to improve transparency in the resource sectors: The *Publish What You Pay* (PWYP) Campaign, launched in 2002 by George Soros' Open Society Institute and Global Witness, aims at mandatory disclosure of all payments to host governments by oil, gas and mining companies. The campaign argues that corporate disclosure is an important step toward comprehensive accountability in the resource sectors and that while voluntary measures are useful, they are unlikely to achieve a global and lasting solution. To achieve comprehensive transparency coverage, PWYP is advocating for a 'double book-keeping' by extractive companies and governments, through revenue disclosure laws in both host and home countries. Specifically, PWYP advocates that developed countries require companies to declare their disaggregated payments to the host country as a condition for stock market listing or export credit.

Second, the British government's *Extractive Industries Transparency Initiative* (EITI) lays out principles of transparency, accountability and prudent management of resources for voluntarily participating countries and companies.⁶ It also provides specific revenue reporting guidelines and criteria for participation. In contrast to the PWYP approach, the British government stressed the responsibility of host governments for transparency, while the U.S. government also lobbied hard against EITI following a mandatory approach. Being voluntary, it is incentive-driven and critics have suggested that the main incentive for joining EITI has been for governments and companies to deflect criticism and gain domestic and international legitimacy. That said, adherence to EITI principles is now a criterion to access financing for extractive sectors from many export credit agencies and other international financial institutions.

Third, the IMF *Guide on Resource Revenue Transparency* (GRRT) promotes transparency through its support for clear roles and responsibilities of governments, public disclosure of all resource revenues, open budget preparation, and external or independent auditing of national accounts. Nevertheless, few resource-dependent countries have followed the more general IMF *Code of Good Practice in Fiscal Transparency* and undertaken Reports on the Observance of Standards and Codes that gives it teeth. The same may be expected with the GRRT, in part because large resource revenues insulate governments from IMF conditionality.

5. CONCLUSIONS AND RECOMMENDATIONS

Since the late 1970s, some developing economies such as Chile, Indonesia and Malaysia have escaped dependence on primary commodity exports or aid. Three key factors behind their success are: sound macroeconomic management that allowed them to take advantage of increased opportunities to trade; central control of corrupt rent-seeking behaviour; and the pro-poor spending of commodity revenues to improve the competitiveness of labour-intensive activities.

In essence, for revenues to be handled effectively and invested carefully, whether from natural resources or aid, policy-makers need to develop institutional mechanisms that increase the transparency and accountability of natural resource and aid revenues, that ensure they are prudently managed and do not become a 'prize of power.' Civil society has a key role to play as a watchdog of government expenditure and anchoring commitments to better revenue management. In particular:

- Strengthen the Extractive Industries Transparency Initiative and the IMF Guide on Resource Revenue Transparency. Develop them into an International Extractive Sector Transparency Agreement with common standards of revenue disclosure, independent monitoring and effective compliance measures;
- Increase the focus on capacity-building in extractive sector transparency agreements to improve revenue management, resource pricing, accounting, reporting and auditing;
- Build effective revenue management mechanisms that increase the accountability and transparency of natural resource and aid revenues, and ensure long-term income stability for natural resource dependent countries;
- Introduce income stabilization mechanisms that help conflict-threatened areas manage and stabilize revenues from natural resources and aid;
- Reinvigorate the debate on measures for commodity price stabilization, beginning with the IMF's Compensatory and Contingency Financing Facility; and with the voluntary schemes being developed by the fair trade movement.

ENDNOTES

- ¹ Speech by H.E. Fradique de Menezes, President, Democratic Republic of São Tomé e Príncipe, 'Creating a stable base for transparency in São Tomé's Oil Sector.' CSIS Conference 'Promoting Accountability and Transparency in Africa's Oil Sector,' Washington, DC, 30 March 2004
- ² Palley, T. 'Lifting the Natural Resource Curse,' *Foreign Service Journal*, December 2003
- ³ Global Witness, *Time for Transparency*, 2004, p.4
- ⁴ UNDP, *Human Development Report 2005*, p.221
- ⁵ DFID, *Fighting poverty to build a safer world – a strategy for security and development*, 2005, p.8
- ⁶ See <http://www.eitransparency.org>

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Since 2000, the initiative has focused on the way in which trade in natural resources can contribute to violent conflict at the sub-state and international level, and on the role of foreign aid and trade liberalization—in tandem or in isolation—in accelerating or alleviating this downward spiral.

On the basis of this understanding, current research focuses on the options available to domestic and international policy-makers. This series of policy briefs recommends six key objectives that the international community should strive to achieve if trade and aid policies are to contribute to peace and security rather than increasing the likelihood and longevity of violent conflict.

Those objectives are; developing conflict-sensitive trade and aid policies; restricting the trade in conflict resources; spreading 'good governance'; promoting conflict-sensitive business practice; and improving the management of revenues from natural resources and aid.

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