Trade, Aid and Security
An Agenda for Peace and Development

Chapter 6: Managing Revenues from Natural Resources and Aid
Richard Auty and Philippe Le Billon

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Chapter 6
Managing Revenues from Natural Resources and Aid

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Introduction

Natural resources and foreign aid revenues can play a crucial role in improving the security of populations in poor countries. Many commodity prices, especially oil and minerals, as well as aid in the form of debt relief and ODA rebounded in the mid-2000s, after more than a decade of decline. If well managed, these financial flows could help improve the lives of some of the poorest and most conflict-affected populations in the world. If mismanaged, however, these revenues could once again trigger economic growth collapses, feed grievances and sustain repressive regimes or armed groups. Iraq or Africa’s Great Lakes region clearly illustrate the dramatic costs of revenue mismanagement – at the individual, regional and international levels.

This chapter examines the research evidence on revenue management in mostly low-income countries, exploring how resource and aid revenues can improve or undermine the security of local populations through economic and political channels. Examples of unsuccessful revenue deployment, such as Algeria and Iraq, are contrasted with more successful cases such as Botswana and Mozambique. Drawing from the lessons of the past and current policy debates, we then discuss in the section on ‘How resource and aid revenues can undermine or improve security’ the main ways in which revenue management can be improved in terms of transparency, accountability, revenue sharing and income stabilization. The concluding section discusses some of the main challenges to improved revenue management and provides a number of recommendations.
How natural resource and aid dependence can undermine the economy

Starting in 1973, severe primary commodity price shocks brought an end to the so-called ‘Second Golden Age of Economic Growth’ experienced by most low-income countries after World War II. Resource-rich countries tended to be among the most adversely affected. Whereas, in 1960, per capita income in resource-rich countries was typically 50 per cent higher than in the resource-poor countries, by the late 1990s it had fallen significantly below the resource-poor level (Auty, 2001, p5). The severe terms of trade shocks (commodity price swings) and economic recessions (or growth collapses) of the period 1974–85 were associated with increased risk of civil strife, particularly in the case of oil countries (Rodrik, 1999; Collier, 2000). The growth collapses were also accompanied by increased dependence on foreign aid, which was intended to speed economic recovery (Boone, 1996, pp290–291). During the 1990s, however, evidence emerged to suggest that foreign aid could have adverse impacts similar to those associated with abundant natural resource revenues (Burnside and Dollar, 1997; Svensson, 2000; Easterly, 2001; Van de Walle, 2005). In short, reliance on natural resource revenues and aid as sources of income resulted in major distortions of both the economy and the political systems.

Economic theory demonstrates that with appropriate policies, revenues from natural resources and foreign aid, which are forms of rent, can accelerate economic growth and support specifically targeted poverty alleviation programmes (World Bank, 2001, p48). Higher aggregate national income accompanied by lower levels of poverty are major factors in reducing the risk of armed conflict and improving the security of individuals. Rents can accelerate growth because they support higher rates of investment and fund the imports required to restructure the economy, lift productivity and sustain rising incomes. Natural resource revenues can also fund the pro-poor provision of public services and expand employment opportunities. Similarly, if well coordinated and tightly targeted, aid programmes can expand social and economic infrastructure, and also transfer assets to the poorest to help them to improve both their skills and income-earning abilities.

Economic policies, however, are not shaped only by economic theory and ideals of equitable economic growth. Political dimensions also matter a great deal in shaping policies, and especially so in resource and aid sectors, where revenue flows are often tightly controlled by governmental actors (Gelb and associates, 1988). As a result, rent from natural resources and aid can prove counter productive by distorting the economy away from its underlying comparative advantage, as well as by feeding corruption. Resource revenues also have an impact on politics and on the quality of governance, with oil, for example, tending to hinder democratization (Ross, 2001; Murshed, 2004).

Taking an economic and political approach focusing on rent-driven growth can help explain why, in recent decades, resource and aid dependent countries
have been prone to growth collapses and vulnerable to civil strife (Ross, 1999). When combined with hard-won developmental experience, a political economy approach suggests not only which economic policies can avoid such adverse outcomes, but also the coalitions that must be formed between government, businesses and social movements in order to implement such policies within the context of different types of political state.

The ‘staple trap’

The vulnerability of rent-rich countries to growth collapses can be explained through the ‘staple trap’ model. In brief, economic dependence on a resource (or staple) can undermine the required competitive diversification of the economy so that it becomes progressively weaker. Since revenues from most resources (and aid) are volatile, such weakened economies are vulnerable to growth collapses if commodity prices abruptly fall. More specifically, the staple trap is the result of interacting economic and political processes.

First, high-rent countries face pressure to spend the proceeds from natural resource windfalls quickly, particularly on behalf of powerful interest groups eager to see tangible benefits. However, the rapid domestic absorption of the commodity revenue can distort the economy and trigger so-called ‘Dutch disease’ effects. The sudden expansion in domestic demand stokes inflation in the price of non-traded goods, which face little international competition, strengthening the domestic currency so that sectors that are traded like ‘non-boom’ agriculture and manufacturing cannot compete internationally and contract, destroying many labour-intensive jobs in the process. This process reverses the diversification of the economy that is required to sustain economic development and leaves it vulnerable to recession.

Second, in the presence of high ‘windfall’ commodity revenues, governments find more immediate and lucrative rewards from capturing and redistributing commodity revenues (including to themselves) than from encouraging wealth creation – which they tend to neglect. This is because high commodity revenues offer the prospect of immediate enrichment for those in power whereas the rewards from expending revenue on long-term wealth creation are far more distant, and therefore more uncertain. Such conditions tend to nurture predatory political systems, in which elites have a strong financial interest in staying in power, even if it is through repressive and authoritarian means. Revenue windfalls also affect the relationship between rentier states and taxpayers by undermining the political representation and accountability requirements associated with broad taxation.

With diminishing competitiveness in agriculture and manufacturing, along with increasing dependence on a booming resource sector that tends to create relatively few jobs, unemployment becomes a cause of concern for governments, fearful of social unrest. As a result, governments tend to spend some revenue to create jobs by expanding the public sector or forcing industrialization by over-protection of infant industries. A bloated and inefficient public sector and non-competitive industrial sector become an increasing burden on the economy, and
particularly on the resource sector that generates their subsidies. If commodity prices fall, governments tend to squeeze even more from the resource sector, weakening its competitiveness while also increasing foreign debt, rather than reining back support for the subsidized sectors. In the absence of economic reform, these distortions eventually lead to a growth collapse, likely to be accompanied by mounting repression in the face of growing opposition. The risk of abrupt and violent political change therefore intensifies.

**Resource dependence and price volatility**

The extent of a country’s dependence on commodity revenues and the price of those commodities are two crucial elements of the staple trap model. The level of dependence assesses the relative importance of the natural resource rent in relation to the overall economy (as percentage of GDP) or to public revenue (as percentage of public revenue). Natural resource rents typically ranged from 9 to 21 per cent of GDP in low-income countries during the mid-1990s (Auty, 2001, p5), with a generally higher level of dependence in terms of public revenue. Levels of dependence can go significantly higher during boom times when commodity prices are high, reaching 92.7 per cent of GDP and nearly all government revenue for the extreme case of Equatorial Guinea in 2005.

Foreign aid has run at 10 to 20 per cent of gross domestic income (GDI) in recent decades, and above 40 per cent of GDI at times in Mozambique, for example (World Bank, 2005), as external intervention increased in response to the growth collapses that occurred in many developing countries during the period of oil price volatility of 1974–85. In addition, government interventions to adjust prices, notably by fixing artificially high exchange rates and by using crop marketing boards to depress domestic crop payments relative to world prices to ‘tax’ wages and profits in some sectors, constitute a third category of rent (termed ‘contrived rent’), which could also amount to 10 to 30 per cent of GDP (Krueger et al, 1992).

In aggregate terms, these three types of rent account for a sizeable fraction of GDP in developing countries – typically around one third. Such high levels of rent dependence have considerable potential to destabilize not only the economy (if the rent is extracted from competitive activities and diverted to non-competitive activities) but also political stability (because large amounts of floating revenues attract political contests for their capture).

Even mature high-income economies with deeply rooted and resilient institutions might experience difficulty in handling such a large and volatile stream of ‘loose’ revenue. However, given the close positive link between per capita income and the quality of governance (Treisman, 2002), low-income developing countries tend to be singularly ill-equipped to manage such large and volatile revenue streams.

This high level of dependence also exposes the economy to variations in commodity prices and aid provision. Two major dimensions are important with regard to primary commodities: the long-term trend in the price of primary commodities and the volatility of prices around that trend. In short, many
commodities have seen a decline of their value relative to other goods and services; by 1999 commodities were one fifth of their value a century earlier (Cashin and McDermott, 2002). As a result, many countries stuck in the staple trap and unable to drastically improve productivity have seen their economic situation worsen over time. Even a resurgence of commodity prices may not rapidly benefit these countries, as they remain out-competed by more efficient and larger producers. The more capital-intensive commodities like minerals require large investments with long lead times before they start to produce. Moreover, oil production sharing agreements, for example, generally allocate most of the revenues in the early years to foreign companies to recoup their initial investments. Oil producing governments often respond by requiring large payments in cash – or ‘signature bonuses’ – when such agreements are passed.

Not only have many commodity prices declined over the past decades, but the volatility of primary commodity prices has intensified, in terms of both the scale and duration of the resulting price shocks. The terms-of-trade volatility of the regions with the highest share of primary products in their exports was two to three times that of the industrial countries during the years 1970–1992 (Westley, 1995). Such fluctuations in commodity prices can administer substantial shocks to non-diversified economies. When commodity exports are one third of GDP, a 1 per cent decrease in price translates into a 1.5 per cent decrease in national income due to the multiplier effect of second-round spending and indirect employment opportunities (Deaton, 1999). The higher the reliance upon a single primary commodity, the greater the impact on the domestic economy of a change in its price. Low-income countries in sub-Saharan Africa are more vulnerable than their counterparts in south Asia, which tend on average to be larger and therefore have more diversified economies.

The duration of the shock is also important. Mineral exporters have performed especially poorly during the last two decades because of price downswings. As noted above, mining tends to have long lead times for investments and so responds slowly to changes in the market price. High mineral prices will spur new projects, but these will take time to deliver additional volume to markets. High prices can thus depress global economic activity and encourage substitution or conservation. In consequence, demand may lie well below expectations by the time new investments eventually come on stream, ushering in an extended period of surplus capacity and consequently low prices. This phase of depressed prices deters new capacity expansion while stimulating demand, thereby setting up the next cycle of price boom and bust. In the case of oil for instance, the frequency of the long-run cycle appears to be around 25 years, with around eight years of high prices giving way to a longer period of relatively depressed prices.

If policy makers could predict price trends, then commodity revenues could be managed to smooth their impact on the domestic economy. Unfortunately, there are fluctuations or sub-cycles within this long-run cycle, which complicate predictions. More generally, commodity price volatility is bad for economic
growth not only because of falling prices, but also because rising prices tend
to lead to increased expenditure, which in the public sector tends to result
in overspending and poorly planned investments. Such increased public
expenditure often acquires a momentum that renders it difficult to cut back
during downswings. This leads to the accumulation of debt, which merely
postpones the necessary fiscal expenditure adjustment so that the eventual
cutbacks are much more painful.

Interestingly, there is evidence that whereas governments tend to react as if
the increased income associated with a commodity boom is permanent, private
actors exhibit greater caution (Bevan et al, 1987). Consequently, private firms
and institutions tend to save more for future downturns and thereby slow
the rest of domestic expenditure. Where governments permit, their responses
include investing overseas, which helps to further retard domestic absorption
and so limit the Dutch disease effects so that the risk of locking the economy
into a staple trap is diminished.

Besides orienting windfalls towards savings, trade policy also appears
important. The negative impacts of price volatility increase with growing
dependence on a small number of natural resource exports (Combes and
Guillaumont, 2002). A closed economy would in theory prevent exposure to
price volatility shocks. In practice, however, closed economy policies remain
selectively open to key primary commodity exports. Such a selectively closed
economy policy thus tends to magnify a lack of economic diversification,
notably by reducing investments, and to aggravate commodity price instability
effects. It thus appears that open trade policy increases the resilience of primary
commodity exporters, even if such exports also increase their exposure to
shocks in the first place.

Overall, heightened commodity price instability has slowed per capita
GDP growth significantly in the developing countries since the 1960s, except
for industrializing east Asia and, to a more modest degree, the larger south
Asian countries. To sum up, dependence on either natural resource or aid
revenue requires matching public expenditure to the absorptive capacity of
the domestic economy and also promoting the diversification of the economy
away from slow-growth commodity dependence.

How resource and aid revenues can undermine
or improve security

The staple trap development trajectory is not inevitable. Rather, it points to
a pattern of behaviour among many resource and aid dependent countries.
The pattern has become so pronounced in relation to natural resources
that the term ‘resource curse’ is commonly used to describe the somewhat
paradoxical negative effects of resource wealth. The cases of Algeria and Iraq
each illustrate how resource or aid dependence can undermine the security of
local populations.
Algeria: Inefficient industrialization, growth collapse and civil war

After a devastating war for independence the Front de Libération Nationale (FLN) government opted to take a lead role in directing revenues from the oil and gas industry. It nationalized this sector in 1972 and promoted resource-based industrialization as the principal vehicle for restructuring the economy, with state-owned enterprises given the dominant role.

Although GDP growth was rapid through the 1970s and into the 1980s, the government neglected social infrastructure and also unemployment, which reached 18 per cent by the late 1980s. By then, the neglected agricultural sector, which prior to independence had fed the country and produced a surplus for export, employed one quarter of the total workforce but produced only one quarter of the country’s food. Moreover, the new industrial sector proved inefficient, and could not sustain economic growth when oil revenues declined through the 1980s (Nashashibi, 1998).

In the context of rapid population growth and rising unemployment, sharply lower oil prices cut the oil rent per capita from the peak of $1200 (in 1990 dollars) in 1981 to $200 in 1986, thereafter fluctuating between $200 and $400 through the 1990s (Aissaoui, 2001, p30). Locked in the staple trap, the Algerian government failed to respond promptly when oil prices collapsed in 1985. It curbed public expenditure and rationed goods, but failed to prevent recurring budget deficit, which accounted for 13.7 per cent of GDP in 1987. External debt topped 100 per cent of GDP and the deteriorating economic situation and rising unrest undermined the position of the FLN government. By the late 1980s, the opposition Front Islamique du Salut (FIS) gained widespread popular support by denouncing the failure of the Algerian government’s petroleum-driven economic model of state-led industrialization and a ‘socialist market’.

In 1989 civil unrest led to the adoption of a new constitution allowing for multi party elections. Despite the manipulation of electoral rules by the ruling party, the opposition FIS dominated the election results (winning 47 per cent of the vote in local elections in 1990; 54 per cent in the national elections of 1992). Unwilling to accept this result, the military intervened and the Supreme Court prevented the FIS from assuming power on the grounds of its alleged links to terrorist activity (Nashashibi, 1998, pp2–3). This triggered civil war that persisted for almost a decade at the cost of an estimated 100,000 lives.

Rather than follow the IMF’s economic reforms, the weakened Algerian government sought to maintain a consensus-based approach between the army, unions and businesses with regard to basic decisions on national resource allocation. Such inclusive political mechanisms maintained both formal and informal efforts to limit destitution in the face of the post-boom economic and civil war related hardships and to sustain a minimum of social cohesion in a context of civil war. Income inequalities eased from the mid-1980s to the mid-1990s (Adams and Page, 2001), but this was mainly because more people were getting poorer. In fact, the proportion of the population living in poverty doubled during the 1990s.
The essential restructuring of the economy was constantly postponed and unemployment reached 30 per cent of the workforce in the early 2000s. The state sector still dominated the economy (Table 6.1), and the hydrocarbons sector in particular, with 30 per cent of GDP, 60 per cent of government revenue and 95 per cent of exports, but barely 2 per cent of employment (Nashashibi et al, 1998, p2). However, the unexpected oil price increases of the mid-2000s provided the Algerian state with a revenue windfall, which it plans to invest in infrastructure projects and to moderate some economic reforms (Beaugé, 2005). This increased public expenditure may help improve the life of many Algerians anxiously awaiting improvements after more than a decade of civil war. Yet such a rapid expansion in public expenditure also risks making wasteful investments and entrenching corruption, calling for strong accountability to prevent this.

**Iraq: Dictatorship, repression and military adventurism**

Oil has been a major driving force behind insecurity in the Persian Gulf, and most notably in Iraq’s internal, regional and international conflicts. The creation of Iraq by the British after World War I had the somewhat ironic objective of securing the control of oil reserves in that region. A pattern of institutionalized corruption in part motivated several attempted coups d’état against the British-supported Hashemite monarchy, which was finally brought down in 1958.

Successive military regimes, including that of Saddam Hussein after the Ba’ath party seized power in 1968, achieved dominance through a pattern of populist patronage and coercion. Oil only came to dominate the economy after nationalization of the petroleum sector between 1961 and 1972, and the 1974–78 oil boom. Annual economic growth averaged 14 per cent in the 1970s

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**Table 6.1 Structure of GDP and employment in Algeria, 1999**

<table>
<thead>
<tr>
<th>Sector</th>
<th>Value added (% GDP)</th>
<th>Private sector share of value added (%)</th>
<th>Employment (million)</th>
<th>Sector share of total employment (%)</th>
<th>Private employment in sector (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Agriculture</td>
<td>11.4</td>
<td>99</td>
<td>1.490</td>
<td>25</td>
<td>99</td>
</tr>
<tr>
<td>Hydrocarbons</td>
<td>29.5</td>
<td>1</td>
<td>0.135</td>
<td>2</td>
<td>2</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>9.6</td>
<td>35</td>
<td>0.690</td>
<td>11</td>
<td>37</td>
</tr>
<tr>
<td>Construction</td>
<td>11.6</td>
<td>55</td>
<td>1.110</td>
<td>18</td>
<td>56</td>
</tr>
<tr>
<td>Services</td>
<td>25.4</td>
<td>75</td>
<td>1.190</td>
<td>20</td>
<td>74</td>
</tr>
<tr>
<td>Public administration</td>
<td>12.5</td>
<td>0</td>
<td>1.435</td>
<td>24</td>
<td>0</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>100.0</strong></td>
<td><strong>41</strong></td>
<td><strong>6.050</strong></td>
<td><strong>100</strong></td>
<td><strong>52</strong></td>
</tr>
</tbody>
</table>

Source: Aissaoui, 2001, p291
and by 1979 Iraq was the second largest OPEC oil exporter behind Saudi Arabia. Oil windfalls made populist economic policies more affordable to the Ba’athist regime. This wealth was also used, however, for a massive arms build-up and for funding the private interests of the Ba’ath party regime’s cronies.

In 1979, Iraq launched an opportunistic and disastrous war against the new Islamic Republic of Iran that bankrupted the country. The economy contracted by 6 per cent per year during the 1980s. Financially bankrupt but still militarily strong, the Hussein regime sought to avert a political and financial crisis by invading Kuwait in 1990. Although this choice sustained Hussein’s rule for 13 more years, drastic blanket sanctions were imposed that aggravated the country’s economic collapse. By 1994, when the sanction regime was still in full force, Iraq’s per capita real GDP was estimated close to that of the 1940s (Alnaswari, 1994).

This situation was somewhat improved under the UN’s Oil-for-Food programme (see Box 6.1), but the state withdrew from many basic social and economic services, while corruption sharply increased in scale and breadth. The control of smuggled goods, including oil, and kickbacks from oil sales became the central economic focus of an Iraqi regime that had lost its formal control over the main economic sector of the country. By 2000, after a decade of war and a decade of international trade sanctions, Iraqi incomes had fallen to less than one fifth their 1980 level, with most Iraqis dependent upon the government, either directly for food or, in the case of the 2.25 million civil servants that comprised one third of the country’s formal workforce, indirectly for employment (Economist, 2003). The US-led invasion of Iraq in 2003 led to massive looting and appropriation of state assets by political factions, and ordinary Iraqis, which further undermined the capacity of the state, while the ongoing insurgency in many areas of the country has retarded a rapid recovery and left large parts of the population highly insecure.

Escaping the resource curse

Not all resource-dependent countries experience growth collapses, as illustrated by revenue management in Norway and Botswana. Norway was already an industrialized country with strong institutions by the time oil revenues flowed in. Careful revenue management, relatively slow oil development and strong domestic absorption capacity, as well as saving part of the oil revenues through an oil fund, were key to this success.

Success was not immediate, however. When oil prices were high during 1973–85, the real costs of Norwegian non-oil producers rose 15–40 per cent more than the costs of their competitors; manufacturing output and exports stagnated, public sector employment rose by 70 per cent during 1970–91 and social welfare jumped to 17 per cent of GDP by the early 1990s – thereby absorbing the bulk of government oil revenue.

When oil prices finally crashed in the mid-1980s, Norway experienced a recession that lasted from 1986 to 1993. This led, among other things, to a self-defeating acceleration in oil extraction during a period of over-supplied markets
Box 6.1 The UN Oil-for-Food programme in Iraq

In operation between 1996 and 2003, the United Nations Oil-for-Food programme generated $64.2 billion dollars from Iraqi oil sales, of which $34.5 billion were allocated to a humanitarian programme for Iraq. In effect, the programme was one of the largest international aid projects in recent decades, but also one of the most controversial.

UN sanctions reduced Iraqi oil exports by 90 per cent between 1990 and 1995, with a terrible toll on its population. After obtaining discretionary control over oil pricing and the selection of purchasers of its oil exports, and humanitarian (and oil industry spare parts) imports, the Iraqi regime finally agreed to a revised sanctions regime. Although this new regime eased the plight of the population, it also opened the door to massive misuse of the programme by the Iraqi government.

The illicit income received by the Iraqi government from manipulating the Oil-for-Food programme is estimated at $1.779 billion, comprising $229 million from surcharges on oil sales and $1.55 billion from kickbacks on humanitarian purchases. An estimated 56 per cent of companies purchasing Iraqi oil and 62 per cent of companies providing humanitarian goods contributed to this illicit income. Beyond consolidating the formal patronage capacity of the regime domestically, the Oil-for-Food programme was also politically manipulated internationally, with the regime extending its reward system overseas through oil vouchers provided as gifts, commissions for services, or in payment for goods to foreign companies and influential individuals. Many of the voucher recipients lobbied for an end to sanctions and for the normalization of relations with Iraq.

The Oil-for-Food programme suggests political opportunism (or ‘realism’) on the part of UN Security Council members, political complicity by the UN Secretariat managing the programme, and widespread collusion on the part of companies. The US and UK sought to maintain the sanction regime by turning a blind eye to practices commercially benefiting Security Council members opposed to the sanction regime – in effect ‘buying’ their consent. The US also turned a blind eye on oil smuggled to ‘friendly regimes’ such as Jordan and Turkey. Between 1997 and 2002, illicit Iraqi revenues from oil smuggling (outside the Oil-for-Food programme) are estimated to have been worth between 5.7 and 13.6 billion dollars.

The UN Secretariat itself did not tackle the problem of illicit revenues, considering it a political issue to be addressed by the Security Council. Bureaucratic corruption by the head of the programme, Benon Vahe Sevan, and conflicts of interests on the part of UN Secretary General Kofi Annan’s son Kojo, have been demonstrated. Many companies and individuals also benefited from kickbacks orchestrated by Saddam Hussein. The official investigation into the programme under Paul Volcker has recognized the political interference of Security Council members in the running of the programme, but it has also strongly criticized the failure of the UN Secretariat to challenge this
interference and to observe its ‘own rules of fairness and accountability’. What the Volcker commission may be missing here, or be prevented from saying by its limited mandate, is that it is the sanction regime itself that failed to follow these rules. From the perspective of a high-ranking UN official, the programme had turned into a ‘Frankenstein’ that escaped the control of its creators. From the perspective of the Iraqi people, however, sanctions were from the onset anything but fair and accountable.

in an attempt to offset lost revenue (IMF, 1998, p8). Burnt by this experience, the Norwegian government established a Government Petroleum Fund in 1990 in order to minimize the economic distortions of oil booms and to stockpile wealth for future generations.

Botswana has also relied heavily on resources revenues since the 1970s. As a low-income country with weak ‘modern’ state institutions, Botswana could easily have followed a growth collapse path towards the staple trap. Unlike many other primary commodities, however, diamond prices have remained relatively stable as a result of the monopoly power of the De Beers company (one of the world’s largest diamond mining companies and the world’s largest trader in rough diamonds). The key in this sector is rather for the government to capture, and publicly account for, a sizeable share of diamond revenues.

The Botswanan government was able to access a large part of the diamond revenue through its control of the deep-shaft mines and a business partnership with De Beers. Although Botswana’s society remains highly unequal economically, the ruling party maintained strong legitimacy through the broad provision of public services, and a relatively open democratic system. The government sought to ensure that public services could be fiscally sustainable, at least in the medium term, by capping budgetary expenditures and saving most surplus revenues in a long-term reserve fund (called the Pula Fund). In terms of governance, the government placed strong emphasis on meritocracy and integrity in its bureaucracy, initially enrolling foreign expertise to increase its capacity, supporting training and education, and creating a stringent anti-corruption legal framework.

There are also successful examples of the prudent use of overseas aid, where foreign aid disbursements tightly channelled by donors have helped improve the economic situation of the country as a whole. Post-war Mozambique is often cited as an example of successful aid spending in light of the partial economic recovery of the country over the past decade when the level of aid dependence was extremely high. Mozambique shows that the dispersion of aid to geographically and socially diverse groups, and the allocation of aid to health, education and productive economic sectors, lowers the risk of the ‘windfall curse’. The inflationary effects of massive assistance in the early 1990s also led the IMF to impose strict limits on the amount of aid available for disbursement by the Mozambican government. Such limits, however,
raised issues of political sovereignty loss and reconstruction delays and were progressively relaxed.

Donors targeted foreign aid at investment to rebuild the shattered economic infrastructure of Mozambique, rather than into current consumption, because tangible investments (such as schools and hospitals) are easier for aid agencies to monitor than public expenditure. Although targeting aid on a sectoral basis is sound, assistance was too often implemented through a multitude of unrelated and incoherent projects, fragmenting assistance and undermining the capacity and role of the government. Donors have more recently used direct budgetary support to address these problems, with the hope of maintaining oversight by directly participating in processes of budgetary allocation.

Overall, external assistance appears to have buttressed a democracy that achieved relatively high levels of institutional quality for a country of its per capita income. Corruption and persistent inequalities, however, have tainted the relative successes of the ‘economic growth’ coalition formed by donor agencies and the Mozambican government around neoliberal policies.

These case studies demonstrate the importance of tackling the volatility of resource prices and improving the management of revenues by governments. In principle, the less volatile and more easily controlled the resource revenue is, the better. The volatility of revenues and high levels of resource or aid dependence highlight the importance of sound macroeconomic policies in smoothing revenue flows and managing adjustment to external shocks such as volatile commodity prices.

The case studies also underline the importance of matching the rate of spending of natural resource and aid rents to the capacity of a country to absorb and make effective use of that spending. Giving more control to governments over these rents is only beneficial if governments deploy them efficiently for pro-poor purposes. As such, the efficient management of these specific revenues often reflects the overall performance of the government. The institutional context in which resources are exploited and revenues allocated is thus crucial to ensure the money is well spent. In this regard, as set out below, key requirements include building transparent, fair and accountable institutions, controlling corruption, stabilizing revenues and tailoring initiatives to the specific contexts of conflict-affected countries.

**Improving natural resource and aid revenue management**

As discussed above, there are clear incentives for improving revenue management for the sake of security in resource and aid dependent countries. Preventive measures mostly concern the governance of revenues, as well as efforts to stabilize the price of resource revenue and diversify economies (see Curtis, this volume). Some of these measures are also relevant in terms of conflict resolution and post-conflict recovery. Revenue management is not only important for the current generation, but also for future ones. Natural
and environmental resource accounting provides a rationale for allocating the natural resource rent between consumption by the present generation and investment for future generations (Auty and Mikesell, 1998). In policy terms, this requires investment of the rent to diversify the production structure of the economy in order to reduce dependence upon the rent stream. Such investment also enhances the resilience of the economy to economic shocks.

Attempts to improve revenue management have been made at both the domestic and international levels, sometimes in combination. At a domestic level, specific regulatory frameworks and institutions define management structures, with resource-revenue management legislation as its foundation. Internationally, transparency benchmarks, reporting rules, initiatives to build accounting capacity and setting up trust funds to help reform failing domestic revenue management and corporate practices are also required. The following sections examine domestic revenue-management laws and international initiatives to improve transparency in the natural resource sectors.

**Improving revenue governance: Revenue management laws**

Revenue management laws generally address three main areas: the collection, administration and allocation of resource rents. Within each transparency, accountability, representation and equity are major issues in order to avoid rent capture by narrow interest groups, notably political elites, and reduce the risks of (renewed) armed conflict.

Revenue management laws generally first set the principles and objectives defining the management of resource revenues, using principles of transparency, fairness in allocation between producing and non-producing regions, and objectives of poverty alleviation and improvement of public health and education services. These laws also often create specific budgetary instruments, such as stabilization and savings funds (see below), and can set financial benchmarks, such as ratios setting maximum annual withdrawals from revenues or saving funds. Finally, these laws define administrative and oversight bodies in charge of the governance of the sector and its revenues.

A key element for resource management laws is their scope, which needs to be comprehensive and have application to all resource-related revenues, not just some types of revenues from some areas. The law also needs to set precise rules of governance (e.g. responsibilities, accountability and penalties) and insulate oil revenues from political party interests (like patronage and populist policies, political party financing, embezzlement). The revenue allocation principles and mechanisms need to be consensual and representative, must notably include a practical means of informing and consulting populations, and cannot be exclusively reliant on prominent civil society organizations.

Financial transparency in revenue flows should be guaranteed, including frequent reporting in the public media and publicly accessible websites. The asset-management strategy should be coordinated with budgetary policy, and borrowing on resource revenues should be prohibited. The conditions of parliamentary scrutiny and budgetary decision-making should be secured,
with a detailed breakdown of accounts. Finally, there should be independent and credible oversight, auditing, and performance evaluation.

Most studies have noted that revenue-management laws can only be effective if they are part of a sound overall fiscal management structure. This should not only ensure that other income streams and expenditure flows are adequately managed, but also that resource revenues are coherently integrated into fiscal policies and budgetary processes. In this regard, there remains some debate about the value of using resource revenue or aid trust funds that aim to deter political interference and insulate the economy from rent distortions (see Box 6.2).

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**Box 6.2 Revenue management laws in conflict-affected countries**

**Azerbaijan: Transparency and presidential probity**

In the wake of a violent transition from the Soviet Union, the Caucasian republic engaged in a broad set of reforms as international oil companies increased their presence. Since 1999 there has been an Oil Fund under presidential control (through oversight-body nominations and expenditure control), and a new Budget System Law providing for greater parliamentary scrutiny and decision making over oil revenue allocation, as well as public reporting on the executed budget. Although there has been improvement, much of the management rests on presidential decisions, and levels of expenditure have exceeded planned withdrawals – by a substantial margin – during recent high oil prices (Tsalik, 2003).

**Chad: Loopholes and frustrations in the Petroleum Development and Pipeline Project**

After nearly three decades of civil war, peace negotiations in the mid-1990s made it feasible for oil companies to develop oil fields in southern Chad. The Exxon-led consortium of oil companies asked the World Bank to act as a ‘moral guarantor’ of the project and to assist the Chad government with revenue management (Horta, 1997). Several oversight committees, including an International Advisory Group, observe and make recommendations on the implementation of the project. The oil revenue management law directs oil revenues into an offshore savings account and towards pro-poor social services (after reimbursement of project-related public debts). While the Chad–Cameroon Project was hailed as a ‘new model’ for oil development in poor countries and benefited from unprecedented attention and efforts, the project failed to ensure that strong institutions were in place before oil revenues start flowing. This new model of governance has come under strong criticism, notably for its lack of comprehensive coverage and implementation of
the International Advisory Group recommendations, inadequate government capacity, and poor oversight of budgetary execution (Gary and Reisch, 2005).

**Iraq: Revenue management under foreign occupation**

Following the US-led war in Iraq, the UN Security Council directed Iraq’s oil revenues and repatriated funds to a Development Fund for Iraq placed under the authority of occupying forces (the US-led Coalition Provisional Authority), provided that the right of the Iraqi people to ‘control their own natural resources’ be recognized, and that the management of oil revenues by occupying forces ‘benefit the Iraqi people’ and be adequately audited. Many of the failings of the US-led Coalition Provisional Authority can be accounted for by the massive challenges that it faced, although policy orientations, shifting timetables largely dictated by US domestic political priorities, bureaucratic infighting and red tape, as well as high staff turnover and lack of experience also contributed in major ways (ICG, 2004). Key failures included: a lack of Iraqi policy ownership; a bias in disbursing Iraqi rather than US funds for reconstruction; inappropriate budgetary allocation mechanisms, benefiting well-connected US companies rather than local Iraqi firms and people; lack of transparency, including in shaping future oil policies; and unjustifiable delays in auditing, including by the International Advisory and Monitoring Board for Iraq, created to independently monitor the Development Fund for Iraq (Le Billon, 2005a).

**São Tomé e Príncipe: Exemplary legislation and political discord**

With two recent coup attempts in 1995 and 2003, and continued political tension within the government, São Tomé e Príncipe’s potential oil wealth has raised much concern for the future of the tiny archipelago. The recent Oil Revenue Law, however, provides extensive guarantees in terms of transparency, accountability and governance (Bell and Faria, 2005). The drafting of the law itself benefited from extensive consultation with opposition parties and the public at large, as well as the technical assistance of the Earth Institute of Columbia University. Despite this exemplary framework and process, there remains much tension within the current regime, with the prime minister resigning after denouncing the discretionary power of the president in signing new production sharing agreements without proper consultation, including with the parliament.

**Sudan: Revenue-sharing between (former) belligerents**

As part of an ongoing peace process, in January 2004 the government of Sudan and the Sudanese People’s Liberation Army/Movement signed a wealth-sharing agreement over oil resources, dividing oil revenues between the two parties. The scheme, however, is not independently supervised. Significantly,
the agreement leaves aside the issue of ownership of subterranean natural resources (Tellnes, 2005). The agreement places the oil sector under the management of a National Petroleum Commission with representatives from both parties, and allocates revenues equally to the national and regional governments. Stabilization and Future Generation funds are to be established. All funds and special accounts are to be on-budget operated. Oil-collateralized loans are not prohibited. Transparency provisions include the creation of a Fiscal and Financial Allocation and Monitoring Commission (staffed only by officials from both governments), and public accounts subject to public scrutiny and accountability. Auditing is to be performed by regional and national audit chambers, whose members are nominated by the presidency and confirmed by the assembly. Overall, the scheme lacks independent oversight mechanisms.

**Timor-Leste: From UN revenue savings policy to Petroleum Fund Act**

A petroleum revenue savings policy was established under the United Nations Transition Authority in East Timor, whereby oil tax revenues were allocated to the annual budget, while oil royalties were saved for future use. In 2005, the government established a permanent Petroleum Fund, collecting all petroleum revenues (taxes and royalties), from which budgetary allocations can be drawn within the limit of a sustainable income from total petroleum wealth (current fund and estimated future income from reserves) estimated by the government. Fund withdrawals have to be approved by the national parliament and all fund operations are placed under the oversight of a consultative council of eminent persons and subject to independent audits. Any encumbrance on the assets of the petroleum fund is prohibited. The Petroleum Fund Act also sets transparency as a fundamental principle and establishes accountability rules. Petroleum revenues for this impoverished state, however, are under threat from an Australian government eager to control the lion’s share of oil and gas reserves in the Timor Sea.

International initiatives can also promote better revenue management, by supporting domestic policies as well as by helping define and enforce good practice in both the public and private sectors. Yet taken in isolation, such interventions have also proven to be controversial and misdirected. Critics of the IMF and World Bank, for example, argue that forced deregulation and privatization in the resource sectors have constituted damaging forms of political interference (Tan, 2002). Critics of transnational corporations have similarly pointed to their very mixed record in terms of their human rights, revenue sharing and support for repressive regimes (Global Witness, 2004).

Aid and resource revenues were perceived until the 1980s – at least in official international development and security circles – as key ingredients of the consolidation of ‘friendly’ states on both sides of the Cold War divide. Growing national debt and structural adjustment policies, the decline of Cold
War geopolitics and greater awareness of economic agendas in wars shifted this focus towards ‘good’ governance and market-oriented priorities (Berdal and Malone, 2000; Bannon and Collier, 2003; Le Billon, 2005b). As a result, there has been a focus on policies to promote transparency, while other policies, like government-led price stabilization mechanisms, have declined. The following sections examine domestic revenue management laws and international initiatives to improve transparency in the resource sectors.

**Stabilizing revenues**

One way of reducing the adverse effects of commodity price volatility on the domestic economy is for local governments to set up capital development funds. In practice, the rent is placed within a fund managed by the central bank, with sizeable windfalls invested offshore to limit Dutch disease effects until such time as the domestic economy can absorb them productively. Investing a fraction of the rent in alternative wealth-generating assets – capital development or economic diversification – can also ensure that the income-generating capacity of the depleting mineral resource is passed on to future generations (Auty and Mikesell, 1998).

Capital development fund management usually entails setting an expected commodity price and automatically transferring revenues above that price to the fund. A public revenue stabilization fund may also be adopted to smooth the flow of volatile commodity revenues into public finances. Within a transparent fiscal system, such a fund can help to constrain the scope for governments to use revenues earmarked for medium-term and long-term objectives to overcome short-term political problems. Revenues can also be stabilized through a number of financial instruments, such as commodity bonds and derivatives, to hedge exposure to commodity price fluctuations. Finally, a public-sector project-evaluation unit can complement the capital and public-revenue stabilization funds by objectively comparing the economic returns to alternative uses of public expenditure, including the potential returns on overseas investments.

The utility of capital development funds has been challenged, however (Davis et al, 2001). The main criticisms are that such funds:

- may be poorly integrated with the budget and so lose control of public spending;
- encourage off-budget spending that undermines fiscal integrity;
- complicate coordination between fund management and budget management;
- tend to function with even less transparency than the government budget and thereby increase the likelihood of the political deployment of the revenues.

In fact, these problems are all associated with poorly designed funds and are not inherent in the system. Moreover, the examples cited to suggest that funds
have failed are drawn from the polarized democracies of PNG and Venezuela, but ignore the positive experiences of consensual democracies like Botswana and Chile (Auty and Mikesell, 1998). As Fasano (2000, p19) concludes from a review of six resource funds, a 'stabilization fund cannot be a substitute for sound fiscal management, and its success or failure can be attributed as much as to fiscal discipline as to the fund’s management'. Ironically, resource funds seem to work best only where they are not needed; that is, when sound fiscal policies are already observed and resource revenues represent only a small part of fiscal inflows.

Internationally, the IMF’s Compensatory and Contingency Financing Facility provides budgetary support in the form of short-term loans to governments facing low resource revenues that are believed to be temporary. Where a more fundamental structural shift in commodity prices occurs, the IMF can provide loans to extend the period of adjustment to reduced prices, while the World Bank and regional development banks, among others, can provide conditional loans for economic restructuring.

The EU also uses such a system – Stabex, or Flex since 2000 – in order to help ACP countries adjust to unfavourable shifts in their terms of trade. Despite easing the criteria for assistance, Flex remains too selective and characterized by long delays in disbursement that undermine its effectiveness. Such mechanisms can be linked to lower debt service obligations, with a reciprocal arrangement to accelerate debt repayment if revenues are unusually high. More broadly, aid could be related to vulnerability to trade shocks, rising in cases where that vulnerability is substantial, provided that the recipient governments exhibit the ability to make effective use of such aid in terms of target criteria such as economic growth or poverty reduction (Combes and Guillaumont, 2002).

Most attempts to assist governments are tied to economic or political conditionalities. Governments are thus frequently reluctant to accept them, especially when the political cost is high. Governments may actually wait until a point of economic crisis is reached before accepting reforms (Bruno and Pleskovic, 1997). Other potential beneficiaries and stabilization mechanisms with fewer political constraints should also be considered. Using international funds to create an insurance mechanism directly targeted at commodity-producing households and companies may be more effective than allocating funds through governments.

Aid trust funds constitute a financial instrument through which funds are collected from donors and allocated to recipients in a supposedly independent fashion. In practice, however, trust funds have often mirrored resource revenue management funds in terms of political and allocation biases. Trust funds often retain close ties with donor interests, such as political leverage, commercial objectives and preferential home-country contracting (Chatterjee, 1994; Schiavo-Campo, 2003).

Aid trust funds can smooth aid flows and help generate future income, notably by timing the disbursement of funds according to domestic needs and absorptive capacity rather than to donor imperatives. Crises are often followed
by donor pledges in part motivated by short-term and visible demand and expected outcomes. Many crises call in fact for a gradual and rising provision of assistance, rather than the boom-and-bust often characteristic of ‘CNN-driven’ crisis management. As discussed below, the level and allocation of aid flows is an important component of aid effectiveness. Recovery in post-conflict situations, for example, requires large and rising levels of aid during the first half-decade. Part of the donations immediately made after the signature of a peace agreement can be ‘saved’ for future use as the absorptive capacity of the country increases. Yet aid inflows often remain donor-dependent, and the separation into an investment trust fund and a recurrent cost fund can result in budgetary fragmentation and policy incoherence (Schiavo-Campo, 2003).

Improving public sector expenditure over the long term is related to effective capital development and revenue stabilization funds. External agencies, such as the World Bank, can intervene in this regard not only by promoting savings, but also by jointly building up institutional capacity and using such mechanisms as loan conditionality and incentives to improve transparency and accountability. Within such an institutional framework, macroeconomic policy should seek to create an enabling environment for investment by balancing public expenditure with revenue, maintaining the external (trade) equilibrium balance and correcting market failure through the provision of infrastructure, education, health facilities and environmental policies.

**International and domestic revenue transparency initiatives**

A lack of transparency increases not only the risks of corruption and embezzlement, but also of inequity, distrust and false expectations. More specifically, in the absence of adequate disclosure, producing provinces and the general population can be financially disadvantaged. Lack of knowledge can also reinforce distrust among stakeholders, most notably between civil society and governments or companies. A lack of clarity on current (and future) revenue flows can also result in rising expectations on the part of populations (and governments), with false hopes of wealth later resulting in grievances, distrust and legitimacy issues. In contrast, transparency can consolidate democratic debate by providing accurate figures upon which stakeholders can negotiate and plan.

Transparency has three main components: revenue disclosure, transparent governance, and auditing and reporting. Disclosure is the basis of transparency and is most often understood as full public disclosure (rather than disclosure limited to business partners and authorities). The objectives of transparency, however, could arguably be achieved through adequate financial governance, auditing and reporting. It may not be as important to know ‘how much’ revenue is flowing in the resource or aid sector, as to know how well these have been managed and accounted for. Most citizens in the world have little idea of precise budgetary flows, but they do care about the adequacy of the political and bureaucratic processes serving their interests. The public character of information should thus be guaranteed not only by disclosure, but also by the
quality of governance. As such, disclosure is particularly important in situations of ‘weak’ governance (Laffont, 2005), where disclosed information may help to compensate for such weakness and consolidate a transition to more effective and legitimate governance.

Transparency is not only about dollar figures, but also about individuals and interest groups in charge of, or influencing, the management of revenue flows. The governance of financial flows needs to be transparent in terms of who is doing what, and with which potential conflicts of interest. The background and personal assets of decision makers need to be made publicly available. For example, a president’s nephew may head an NGO and not be a government official, but is unlikely to have an ‘arm’s length’ relationship with the ruling party and should not qualify as a civil society representative on a monitoring board. Reliable and easily accessible information are key elements of transparency. Major challenges in this regard include a lack of credibility about sources due to conflicts of interests or poor expertise, as well as financial flows hidden in obscure and difficult to access or understand documents.

According to Goldwyn and Morrison (2004), any transparency model in oil-producing countries should include the following:

- disclosure of corporate and government revenues (royalties, taxes, signature bonuses and other fees);
- open and transparent processes for bidding on concessions and procurement;
- disclosure of oil-backed loans;
- auditing of national accounts and oil companies (including state oil companies);
- publication of fiscal accounting reports requested by the IMF;
- expenditure transparency in public budgeting;
- legislated access to information;
- independent auditing and public reporting of public finances.

Transparency can be supported at the international level through corporate revenue disclosure rules, and the promotion of international norms of public and private financial governance (through voluntary or mandatory approaches), capacity-building assistance, and international auditing and reporting. The IMF and DAC constitute the two pillars of international transparency for resource revenues and aid, respectively, but they are not enough. 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. Yet such reporting depends to some extent on the goodwill of domestic governments, many figures (or detailed breakdowns) remain confidential and it rarely engages with the most politically sensitive aspects of transparency. The DAC provides statistics on aid flows (and other resources) to developing and transition countries, available on a donor, recipient, grants/loans, and major sectors basis. These figures, however, fail to provide detailed accounts of the use of aid and do not report on many private financial flows.
International financial institutions and auditing companies should (continue to) take on an advocacy and implementing role to promote public disclosure. International media – especially radio and television – should systematically incorporate revenue information in the same way as financial reporting is done on currencies and stock exchanges. International advocacy organizations can play a strong role in analysis and as channels of information to both domestic and international audiences. Their international status and location offer some protection against pressure from domestic authorities, in effect ‘taking the heat’ of reporting off local civil society organizations.

Three complementary initiatives are now underway to improve transparency in the resource sectors. The British-government-led Extractive Industries Transparency Initiative (EITI) lays out principles of transparency, accountability and prudent management of resources for voluntarily participating countries and companies.\(^\text{12}\) It also provides specific revenue reporting guidelines and criteria for participation. In contrast to the Publish What You Pay (PWYP) campaign detailed below, which largely inspired the initiative, the British government stressed the responsibility of host governments on transparency, while the US government also lobbied hard for EITI to follow a voluntary rather than mandatory approach (Goldwyn, 2004). 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.

So far, EITI fails to require that its prescriptions are legislated and that the overall process be formally overseen by a democratic mechanism (although arguably this is a ‘non-starter’ in many countries where transparency is most needed). However, adherence to EITI principles is now a criterion for access to finance for extractive sectors from many ECAs and other international financial institutions. Supporters believe that EITI may progressively assume widespread international recognition.

Key countries with major domestic or international extractive industries are not yet EITI members, such as the US, Canada and France, as well as China, India and Malaysia. EITI should also be integrated into ‘post-conflict’ management, notably in Algeria, Angola, Colombia, Iraq, Liberia and Sudan. Critics have suggested that DFID, in consultation with EITI partners, should have a more prescriptive approach to address the ‘advice needs’ of potential participants (Global Witness, 2005). Although local policy ownership and some flexibility are needed, a common criteria and reporting regime is highly desirable. Finally, EITI should also protect its reputation through reviews of implementation criteria and strong links with accountability mechanisms.

The PWYP campaign launched in 2002 by Global Witness and George Soros’ Open Society Institute aims at mandatory disclosure of all payments to host governments by oil, gas and mining companies.\(^\text{13}\) The campaign was supported in 2005 by a worldwide coalition of 270 NGOs and major investment funds, as well as a few extractive companies, such as STATOIL from Norway, that published a breakdown of these payments to governments worldwide.\(^\text{14}\)

The PWYP campaign argues that corporate disclosure is an important step towards comprehensive accountability in the resource sectors. Campaigners
note that voluntary initiatives are proving useful with some countries and companies, but remain unlikely to achieve a global and lasting solution. Most companies have so far resisted disclosure, on grounds of contractual confidentiality and competition (or even irrelevance, in the early days of the campaign). With some of the largest oil companies being non-listed state companies and very few producing countries ‘publishing what they get’, mandatory disclosure in producing countries is also regarded by campaigners as essential. To achieve this comprehensive transparency coverage, PWYP is advocating ‘double book-keeping’ by extractive companies and governments, through revenue disclosure laws in both host and home countries. PWYP campaigners have articulated several approaches through key institutions, such as stock markets, IFIs, export credit agencies and accounting standards, but many have yet to come to fruition.

The IMF Guide on Resource Revenue Transparency (GRRT) aims to promote transparency by requesting a clear definition of roles and responsibilities from governments, as well as public disclosure of all resource revenues, financial assets, debts and quasi-fiscal information on state-owned enterprises by governments. The GRRT also calls for open budget preparation, execution and reporting, with clear policy statements and revenue volatility risk evaluation. It also suggests external or independent assurances of integrity, through international accounting, auditing and reporting standards, with national audit office reporting to parliament. The GRRT stresses the diversity of country backgrounds and the need for time, sustained commitment to reforms on the part of domestic governments, companies and donors and ‘a close linkage between fiscal transparency assessments, country administrative reform, and carefully designed technical support from international and bilateral agencies’ (IMF, 2005, p9).

So far few resource-dependent countries follow the more general IMF Code of Good Practice in Fiscal Transparency and undertake the Reports on the Observance of Standards and Codes (ROSCs) that gives it teeth. The same may be expected with the GRRT, in part because large resource revenues insulate governments from the assistance and demands of IFIs. The IMF should thus attempt to make GRRT implementation mandatory, ensure greater civil society participation, and systematically conduct and publish ROSCs.

An international extractive sectors transparency agreement

Both PWYP and EITI aim to emulate the success of the KPCS on conflict diamonds by enlisting the support of key international institutions, governments and companies. But, in the opinion of several analysts, neither PWYP nor EITI – as they now stand – possess the scope and leverage to succeed; see Table 6.2 (Goldwyn, 2004). PWYP initially failed to cover non-listed companies, while EITI has no hold on unwilling producing countries. EITI also focuses too heavily on ‘developing countries’ heavily dependent on natural resources, and to some extent overlooks the responsibilities of industrialized countries towards fair, transparent and accountable revenue management both domestically and internationally.
Building on current initiatives and the lessons of the KPCS, an effective international scheme may require a quasi-global participation backed by criteria enshrined into national legislation, with effective sanctions in effect for non-participation (e.g. foregoing vast trading and investment opportunities) and non-compliance (e.g. exclusion) (Mokgothu, 2003). In such a scheme:

- participation would be required from the overwhelming majority of resource importing and exporting countries, and relevant institutions (e.g. backed through a resolution of the UN General Assembly, and possibly UN Security Council);
- participating countries would agree to common standards of resource revenue disclosure and governance (much like the existing EITI and IMF’s GRRT) and accordingly enforce appropriate regulations and minimal standards;
- trade and investments in resource sectors outside of the participating countries and institutions may be subject to a review process by a designated authority at the home country level and notification at the international

Table 6.2  PWYP and EITI compared

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<thead>
<tr>
<th>PWYP</th>
<th>EITI</th>
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<tr>
<td>Work through company reporting regulated by their home governments (additional to EITI).</td>
<td>Work with individual host governments.</td>
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**Pros**
- One mechanism can cover all countries in which internationally regulated companies operate.
- Affords companies protection and a level playing field.
- Consistent level and availability of information to civil society and investors.

**Cons**
- Home government regulations cover only companies that are registered or raising finance in their territory.
- Current lack of political will for regulation and global standards.

**Pros**
- Supports national ownership of initiative.
- Covers all companies operating in the host country.

**Cons**
- Impossible where host government is unwilling (and where need may be greatest).
- Slow roll out on a host country by country basis.
- Reversible on change of host leadership.

*Source: Save the Children (2005)*
level (a more stringent regime would require a review process at the international level); • peer-review monitoring would be conducted to ensure continued compliance of participating members, backed by capacity-building assistance and enforced if necessary through exclusion.

**Initiatives for conflict-affected countries**

A characteristic of conflicts in low-income countries is to increase dependence on a narrow range of primary commodities and aid while manufacturing and services (such as tourism) contract. Revenue management during hostilities and post-conflict transition can prove decisive to the security of local populations. Three broad types of initiatives can curtail the use of resource revenues by belligerents to finance and profit from hostilities. They are: capturing resource areas from belligerent forces; imposing economic sanctions; and sharing resource revenues between belligerents.

The relative effectiveness of these initiatives appears to respond in part to the characteristics of the targeted resource (Le Billon, P. (2004) ‘Natural resources and the termination of armed conflicts: Share, sanction, or conquer?’, unpublished manuscript). Resources most easily accessible to rebel forces – such as alluvial diamonds – are best addressed through sanctions (see Chapter 4 on conflict resources), while military capture is most effective in the case of bulky resources controlled by the government, such as oil. Controversially, when illegal resources are financing war, such as narcotics in Burma, sharing arrangements between belligerents have proven to be more effective, but it is arguably a rare official option for governments and even less so for external actors attempting to resolve the conflict. New market regulation schemes, such as commodity certification and transparency schemes, have also improved the control of conflict trade and revenue governance. Resource revenues are not, of course, the only dimension of conflicts, and none of these initiatives provides a comprehensive solution on its own.

Although international financial institutions and donors intervene increasingly early in conflict termination processes, the political economic implications of peace-building have generally been neglected and often left to the initiative of belligerents who can jockey for key economic positions within the new authority or simply embezzle funds to re-arm. Beyond sanctions and global regulatory measures, practical regulatory frameworks can be set up to deprive belligerents of revenues they could use to follow a double agenda of peace transition and rearmament, as has happened repeatedly in Angola, Cambodia, Colombia, Liberia, Sierra Leone and Sri Lanka.

Internationally supervised tax collection and budgetary allocation could seek to ensure that populations and public institutions benefit from resource revenues. Direct payment of resource revenues could be made to the population, as suggested in the case of Iraq (Palley, 2004). This would have the advantage of clearly distributing a ‘peace dividend’ to the neediest, and it partly addresses the problem of lack of representation and accountability through broad-based taxation that affects the many resource-dependent countries. Spreading the
wealth in such a way would have effects that might be counterproductive, however, such as inflation and rising consumption of imported and non-productive consumer goods. Businesses themselves could be deterred from operating outside the scheme through a system of incentives and sanctions. If successful, and in the absence of alternative sources of support, opting out of a peace process would become prohibitively costly for belligerents. Like all instruments of control, the effectiveness of such a scheme would depend in part upon the characteristics of the targeted resource sector and the economic incentives attached.

Conclusions and recommendations

Since the late 1970s, some developing economies, such as Chile, Indonesia and Malaysia, have escaped the staple trap of primary commodity export or aid dependence. Three key factors behind their success include: sound macro-economic management that allowed them to take full advantage of increased opportunities to trade; central control of corrupt rent-seeking behaviour so that illicit imposts are known and not random; and the pro-poor expenditure of some commodity revenues to improve the competitiveness of labour-intensive activity. All successful countries maintained, or eventually shifted towards, increased public accountability as they sought to competitively diversify their economies out of slow-growth primary commodities into higher-growth commodities and a widening array of manufacturing and services (Martin, 2002). The larger economies of Malaysia and Indonesia made a spectacularly rapid transition from resource-based growth to manufacturing-led growth during the 1980s.

There remains, however, a large number of less successful primary commodity export and aid dependent low-income countries that have yet to restore rapid economic growth after the growth collapses of 1974–85. Many are located in sub-Saharan Africa, where their populations face numerous sources of insecurity, from human rights abuses to poor health services. It is imperative that revenues generated by natural resources and aid reach and benefit these populations, notably through strong and legitimate institutions allocating revenues fairly and efficiently. Inappropriate domestic and foreign policy interventions, as well as the poor quality of domestic institutions and political incentives constrain such improvements. It is thus imperative for these priorities to be considered within the broader political and economic contexts in which revenue management is to be addressed.

To achieve this both domestic and international efforts are needed. The literature and case study evidence surveyed in this chapter suggest three policy priorities:

1 Creating an enabling environment within which the private sector can invest efficiently to diversify the economy into competitive and employment-intensive activity.
2 Stabilizing revenue flows from natural resources and aid to ensure that such flows do not out-strip domestic absorptive capacity, and can therefore be applied to secure long-term improvements in social welfare rather than short-term gains for the politically well connected.

3 Controlling corrupt rent-seeking and ensuring that an increasing fraction of revenue goes towards increasing the capacity of the poorest to participate in economic development.

Hopes for improved terms of trade for the commodity producers rest to an important degree upon improving economic performance and thereby reducing the labour surplus that depresses the wages of the poor throughout the tropical regions (Deaton, 1999). In the absence of this advance, international and domestic interventions in supply and/or demand management will struggle. Past interventions through international commodity agreements and domestic commodity marketing boards, for example, have a poor track record. A superior long-term solution is therefore to promote the competitive diversification of the economy out of slow-growth commodities that exhibit declining terms of trade.

A further obstacle to diversification out of dependence upon slow-growth commodities lies in the vested interests that benefit from the corrupt rent-seeking that past policies (notably closure of the economy to create domestic monopolies for the politically well connected) nurtured. The resistance of such elites to top-down reform prompts an alternative strategy that is based upon the establishment of early reform zones, which are geographical areas within which efficient infrastructure, competitive incentives and cost-effective and reliable public services immediately apply. Such zones can accelerate the attraction of domestic and foreign investment into competitive activity that generates employment, taxes and skills and at the same time builds a pro-reform political constituency. China provides a clear example of such a dual-track reform strategy: it set up experimental export zones in the mid-1980s while it postponed reform of the moribund state sector industry until the competitive market economy had grown sufficiently in size and resilience to help absorb surplus labour from the lagging state sector. Elsewhere, Malaysia and Mauritius also deployed a dual-track strategy that nurtured a competitive manufacturing sector able to propel the economy when commodity revenues slowed.

**Recommendation 1 Assess the local viability of early reform zones in specific commodity and/or aid dependent countries**

The most important areas for successful economic diversification reside in international and domestic trade contexts. The conditions of meaningful access to markets by low-income countries are far from being met. One obvious reform priority centres upon dismantling the protectionist trade policies of the leading trading blocks in North America, western Europe and Japan, which subsidize domestic farmers and sunset industries, such as mass textiles, at the expense of low-income developing countries. Reforms in market access,
such as the diffusion of most-favoured-nation status or Europe’s everything but arms policy, are well directed but often have only a minor effect on the trade of the poorest countries, including short booms in ‘footloose’ light manufacturing plants. The questions of production subsidies, tariff escalation, and non-tariff barriers need to be urgently addressed by the dominant markets, notably the USA, EU and Japan, as well as China and India. The influence of large multinationals on producer prices and revenue share also needs to be addressed given the massive corporate concentration of some sectors and weak bargaining position of many producers. Meaningful market access also entails enhancing the trading capacity of low-income countries, which can be advanced through both international assistance in building trade capacity and domestic trade policy reforms.

**Recommendation 2** Systematize the identification of resource revenue allocations in international statistics (e.g. World Bank or IMF databases) to facilitate their use in international negotiations and public debate
Improving the terms of trade and the share of revenue accruing to producing countries and governments may paradoxically expose them to even greater economic shocks. A further priority is therefore to minimize economic shocks and promote sustainable diversification of the economy to escape the staple trap. Although countries can help stabilize fluctuating rent flows through their own domestic policies rather than by producer action to control commodity prices, they often require international coordination and assistance.

**Recommendation 3** Reinvigorate the debate on measures for commodity price stabilization, beginning with the IMF’s Compensatory and Contingency Financing Facility and the voluntary schemes being developed by the fair trade movement. As a priority, income stabilization mechanisms should improve natural resource revenue flows in conflict-threatened areas
Greater and more stable revenues have little influence on the security of the population if corruption is rife and revenues are unfairly and inefficiently allocated. The third priority is thus to address rent-seeking and revenue allocation by promoting transparency, political accountability, voice and rule of law. Yet any intervention also needs to be carefully tailored to the domestic political economy if it is to succeed. Donors and agencies can also provide technical assistance to host governments in revenue management, resource pricing, accounting, reporting and auditing. This is particularly the case for sound domestic fiscal frameworks, and support of resource stabilization and savings funds.

**Recommendation 4** Build effective revenue management mechanisms that increase the transparency and accountability of natural resource and aid revenues, and promote long-term income stability for natural resource dependent countries
Recent global initiatives on transparency and accountability in trade and aid transactions have produced promising results, but they are limited by conflicts over national sovereignty and by voluntary rather than mandatory approaches.
Transparency and accountability can be improved by the regulation of financial markets (including banks) and better-targeted international assistance. The repatriation of embezzled funds and debt cancellation can help remedy past mismanagement and help compensate for lost incomes during bust times. Resource exporting and importing countries can agree upon national, bilateral or international extractive sector transparency agreements.

**Recommendation 5** Strengthen the Extractive Industries Transparency Initiative and the IMF Guide on Resource Revenue Transparency. Merge them into an International Extractive Sector Transparency Agreement with common standards of revenue disclosure, independent monitoring and effective compliance measures. Increase capacity building to improve revenue management, resource pricing, accounting, reporting and auditing.

International initiatives can help to bolster domestic responses to many of these priorities and recommendations. As suggested in this chapter, such initiatives are particularly significant in conflict-prone countries. These countries are often affected by a lack of trust between, and within, government and society. This makes the potential role of international agencies significant as independent third parties and guarantors of agreements. Low institutional capacity, poor or unfair regulatory environments, and/or predatory practices also often characterize conflict-prone countries. Capacity-building assistance and strong oversight, addressing issues of impunity, are of major importance. Unless these tasks are seriously addressed at the international level, aid and trade will continue to prove a potential source of insecurity.

**Notes**

1. However, several countries, including Chile, Ghana, Mexico and India, were already beginning to exhibit signs of economic distress even before the 1974–85 period of heightened primary commodity price shocks, due to the cumulative misallocation of revenues since the 1950s that was diminishing the resilience of their economies.

2. These revenues are in effect rents. Natural resource rent is defined here as the residual revenue after deducting from total revenue all the costs of producing a commodity, including the risk-related return on investment. In theory, such rent can be extracted from the economic activity that generates it, say through taxation, without depressing production incentives – hence its description as a ‘gift of Nature’. However, the definition identifies potential rent, which may be lost to the public good if dissipated through government corruption, monopoly profits and a wage aristocracy (all of which often occur with import substitution industry) and/or subsidies for goods services consumed overwhelmingly by the rich. Foreign aid can be conceived as a form of economic rent, which we can describe as geopolitical rent: a ‘gift from outside the country’ taking the form of a grant or low-interest loan, often tied in terms of its access and use to political and commercial interests, quality of governance or policy reforms. The critical destabilizing property of rent, whether natural resource or geopolitical, is its capacity to engender contests for its allocation that if mismanaged can undermine both the economy and the political state.

Interim report of the independent inquiry into the UN Oil-for-Food programme, 2005, p.4.

Interview with high-level UN official, New York, 2000.

See also Swanson et al (2003); Goldwyn (2004); Green (2005); Ballentine and Nitzschke (2005), and PWYP website www.publishwhatyoupay.org/english/

See www.gic-iag.org/ehome.htm


UN Security Council, Resolution 1483, 21 May 2003, approved by all members except Syria (abstained).


See www.eitransparency.org

See www.publishwhatyoupay.org/english/background.shtml


A further potential loophole concerns the regulation of international brokers registered in offshore jurisdictions. Such brokers specialize in getting resource concessions through corrupt deals, before selling them on in a ‘clean’ manner to larger and complacent resource companies. Local ‘sleeping partners’ associated with the operations of resource companies, such as the board directors or parastatal companies in charge of some subcontracting operations, also act as agents for corruption by scooping large cash bonuses, commissions or profit shares.

Specific criteria have not been set in this respect, but EITI generally refers to 50 countries in which extractive industry revenue or export proceeds represent at least 25 per cent of fiscal revenues or total exports, respectively. See IMF (2005) and Boateng (2005).

Investments or trade by non-participants in participating countries, as well as by participants in non-participating countries, would be subject to a review and notification process through the designated authority of the participating party (see Schumacher (2004)); on review process, see Gagnon et al (2003).

References


Managing Revenues from Natural Resources and Aid


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