



**Resources for Peace?
Managing Revenues from Extractive
Industries in Post-Conflict Environments**

Philippe Le Billon

April 2008

**POLITICAL ECONOMY
RESEARCH INSTITUTE**

Gordon Hall
418 North Pleasant Street
Amherst, MA 01002

Phone: 413.545.6355
Fax: 413.577.0261
peri@econs.umass.edu
www.peri.umass.edu

WORKINGPAPER SERIES

Number 167



CENTER ON
INTERNATIONAL
COOPERATION

POLITICAL ECONOMY
RESEARCH INSTITUTE

**RESOURCES FOR PEACE?
MANAGING REVENUES FROM EXTRACTIVE
INDUSTRIES IN POST-CONFLICT
ENVIRONMENTS**

Philippe Le Billon

Public Finance in Post-Conflict Environments
A Policy Paper Series
February 2008

THE CENTER ON INTERNATIONAL COOPERATION (CIC) at New York University works to enhance international responses to humanitarian crises and global security threats through applied research and direct engagement with multilateral institutions and the wider policy community. It has an international reputation for agenda-setting work on post-conflict peacebuilding, global peace operations, and UN reform.

For more information, please go to <http://www.cic.nyu.edu>

THE POLITICAL ECONOMY RESEARCH INSTITUTE (PERI) at the University of Massachusetts, Amherst, engages in research, policy advising, graduate education, and outreach. Established in 1998, PERI seeks to assist efforts to improve living standards and create a more just, democratic, and ecologically sustainable world.

For more information, please go to <http://www.peri.umass.edu>

OTHER POLICY PAPERS IN THIS SERIES:

Michael Carnahan

“Options For Revenue Generation In Post Conflict Environments,” *May 2007*

Frances Stewart, Graham Brown, And Alex Cobham,

“Promoting Group Justice: Fiscal Policies In Post-Conflict Countries,” *October 2007*

Peter Middlebrook and Gordon Peake

“Right-Financing Security Sector Reform” *January 2008*

The editors would like to acknowledge the support of AusAID for publication of this report.

PREFACE

PUBLIC FINANCE IN POST-CONFLICT ENVIRONMENTS: A POLICY PAPER SERIES

In the wake of violent conflict, a key element of building a durable peace is building a state with the ability to collect and manage public resources. To implement peace accords and to provide public services, the government must be able to collect revenue, allocate resources, and manage expenditure in a manner that is regarded by its citizens as effective and equitable.

The tasks of revenue mobilization, budget allocation, and expenditure management are bound together by political imperatives as well as economic logic. To collect revenues, the state must be seen as legitimate in the eyes of its citizens. And to secure legitimacy, the state must allocate resources and manage expenditure effectively and equitably.

The need to build legitimate and capable states in war-torn societies is now widely recognized. *The Principles for Good International Engagement in Fragile States*, adopted by the development ministers of major donor countries in March 2005, declares that statebuilding is ‘the central objective.’ This represents a striking break from the prevailing wisdom in the closing decades of the 20th century, when the state was widely regarded as the problem. The state has been rediscovered: it is now invoked as the solution. The policy rhetoric has changed from downsizing states to building state capacity.

Yet little systematic work has been done on what the international community can and should do to strengthen the capacities of post-war states to mobilize, allocate, and spend public resources.

This policy paper series, jointly published by the Center on International Cooperation (CIC) at New York University and the Political Economy Research Institute (PERI) at the University of Massachusetts, Amherst, seeks to redress this gap by presenting innovative policy proposals targeting critical issues in postwar public finance.

Building state capacities in public finance is crucial to the success of peacebuilding efforts for three reasons:

- » First, governments must be able to ensure *sustainable funding* for new democratic institutions, for social programs that ease tensions and redress grievances, and for public investments to promote economic growth and development. In the early post-war years, countries often receive a

large influx of external assistance that temporarily can meet some of these needs. But aid typically diminishes over time, so domestic resources are necessary to sustain these institutions and programs. A key challenge is to ensure that aid does not ‘crowd out’ domestic fiscal capacities, but instead stimulates their growth.

- » Second, fiscal capacities are needed to build a *legitimate state*. Democratic elections do not, in and of themselves, ensure state legitimacy. Neither do ‘quick impact projects’ in which international aid agencies seek to fill urgent needs. Legitimacy comes in large part from government delivery of services that people need and want. Elections provide an avenue for the citizenry to voice demands; responding to those demands requires the capacity to mobilize, allocate, and spend public resources effectively.
- » Third, in some cases there is a need to curtail extra-legal taxation by ‘warlords’ and armed groups so as to *enhance security*. In Afghanistan, for example, control of border customs outposts is not only a fiscal issue but also a security issue. Similarly, control over revenues from natural-resource extraction, such as logging in Cambodia or diamonds in West Africa, is often crucial for establishing the state’s monopoly not only in legitimate taxation but also in legitimate force. At the same time, domestic fiscal capacity is the only sustainable source of financing for public security after external peacekeepers have withdrawn.

The papers in this series offer policy proposals designed to strengthen the fiscal dimension of statebuilding. The authors draw on extensive personal experience in public finance matters in war-torn societies, and on lessons from comparative studies, including *Peace and the Public Purse: Economic Policies for Postwar Statebuilding* (Boulder: Lynne Rienner, 2007), the outcome of the first stage of the CIC’s statebuilding project. After a concise recapitulation of the problems to be addressed, the authors concentrate on proposing solutions that can be practically implemented.

We hope these policy papers will find a wide audience amongst those who are grappling with the difficult challenges of post-war reconstruction, and that the proposals they put forward will assist in the twin tasks of building legitimate and effective states and building a durable peace.

JAMES K. BOYCE
Lead economist, Peacebuilding as Statebuilding Program

RESOURCES FOR PEACE? MANAGING REVENUES FROM EXTRACTIVE INDUSTRIES IN POST- CONFLICT ENVIRONMENTS

EXECUTIVE SUMMARY

Revenues from extractive sectors play an important role in many post-conflict environments. Oil and gas, minerals, and logging often provide more than 30% of state fiscal receipts. When managed well, these revenues can help to finance postwar reconstruction and other vital peace-related needs. When mismanaged, however, resource revenues can undermine both economic performance and the quality of governance, thereby heightening the risk of renewed violence. Managing revenues from extractive industries is a crucial challenge for peacebuilding. This paper offers seven proposals that address this challenge.

1. MANDATE PEACEBUILDING MISSIONS WITH RESPONSIBILITIES TO REGULATE RESOURCE EXTRACTION.

In the *transition phase*, peacekeeping forces should curtail access to resource revenues for potential “peace spoilers.” During the *peacebuilding phase*, mission staff should seek to address broader linkages between resource extraction and conflict; where needed, this assistance should include deployment of peacekeeping forces in resource production areas and transportation hubs to help control exploitation and address resource-related conflicts. In cases of *UN trusteeship*, activities of peacebuilding missions include the direct management of extractive sectors, but transitional authorities, whether local or international, should not grant long-term contracts in extractive sectors.

2. RECOVER STOLEN RESOURCE REVENUES, REAPPRAISE CONTRACTS, AND NEGOTIATE NEW CONTRACTS.

Major losses of public revenue often result from wartime looting and from the contractual provisions entered into by previous governments. *Ex post facto* policies are needed to recover stolen funds, not only to augment fiscal revenues but also to signal the end of impunity and discourage others from such behavior. In the wake of violent conflict, a systematic review of extractive sector activities and contracts should be undertaken, with the concept of “odious contracts” being applied to cancel past contracts when this is warranted. Tax reappraisal for activities conducted during the war should be considered, and penalties levied on companies that knowingly traded in conflict resources. Donors should encourage such reappraisal by providing technical assistance, by supporting civil society organizations that play a monitoring role, and by offering budgetary support to make up for potential revenue losses during review periods.

3. MAXIMIZE DOMESTIC BENEFITS FROM RESOURCE EXTRACTION.

Rather than rushing to involve foreign companies in resource extraction, domestic entrepreneurship should be developed to the fullest extent feasible. Some resources can yield greater domestic benefit if extracted through labor-intensive methods. Domestic ownership can be public, private, or a mix of the two. Effective regulatory mechanisms in many ways are more central than the issue of ownership. Measures needed to guard against crony capitalism, asset stripping, and capital flight include transparency in contracts and revenues, and the establishment of firewalls between regulators and the regulated.

4. DISBURSE RESOURCE REVENUES DIRECTLY TO THE POPULATION.

Revenue-sharing agreements between governments in a divided state, or between ruling parties in a coalition government, have a poor record in terms of risk of renewed conflict. As an alternative, direct revenue allocation to the population should be considered, particularly where poverty rates are high and resource revenues are substantial enough to make a real difference for the poor. Given the need

for state revenues, one option is a hybrid scheme whereby part of the revenue is distributed to the population directly, and the other part is retained by the government for public investment and social expenditure. Another option is to transfer all resource revenue to the population and then tax the receipts according to the income levels of the recipients. This would build tax administrative capacity and at the same time help to close the taxation-representation gap that afflicts many resource-dependent regimes, encouraging citizens to demand that the state justify its taxation and be accountable to its people.

5. ESTABLISH RESOURCE-SPECIFIC REVENUE INSTRUMENTS.

Three major types of fiscal instruments can be created by domestic revenue management laws. First, revenue volatility-smoothing instruments should be promoted, with the support of donors and extractive companies, to reduce sharp variations in the level of revenues resulting from up-and-downs in resource revenues deriving from project cycles and resource prices. Second, savings funds can be established to offset depletion of non-renewable resources, but in light of immediate postwar needs these usually should be limited to a small amount of revenue whose management can help build institutional capacity for longer-term financial planning. Third, revenue management laws can establish allocation mechanisms, such as annual fund withdrawal ceilings and prescribed ratios of revenue allocation across areas and sectors.

6. SET UP A RESOURCE COMPACT VIA AN EXTRACTIVE SECTOR FORUM AND ESTABLISH AN INDEPENDENT MONITORING BODY.

The aim of a “resource compact” is to foster constructive engagement among stakeholders and improved regulatory capacities in terms of legislation, implementation, and monitoring. Such a compact can be forged by an extractive sector forum that brings together citizens, politicians, and companies in public debates. The forum should inform the general population about the

resource sectors; identify the nature, objectives, and operational principles guiding the extractive sector; and provide a public platform for extractive sector stakeholders, thereby helping to fill the post-conflict regulatory deficit. An independent extractive sector monitoring body should be established by the compact, to complement state monitoring agency.

7. NEGOTIATE AN INTERNATIONAL EXTRACTIVE SECTOR AGREEMENT AND ESTABLISH AN INTERNATIONAL REVENUE MANAGEMENT AGENCY.

Finally, an international extractive sector agreement could reduce the economic and political risks faced by populations in producing countries. The agreement, drawing on relevant existing international law and codes of conduct, should define “conflict resources,” set clear norms and reporting procedures regarding revenues generated in conflict-affected countries, and identify punitive measures for companies found to be in violation of the agreement. The agreement should set contractual benchmarks and facilitate access to instruments that reduce revenue volatility and better distribute risk between companies and governments. An international revenue management agency would help to ensure that the “revenue pipeline” from companies to governments and populations is tight, so that revenues reach the population.

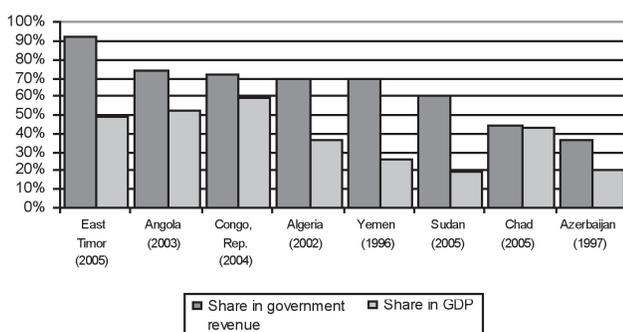
Post-conflict environments present exceptional challenges and opportunities for improving. The proposals advanced in this paper are not equally applicable to all post-conflict cases. The specifics of the setting – including the sectors involved, the capacities of institutions, and the broader political and economic dynamics of the post-conflict recovery – will shape decisions on priorities from the menu of policy options. These options can do much to harness extractive resources to the requirements of peacebuilding. Their pursuit will require champions and appropriate incentives.

RESOURCES FOR PEACE? MANAGING REVENUES FROM EXTRACTIVE INDUSTRIES IN POST- CONFLICT ENVIRONMENTS

Philippe Le Billon¹

Revenues from extractive sectors play an important role in many post-conflict environments, where petroleum, minerals, or timber frequently provide more than 30 percent of state fiscal receipts (see Figure 1).² When managed well, resource revenues can help to finance reconstruction and other peace-related needs. When mismanaged, however, resource revenues can undermine economic performance and the quality of governance, thereby raising the risk of renewed conflict and failing the hopes of populations.³ Resource revenues need to be kept out of the reach of peace spoilers and directed towards statebuilding and economic recovery. And in divided states, such as Sudan, disputes over resource revenue control have to be resolved. Managing revenues from extractive industries is thus crucial if peace is to be sustained.

FIGURE 1 – SHARE OF EXTRACTIVE SECTORS IN GOVERNMENT REVENUE AND GDP⁴



1 Philippe Le Billon is Associate Professor at the Liu Institute for Global Issues and the Department of Geography of the University of British Columbia. He is the author of *Fuelling War: Natural Resources and Armed Conflict* (IISS & Routledge, 2005).

2 One third of post-conflict countries since 1989 had fiscal dependence on extractive sectors above 30 percent (excluding foreign grants and loans) in the years following conflict termination. (Information culled from IMF country reports and Peace Research Institute in Oslo conflict dataset).

3 For discussion, see Michael Ross, "What do we know about natural resources and civil wars?" *Journal of Peace Research* 41(3), 2004:337-356; and Philippe Le Billon, *Fuelling War: Natural Resources and Armed Conflicts*, Adelphi Paper 373, (London: Routledge and IISS, 2005).

4 Data from IMF country reports and the Peace Research Institute in Oslo (PRIO).

This paper examines extractive sector challenges in post-conflict contexts and offers several proposals for resource revenues to consolidate a transition to peace. The first set of proposals relate to extraction management, including peacebuilding mission mandates, the recovery of looted wealth, post-conflict contract reappraisal, and the promotion of domestic entrepreneurship and employment. The second set refers to uses of resource revenues, including direct disbursement to the population and the creation of special funds. The final set concerns resource governance, including setting up a "resource sectors compact" that brings together government, companies and civil society, and international agreements on extractive industries.

CHALLENGES IN "POST-CONFLICT" EXTRACTIVE SECTOR MANAGEMENT

The post-conflict context is often unfavorable for effective extractive sector revenue management for several reasons. First, governments often suffer from a lack of knowledge about the resources available for exploitation and recent developments in the sector – due, for example, to lapses in surveys, undocumented wartime resource exploitation, death or flight of qualified personnel, and outdated training. As a result, governments fail to maximize revenue collection, especially when negotiating with better informed companies.⁵ Meanwhile, the population may have unreasonable expectations of revenues flowing out of the extractive sectors, and unsurprisingly attribute low official revenues to high government corruption. A major challenge is thus to rapidly acquire and spread knowledge about potential resource revenues, and to inform both policy decisions and public opinions. As a general principle, resource surveys, revenue flow analyses, tax structures, and information dissemination should be supported by international organizations assisting in the post-conflict and reconstruction process.

Second, breaking the vicious cycle between high risks and low fiscal returns represents a major

5 For example, recent progress in remote sensing (e.g. satellite imagery) or better advice on tax avoidance mechanisms can grant an advantage to companies.

challenge. The risk of renewed conflict, degraded infrastructures, and uncertainties in the regulatory environment may disadvantage the government in its negotiations with investors.⁶ Governments often offer major tax incentives to attract large-scale investments. Post-conflict conditions also often attract the most risk-taking companies that may be more inclined to use bribery, deploy private armed protection, and take shortcuts in terms of corporate social responsibility. Financial institutions and donor governments eager to fast-track foreign direct investment (FDI) may turn a blind eye to the backgrounds and records of these companies.⁷ As a general principle, transitional authorities should not be granted the right to award long-term contracts for extractive projects. International assistance should provide for budgetary and security support both to lower risks and to help maximize fiscal returns.

Transitional authorities should not award long-term contracts for extractive projects, especially if these include tax incentives.

Third, due to limited large-scale investment, resources are often first exploited through small-scale ventures that offer livelihood opportunities for local populations but often prove difficult for the government to tax. This is often the case, for example, with logging and the mining of alluvial minerals. A major challenge in such

6 Hostilities and 'high risk' may be considered an advantage for some companies. For example, the stock market responded negatively to the end of hostilities in Angola, probably considering that diamonds companies would face higher competition and stronger government bargaining power, see Massimo Guidolin and Eliana La Ferrara, "Diamonds are forever, wars are not. Is conflict bad for private firms?," *American Economic Review*, 2008.

7 Risk insurance to resource projects may erode accountability and fiscally hurt citizens in both exporting and importing countries. Many financial institutions and credit agencies have sought to prevent such outcomes through principles of conduct and selection criteria. See, for example, the World Bank Group's Extractive Industries Review, and the voluntary Equator Principles for the banking sector (<http://www.equator-principles.com/>) that build on the International Financial Corporation guidelines but remain voluntary and do not address major incentives such as bank staff bonuses linked with approved project financing. For discussion, see Andreas Missbach, "The Equator Principles: Drawing the line for socially responsible banks? An interim review from an NGO perspective," *Development* 47(3), 2004:78-84. For a critique of the role of export credit agencies, see Friends of the Earth and Pacific Environment, *Extractive Sector Projects Financed by Export Credit Agencies: The Need for Foreign Investment Contract and Revenue Reform*, 2005.

cases is to balance local livelihood opportunities and fiscal revenue maximization. As a general principle, a comprehensive assessment of options for each sector and exploitation area should clarify objectives, outline possible scenarios, and help maximize broad developmental benefits. Assessments and policies need to be based on the participation of local entrepreneurs and workers (including among the poorest), as well as free, prior, and informed consent by local communities.

Finally, budgetary allocation in post-conflict environments often presents special difficulties. Incentives for corruption are often heightened by the ephemeral character of political and bureaucratic appointments in transitional governments. Political factors frequently intervene, notably through arrangements for revenue sharing between former belligerent parties. Corruption may be tolerated by both politicians and donors for the sake of "political stability." Donor support for social services can weaken pressure on the government to allocate revenues to these high priority areas. Some donors may tie their nominally "unconditional" assistance to privileged access to resource sectors, such as the granting of resource projects to home companies or preferential treatment in resource supply access.⁸ A major challenge is thus to ensure that the path of revenue allocation consolidates both economic recovery and good governance. As a general principle, revenue allocation mechanisms should foster a sense of entitlement over revenues amongst the population, building incentives and mechanisms to protect revenues from abuses by governments and extractive industries.⁹

PART 1: MANAGING EXTRACTION

The post-conflict transition is often characterized by a rush to extract natural resources: local populations need jobs, governments need revenue, and companies want to access the most attractive resource-extraction prospects. Undue haste is especially characteristic when elites are driven by

8 See, for example, Luke A. Patey, "State rules: oil companies and armed conflict in Sudan," *Third World Quarterly* 28(5), 2007:997-1016.

9 For discussion, see Macartan Humphreys, Jeffrey D. Sachs and Joseph E. Stiglitz, *Escaping the Resource Curse*, (New York: Columbia University Press, 2007).

short-term personal interests and when donors actively promote FDI. Four main extraction-management challenges arise in such contexts: regulating the post-conflict rush on resources; recovering looted assets and dealing with the legacy of “odious contracts” signed previously by belligerents or transitional governments; striking a balance between fiscal and other socioeconomic objectives; and averting the foreign take-over of resource sectors.

Regulating the “post-conflict rush”

Extractive businesses are among the most resilient to armed conflicts. Often they are the last to depart from conflict areas and the first to return after the end of hostilities.¹⁰ Rapid recovery in the extractive sector is thus often possible. Although restarting an industrial mine may take years, many local entrepreneurs and international “juniors” (mid-size companies) handling small and medium-scale projects can rapidly increase outputs, as attested by diamond rushes in Angola in the mid-1990s and Sierra Leone in the early-2000s. These activities can help jump-start the economy, but their effect on postwar statebuilding can be ambivalent. Tax evasion, collusion with peace spoilers controlling resource production areas, conflicts with local communities, environmental degradation and labor abuses are frequent and difficult to regulate. Not only are these businesses subject to overlapping and sometimes transient authorities, but they also frequently deploy their own private security forces.¹¹ Policies and legislation are often in a stage of reappraisal, while the ranks, capacity, and authority of resource management institutions are frequently depleted. The challenge is thus to fast-track regulatory policies and institutions alongside – and preferably ahead of – the post-conflict

10 In 1992, internal armed conflict was only ranked 20th among the investment criteria considered by international mining companies for exploration and mining; see James M. Otto, “Position of the Peruvian Taxation System as Compared to Mining Taxation Systems in Other Nations,” 2002, available at http://www.mef.gob.pe/INFECO/documentos/perufinalreport_280504Otto.pdf; Jane Nelson, *The Business of Peace. The Private Sector as Partner in Conflict Prevention and Resolution*, (London: International Alert, Council on Economic Priorities, and the Prince of Wales Business Leaders Forum, 2000).

11 See Damian Lilly and Philippe Le Billon, *Regulating Business in Zones of Conflict: A Synthesis of Strategies*, (London: Overseas Development Institute, 2002); Madeleine Drohan, *Making a Killing: How and Why Corporations Use Armed Force to Do Business*, (Toronto: Random House Canada, 2003).

rush. Regulations, however, need to be sensitive to livelihood opportunities for local populations. Priority should thus be placed on regulating large scale extractive projects with long-term consequences, while artisanal and small-scale activities should be supported through legalization and capacity building (see Proposal 3).

PROPOSAL 1: MANDATE PEACEBUILDING MISSIONS WITH RESPONSIBILITIES TO REGULATE RESOURCE EXTRACTION.

Multidimensional peacebuilding missions, including their peacekeeping forces, can be mandated and deployed in resource production areas and key transportation hubs to better control resource exploitation and address resource-related conflicts. Such a mandate can be backed by a commodity sanction regime that is conditional upon adherence both to peace process benchmarks and legal practices in the resource sector. A logging sector, for example, can be closed for exports until sound regulatory institutions are in place, and until the security and political situation can ensure that these are effective on the ground.

Peacebuilding missions have often been hesitant about such roles, viewing these as high-risk burdens and distractions from their main mandate. In Sierra Leone, the UN mission (UNAMSIL) actively engaged in diamond-sector regulation only in the last stages of its operation. Initially, it was wary of infringing its mandate, antagonizing local interest groups, exposing its troops to criminal violence, and reinforcing rumors of diamond deals by peacekeeping forces.¹² Some of these concerns were legitimate. Yet reports from military observers about the importance of diamond-related conflicts, including on-going armed skirmishes, and assistance requests from the government and from donors funding diamond reforms led to its eventual engagement. From 2003 onwards, UNAMSIL conducted aerial surveys and foot patrols, and targeted conflict-settlement interventions in the diamond sector, often jointly with the Ministry of Mines, but also occasionally in a supervisory capacity.

12 Interviews with UNAMSIL officers, April 2001.

UN peacebuilding missions have accumulated much experience as transitional authorities and in implementing sanction regimes: experience that could be collected and analyzed to improve future missions. In the *transition phase*, peacekeeping forces should focus on curtailing access to resource revenues for potential “peace spoilers.” This can be done by identifying players in the extractive industries, demilitarizing resource production areas, and closing down activities benefiting spoilers by targeting key trading intermediaries and transportation bottlenecks such as bridges and ports. Peacekeeping forces can also intervene to prevent the escalation of resource-related conflicts, as in the clashes between local youths and demobilized rebel soldiers during the 2001 “diamond rush” in Koidu, Sierra Leone’s diamond capital.

During the *peacebuilding phase*, mission staff should seek to address broader linkages between resource revenues and conflicts, by assisting local authorities and international agencies in charge of the resource sectors. Monitoring activities, logistical support, and the “good offices” of the UN Secretary General’s Special Representative can all contribute in this regard. In the Democratic Republic of Congo, for example, the UN mission (MONUC) shares information collected on illegal logging with several UN agencies, NGOs, and government authorities.

In the case of *UN trusteeship*, activities include the management of extractive sectors. Transitional authorities, whether local or international, should not be granted the right to award long-term contracts in extractive sectors.¹³ But revenues from resource sectors should be put under international trusteeship, or at least supervision.¹⁴ Even as trusteeship is relaxed as domestic post-conflict institutions consolidate themselves, it is

13 This principle is recognized in article 55 of the 1907 Hague Regulation (occupying state as “administrators and usufructuary”), and was upheld by a 1976 US Department of Justice Memorandum, in the case of oil exploitation by Israel in the Sinai (reprinted 16 ILM 753, 1977). This principle can be applied to domestic transitional governments through local legislation, peace agreement, or UN Security Council resolution.

14 See for example, Philippe Le Billon, “Getting it done,” in Ian Bannon and Paul Collier, eds., *Natural Resources and Armed Conflicts: Actions and Options*, (Washington, DC: World Bank, 2005), pp. 215-286.

desirable to maintain external supervision and a capacity to intervene in revenue management, possibly for as long as a decade. Given sensitivities over sovereignty, such efforts risk raising questions about the motives of intervening parties unless strict independence and an absence of vested interests can be demonstrated. With regard to the opening of oil fields, the Australian intervention in East Timor and the American intervention in Iraq offer cautionary examples.

Recovering looted assets and tackling odious contracts

Major losses of public revenue can result from wartime looting and contractual provisions inherited from previous governments. International aid can mask these losses, but they become more apparent when donor fatigue sets in and countries are most in need of sustained revenues.

PROPOSAL 2: RECOVER STOLEN RESOURCE REVENUES, REAPPRAISE CONTRACTS, AND NEGOTIATE NEW CONTRACTS.

Ex post facto policies are needed for the recovery of “looted” resource wealth and the reappraisal and renegotiation of contracts. Wealth recovery seeks to identify and repatriate the proceeds generated by illegal resource exploitation, as defined by domestic legislation or international sanction regimes. This can include the assets of rebel groups and members of unconstitutional governments, and the proceeds of companies that participated in illegal commercial activities. The objective is not only to recover money to add to fiscal revenues, but also to signal the end of impunity and discourage extractive companies and banking institutions from participating in war-time resource looting.¹⁵

For contractual reappraisal, a first step is full disclosure of contracts, corporate structure and ownership. Confidential commercial clauses are not to be considered legally valid, given that the review is legally mandated for all contracts in the country. Tax evasion and abusive practices including

15 For a presentation of challenges and options, see the joint Office on Drugs and Crime (UNODC) and World Bank ‘Stolen Assets Recovery’ (StAR) initiative, <http://siteresources.worldbank.org/NEWS/Resources/Star-rep-full.pdf>.

tax holidays, transfer pricing, biased commodity-pricing mechanisms, and liability sheltering need to be revoked. This requires a systematic review of extractive sector activities and contracts, including those involving state companies, with a concept of “odious contracts” being applied to cancel existing contracts if necessary.¹⁶ Tax reappraisal for company activities conducted during the war should be considered, and penalties imposed on companies that knowingly traded in conflict resources (see below).

Abusive practices need to be revoked. This requires a systematic review of extractive sector activities and contracts, with a concept of ‘odious contracts’ being applied to cancel existing contracts if necessary.

Donors should support such reappraisal through technical assistance and support for civil society organizations demanding and monitoring changes. To gain the support of domestic authorities, donors should consider providing budgetary support to make up for potential losses in revenue during review periods. In order for this process to be meaningful, reviews must be open, with their findings and contractual revisions made public. If necessary, disciplinary measures against reluctant companies and governments should be considered, including through the targeted reactivation of United Nations Security Council sanctions.

Tracking down assets requires extensive expertise, judicial support, and collaboration from financial institutions.¹⁷ The focus in such cases should be on major investors, traders, and exporters. Measures including judicial due process and the disbandment of political militias should be in place

16 The concept of ‘odious contract’ is also applied to ‘odious debt’ contracted by past governments against the interests of the people, without their consent, and with the full awareness of the creditor. For discussion, see Ashfaq Khalfan, Jeff King, and Bryan Thomas, *Advancing the Odious Debt Doctrine*, (Montreal: Centre for International Sustainable Development Law, 2003); and Patricia Alvarez-Plata and Tilman Brück, “Postwar Debts: Time for a New Approach,” in James K. Boyce and Madalene O’Donnell, eds., *Peace and the Public Purse: Economic Policies for Postwar Statebuilding*, (Boulder: Lynne Rienner, 2007).

17 See Jonathan M. Winer and Trifin J. Roule, “Follow the money: The finance of illicit resource extraction,” in Ian Bannon and Paul Collier, eds., *Natural Resources and Armed Conflicts: Actions and Options*, (Washington, DC: World Bank, 2003), pp. 161-214. Among the rare cases of legal prosecution, in 2006 a Dutch timber merchant, Gus van Kouwenhoven, was sentenced to eight years of imprisonment for breaking the UN arms embargo on Liberia.

to prevent politicians exposed for malpractices from “spoiling” the peace. Such policies may deter future investments if contractual criteria are not clear. Adoption of an international extractive sector agreement (see below) would provide guidelines for such contractual reappraisal.

Despite these constraints, there have been some successes in contractual amendments. In the Democratic Republic of Congo, a National Assembly commission led by Christophe Lutundula identified dozens of illegal or dubious contracts signed between 1996 and 2003. Its December 2005 report recommended the renegotiation or cancellation of 16 contracts, judicial investigation of 28 Congolese or international companies, and prosecution for fraud of 17 persons. The Congolese Parliament has repeatedly delayed official consideration of this report, with some senior politicians implicated in these deals hoping to bury it.¹⁸ Yet following repeated calls by civil society and opposition politicians for contractual reviews, another government commission concluded in late 2007 that out of 61 mining contracts reviewed – many of them signed during the “transition” period – 38 contracts had to be renegotiated and 23 cancelled because of irregularities.¹⁹

In Liberia, forestry concessions were cancelled, and president Ellen Sirleaf-Johnson was able to renegotiate an iron ore mining contract between Mittal Steel and the previous transition government that, among other abusive clauses, had allowed the company to determine the price of iron ore and thereby its own taxation rate. Public exposure of inequities in the contract by Global Witness, an international NGO with a strong track-record that mobilized external technical expertise, as well as Sirleaf-Johnson’s own background in banking and her international profile as Africa’s first elected female president, contributed to substantially improving the new contractual terms (see Table 1).²⁰

18 *The Curse of Gold* (Washington DC: Human Rights Watch, 2005); Lutundula Commission Report, December 2005 available at <http://www.freewebs.com/congo-kinshasa>.

19 J. Clayton, “Mining groups face Congo shake-up after review,” *The Times*, November 8, 2007.

20 Global Witness, *Heavy Mittal? A State within a State. The inequitable Mineral Development Agreement between the Government of Liberia and Mittal Steel Holdings NV*, 2006.

TABLE 1 - FISCAL ASPECTS OF MITTAL CONTRACT RENEGOTIATION IN LIBERIA²¹

Initial Contract	Renegotiated Contract
Mittal sets iron ore price, and thus effective royalty rate and tax rate	Iron price set by international market price
Five year tax holiday, with unlimited extension	No tax holiday
Obligations guaranteed only by concessionaire (Mittal's subsidiary)	Obligations guaranteed by parent company
Transfer to Mittal of main national railway line and deep-sea port	No transfer, no exclusive right
Extended and backdated equitable treatment clause	Equitable treatment clause limited to iron ore sector and no backdating
Concessionaire rights to all minerals in the concession area	Rights to iron ore only
Contract governed by United Kingdom law	Contract governed by Liberia law
Minimal social obligations	National senior managers and health care obligations

Revisiting liberalization policies

Extractive sectors have been liberalized since the late 1980s, particularly in post-conflict countries. Liberalization policies often increased foreign investment and economic output, using reduced taxation rates as a core incentive. The overall fiscal impact has varied among countries, but observers have pointed to long-term risks associated with lower fiscal returns on non-renewable resources.²² Fiscal regimes have privileged income tax and production sharing agreements (PSAs) that grant the government a share of the resource earnings, rather than royalties or publicly owned companies.²³ One problem is that the terms of the

21 Global Witness, *Update on the Renegotiation of the Mineral Development Agreement between Mittal Steel and the Government of Liberia*. August 2007.

22 James M. Otto, "Global changes in mining laws, agreements and tax systems," *Resources Policy* 24(2), 1998: 79-86; Gavin Bridge, "Mapping the bonanza: geographies of mining investment in an era of neoliberal reform," *The Professional Geographer* 56(3), 2004: 406-421.

23 In Azerbaijan, for example, oil and gas fields with weak future prospects continued to be operated by the state oil company (SOCAR), whereas "new fields are developed and managed under the leadership of international partners" and their income is shared between government and companies according to a pre-determined production sharing agreements, see IMF, "Azerbaijan Republic -

resulting agreements reflect the limited bargaining power of post-conflict states. A second problem is that politicians often take decisions with long-term impacts based on short-term considerations. They may be more eager, for example, to invite a foreign company that is able to jump-start a project and offer a large signature bonus than to develop a domestic industry, ignoring the downsides of locking the resource sector into foreign control and exacerbating its "enclave" character.

PROPOSAL 3: MAXIMIZE DOMESTIC BENEFITS FROM RESOURCE EXTRACTION, INCLUDING NOT ONLY REVENUE BUT ALSO LOCAL EMPLOYMENT, DOMESTIC ENTREPRENEURSHIP, AND NET NATIONAL PRODUCT.

Attracting foreign companies to the extractive resource sector is frequently the major priority of the government and aid donors alike. Yet domestic benefits may be better secured outside of fast-tracked FDI projects. Some resources, such as timber and surface deposits of high grade ore, can be exploited through labor-intensive methods requiring minimal technological and capital inputs. These modes of exploitation (artisanal or small-scale) may have lower tax potential, but they often have higher net national value added than capital intensive projects (see Table 2). Domestic ownership provides more flexibility over rates of taxation for sectors under domestic ownership than those imposed by the "global norm" of foreign investment.

Domestic ownership can be public or private, or a mix of both. Private ownership can help to hold the state accountable, but the state must also hold the private sector accountable. Effective regulatory mechanisms are, in important ways, more central than the issue of public versus private ownership.²⁴ In practice, governments have frequently sought to bail out private companies - for example, through

Selected Issues and Statistical Appendix." *IMF Country Report No. 03/130, 2004*. Such a model was also promoted under a controversial draft oil law for Iraq. For a critique, see Greg Muttitt, *Crude Designs - The Rip-off of Iraq's Oil Wealth*. (London: Platform, 2005)

24 Erika Weinthal and Pauline Jones Luong, "Combating the resource curse: an alternative solution to managing mineral wealth," *Perspectives on Politics* 4(1), 2006: 35-53.

tax exemption - when faced with the prospect of large-scale unemployment or when key political supporters are at risk. Measures are needed, in any case, to prevent crony capitalism, asset stripping, and capital flight. Among these are transparency in contracts and revenues, and firewalls between regulators and regulated.

Table 2 compares FDI-industrial and domestic-artisanal (or small-scale) resource extraction. Industrial exploitation generally provides higher resource recovery rate than artisanal methods. Yet higher imported inputs, expatriate wages, depreciation, and profit repatriation reduce the net national product (NNP) of industrial production below that of domestic artisanal extraction. The potential advantage of industrial exploitation is higher tax revenue, but only assuming sound tax policies. Attention should also be given to indirect economic effects of both modes of production. Domestic small-scale operations can generate crucial financial capital for rural economies and more local economic development.

TABLE 2 – FOREIGN-INDUSTRIAL VERSUS DOMESTIC-ARTISANAL RESOURCE EXTRACTION²⁵

	FDI-industrial	Domestic-artisanal
Value of resource deposit	100	100
Resource recovery (gross output)	95	70
Material inputs		
• Imported	20	3
• Locally produced	7	1
Gross Domestic Product	68	66
Wages and payments		
• Expatriates	7	0
<i>of which repatriated</i>	3.5	-
• Nationals	14	50
Tax payments	20	4
Depreciation	9	1
Repatriated profits	18	11
Gross National Product	46.5	55
Net National Product	37.5	54

²⁵ This table builds on the case of mining in Sierra Leone; see Tony Killick, "The benefits of Foreign Direct Investment and its alternatives: An empirical exploration," *Journal of Development Studies* 9(3), 1973: 301-316. Some domestic-artisanal profits are repatriated by exporters with transnational ties (e.g. diasporas or domestic elites with family members abroad). See also D. F. Stewart, "Large-scale or small scale mining: Meeting the needs of developing countries," *Natural Resource Forum* 13(1), 1989: 44-52. Repatriated profits in domestic artisanal correspond to "capital flight", notably from diaspora and dual-nationality exporters (such as Sierra Leonean Lebanese).

PART 2: CHANNELING REVENUES

The uses of revenues from extractive sectors is a major political and economic issue. Politically, revenues can undermine a transition to democracy and exacerbate identity politics. Economically, revenues can retard economic diversification and jeopardize sustainable economic recovery. Both sorts of risk are particularly acute in low-income divided states facing high levels of "horizontal" inequalities between social groups with distinct identities.²⁶ Two key challenges in post-conflict revenue management are therefore (1) how to address resource-related identity politics, and (2) how to ensure that revenues contribute to a sustainable and diversified economy.

Resources and identity politics

A distinction can be made between resources and resource revenues. The territory where resources are located may be indivisible, whereas resource revenues can be easily divided. The difference was built into the peace agreement in South Sudan, a compromise in which the ownership of oil reserves was left outside the scope of the agreement, until a referendum takes place, while focusing instead on oil revenue sharing and petroleum sector management. The problem is to create a revenue sharing arrangement that is as secure as a territorial division would be.²⁷

With respect to resources, populations in producing regions have claims related not only to ownership but also to the socio-environmental impacts associated with resource extraction. There is now a substantial body of experience in addressing these impacts.²⁸ But experiences in post-conflict countries remain relatively few and far between. In Sierra Leone's diamond sector, a scheme was established to allocate some of the diamond export

²⁶ See Frances Stewart, Graham Brown and Alex Cobham, *Promoting Group Justice: Fiscal Policies in Post-Conflict Countries*, (New York: Center on International Cooperation, and Amherst, MA: Political Economy Research Institute, Policy Paper on Public Finance in Post-Conflict Environments, 2002).

²⁷ See Jostein F. Tellnes, "The unexpected deal: Why the Government of Sudan and the SPLM/A reached an agreement on oil issues through the IGAD peace talks 2002-04," Unpublished paper, (Centre for the Study of Civil War, Oslo: PRIO, 2005)

²⁸ Béatrice Labonne, "The mining industry and the community: Joining forces for sustainable social development," *Natural Resource Forum* 23(4), 1999: 315-322.

tax revenue to local communities. This promoted the formalization of artisanal mining ventures, helping to raise taxes while returning some of the revenue to local communities. The scheme suffered from several shortcomings, however: it was not implemented for large industrial ventures, despite the fact that these often had the largest socio-environmental “footprint;” and many customary chiefs who received much of the revenues were not accountable to communities.²⁹

Revenue sharing agreements between governments in a divided state, or between ruling parties in a coalition government, have a poor record.

Experiences over the past two decades suggest that revenue sharing agreements between governments in a divided state, or between ruling parties in a coalition government, have a poor record in terms of risk of renewed conflict.³⁰ Wealth sharing may facilitate the positive conclusion of a peace negotiation, but this does not guarantee a positive outcome over the medium term. Indeed, such agreements can have several negative consequences:

- First, revenue sharing negotiated under false pretences can enable belligerents to rearm. In Sudan, for example, oil fields were developed under the terms of the 1997 Khartoum Peace Agreement, which granted several Southern armed factions a share of oil revenues in exchange for a cessation of hostilities. This agreement eventually collapsed and conflict in the region reignited, this time with a much wealthier Sudanese government.
- Second, resource revenue allocation may be perceived as rewarding the belligerent party, providing incentives for other groups to follow suit in a “copycat” effect. The Sudan Liberation

Army in Darfur, for example, is perceived as motivated in part by the example of the oil-revenue sharing deal negotiated with the government by the Sudan People’s Liberation Army in southern Sudan.³¹

- Third, sectarian divisions of resource revenues risk aggravating tensions among communities. In Nigeria, state-based revenue allocation relying on identity politics undermined secular modern governance through the reshaping of incompatible community identities.³² In Iraq, securing oil revenue allocation based on population rather than on a territorial basis is a preoccupation for Sunni Arab political parties based in areas with little proven oil reserves, and the regional autonomy promoted by oil-rich Shiite and Kurdish political parties promotes mistrust.³³

Some central governments have sought to address antagonistic identity politics through fiscal decentralization, with mixed results.³⁴ The process through which decentralization is achieved seems to matter as much as its economic outcomes. The best results, as in South Africa and Mozambique, have been characterized by broad popular participation (including by minority groups), bargaining between government and sub-national groups, state outreach in remote areas, trust-building among groups participating in local governance institutions, and revenue redistribution across regions. Building on these experiences, direct disbursement of revenues to the population

31 John Young, “Sudan: A flawed peace process leading to a flawed peace,” *Review of African Political Economy* 32(103), 2005: 99-113.

32 Michael J. Watts, “Antinomies of community: Some thoughts on geography, resources and empire,” *Transactions of the Institute of British Geographers*, 29, 2004: 195-216. Yash Ghai, “Decentralization and the Accommodation of Ethnic Diversity,” in C. Young (ed), *Ethnic Diversity and Public Policy: A Comparative Inquiry*, (Basingstoke: Palgrave, 1998).

33 The clause of the 2005 Iraqi constitution guaranteeing a distribution of “oil and gas revenues in a fair manner in proportion to the population distribution in all parts of the country” only applies to currently developed fields. Revenues from undeveloped fields were left under the control of regional authorities.

34 Arild Schou and Marit Haug, “Decentralisation in Conflict and Post-Conflict Situations,” Working Paper 2005:139, (Blindern: Norwegian Institute for Urban and Regional Research, 2005); Joseph Siegle and Patrick O’Mahony, “Assessing the merits of decentralization as a conflict mitigation strategy,” Development Alternatives Inc., 2007 available at http://www.dai.com/pdf/Decentralization_as_a_Conflict_Mitigation_Strategy.pdf.

29 Global Witness, “Peacebuilding Omission?,” October 2007. Available at http://www.globalwitness.org/data/files/pages/global_witness_pbc_submission_101007.pdf.

30 Philippe Le Billon and Eric Nicholls, “Ending ‘Resource Wars’: Revenue Sharing, Economic Sanction, or Military Intervention?,” *International Peacekeeping* 14(5), 2007: 616-635; ongoing research at PRIO by Helga Malmin Binningsbø and Siri Aas Rustad.

can be proposed as a way to reframe the institutional and economic relationships among resources, governments, and the people.

PROPOSAL 4: DISBURSE RESOURCE REVENUES DIRECTLY TO THE POPULATION

As an alternative to channeling resource revenues through regional and local governments and the parties that control them, direct disbursement to the population offers several advantages.³⁵ Direct revenue allocation provides tangible evidence of a ‘peace dividend’ for the population. Recent studies show that direct cash payments contribute positively to poverty alleviation and disaster recovery, including in conflict-affected environments.³⁶ Direct disbursement to the population also sends a signal that resources are owned by the people, not by the government or the parties that control it. This can increase pressure on companies and governments to maximize public revenues. If the choice is made to distribute the revenue equally across the entire population, this can contribute to a sense of national identity and common destiny. Last but not least, direct disbursement is less subject than the government budget to political manipulation and associated grievances.

Direct disbursement to the population sends a signal that resources are owned by the people, not by the government or the parties that control it.

Are direct revenue transfers unrealistic given low state capacity, lack of information on citizens, and rudimentary financial and fiscal systems in many post-conflict countries? Direct payments of oil revenues have been suggested in the case of Iraq, only to be quickly dismissed due to

35 The Alaska Permanent Fund Dividend established in 1976 is among the oldest scheme specifically aimed at direct disbursement (see <http://www.apfc.org/>; Scott Goldsmith, “The Alaska Permanent Fund Dividend: An Experiment in Wealth Distribution,” Paper presented at the Ninth Congress of Basic Income European Network, Geneva, Switzerland, September 12-14, 2002 available at <http://www.iser.uaa.alaska.edu/Publications/BIEN-Permanent%20Fund%20Dividend%20Paper.doc>. See also Xavier Sala-i-Martin and Arvind Subramanian, “Addressing the Natural Resource Curse: An Illustration from Nigeria,” *NBER Working Paper 9804* (Cambridge, MA, 2003).

36 Paul Harvey, “Cash-based Responses in Emergencies,” *HPG Report 24* (London: Overseas Development Institute, February 2007).

continued insecurity and weak bureaucracy.³⁷ But the situation in Iraq is not post-conflict. Logistical challenges remain in many real post-conflict cases, but they can be overcome. Moreover, tackling them can provide benefits beyond putting money in the hands of individual citizens. For example, the tasks of peacebuilding missions often include voter registration. This “political entitlement” process could be matched with an economic entitlement process, whereby a system of citizen identification is set up. The basis for income tax collection can also be strengthened, by providing an incentive to enter into a formal financial relation with the state. Direct disbursement can also help to build – or rebuild – the financial sector.

Apart from implementation difficulties, direct revenue transfers may pose other problems. The transaction costs may make this option uneconomic when per capita revenues are low. If revenues are spent on non-productive imported goods, this can be detrimental to the trade balance and undermine local production. Political manipulation can still occur, notably in the timing of revenue disbursement.³⁸ And direct disbursement does not itself resolve the particularistic claims of populations in production regions.

In the absence of adequate alternative sources of revenue, direct disbursement may also reduce the state’s ability to public goods and services. If direct disbursement of revenues were used to justify and legitimate privatization reforms of public services, this could have a regressive impact on the poorest. Given the need for state revenue, one option is a hybrid scheme, whereby part of the revenue is distributed to the population directly and the other part goes to the government for public investment and social expenditure.

An alternative way to address the need for state revenue is to not only transfer revenues to the population, but also to tax them according to the

37 Thomas Palley, “Oil and the case of Iraq,” *Challenge* 47(3), 2004: 94-112.

38 For example, direct disbursement was made in the 1950s by the government of Alberta, Canada, just prior to an election. See Robert Bacon and Silvana Tordo, “Experiences with Oil Funds: Institutional and Financial Aspects,” (Washington DC: Energy Sector Management Assistance Program, World Bank, 2006).

income levels of the recipients.³⁹ This would have a progressive income effect, leaving more revenue in the hands of the poorest. At the same time, it would inform citizens about both the revenues generated by the extractive sector and the funding requirements of the state. This system could help close the taxation-representation gap that afflicts many resource-dependent regimes, leading citizens to demand that the state justify its taxation and be accountable to the people.

Donor support for such a scheme could help to advance the economic objective of poverty reduction and the political objective of state-building. Donors could step in to compensate for state revenue losses and thereby provide an incentive for the government to support this scheme. This budget support could be phased-in to respond to the absorptive capacity of the government, and phased-out to incentivize the state to develop its fiscal autonomy and foster economic diversification.

Contributing to a sustainable and diversified economy

Economic recovery is a priority and a moral obligation in post-conflict contexts, given years of violent dispossession, neglect and curtailed opportunities. Moreover, peace can be consolidated by tangible peace dividends, reduced unemployment, and channeling efforts into “business” rather than divisive politics. It would be naïve, however, to think that economic recovery is not political, or that it is inevitably conducive to building a durable peace. Rather, attention needs to be paid to the ways and means through which recovery is achieved.

The channeling of resource revenues ideally should foster a diversified and sustainable economy that insures against future growth collapse and

39 See Martin Sandbu, “Natural Wealth Accounts: A proposal for alleviating the natural resource curse,” *World Development* 34(7), 2006: 1153–1170. Income levels may be difficult to determine and enforce. A possible option is to have individuals self-identify as poor, middle, or rich, with their tax rate varying accordingly. Self-identification could be posted on a public notice board at the post office (or wherever dividend payments are disbursed), letting social pressure/status concerns act as an enforcement mechanism for truthful self-identification (James Boyce, pers. com, October 2007).

thereby reduces the risk of a renewed outbreak of hostilities. But extractive sectors present several challenges to sustainability and diversification:

- First, extractive sectors often rely on non-renewable resources. Investments in prospecting and more efficient technologies can augment the status of reserves, but these are ultimately finite. Dividend savings funds, as in the case of Norway’s, may be part of the solution to resource depletion. But in post-conflict countries, reconstruction and social needs militate against setting aside a substantial fraction of resource revenues (see below).
- Second, extractive resources tend to create a “resource trap” or “staple trap,” locking countries into dependence and exposing them to future revenue instability.⁴⁰ Revenue windfalls resulting from booming prices or one-time bonuses may generate unsustainable expenditures and policy “myopia,” delay reforms, and create unrealistic expectations within the population. Revenue collapses, on the other hand, may induce governments to borrow beyond their means.
- Third, resource revenues face a high risk of capture by ruling elites unless robust institutions are in place to prevent this. There is good evidence that extractive-sector revenues are especially vulnerable to embezzlement, and that resource wealth is correlated with higher levels of perceived corruption in low-income countries.⁴¹ There is also some evidence

40 See Richard M. Auty, *Resource Abundance and Economic Development*, (Oxford: Oxford University Press, 2001). In principle, reinvesting revenues into other sectors could assist diversification, but in practice, many countries fail to efficiently manage this process due to misdirected resource revenue allocation (e.g. through so-called ‘white elephants’ projects, protection of uncompetitive ‘infant-industry’, or corruption), constraints on labor skills, and trade barriers. There are also incentives not to diversify the economy in order to curtail the risk of political competition coming from independent sectors. Diversification is also harder now that much of the manufacturing sector has already been “captured” by the first and second generations of Newly Industrialized Countries, most recently by China. For discussion of the latter constraint, see Raphael Kaplinsky, Dorothea McCormick and Mike Morris, *The Impact of China on Sub-Saharan Africa*. China Office, DFID, 2006; Ian Coxhead, “A New Resource Curse? Impacts of China’s Boom on Comparative Advantage and Resource Dependence in Southeast Asia,” *World Development* 35(7), 2007: 1099–1119; and Mauricio Mesquita Moreira, “Fear of China: Is There a Future for Manufacturing in Latin America?” *World Development* 35(3), 2007: 355–376.

41 Carlos Leite and Jens Weidmann, “Does Mother Nature Corrupt - Natural Resources, Corruption, and Economic Growth,” IMF Working Papers 99/85, 1999.

that levels of corruption increase in post-conflict situations, possibly due to increased opportunities coupled with competitive politics and economic liberalization.⁴²

PROPOSAL 5: IMPLEMENT RESOURCE-SPECIFIC REVENUE INSTRUMENTS, INCLUDING REVENUE VOLATILITY-SMOOTHING, SAVINGS FUND, TARGETED ALLOCATION, AND MEASURES FOR TRANSPARENCY AND ACCOUNTABILITY.

Recent international efforts to address these challenges have been devoted mostly to transparency issues. Examples include the Extractive Industries Transparency Initiative (EITI), the Publish What You Pay campaign, and the IMF's Guide on Resource Revenue Transparency (GRRT).⁴³ International support for revenue stabilization mechanisms, in contrast, has faltered in the past two decades.⁴⁴ Meanwhile, with the exception of OPEC, most commodity producer organizations have given up their price stabilization activities.

Domestic "revenue management laws" generally define the principles and objectives of resource revenue management. Transparency, accountability, representation and equity are major issues these laws must address in order to avoid revenue capture by narrow interest groups and to reduce risks of (renewed) armed conflict. They can also create three major types of fiscal instruments. First, revenue volatility-smoothing instruments seek to reduce sharp variations in the level of revenues resulting from ups-and-downs in resource production or resource prices. This can be achieved through stabilization funds setting aside revenues when these exceed forecasts or the government's absorption capacity, and by releasing reserve funds when revenues decrease. Savings funds serve a similar function, but with a longer

42 Philippe Le Billon "Corruption and the 'liberal peace': Peacebuilding and post-conflict patterns of corruption," *International Peacekeeping*, 15(2), forthcoming 2008.

43 For information, see <http://www.publishwhatyoupay.org/english/>; and <http://www.eitransparency.org/>.

44 Multilateral schemes to lessen commodity price shocks, such as the IMF's Compensatory and Contingency Financing Facility and the EU's Flex mechanisms, are limited in scope and hard to access.

term horizon, seeking not to buffer variations but to build a future source income, in particular when the resource will be exhausted. Ironically, these have generally been introduced where they are least needed; that is, where sound fiscal policies are already observed and resource revenues represent only a small part of fiscal inflows.⁴⁵ Stabilization funds should be encouraged in post-conflict contexts given the major volatilities in resources revenues, provided that these are well integrated into budgetary management and secured from embezzlement. Savings funds, in contrast, are not a priority given post-conflict economic recovery and social needs. Establishing a savings fund can be part, however, of a program of institution building. But allocating significant amounts of money to it in the early phase of the transition may be more a source of tension than a contribution to state consolidation.

Finally, revenue management laws can establish allocation mechanisms, such as an annual fund withdrawal ceiling and ratios of revenue allocation to areas (such as provinces) and sectors (such as health and education). Introducing or consolidating such legislation and the administrative and oversight bodies needed to implement it should be a priority of post-conflict state-building. One option is to put the proposed legal framework to a referendum. Not only would this grant stronger legitimacy but it would also help mobilize and involve communities in debating the draft. The absence of flexibility in budgetary allocation, however, can be a source of tension, as demonstrated in the case of Chad's crisis over oil revenues allocation.⁴⁶

45 For discussion, see Richard M. Auty and Raymond F. Mikesell, *Sustainable Development in Mineral Economies*, (Oxford: Clarendon Press, 1998); Ugo Fasano, "Review of the experience with oil stabilization and savings funds in selected countries," *IMF Working Paper WP/00/112*, (Washington D.C.: International Monetary Fund, 2002); Humphreys et al., *Escaping the Resource Curse*, op cit.

46 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 and the government faced bankruptcy in the face of armed opposition. See Ian Gary and Nikki Reisch, *Chad's Oil: Miracle or Mirage? Following the Money in Africa's Newest Petro-State*, Catholic Relief Services and Bank Information Center, 2005.

PART 3: STRENGTHENING RESOURCE GOVERNANCE

Robust institutions can address some of the deleterious economic and political impacts of resource dependence and thereby help to consolidate peace. Many of these institutions directly relate to domestic statebuilding. The state, however, does not operate in a vacuum. The international institutional environment and the behavior of multinational extractive companies are central to post-conflict recovery. Two proposals for strengthening resource governance are presented below, both of which require the support of international as well as domestic actors: a national extractive-sector compact on resource governance; and an international agreement on extractive sectors, including an international revenue management agency.

PROPOSAL 6: SET UP A RESOURCE COMPACT VIA AN EXTRACTIVE SECTOR FORUM THAT INCLUDES ALL STAKEHOLDERS, AND ESTABLISH AN INDEPENDENT MONITORING BODY.

Incentives are a major driver of policy outcomes. Because resource sectors and post-conflict contexts are highly specific, finding the right balance of incentives is less a matter of applying a blueprint than of overcoming particularistic interests opposed to the public interest. The public itself needs to come forth, informed and supported by civil society organizations, reformist politicians and bureaucrats, aid donors, and progressive extractive companies. One striking feature of post-conflict resource reforms is the frequently confrontational engagement of civil society organizations with companies and authorities, and the criminalization of extractive activities of local populations.⁴⁷ In the best cases, this leads to changes in the right direction, but on many occasions the outcome is greater secrecy and repression. Another

common feature is an outdated, ineffective, or corrupt regulatory environment. The resource compact should thus allow for both constructive engagement among stakeholders and improved regulatory capacities in terms of legislation, implementation, and monitoring.

The state does not operate in a vacuum: the international institutional environment and the behavior of multinational extractive companies are central to post-conflict recovery.

The heart of the compact is an extractive sector forum that should bring together citizens, politicians, and companies into public debates that are reported by the media and considered by relevant institutions such as parliamentary commissions, relevant ministries, donor agencies, and extractive companies.⁴⁸ A main priority of the forum is to identify and spell out the nature, objectives, and operational principles guiding the extractive sector.⁴⁹ The forum should play an active role in informing the general population about the resource sectors, including the potential value of reserves, forecasted revenue streams, the possible modes of exploitation and their socio-environmental impacts, in order to foster accountability mechanisms. To this end, the forum should have a secretariat capable of acquiring, analyzing, and diffusing information. A second priority of the forum is to provide a public platform for extractive sector stakeholders, notably for marginalized ones. Such platform can facilitate representation and negotiations in shaping sectoral policy and legislative affairs, and contribute to filling the regulatory vacuum of post-conflict transition.

⁴⁷ Cumbersome regulatory measures and ‘crackdowns’ on so-called illegal logging or mining are common place in post-conflict countries, and can represent a barrier to local livelihoods recovery and bias favoring revenue concentration by large corporations. See Neil Cooper, “Picking out the Pieces of the Liberal Peaces: Representations of Conflict Economies and the Implications for Policy,” *Security Dialogue* 36(4), 2005: 463-478; Heiko Nitzschke and Kaysie Studdard, “The legacies of war economies: challenges and options for peacemaking and peacebuilding,” *International Peacekeeping* 12(2), 2005: 222-239.

⁴⁸ See, for example, Business Principles for Sudan during the Interim Period (www.ecosonline.org). In this case, the forum was a consortium of European civil society organizations that spelled out the principles, activities, normative framework, and benchmarks for oil companies to play a positive role in Sudan.

⁴⁹ For an example of the limits and possible biases of participatory politics and stakeholder consultation processes over oil revenue allocation, see M. Humphreys, W.M. Masters, and M.E. Sandbu, “The role of leaders in democratic deliberations. Results from a field experiment in São Tomé and Príncipe,” *World Politics*, 58(4), 2006: 583-622.

The resource compact should establish an independent extractive sector monitoring body. Arm's length relations are key to credible monitoring, and should be strengthened through financing by a donor trust fund and diversity in monitoring team membership. The monitoring body should enjoy freedom of access to information and field sites (including to company sites), and its findings in turn should be reported to the public. Support should also be provided for the complementary state monitoring agency so that the state's capacity to perform its regulatory role is consolidated.

PROPOSAL 7: NEGOTIATE AN INTERNATIONAL EXTRACTIVE SECTOR AGREEMENT AND ESTABLISH AN INTERNATIONAL REVENUE MANAGEMENT AGENCY.

Conflict situations have focused the attention of the international community on resource governance, opening political space for an international agreement on extractive industries.⁵⁰ An international task force including national governments, relevant international organizations, industry associations and civil society organizations is needed to negotiate such an agreement, drawing on relevant existing international law and codes of conduct.⁵¹ National ratification of the agreement could be backed by incentives, as well as by peer and consumer pressure. This agreement would have the potential to achieve the status of a widespread mandatory norm.

Among its key elements, the agreement should define "conflict resources" and set clear ethical norms and reporting procedures regarding revenues generated in conflict-affected countries in order to deter activities that risk prolonging or reigniting violent conflicts. One useful definition is proposed by Global Witness: conflict resources are

50 See, for example, the proposal for an international charter for extractive industries of Paul Collier, *The Bottom Billion. Why the Poorest Countries are Failing and What Can Be Done About It*, (Oxford: Oxford University Press, 2007). Collier's proposal would establish voluntary norms, in contrast to an international agreement that would acquire a mandatory status in international law.

51 The joint task force could draw upon the experience of the Kimberley process, the World Bank extractive industries review, the Canadian Government roundtable on extractive industries, and the Mining, Minerals and Sustainable Development project.

"natural resources whose systematic exploitation and trade in a context of conflict contribute to, benefit from, or result in the commission of serious violations of human rights, violations of international humanitarian law or violations amounting to crimes under international law".⁵² Resources suspected of meeting such criteria should be subject to independent investigations, such as those of UN expert panels, and the activities and assets of companies involved in these sectors made liable to international sanctions, fines, and criminal procedures.

Second, the agreement should set contractual benchmarks, notably in terms of standards for public bidding procedures, tax assessment (in order to avoid transfer pricing and other tax avoidance mechanisms), and transparency and accountability in revenue collection and allocation. The agreement also needs to address resource revenue risk, notably by facilitating access to revenue smoothing instruments and by better sharing risk between companies and governments.

The people of low-income producing countries should not bear more risks than large and highly profitable companies.

Third, an International Revenue Management Agency should be created as part of the agreement. The mandate of this agency would be to ensure that the "revenue pipeline" between companies, governments, and populations is tight, and that revenues – whether in the form of direct disbursement, public services, or both – reach the population. In effect, the agency would provide international insurance mechanisms, in a manner analogous to the role that export credit and receivables management agencies now play in reducing investment and revenue risks for extractive companies. There is considerable expertise available for companies to recover lost revenues following currency or political crises, yet

52 Global Witness, *The Sineus of War: Eliminating the Trade in Conflict Resources*, 2007, available at http://www.globalwitness.org/pages/en/definition_of_conflict_resources.html. See also, Le Billion, "Getting it done," op cit.

little of that expertise has been deployed on behalf of the interests of local populations in producing countries. The people of low-income producing countries should not bear more risks than large and highly profitable companies.

The agency could protect populations from revenue volatility linked to unforeseen events, currency devaluation, and resource price variations, using revenue stabilization instruments and direct budgetary assistance, to support and complement the role of existing institutions (e.g., producers associations and international financial institutions). The agency could also respond to tax evasion and corruption, addressing complaints by citizens and civil society with regard to fiscal management. It could conduct budgetary audits to assess the “spending” side of revenue management and track down irregularities, which could then be publicly reported and addressed through local or international institutions. In exceptional cases, government revenues could be directed towards a trust held by the agency. Financing for the agency could be secured through a consortium of donors, companies, and producing governments. Incentives for all parties would include greater stability and greater legitimacy for the resource sector activities.

CONCLUSIONS

Post-conflict environments present a promising but challenging context for managing extractive sector revenues. A central question is whether revenues should be shared among governments in a divided state and among parties in a coalition government. The record of wealth sharing agreements in the past two decades has been poor. Wealth sharing may enable the positive conclusion of a peace negotiation, but it does not guarantee conflict settlement over the medium term. Efforts to mainstream the management of extractive sectors into conflict resolution and peacebuilding initiatives should not only focus on drafting agreements sensitive to extractive sector issues, but also on providing the guarantees that extend from rights over natural resources to accountability mechanisms in revenue allocation.

Without such guarantees, wealth sharing is insufficient, and in the wrong political context it can even prove counterproductive. In addition, the rights of transitional governments to allocate long-term resource exploitation contracts should be curtailed, and the resource revenues generated under transitional governments should be under external supervision.

A second question is whether extractive sectors should be rapidly developed, even if at the expense of domestic entrepreneurship and/or fiscal revenues. Extractive industries can spur economic recovery and contribute to political stability, but a first requirement for these positive impacts is for relevant institutions to be sufficiently strong before exploitation occurs. Rather than rushing to involve foreign companies, domestic entrepreneurship should also be developed to the fullest. Comprehensive options assessments should be systematically conducted, and resource exploitation should be the subject of prior and free informed consent by local communities. To these ends, an international agreement on extractive sectors and the reappraisal of previous extractive resource contracts are proposed.

A final issue is that of revenue allocation mechanisms, including responses to the instability and exhaustibility of resource revenues. Revenue stabilization funds should be promoted with the support of donors and extractive companies. Savings funds, in contrast, are not a priority in poor countries, and if introduced they should be limited to a small amount of revenue whose management can help build institutional capacity for long-term financial planning. Direct payments or resource revenues to the population should also be given serious consideration, particularly where poverty rates are high and resource revenues are sufficient to make a difference for the poor. An international agreement, including an international revenue management agency, should seek to reduce the economic and political risks faced by populations in producing countries.

The objectives and behavior of international agencies play an important role in reforming extractive resource sectors. Intergovernmental organizations and donor agencies should provide assistance to maximize revenue collection and to ensure transparent, fair, and accountable allocation. Revenue and socio-economic forecasting should be provided and the results widely broadcasted so as to build realistic expectations in the government and among the population. Donors should not systematically promote FDI-related extractive policies and projects - at present a central goal of their export and credit agencies - over domestic entrepreneurship. Rather, donors should support host authorities in allocating resource reserves according to broader social and environmental criteria, including the protection and strengthening of local livelihoods. Given that greater resource revenues eventually reduce donor financial leverage, as the relative importance of aid diminishes, extractive companies should enter into agreement with donor agencies to ensure the durability of reforms. An incentive to do so could be provided by making such agreement a condition of access to the services of export credit agencies. An international extractive industries agreement would help to curtail competitive behavior among donors eager to promote their resource interests, and provide a legal environment guiding the behavior of extractive companies and governments.

The options and proposals advanced in this paper are not equally applicable to all cases of post-conflict extractive resource management. The specifics of the setting - the sectors involved, the capacity of institutions, and broader political and economic aspects of post-conflict recovery - will play a major part in deciding which to pursue. Just as importantly, the pursuit of these options will require champions and the appropriate set of incentives.



**CENTER ON
INTERNATIONAL
COOPERATION**

POLITICAL ECONOMY RESEARCH INSTITUTE
PERI

University of Massachusetts Amherst