TREASURE HUNT

How Good Financial Governance can support resource-endowed countries in achieving the SDGs

giz Deutsche Gesellschaft für Internationale Zusammenarbeit (GIZ) GmbH

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Foreword

About This Book

About This Book

The Deutsche Gesellschaft für Internationale Zusammenarbeit (GIZ) has been working on the topics Good Financial Governance and Resource Governance for several years. Revenues from the extractive sector can – if well managed according to Good Governance criteria – contribute significantly to the development of resource-endowed countries. However, in many partner countries of the German Development Cooperation (GDC), resource abundance has not translated into sustainable development in a meaningful way. This publication aims at further conceptualising the Good Financial Governance approach in its relevance for resource-endowed developing countries. During five productive days, the team focused on the technical, political and normative challenges resource-endowed developing countries face regarding Public Finance Management systems and the management of resource revenues. The discussions moved from technical fiscal issues to expectation management, climate change and equity considerations. The outcome is the following book, which covers how Good Financial Governance can contribute to better management of the Extractive Sector.

The book is called Treasure Hunt, a term referring to both the gold digger atmosphere that surrounds the exploration of natural resources and the often *Don-Quijotian* quest of public officials for revenues.

All this has been condensed into a book during five days, using the Book Sprints technique. A team of GIZ advisors working in the Democratic Republic of Congo, Sierra Leone, Ghana and Germany came together in Bad Honnef, where they were joined by two external experts from Australia and the USA. The Book Sprint is a facilitated collaborative writing technique in which participants constantly brainstorm, write, edit and copy-edit each other in a workflow that somehow manages to combine high fluidity with structure. This is a "fast and furious" process, so the reader may forgive some inaccuracies and gaps.

The book is a work of collective authorship published under the Creative Commons licence, but that does not mean that every one of us, or the affiliations we represent, subscribes to every statement made.

Don't blame us - the weather was bad and the beer was warm!

Bad Honnef, June 3rd, 2016

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List of Abbreviations

AAAA – Addis Ababa Action Agenda

ABFA – Annual Budget Funding Amount

ASM – Artisanal and Small-scale Mining

BEPS – Base Erosion and Profit Shifting

BMZ – Federal Ministry for Economic Cooperation and Development

CSR – Corporate Social Responsibility

EI – Extractive Industries

EITI – Extractive Industries Transparency Initiative

EIRT – Extractive Industries Revenue Task Force

FPIC – Free Prior and Informed Consent

GDC – German Development Corporation

GDP – Gross Domestic Product

GFG – Good Financial Governance

GIZ – Deutsche Gesellschaft für Internationale Zusammenarbeit (GIZ) GmbH

IMF – International Monetary Fund

INTOSAI – International Organisation of Supreme Audit Institutions

MSG – Multi-Stakeholder-Group

MoF – Ministry of Finance

MoM (MoMOG) – Ministry of Mines, (Oil and Gas)

NRA – National Revenue Authority

NRTS – Non-Tax Revenue System

ODA – Official Development Aid

OECD – Organisation for Economic Co-operation and Development

PIAC – Public Interest and Accountability Committee

PFM – Public Financial Management

PRMA – Petroleum Revenue Management Act

SAI – Supreme Audit Institution

SDG – Sustainable Development Goals

SOE – State-Owned Enterprise

VAT – Value Added Tax

WTO – World Trade Organisation

Rationale

Agenda 2030

Good Financial Governance in Resource-Endowed Countries

Agenda 2030

The Sustainable Development Goals (SDGs) provide the new global framework for development. The Financing for Development (FfD) Process states that domestic resources must be the most important funding source for achieving SDGs.

Building effective institutions, reducing illicit financial flows and corruption, improving domestic resource mobilisation, and tackling climate change are particularly relevant concerns for Good Financial Governance (GFG) in the extractive sector.

Certain SDGs may conflict with the objective of resource-endowed developing countries to maximise revenue generation from the sector.

Background

In September 2015, the world agreed on new targets for sustainable development. The 17 SDGs outline the Agenda 2030 with 169 targets. Unlike the Millennium Development Goals, the SDGs are universal and not only targeted at developing countries. Furthermore, the SDGs place greater importance on governance and climate change. The Financing for Development Process and the Addis Ababa Action Agenda (AAAA) provide the means for implementation of Agenda 2030. The AAAA states that domestic resources must be the most important funding source for development. Official Development Aid (ODA) can only serve as a temporary solution to cover the financial deficits of developing countries. According to the AAAA, Illicit Financial Flows represent an important area of intervention for the international community. The AAAA also addresses the special challenges of resource-rich countries. Paragraph 26 of the AAAA states:

> *"... We encourage investment in value addition and processing of natural resources and productive diversification and commit to addressing excessive tax incentives related to these investments, particularly in extractive industries. We reaffirm that every State has and shall freely exercise full permanent sovereignty over all its wealth, natural resources, and economic activity. We underline the importance of corporate transparency and accountability of all companies, notably in the extractive industries. We encourage countries to implement measures to ensure transparency and take note of voluntary initiatives such as the Extractive Industries Transparency Initiative. We will continue to share best practices and promote peer learning and capacity building for contract negotiations for fair and transparent concession, revenue, and royalty agreements, and for monitoring the implementation of contracts."*

Relevance of SDGs to Good Financial Governance in extractive industries

Even though it is not specifically mentioned in the Agenda 2030, the extractive industry sector bears great potential to help towards achieving the SDGs through several channels such as domestic revenue generation, employment, and infrastructure development. At the same time, the sector may negatively impact on the achievement of the SDGs

due to contributing to environmental pollution, climate change, human rights violations, inequality and corruption. As highlighted in the "Mapping Mining to Sustainable Development Goals: A Preliminary Atlas," the mining sector, and similarly the oil and gas sectors, can have direct or indirect impacts on all SDGs.

The most relevant SDGs for **Good Financial Governance** in the extractive sector are related to financial flows from the sector (which in turn can affect all SDGs). These include SDG13, SDG16, and SDG17.

Figure 1: SDGs relevant to Good Financial Governance in extractive industries

> ***SDG13:*** *Take urgent action to combat climate change and its impacts.*

While there are no targets that are directly relevant to GFG in the extractive sector, the subsequent Paris Agreement of December 2015 may significantly influence revenues coming from coal, oil and gas. Countries agreed to:

> *"Holding the increase in the global average temperature to well below 2°C above pre-industrial levels and to pursue efforts to limit the temperature increase to 1.5°C above pre-industrial levels, recognising that this would significantly reduce the risks and impacts of climate change."*

It has been estimated that in order to achieve this target, around a third of global oil reserves, half of global gas reserves and over 80% of current global coal reserves need to be stranded (remain undeveloped underground) in order to meet the 2°C target (McGlade and Ekins, 2015, *The geographical distribution of fossil fuels unused when limiting global warming to* 2°C, Nature). This does not include any additional reserves that might be discovered in the future.

> ***SDG16:*** *Promote peaceful and inclusive societies for sustainable development, provide access to justice for all, and build effective, accountable institutions at all levels.*

> *Target 16.4: By 2030, significantly reduce illicit financial and arms flows, strengthen the recovery and return of stolen assets, and combat all forms of organised crime.*

Target 16.5: Substantially reduce corruption and bribery in all their forms.

As highlighted in the subsequent chapters of this book, revenues from the extractive industry sector can encourage corruption and lead to the resource curse if not managed appropriately. Avoiding these is a primary objective of Good Financial Governance in the extractive sector.

***SDG17**: Strengthen the means of implementation and revitalise the Global Partnership for Sustainable development.*

Target 17.1 Strengthen domestic resource mobilisation, including through international support to developing countries, to improve domestic capacity for tax and other revenue collection.

Resource-dependent countries often rely heavily on extractive industries for their domestic revenue generation. The erosion of domestic revenues resulting from tax evasion and avoidance, such as abusive transfer pricing practices, needs to be addressed at the national level through improved auditing practices and at the international level through improved information exchange. Transfer pricing will be dealt with in more detail in subsequent chapters.

Areas for further thinking

Can gas be used as a "transitional" energy source to decarbonise the world economy (due to being less carbon intensive than coal and oil)? Or would the timeline for developing gas-related infrastructure be too long to meet the targets agreed to?

Impact on countries with fossil fuel reserves

Countries with important fossil fuel reserves rely on their resources for energy and revenue generation. The latter is of particular importance for Good Financial Governance in the extractive sector. 43 countries were considered fossil resource-dependent in 2014 (using the IMF's definition of 25% of export value being made up of fossil fuels). The necessity to manage fossil resources will have a particularly heavy impact on the budgets of these countries.

The most economic way to tackle this problem on a global level is to extract the resources with the lowest production costs and strand those assets with relatively high production costs. One way to achieve this would be through a global carbon tax which would render unconventional and Arctic gas and oil developments as uneconomic. Fuel from low-cost projects such as those in the Middle East would continue to be extracted. However, there are equity questions that need to be addressed: Should the level of development of the country be considered? Should the current reliance of a country on fossil fuels be considered? Should countries that historically have not contributed to climate change (primarily low-income countries) be treated the same as countries that have industrialised on the back of fossil fuel extraction and use? Should countries that are particularly vulnerable to climate change be compensated by those that benefit from fossil fuel extraction and use? If the answer to these questions is yes, then alternative financing and compensation schemes would have to be developed.

While a global agreement is required to tackle these complex questions, at the country level, governments need to start assessing the impacts such agreements may have on their economy. Especially for fossil fuel-dependent countries, it becomes even more important to diversify their economies away from coal, oil and gas, and broaden their tax base.

Areas for further thinking

Little work has been done to date to provide a framework for discussion of which fossil resources need to be "stranded" in order to achieve the objectives.

Another question related to this, but highlighting the revenue side of this aspect is: how to mitigate risks of sinking capacity for domestic resource mobilisation due to the stranding of fossil resources?

Area for further thinking

Little support is being provided to resource-endowed developing countries in understanding the impact the climate change agreement may have on their economies.

Positioning GIZ to help achieve the Agenda 2030

GIZ is already working in a lot of the areas that address the SDGs. The following chapters of this book will outline, according to the Good Financial Governance approach, how interventions can be improved to help address SDGs 16 and 17 directly, and potentially the remaining SDGs indirectly, through efficient revenue collection and budgetary spending in relevant sectors.

The German Development Corporation is also working with partner countries to achieve the climate action goal. GIZ provides multiple support programmes to partner countries through its climate change work stream. Furthermore, KfW provides financing to renewable energy projects and has stopped financing coal-fired power projects. However, there is currently little work being done on linking climate change and SDG 13 with Good Financial Governance in EI, which, as outlined above, will become increasingly important. This is not surprising and no other bilateral or multilateral development organisation is working in this area. This can partly be traced back to the recent nature of the Paris Agreement, which is the first time that countries agreed on a temperature rise cap, which provides a framework regarding how much fossil fuels can be safely extracted.

Areas of intervention

› Review development project objectives to align them with Agenda 2030.

› Coordinate between climate change and GFG in extractive industries workstreams to see whether there are areas of intervention which can address SDG 13.

Good Financial Governance in Resource-Endowed Countries

GFG is the key tool for resource-endowed countries in achieving the SDGs.

Certain characteristics of the extractive sector potentially have an adverse effect on the quality of Public Financial Management (PFM) systems and hence states with significant resource reserves will need specific GFG tools to safeguard the overall quality of PFM.

The German Development Cooperation promotes change processes to achieve GFG in resource-endowed states, considering a technical, a normative, as well as a political economy dimension.

Introduction

GFG and transparency of extractive revenues are relevant to the entire revenue management process (including collection, budgeting and expenditure) and are key to tapping the potential of natural resources to help to achieve central SDGs in resource-endowed states, as discussed in Chapter 3.1. The following chapter will discuss specific challenges regarding GFG that such countries face.

GFG as a key element of German Development Cooperation

The Federal Government of Germany is actively contributing to the shaping of international discussions in the area of public finance. Support of partner countries in public finance reforms plays a key role in the conceptual orientation of the German Development Cooperation (GDC). Therefore, the Federal Ministry for Economic Cooperation and Development (BMZ) has developed its **GFG approach**. GFG is an important contribution to compliance with international commitments to which Germany adheres. It especially comprises the use and strengthening of partner systems, for example, in the context of programme-based approaches.

Germany emphasises that an efficient and transparent public finance system is an indispensable pre-condition for **sustainable development and poverty reduction as described in the Agenda 2030**. As a central policy tool, public finance systems mobilise, channel and control public funds. A functioning public finance system fulfils important **governance functions**: it creates legitimacy for state action, stimulates citizens' identification with the state, and sets the general framework for private sector engagement and economic growth.

The GFG approach refers to PFM not solely as a technical issue but as one which adheres to the **values** of GDC, namely human rights, promotion of social responsibility and a sustainable free-market economy, as well as open democratic societies and individuals' initiative.

GFG is a **holistic, systemic and value-based** approach which is aligned to the understanding of Good Governance in GDC. By implementing GFG, Germany helps to reduce poverty and foster economic, social and ecological sustainable development. The approach is based on the consideration of aspects from **three dimensions** and their **inter-linkages**.

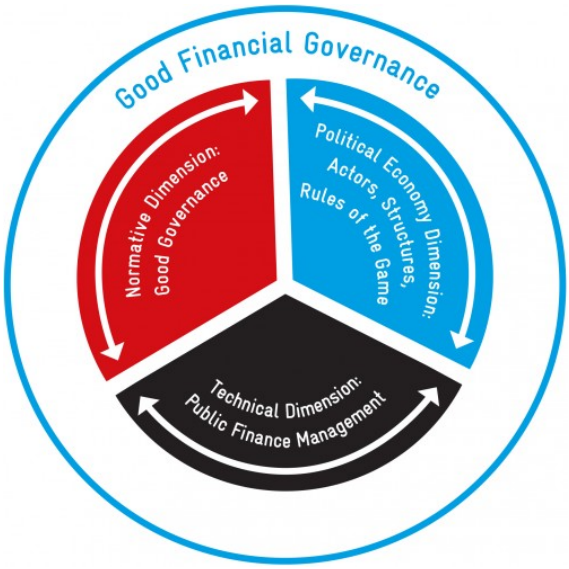

Figure 2: Three dimensions of Good Financial Governance

Resource Governance in German Development Cooperation

The GDC approach to resource governance is based on the potentials and risks the extractive sector entails for sustainable development. Today, a large proportion of the world's poor live in countries whose economies are dominated by extractive resources, as highlighted in the figure below. These resources could potentially drive a country's development, reduce its financial dependency on donors, and increase the population's prosperity. In many countries, however, the opposite effect may have resulted: state structures are weakened, the environment destroyed, and social conflicts created or exacerbated. Although the extractive sector makes a major contribution to gross domestic product and holds huge potential for increasing public revenues, sustainable development effects for the poor population often fail to materialise. This is due mainly to weak governance structures and corruption. Furthermore, resource-dependent states are at high risk to show an overall worse governance quality than countries without a significant extractive sector. The mechanism behind this link still being contested, yet the indication is quite clear (e.g. Oxford Policy Management 2011: *Blessing or curse? The rise of mineral dependence among low- and middle income countries*, see the PDF Document here).

Area for further thinking

More research is needed to better understand the link (correlation or coincidence) between resource dependency and bad governance.

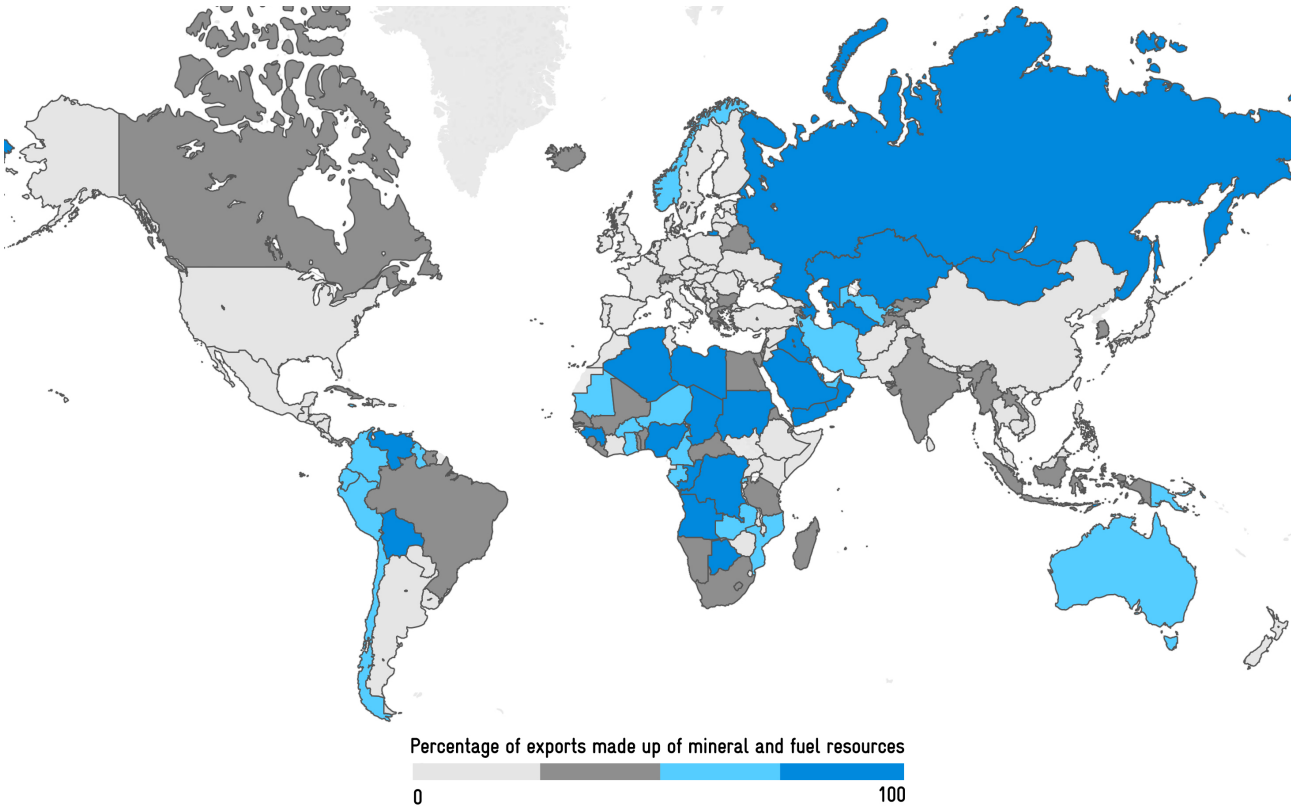

Figure 3: Map of resource dependence

The resource governance approach of GDC aims at supporting partner countries in finding the right balance between maximising the potential and managing the risks from the extractive sector. Normatively, this management needs to be as inclusive as possible and to follow a human rights-based approach. Based on this, GDC works in the following areas:

1. Strengthening the institutional framework in the resource sector
2. Development of sector strategies/policies, laws and regulations (including contract negotiation processes)
3. Public Financial Management of extractive sector revenues
4. Minimising corruption and illicit financial flows
5. Supporting regional cooperation, for example, on shared infrastructure
6. Decentralisation of mining sector administration
7. Promoting human rights in the extractive sector

Our work in these areas is based on a **comprehensive understanding of capacity development**. In this context, 'capacity' means the ability of people, organisations, and societies to manage their own sustainable development processes and adapt to changing circumstances. This includes recognising obstacles to development, designing strategies to tackle them, and then successfully implementing these strategies. This proactive management capacity encompasses the political will, interests, knowledge, values, and financial resources that the agents concerned need in order to achieve their own development goals. The understanding of GDC Capacity Development needs to happen consistently at four levels:

At the level of individuals:

- **Competence building**

Purpose: promote personal, social, technical, managerial, methodological and leadership competencies in order to develop comprehensive, proactive capacities in individuals and networking through joint learning processes. Good examples for resource governance are training on the EITI and on contract negotiations.

At the level of organisations:

- **Organisational development**

Purpose: promote organisational learning and raise the performance and flexibility of an organisation. A good example of resource governance is the establishment of an IT-based mining licence system to empower the mining administration to efficiently manage the life cycle of the mining licences.

At the level of society:

- **Cooperation / Development of cooperation partnerships**

Purpose: establish and develop cooperation between organisations to improve coordination and performance; establish and develop networks for knowledge sharing and co-creation. A good example for resource governance is the establishment of coordination mechanisms between the mining and financial administration in order to monitor revenue management in the mining sector.

- **Political framework / Development of enabling frameworks**

Purpose: develop enabling legal, political and socioeconomic frameworks so individuals, organisations, and societies can develop and raise their performance capability. A good example for resource governance is GIZ's cooperation with the African Minerals Development Centre to roll-out the Africa Mining Vision in African Union member countries.

GFG in resource-endowed countries

The IMF *Guide on Resource Revenue Transparency* (IMF 2007) categorises mineral and/or hydrocarbon-rich countries (pp. 54-56) by the following definition:

> *"A country is considered rich in hydrocarbons and/or mineral resources if it meets either of the following criteria: (i) an average share of hydrocarbon and/or mineral fiscal revenues in total fiscal revenue of at least 25 percent during the period 2000-2005 or (ii) an average share of hydrocarbon and/or mineral export proceeds in total export proceeds of at least 25 percent ..." (see* IMF 2007*, p. 2).*

One of the problems with this definition is that it can lead to false expectations and may send the wrong signal regarding the importance of the sector for poverty reduction. For example DR Congo, categorised as a resource-dependent state under the IMF definition, gives a different impression if one takes into account that the DR Congo annually earns roughly USD 405 million from the extractive sector and then sets this into relation to the population figure. Given 74 million Congolese, this means USD 0.015 – an insignificant one or two cents per capita per day or less than USD 5.50 per capita per year.

For the purpose of this paper, we will not thoroughly restrict the discussion to this definition. The preferred term, 'resource-endowed', refers merely to countries with natural resource reserves. Despite temporary declines in prices, projects being in the early stage of development, or the presence of other strong economic sectors which result in countries (temporarily) not being classified as resource-rich or resource-dependent according to the IMF's definition, various characteristics of the sector and corresponding expectations may still significantly influence the political economy in a given country. With the definition cited above in mind, and when appropriate, we also use the terms 'resource-rich' and 'resource-dependent'. However, we use 'resource-rich' if our emphasis lies on the potential associated with the extractive sector (e.g. economic growth, increased revenue), whereas 'resource-dependent' puts emphasis on the the risks (e.g. cyclical nature of the revenues or economic dependency).

Certain characteristics of the extractive sector potentially have an adverse effect on the quality of the PFM system and hence resource-dependent states will need specific GFG tools to safeguard the overall quality of PFM. Applied to the extractive sector, the three dimensions can be described as follows.

Technical Dimension

The **technical dimension** encompasses measures to strengthen PFM processes, tools and capacities. For resource-dependent countries, some specific technical instruments are necessary due to the characteristics of the extractive sector that have a negative impact on the overall quality of GFG. For example, the cyclical nature of the sector demands fiscal tools to stabilise public revenue and improve budgetary planning.

The **key question** we ask here is: what technical solutions are available to safeguard GFG in resource-dependent states?

Political Economy Dimension

The **political economy** dimension takes into account that reforming public finance is a politically highly-sensitive process as it interferes with established power structures and allocation of scarce resources in a society. In order to successfully apply the technical instruments described in Chapter 5, we will consider the different stakeholders, their interests and their interactions, in formal and often informal structures. Due to the fact that relatively few companies generate a concentrated amount of revenue, stakes are high and the political competition for access to these revenues is strong. This makes the political economy different to other sectors as interests in keeping the status quo are much stronger on the side of political elites who already have access. Hence, the particularly high relevance of the political economy of change processes of GFG in resource-endowed states.

The **key question** we ask here is: with regards to the implementation a specific technical solution and the intended change, which stakeholders are involved and what are their interests ?

Normative Dimension

The **normative dimension** puts a special emphasis on the resource governance situation in a country. Resource governance for us is the way governments manage the sector and the ways in which the benefits and costs yielded by the sector are (re-)distributed in society. From a normative perspective of "good resource governance," we look at the quality of these distribution processes, such as the level of inclusiveness with regards to all stakeholders, the rule of law, transparency and state efficiency in managing them. The GFG approach will focus on fiscal (re-) distribution processes, with relevance to the extractive sector.

The **key questions** we ask here are: does the technical instrument have (re-)distributional effects, and are the affected stakeholders involved in decision-making? are these distributional processes managed efficiently by government according to the rule of law and in a transparent way?

Area for further thinking

A coherent approach to analysing the political economy of specific change processes towards GFG in resource-endowed countries is currently missing. We recommend undertaking ex-post analysis of already implemented change processes in order to work towards a standardised approach.

Framework Conditions in Resource-Endowed Countries

Resilience to Sector Dynamics

Expectation Management

Inter-agency Cooperation

Resilience in Sector Dynamics

The volatility of prices linked to the cyclical nature of commodity markets and EI project cycles is a major challenge for PFM systems. This is especially pertinent for domestic revenue mobilisation and national budgets of resource-dependent developing countries where the ability to fund the SDGs can be severely limited.

Countries heavily dependent on revenues from the extractive sector should have a comprehensive strategy for proactive management of the impact of commodity and project cycles.

Stabilisation and diversification are avenues for resource-endowed states ensuring a sustainable development path.

Introduction

Management of extractive resources, especially when it comes to the management of revenues and other aspects of public finance management, is challenged by several features of extractive resources both at micro- and macro-economic levels:

- At the **micro-economic level**, revenues from extractive resources do not flow evenly but follow **project cycles**. Few revenues are received during exploration and the early stages of production. Only once the project becomes profitable, larger revenues flow.
- At the **macro-economic level**, **volatility of commodity prices** challenges PFM, whith revenue projections being inaccurate or economic activities slowing down. Volatility of commodity prices requires policy instruments that ensure short-term revenue fluctuations do not translate into erratic government spending. Furthermore, with large investments into a specific sector, a country's currency may appreciate, harming the competitiveness of other sectors and leading to deterioration of businesses that produce goods for export, a phenomenon called "**Dutch Disease**". The term was first coined when describing the adverse effect on manufacturing in the Netherlands attributed to the discovery of natural gas.

The micro and macro-economic levels influence each other. Companies might choose to delay production due to low prices, further increasing the negative impact on revenues. Alternatively, a company already producing might choose to increase production during a period of low prices, in order to balance that decline and push competitors out of the market. Countries heavily dependent on revenues from the EI sector should therefore have a comprehensive strategy for proactive management of the impacts of commodity and project cycles, and apply this not only in times of downturn or crisis.

Project life cycles

In PFM, governments and public administration have to take into account that related revenues flow according to the extraction project life cycle. An extraction project will primarily generate revenues for the government during the production phase, but would typically generate much less revenues during the exploration and development phases. Obviously, the legislative framework is decisive when it comes to revenue flows as it determines tax rates, tax exemptions and other specifics. The below figure outlines the taxes collected at the various stages during the life cycle of an EI project.

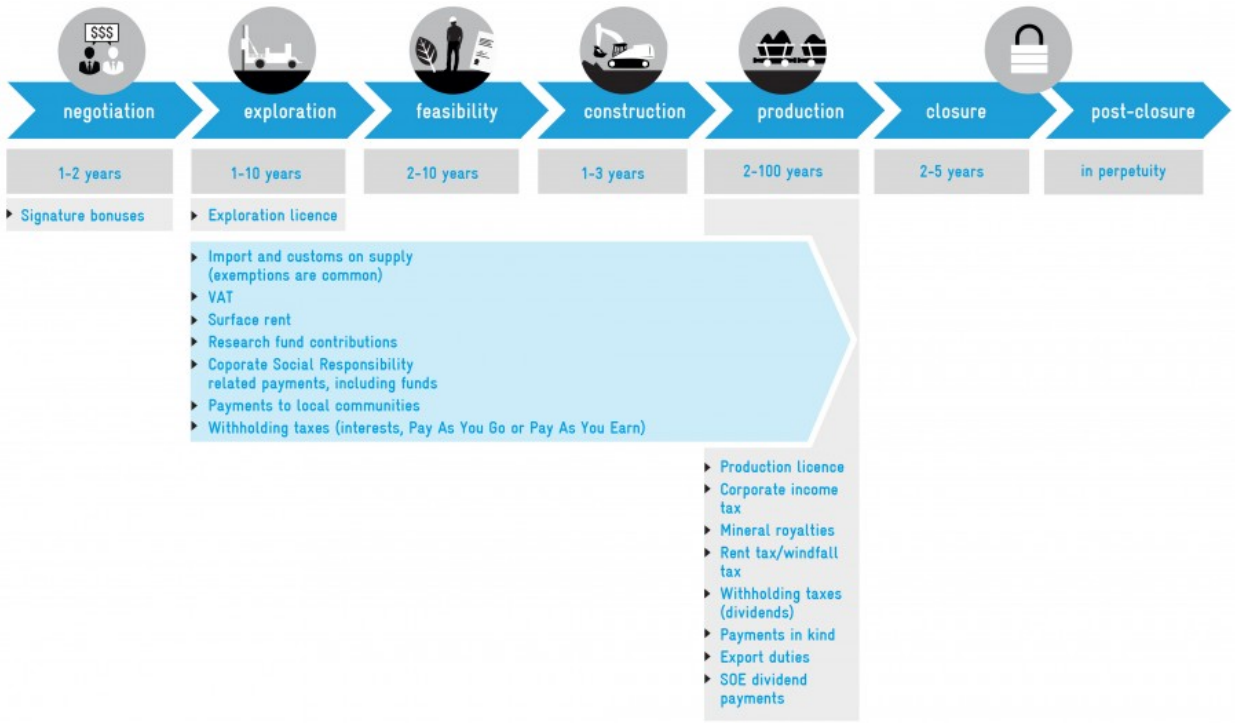

Figure 4: Project life cycle including payments

Countries which do not have an 'organically' grown extractive sector, but which have opened up the sector for investment and issued licences around the same time, may suffer from more extreme economic impacts when commodity prices rise or fall, given that most projects are at the same stage in the life cycle (this is the case in many African countries which attracted significant amounts of foreign direct investment in the sector after the Washington Consensus in the 1980s and 1990s).

If a country decided to exploit its extractive resources and extractive projects started around the same time, it would typically go through a phase of high investment (and, consequently, low tax payments) followed by a boom of initial rapid economic growth (reflected in growth in GDP) directly and indirectly related to the activities in the extractive sector. Employment and thus purchasing power may also increase. When companies enter into the production phase and capital investments are amortised, state revenue should increase. Stagnating economic growth, increasing unemployment and shrinking revenues will typically follow when the resources are exhausted and revenues have not been invested in productive sectors.

Commodity boom-bust cycles

A major factor influencing the impact of the extractive sector on economic development of a country are international boom-bust cycles related to a fluctuation of commodity prices (price volatility resulting from changes in supply and demand). Initial projections often do not hold true, and economic operators as well as the government must prepare and react to the international dynamic.

While economic operators may use the current slow-down in order to prepare for the next boom (e.g. modernise), the government will most likely be busy managing a 'cri-

sis'. The narratives may be different but tend to be used strategically when tax exemptions or tax reductions are negotiated.

The recent downturn of commodity prices heralded the end of almost a decade of an impressive commodity boom. A slow-down of the world economy, driven primarily due to structural changes in China combined with an oversupply of commodities, caused prices to crash. The volatility of prices linked to the cyclical nature of the commodity markets is a major challenge for PFM systems in resource-endowed countries. The fall in prices has led to a funding shortage for these countries to achieve the SDGs.

In some countries, there are allegations that the past commodity boom has not lived up to the expectations, with countries not being able to capture an adequate share of the rent and the EI sector not having contributed to economic development. In many countries, regulations were changed during peak prices in order to capture the rent, but these laws were only implemented towards the end of the boom. This counter-cyclical policy response can exacerbate the problem with higher taxes in low-price scenarios driving companies out of business.

Areas for further thinking

While fiscal regimes in the oil and gas sector tend to have more progressive mechanisms, these are less prevelant in mining legislations. Many mining-producing country governments were contemplating the introduction of resource rent taxes (or windfall taxes) in order to capture the rent from the mining sector during the boom years. However, such regulations were deeply opposed by the mining industry. Now, during the low-price commodity environment where such tax would not kick in, it might be easier to introduce such progressive taxation systems that would ensure that resource-rich countries do not miss out on the rents created during the next commodity boom.

Economic stabilisation and diversification

Given the exhaustability of commodities and the volatility of revenue flows, extractive revenues pose particular policy challenges when it comes to ensuring economic stabilisation and diversification in the short, medium and long term. The effective stabilisation of the local economy, currency and extractive revenue spending, as well as investments in diversification policies, help countries achieve the SDGs. Countries can use various mechanisms to address stabilisation and these are expanded upon in Chapter 5.4. on Revenue Allocation.

To diversify, countries can rely on domestic revenues (including those collected from the EI sector) to target development in other sectors in the economy. These sectors should be set out in a industrial or diversification strategy. Given that in resource-rich countries the extractive industry sector plays a major role, revenues should also be allocated to create linkages to the EI sector that could help in the diversification process. The figure below outlines the various linkages to the EI sector and shows to what extend they may contribute to economic diversification.

The impact fiscal linkages (revenues) have on economic diversification depends on the objectives and efficiency of government spending. Investments in infrastructure and human capital that foster private sector development in other areas of the economy will contribute to diversification. Spending the revenues on salaries of public servants is less likely to contribute to economic diversification. Within the production value chain, linkages to the upstream sectors (SMEs providing goods and services to the EI project) and downstream sectors (for example steel plants that process iron-ore) will have a moderate impact on diversification. These sectors are still closely linked to the EI sector. This is also the case for consumption linkages, whereby people employed in the EI value chain spend their earnings in the domestic economy. Spatial or infrastructure linkages, whereby the infrastructure built for the EI sector is shared with other users, can contribute to other economic activies being unlocked. Even if the commodity prices fall, the infrastructure is still available to other users. Similarly knowledge and horizontal linkages are highly relevant for economic diversification as skills and knowledge acquired in the EI sector are used to develop new industries.

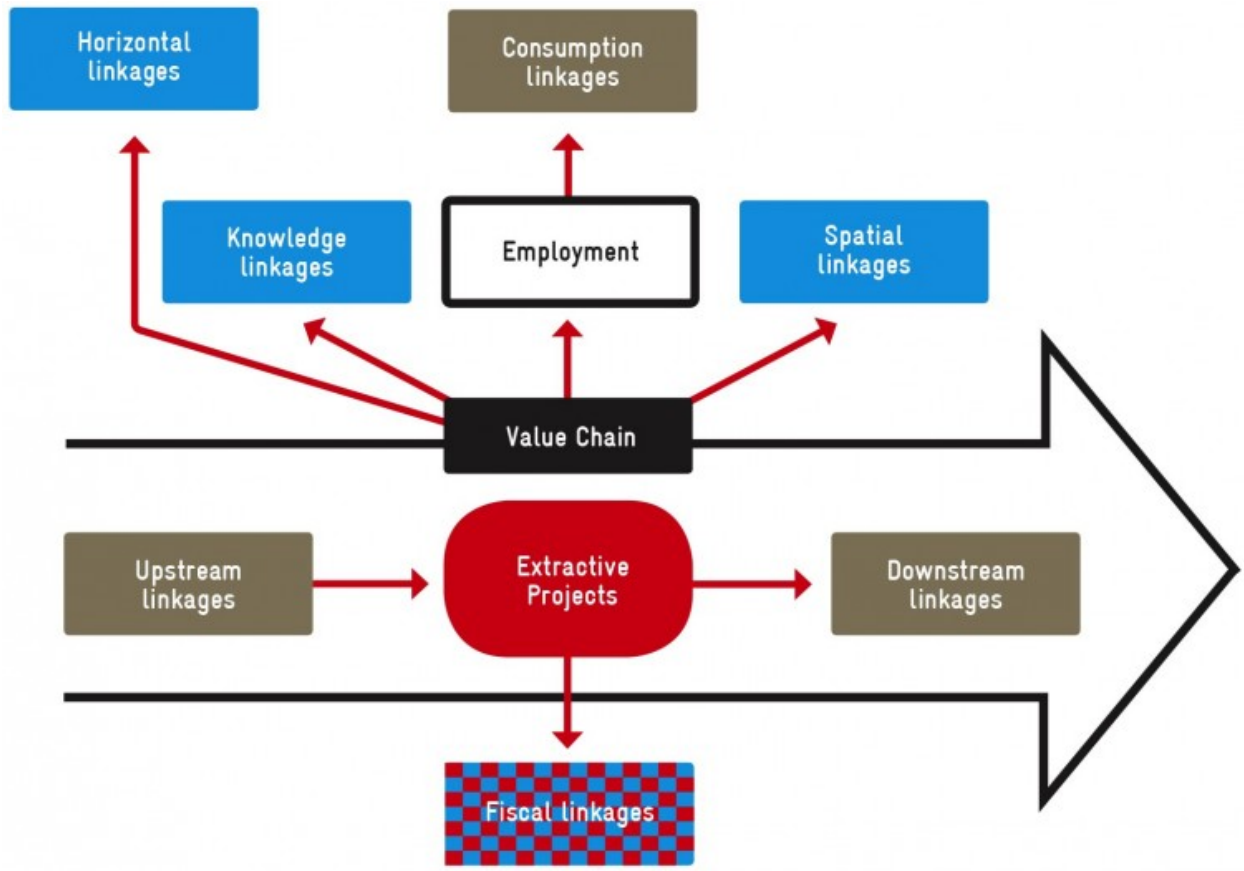

Figure 5: Linkages to the extractive industry sector & potential for diversification

Areas for further thinking

To support resource-endowed developing countries in their efforts to foster a stable and diversified economy, development organisations should broaden their advisory portfolio and be in a position to support governments and other development partners in their efforts to design and implement adequate strategies. These strategies include mitigation strategies to counter the destabilising effect of extractive revenues on the economy and to direct such revenues into policies aimed at economic diversification and transformation.

To summarise, in order for a country to diversify its economy, it needs to stabilise spending, given that without macroeconomic stability new industries will not develop. Once this is achieved, revenues earned from the EI sector can be used to target industries that will help diversify its economy. Given that the EI sector is already a major 'anchor' industry, it makes sense to target linkages to the sector through local content strategies. In particular, infrastructure, technology and horizontal linkages are highly relevant for diversification. GFG plays an important role in both ensuring that the stabilisation mechanisms have clear rules and are transparent, as well as the budget allocations to targeted sectors in the industrial/diversification strategy, to ensure that these revenue flows are not used for patronage purposes.

Areas of intervention

› Put emphasis on a resource rent tax (or a less complex proxy) based on profitability of projects (e.g. rate of return) in the overall tax take in order to benefit from boom cycles and automatically decrease fiscal pressure on companies during bust times.

› Develop transformative policies (e.g. state investment vs. government incentive; industrial development corporations, investment promotion agencies, and special economic zones) as well as complementary policy domains such as

trade, labour, infrastructure, and education. For Africa, the Africa Mining Vision represents a very good example of such a policy framework.

› Methods for earmarking extractive revenues for such policies and harmonising public and private investments at a local level also play a role.

› Particular benefits to disadvantaged groups of society through economic diversification should be taken into account. While the fostering of economic linkages of the resource sector plays an important role in diversifying an economy, there are also potential trade-offs between economic linkages and the aims of stabilisation and diversification due to Dutch Disease effects.

Expectation Management

High EI revenues often generate expectations demanding quick returns, creating risk of conflict and unsettling governance.

Managing expectations of government officials, affected communities and the general public is thus crucial.

An open and transparent revenue management and distribution process can facilitate expectation management.

Introduction

The opportunities and risks associated with the extraction of mineral and petroleum resources are of enormous importance for developing countries, and can have a lasting and strong impact on a country's development. The extractive sector also affects many other sectors such as infrastructure, energy production and consumption, the environment, land use, and other industrial processes.

The presence of mineral and/or petroleum resources creates high expectations within the population, especially in communities close to mining sites, regarding an imminent boost for development through additional public spending and employment opportunities. At times, there might also be inflated expectations of governments due to a lack of knowledge about the sector and its 'rules of the game'. Private stakeholders should also know what is expected of them and what they can expect from the host governments.

From a development policy perspective, it is therefore important for all stakeholders in a country to understand how and to what end the state intends (and will be able) to use its resources. What does it aim to achieve in terms of social and economic development? Where should the country be in 10, 20 or 30 years, and what contribution is the extractive sector able to make? Planning processes of this kind must include not only a large number of ministries and public authorities on various levels, but also civil society and the private sector. It is only through detailed analysis and such communication that realistic and commonly shared goals can be set and the risk of resentment and civil unrest reduced.

Figure 6: Stakeholders in extractive resources

While high revenue projections for the future may create high expectations for immediate social and infrastructural investments by the state, questions may also arise regarding benefits across generations and across the nation (resource-rich regions vs. regions without or with low-value extractive resources).

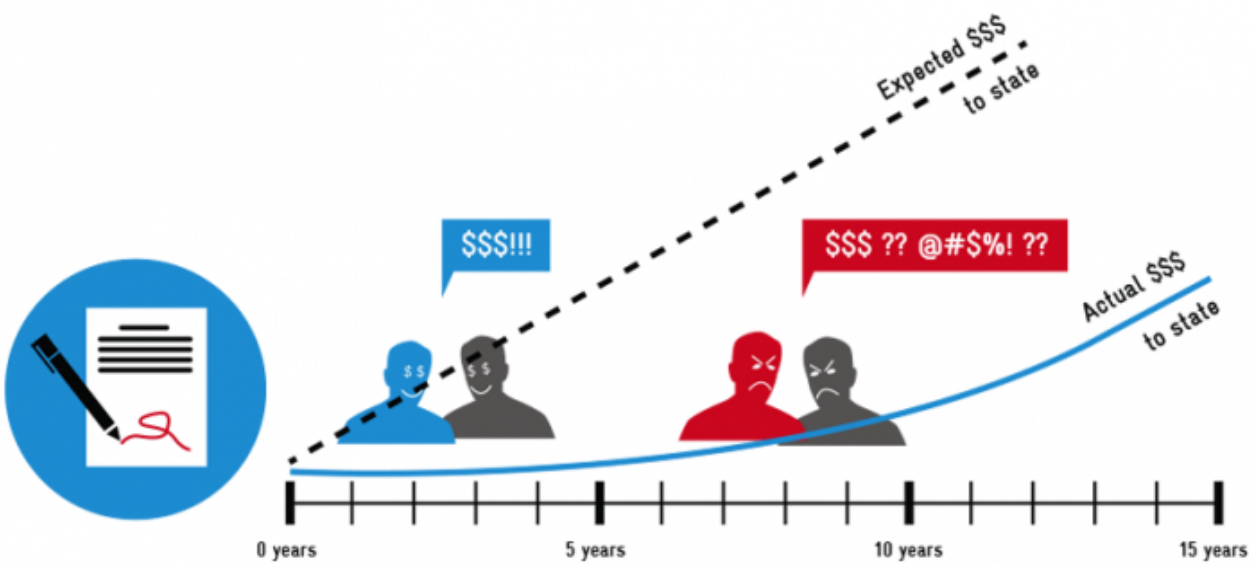

Figure 7: High revenue projections creating high expectations among population

The local population directly surrounding the extraction areas will likely be most affected - both positively and negatively. While EI production can create employment opportunities, it might also create fears about environmental effects or land grabbing. Local companies might, on the one hand, expect additional economic opportunities, but also fear mounting competition or even being driven out of business. Additional challenges apply in times of low commodity prices, where expectations need to be adjusted. It is thus crucial to ensure good political communication of opportunities and risks associated with the extractive sector.

Expectation management, conflict and accountability

Against this backdrop, political dialogue, national visions and policies, and political communication in the extractive sector have a crucial role in managing expectations and preventing conflict between stakeholders.

The development of adequate communication strategies needs to be tackled as early as possible and should be adjusted along the EI process (EI value chain, production life cycle). Once it is foreseeable that the EI sector will play a larger economic role, a comprehensive and realistic strategy for the sector should be developed. The development should encompass a participatory process involving all relevant stakeholders. Further, if deemed necessary, the development of specific strategies can ensue, such as strategies to promote local content and strengthen local SMEs (Small and Medium Scale Enterprises)

in the mining industry, to formalise artisanal mining, or to harmonise national policy frameworks with regional or international standards.

From a Good Financial Governance perspective, it is especially important to communicate about EI revenue and its distribution. Further, information about expected additional costs needs to be shared. Jointly agreed-upon strategies, visions and objectives allow for greater transparency and accountability. It is not only that civil society, government oversight institutions (especially the supreme audit institution, SAI) and parliament can demand relevant information regarding implementation efforts and achievements, but they then also need to use that information for advocacy purposes and as the basis of a demand for action.

Areas of intervention

› The instruments mentioned below can help improve the planning and management of the extractive sector along the entire value chain and, above all, reduce conflict. Facilitating a high-quality, participatory and transparent policy formulation process can help define an enabling framework for responsible resource governance in the specific context.

› Detailed, regular and independent analysis about the economic and revenue potential of the sector

› Communication strategies specifically aimed at different stakeholder groups (i.e. local economy/ private sector, general public, affected communities)

› Policy dialogues with effective stakeholder involvement

› Strategic and proactive involvement of media as key agents and partners with an adequate use of media outlets (TV, radio, social media)

› Country mining visions – inclusive and participative process of vision development as well as comprehensive dissemination of vision

› Multi-sector and multi-stakeholder planning of the extractive sector

› Analysis of existing policies and strategies, and harmonisation of these with international and regional approaches

› EITI process and Open Contracting – make effective use of transparency initiatives

› Monitoring and evaluation systems for sector strategies

› Benchmarking of the extractive sector's contribution to (national) development as a basis for policy advice

Inter-agency Cooperation

Economic rent potential in extractives, particularly in the petroleum industry, may discourage information sharing and cooperative behaviour within government.

Regular exchange of information, coordination and cooperation between different government institutions is vital for efficient EI revenue management.

Introduction

More than in other economic sectors, effective governance of extractive industries and its revenue contributions involves a high number of stakeholders. Economic Planning Ministries set a comprehensive development framework taking into account characteristics of the extractive sector. Financial institutions such as the Ministry of Finance or Revenue Authority are usually responsible for collecting the majority of EI revenue streams. The Ministry of Mines should design and implement a sector strategy which should be reconciled with strategies in related sectors such as transportation, water and environment. The government unit managing the mining cadastral register or petroleum production needs to exchange information with the revenue authority to ensure tax compliance of extractive companies. To achieve better transparency and accountability on the allocation and use of revenues from EI, supreme audit institutions and the parliament need to perform effective oversight and be aware of EI characteristics. All these institutions have specific mandates and expertise related to the extractive sector, which makes it imperative to regularly share information and data (see Chapter 5.8. on Data Availability), rely on each other's expertise, and closely coordinate action.

However, in developing countries, intra-governmental coordination and cooperation often poses a particular challenge due to strong individual interests in weak institutions, ethnic rivalries, clientelism, and patronage. As mining and petroleum projects involve vast amounts of money (hundreds of millions of dollars), their presence may even deteriorate inter-institutional cooperation, encourage compartmentalisation, and promote individual rent seeking. So interventions often have to work against such tendencies.

Coordination mechanisms

Even if the legislative framework is clearly defined, actual roles and implementation practices may deviate from it. While there are a number of good practices, it is impossible to identify an ideal intra-governmental cooperation mechanism, as institutional setups differ from country to country. Especially in the oil and gas sector, the government body mandated with the management of the sector is organised under a particular institutional arrangement in a number of countries. Due to the outstanding revenue potentials, the petroleum unit is often directly reporting to and supervised by the highest level of government, i.e. State House or Office of the President. Ideally, there would be a close link between fiscal institutions and petroleum units or ministries, however, this is rarely the case in reality.

Inter-ministerial platforms and bodies

There are positive experiences with inter-ministerial bodies (e.g. task forces, commissions) ensuring regular exchange between different institutions. They help to facilitate cooperation and can take coordination a step further by contributing to a mutual understanding of roles, responsibilities, procedures, challenges and linkages. Such bodies should identify clear objectives for their meetings and be guided by a jointly developed work plan. Chairing inter-ministerial groups may be assigned to the Office of the President, State House, Prime Minister, Ministry of Economic Planning or another central agency. There are further opportunities to create mutual understanding, trust and a good working relationship between institutions, which could also be combined with regular exchange formats, for example joint capacity building activities, workshops on EI related topics or joint audits. Also, these exchange platforms provide an opportunity to improve donor coordination and channel donor support to joint inter-ministerial projects. In terms of managing risks this potentially can increase donor support.

Example from Sierra Leone: Extractive Industries Revenue Task Force

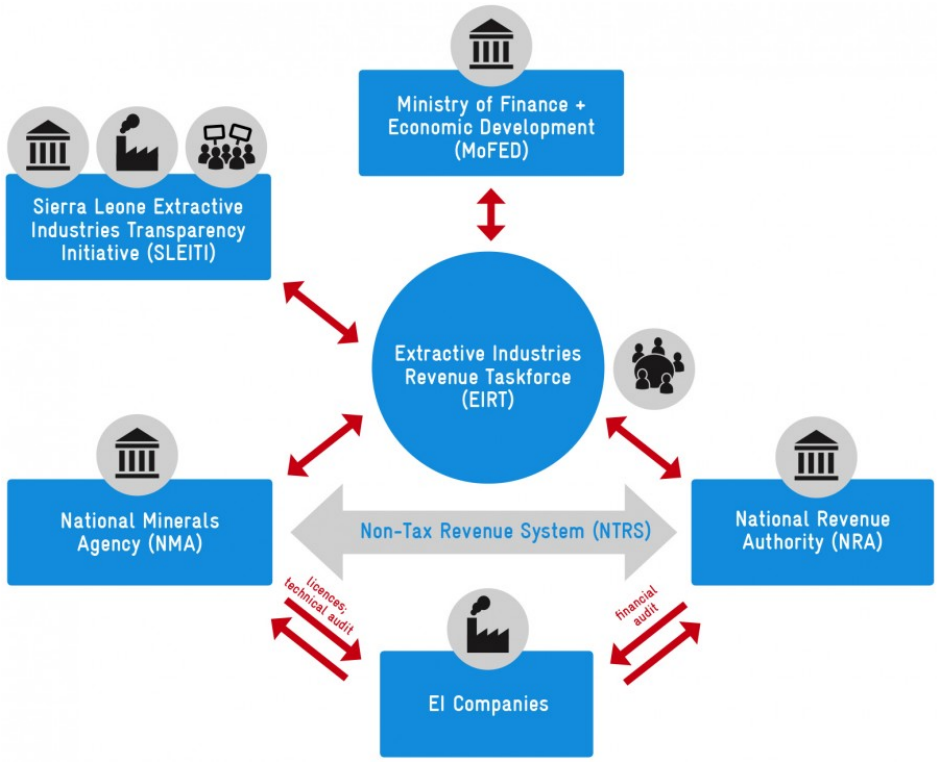

Figure 8: Information flows

Exchange of information, coordination, and cooperation between relevant government institutions in Sierra Leone has significantly improved with the introduction of the Extractive Industries Revenue Task force (EIRT). The task force was initially introduced in 2011 to facilitate exchange of data about extractive industries between fiscal and sector institutions. Over the years, this intra-governmental body has broadened its scope and now works on several joint activities aiming to improve extractive companies' compliance and revenue transparency.

For example, the task force steered the introduction of the Non-Tax Revenue System (NRTS) used by the National Revenue Authority (NRA) to manage mining royalties. The NRTS is integrated with the Mining Cadastre Administrative System at the National Minerals Agency (NMA) and guarantees both agencies easy access to data at any time. Moreover, the task force facilitated the planning of joint audit exercises and provides consolidated information to politicians and government agents for contract negotiations with mining companies.

The efficient exchange of data established a clear initial objective to orient the work of the task force. The work of the task force gradually expanded to further joint activities. A lot of effort has been invested in continuously clarifying roles and mandates, finally explicitly detailed in an Memorandum of Understanding (MoU). The MoU was a significant milestone as it created trust and ensured that institutions didn't feel "threatened" that other agencies would encroach on their areas of responsibility. The members of the EIRT work at the technical rather than the political level within their respective institutions, which may bear less potential for conflict but also means that neither individual members nor the task force itself have any decision-making power. Training and workshops offered specifically for the task force members have proven to increase commitment and sustain a positive dynamic.

Notwithstanding all the positive aspects of a common government platform for EI, some important stakeholders such as the Ministry of Mines and Mineral Resources or the Petroleum Directorate have decided not to actively participate in the task force, limiting its overall impact on the management of the sector. Despite the positive experiences so far, in a fragile country like Sierra Leone, the EIRT is at risk of losing driving power if key agents change, e.g. the current Chair held by a representative from the Ministry of Finance and Economic Development.

Broader information network

If commercial banks and the Central Bank are involved in EI revenue collection, as it is the case in some countries, they would need to be part of the information exchange. A permanent exchange format might not be necessary for these stakeholders but it should be evident at which stage of the procedures their information and action becomes important and how and to whom within government they have to provide information.

Further links between ministries and government agencies become crucial when it comes to the management of social and environmental impacts of resource extraction such as waste-water treatment, solid waste management, proximity to or even overlaps with protected areas. In the management of local development funds, coordination and cooperation are necessary, not only with sectoral agencies but also across different levels of government (national, provincial and local).

Coordination between government agencies in terms of obtaining information from the private sector and/or other economic agents such as state-owned enterprises, should also not be neglected. Mining and oil/gas companies are often the main providers of basic information in the sector as well as about individual projects. In order to avoid myriad reporting requirements, information requests from government addressed to the private sector shall be coordinated and follow a predictable schedule.

Data exchange and mutual trust

A very practical issue is the formats and technical facilitation of data exchange between government institutions; ideally exchange would be automated and managed in an integrated information system with access for different stakeholders. Examples for basic data for exchange are information about licences and contracts issued, figures for production, export, commodity prices, economic performance of single projects and the sector as a whole, taxes and fees due and payments made. However, a sufficient level of trust between institutions is indispensable for such exchange of information to work, which is often a challenge. Written agreements to determine which information is exchanged, by whom, and how often, have proven to facilitate information sharing and prevent uncertainty about collusion with tax secrecy rules. Digital systems are, however, only as good as the people and data behind them, and efforts should be made to collect qualitatively satisfying data and ensure government officials know how to use the system in place.

One-stop-shops

For the sake of simplicity, in order to improve the investment climate, some countries set up one contact point (a one-stop-shop) for extractive companies where information requests are pooled and later channelled back to the respective government entity. One-stop-shops are obviously also helpful when it comes to the provision of information to private sector stakeholders, for example when rules change or new procedures are put in place. This cannot, however, replace inter-ministerial or inter-agency collaborative formats for specific topics such as revenue generation, audits and control.

Areas for further thinking

Can more work be done by GIZ on producing a model MoU for co-operation and information exchange?

What IT-solutions can be provided for an efficient exchange (e.g. joint data management system)?

Areas of intervention

› **Regular exchange platforms** for institutions involved in natural resource revenue collection and management offer an opportunity to encourage exchange of information, get institutions familiar with each other, and clarify roles and responsibilities. These are basic conditions for effective coordination and cooperation.

› The introduction of **integrated digital systems** with access for various institutions can facilitate data exchange but there must be sufficient training on how to use the system.

› Use the exchange platforms also as **donor coordination** mechanisms in order to streamline donor support to the sector.

› A **mapping of information and money flows** regarding EI revenues might help to choose a focus for interventions aiming at improving trust, data exchange and coordination.

Challenges for Good Financial Governance in Resource-Endowed Countries

Overview: How to Ensure GFG in Resource-Endowed Countries

The below table summarises the three dimensions of Good Financial Governance in the extractive sector for the following eight chapters and provides examples where GIZ is already supporting partner countries or where GIZ could play a role going forward.

Challenges	Technical dimension: safeguard GFG	Political economy dimension: assessing interests of the various stakeholders	Normative dimension: (re-) distributional and inclusive process managed efficiently and transparently by Government according to the rule of law
Legal and Fiscal framework	Ensure alignment and consistency among the various national legislations that are relevant for the EI sector. Ensure that the national legislation does not contradict the international legal framework. Minimise the role of contracts.	Ensure that all agencies involved in managing the sector own the legislative reform process jointly. Provide a forum to address potential conflicts of interest early on.	Provide opportunities also for non-governmental stakeholders to participate in the legislative reform process.
Contracts	Ensure consistency between fiscal legislation and concessions in contracts. Avoid a parallel fiscal system for single projects.	Promote contract transparency to empower stakeholders to hold negotiators accountable for the negation results. Give clear mandate to an inter-agency government negotiation team.	In case (re-) distribution is part of the contracts (e.g. social investments) ensure affected stakeholders have a voice in the negotiations. Envision trade-offs between possible elements of a contract, e.g. between revenue maximization and local content promotion.
Revenue Collection	Develop detailed transfer pricing rules to avoid tax erosion.	Streamline the revenue collection and avoid multiplication of collecting agencies.	Ensure transparency of revenue data to empower non-state actors to hold Government accountable.
Revenue allocation	Support budget planning through accurate forecasting modeling. Put special emphasis on the capacity of the decentralised administration to manage revenues.	Avoid all forms of extra-budgetary management of extractive sector revenues, including the funding of the sector administration.	Ensure an inclusive and transparent process to decide how revenues are to be redistributed. Ensure well-designed Sovereign Wealth Funds.
State Ownership	Ensure that governments are well-informed about the risks associated with state participation in projects.	Clear definition and limitation of the tasks and role of SOE within the sector; limitation of political interference by a clear separation of roles within SOEs.	Foster accountability, transparency.
Artisanal and Small Scale Mining	Design ASM systems that encourage formalisation. Ensure qualification of local mining inspectors.	Map out the importance of ASM for revenue generation for the central government (given that enforcement is more likely to be effective at the sub-national level). Understand the interests of all stakeholders within the ASM value chain, particularly of the licence holders.	Ensure that revenues are made available to support ASM operations (such as rehabilitation).
Data Availability	Ensure availability and usability of data to increase transparency and monitoring – which are essential for the effective management of revenues.	Understand the interests behind making data available; this is particularly relevant for contract, beneficial ownership and payment transparency.	Make open fiscal models available and strengthen data literacy in order to increase the ability of civil society, media and parliaments to understand and analyse provided information.
Transparency, Oversight and Accountability	Secure the independence of supreme audit institutions (SAI) and their access to all necessary information to provide fiscal and budgetary oversight. Provide sectoral knowledge for the audit of extractive resources. Ensure EI sector knowledge for parliamentarians.	Strengthening the role of the parliament as an oversight body, ensuring balance of interest. Strengthen mandates, roles and responsibilities of Supreme Audit Institutions.	Foster the involvement of all stakeholders in budgetary oversight: government, parliament, civil society, media.

Legal and Fiscal Framework

Given the special characteristics of the extractive industry sector, the fiscal and legal framework is often complex with various agencies and payments involved.

Without clarity, alignment, and coordination, the complexity of the fiscal framework can lead to misinterpretation, loopholes, and increased costs for the government and for companies.

With the extractive sector often being one of the main contributors to the Gross Domestic Product (GDP), employment, and domestic revenues, coherence between the fiscal framework and other legislative areas (such as local content) is an imperative for good financial governance.

Introduction

The rules, rights and obligations of companies, governments, and citizens are set forth in a system of legal documents called the legal framework. Part of this is the fiscal framework that specifies fiscal rights and obligations vis à vis the state. A coherent fiscal framework is key for the extractive sector to unfold its potential for sustainable and inclusive economic development. Strengthening judicial and regulatory systems for implementing the fiscal framework is a long-term process. As complexity increases, the need for harmonisation and transparency inevitably grows. This involves updating standards, laws and regulations.

Hierarchy of law

Legal frameworks comprise different sources of law that include the constitution, legislation, regulations, and contracts. These documents relate to one another. The legal hierarchy determines which sources of law have more force than the other. Ideally, the constitution lays the basis of the legal framework, followed by legislation. The next level is regulations and rules, and the most specific sources are contracts. This fiscal framework can be defined in different documents across this hierarchy. For example, some countries have special fiscal provisions in the mining law and give concessions for that in contracts. In other cases one revenue code encompasses all sectors and is also valid for the extractive sector.

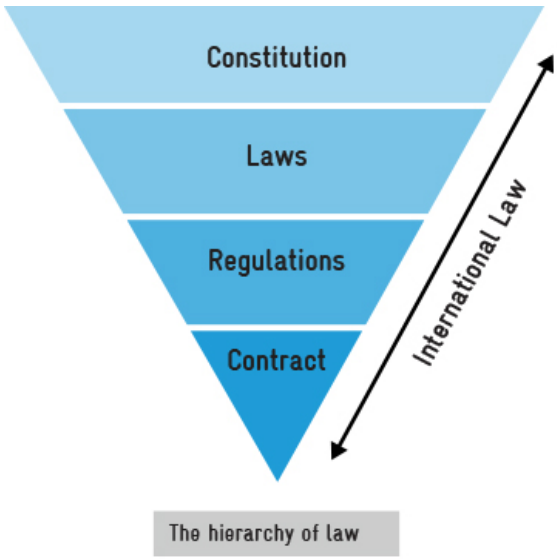

Figure 9: The hierarchy of law

Most resource-rich countries have laws that focus on fiscal elements of the oil and/or mining sector (for example, the mining code, petroleum exploration and production act, among others). In addition, more general laws often represent a major component of the rules for the industry, including environmental laws, labour laws, tax laws, and land management laws.

The international legal system also plays an important role. Most countries have signed up to the World Trade Organisation (WTO) which promotes trade liberalisation. Furthermore, there has been a proliferation of bilateral investment treaties that countries have signed up to which are often more liberalising than those set out by the WTO. As set out in the Chapter 4.1. on Resilience in Sector Dynamics one of the tools resource-rich countries can use to diversify the economy is to rely on local content legislation. These may be in direct conflict with the international legal framework as they might be considered as non-tariff trade barriers.

Area for further thinking

To what extent should countries follow local content policies and how does this policy trend align with the international legal framework?

Complexity of the legal and fiscal framework

The complexity of legal layers also applies to tax rules. Multiple layers of tax rules create complexity for administrators and taxpayers alike. For instance, the tax law will have rules of general application which apply to extractive entities as well as to taxpayers in other industries (e.g. capital allowances). The tax law may also have rules specific to the extractives sector (e.g. more generous capital allowances for assets used in exploration or development). Some jurisdictions may also have incorporated tax rules into the mining law (e.g. arm's-length rules). On top of this, there may be special contracts with individual companies which seek to modify the tax rules still further. This complexity of layers can be addressed to a limited extent by convincing governments that all rules relating to taxation should be contained in the tax law rather than in the mining laws.

Lack of consistency in fiscal provisions in individual contracts creates complexity for administration and uncertainty for investors. Different contracts can apply different rates of tax and duties to the same products and allow tax concessions to be given over vastly

different periods. Investors utilise these inconsistencies in contract negotiations to attempt to drive a better bargain. A lack of consistency not only creates uncertainty for administration and investors but also makes systems less transparent and more difficult to hold accountable.

This lack of consistency can be addressed by rules in the tax law which specify which of the tax laws can be stabilised and for how long. This means that investors would not negotiate the whole contract but only certain parts of the contract, and within defined limits. For example, the law could state that only the income tax rate and mineral royalty rate can be stabilised but not the VAT rate, and the stabilisation can only be for a maximum period of a defined number of years.

Incentives

The regulatory framework may allow performance bonuses and incentives for tax auditors. The question here is how salaries and incentive schemes influence the collection / recovery - it describes the conflict between tax authorities' revenue targets and personal targets of tax auditors.

Public officials in developing countries can be underpaid and consequently are likely to resort to corrupt practices to augment their income. Such incentive schemes risk corruption and encourage the misapplication of the law: tax officials may for example not be interested in timely and/or full recovery of payments but encourage misapplication in order to benefit from bonuses for the 'discovery' of the fault. The government would consequently lose out on revenues while the individual tax official gains.

To reduce the scope for corruption, specific regulations should be provided in the legislation and regulations that define the civil service and these regulations should apply to public servants. Additionally, a corresponding sanction regime for public servants in case of misbehaviour, has to be in place, and also enforced.

Involvement of multiple government agencies

Different government agencies may have conflicting legal interpretations of laws which are related. The laws are administered by different agencies (the revenue authority for income tax and the mining authority for mineral royalties) and can be interpreted differently. Often mining legislation and tax legislation will have provisions relating to determining an arm's-length price for minerals but which are administered by different government agencies and again are prone to differing interpretation. The inconsistencies can potentially be used as leverage by investors to obtain a better deal. Ideally, revenue provisions should be contained in tax law and be administered by tax officials. Where that is not possible (usually for political reasons), every effort should be made to interpret such provisions in a consistent manner. This requires close co-operation between agencies.

Some countries may have many (small) payments required by law to be made by mining companies to different agencies and authorities (see for example Doing Business "Paying Taxes" by The World Bank). This can result in a significant compliance burden for com-

panies and act as a disincentive to investment in that country. Oversight and data collection becomes a problem resulting in low accountability and high corruption risks.

Lack of commitment to the rule of law

The *rule of law* is the legal principle that law should govern a nation, as opposed to being governed by arbitrary decisions of individual government officials. Adherence to the rule of law creates certainty in administration and a stable investment climate. This is because potential investors are confident in the way the law will be applied and that they will not be subject to the whim of a tax official. The rule of law means that discretion in tax law should be limited. However the person who has ultimate leadership of the tax authority (e.g the Commissioner General) has general administration of the tax law and has the ability to not apply the law in limited circumstances for the purposes of sound administration (e.g. he/she has authority to settle cases, or to give a tax amnesty to a class of taxpayers).

Areas of intervention

› Advise governments with the drafting of the regulatory framework coherently and ensure transfer of knowledge. Ensure that the local administrators participate in the writing of the law and understand the intent and consequences of their laws. This process of ensuring that there is knowledge of policy intent in the administration may reduce discretionary applicationn of laws. This can only enhance the rule of law in the country.

› Align policy advice across units; this is particularly relevant between trade and local content advisory work. For example, the investment regime often grants international extractive industry companies import tax exemptions. However, if these are not extended to local suppliers, they are in direct conflict with local content policies.

Revenue Collection

Opportunities to collect revenues are bound to the project lifecycle and vary considerably over time. Sectorial knowledge in the Ministry of Finance and knowledge about taxation within the sectorial ministry can contribute to better coordination between actors.

Rent capture from the EI sector is often limited despite this being a highly profitable industry. Therefore, a coherent extractive industry taxation regime established by the government is crucial for citizens to benefit from their country's resource wealth whilst ensuring responsible investment in the sector.

The control/verification/audit procedure performed by the tax administration is a complex task, given that resources of the tax administration are limited and have to be used efficiently. A risk differentiation framework can help in determining appropriate compliance activity.

While requests and agreements regarding tax exemptions between government and companies may be legitimate, information inequalities pose a severe problem for preventive measures.

Much energy has been put into awareness and training of the transfer pricing/profit shifting problem with little apparent audit activity resulting.

Introduction

Resource endowment and the respective state revenues provide countries with excellent opportunities for development. However, an effective fiscal regime and a functional tax administration are crucial requirements for transforming resource wealth into human and economic development. While a government is supposed to collect revenues from all economic activity in a country, revenue collection from extractive industries deserves increased attention and specific approaches. The sector is marked by high capital intensity, limited employment opportunities, high entrepreneurial risk and price volatility. More importantly, the life span of mining, oil or gas projects is characterised by long project cycles. Often decades elapse from exploration to production. Due to up-front investment, revenues accrue only after a long time span has elapsed, depending on the mineral, taxation regime, and investment needs. Opportunities to collect revenues are bound to the project lifecycle and vary considerably over time. In addition, a large share of minerals, oil, and gas produced in developing countries is exported without significant value addition in country. This often results in limited rent capture from the EI sector, despite it being a highly profitable industry. Therefore, a coherent extractive industry taxation regime is crucial for citizens to benefit from their country's resource wealth whilst ensuring responsible investment in the sector.

The Government plays a critical role to set an adequate fiscal framework for the EI industry while enforcing its tax regime to ensure compliance. However, underlying political economy drivers, resulting from a large range of actors involved and an often high administrative fragmentation, make reform in this area ever more difficult.

Fiscal regimes

Fiscal regimes in most countries have grown to rather complex sets of rules and regulations with myriad associated taxes, fees and other payments to be collected by government agencies. Additionally, the uncertainty of the EI sector about market prices and the high political pressure make fiscal regimes more unstable and prone to frequent change. The following political economic factors influence the set up and development of a fiscal regime: characteristics of resource endowment, the mechanisms and institutions available for enforcing commitments, revenue administration capacity and governance, distribution of power, policy rigidities, and the extent of tax competition. (Barma 2012: *Rents to Riches? The Political Economy of Natural Resource-led Development*)

The most common types of EI revenues are licence fees, mineral royalties, corporate income tax, surface rent, withholding tax and VAT. Some countries also apply a windfall or excess-profit/rent tax in times of high prices and profits, or receive dividends from (partial) state ownership of mining operations. There is extensive literature covering these different revenue types and their pros and cons.

Support for the development of EI tax systems differs in countries with a longstanding extractive industry to those in countries with a newly developing extractive sector. Countries with an EI sector in its infancy cannot draw on longstanding technical expertise, a well-developed taxation regime, nor an adapted institutional set-up. On the other hand, in countries with a well-developed government sector concerned with taxing the extractive sector, myriad often competing institutions exist.

Different kinds of revenue, different kinds of agencies involved

In the extractive sector, more than in any other economic sector, myriad actors are involved. Currently available literature focuses less on the different stakeholders involved in EI revenue collection and their interactions, but rather on different tax types. Not only the tax authority is responsible for the collection of taxes and fees but also the respective line ministry or agency. Sometimes sub-national units as well collect certain payments.

Each country has a different institutional structure supporting the collection of revenues from EI. This is typically the tax authority, which can be a semi-independent institution or a department within the ministry of finance. Further relevant stakeholders might be customs or different units within the mining/oil agency or ministry. Potentially, regarding tax payment, also commercial banks or the central bank can play a role in the tax collection process at the national level. A number of resource-rich countries have established a specialised unit for extractive industries within the tax authority. Specific challenges arise when an exchange of information between EI sector institutions and the fiscal authorities is weak e.g. when the administration responsible for collecting EI revenues does not have sufficient information on mineral valuation or the production or exportation volumes.

Therefore, inter-institutional coordination during the tax collection process usually remains highly necessary. In developing countries, it remains complex and difficult to achieve. Reform efforts need to take into account the political economy of administration of resource rich countries.

The process of revenue collection

Standard steps within tax administration (or within other agencies that collect extractive industries-related revenues) include: registering of taxpayers, filing of returns (self-assessment vs. assessment through tax authority), control/verification/audit by tax authorities to detect inaccurate information in taxpayers' returns, tax dispute (administrative/judicial), and payment of obligations. These key steps are supported by means to improve voluntary compliance of taxpayers such as providing necessary information on tax regimes and taxpayer obligations, preferably according to taxpayer size (small, medium, large) and if possible according to economic sectors e.g. mining and oil (see Calder 2014: *Administering Fiscal Regimes for Extractive Resources - A Handbook*).

Except for ASM, the first step of registering EI companies as taxpayers should be quite easy to do as their number is limited and it might be done immediately when companies register for operations in a given country. Industrial EI companies will be often found grouped as large taxpayers by the tax administration. Filing of returns and receiving these returns (especially VAT, corporate income tax) is defined by the general tax code. VAT returns are usually filed each month, income tax once a year, however, payments of estimated annual liability can sometimes be required in advance on a quarterly basis.

The control/verification/audit procedure performed by the tax administration is a complex task given that resources of the tax administration are limited and have to be used efficiently. It is generally considered best practice that companies representing the highest risk of non-compliance with tax obligations should be subject to continuous audit. In resource-rich developing countries this would include most large oil and mining companies or projects. However, if the tax administration lacks the necessary resources to continuously audit large companies, it should stick to an audit strategy, including different compliance products, based on a set of risk factors, and distribute its resources accordingly. Some tax administrations publish their audit strategy to the public, others do not. Decisions regarding publishing should be taken according to the respective country context.

A technique of determining compliance approaches which is attracting attention in tax administrations around the world is the risk differentiation framework. The framework rates all taxpayers in the target group in terms of their likelihood of non-compliance (based on an analysis of their track record of cooperation with the revenue authority) and the consequences of non-compliance. The ultimate position of the taxpayer in the framework determines the compliance approach used by the revenue authority in respect of that taxpayer.

For instance, in a developing country which is reliant on revenues from the extractives sector and which has only a handful of very large mining entities, all of those entities would be high consequence taxpayers because, regardless of the risk of them being non-compliant, the revenue consequences of any non-compliance is great.

Of that group, those who lodge information and returns on time and make few mistakes are fully compliant, and they would be considered Key Taxpayers and would receive more of a service focus (such as having Key Client Managers, and monitoring rather than continuous audit). Those who are less compliant would receive a more focussed compliance approach, such as continuous audit.

For a more detailed explanation see the Fact sheet on the risk differentiation framework (Australian Taxation Office).

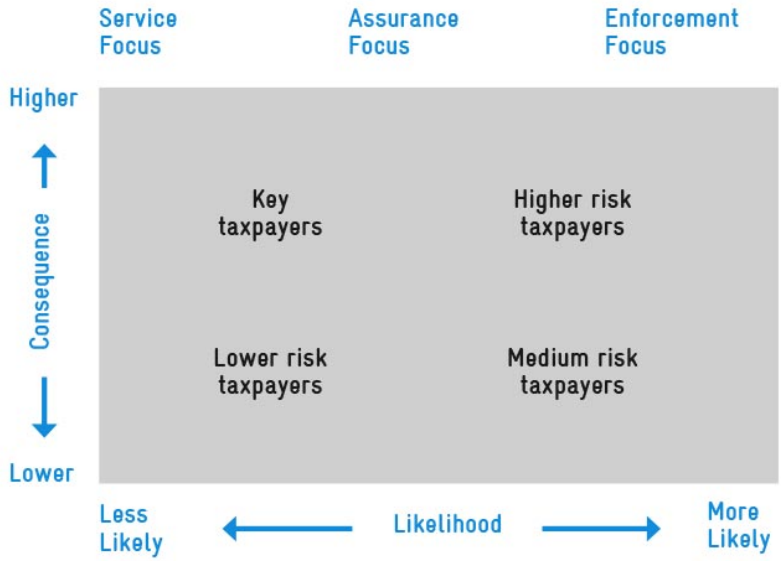

Figure 10: Risk differentiation framework

Once the audit case has been started via notice to the taxpayer, different skills are needed to assess whether the EI company has provided accurate information in their tax return. The auditor ideally should have knowledge about the mineral resource and company structures typical in this sector. Additionally, the auditor may rely on external information such as EITI reports, price information for international markets if traded there, export and productions statistics. Ideally, auditors have easy access to information from 1) departments within tax administration and customs, 2) sectoral government agencies (company register, mining cadastre) at any stage of the control/verification/audit procedure.

When the control process has been concluded, the taxpayer has time to object the tax assessment. If so, the objection should be carefully reviewed and another unit within the tax administration should double check in order to limit discretion of tax auditors. For various reasons, there might be different misbehaviours such as collusion between companies being audited and tax auditors.

Code of ethics, payment and bonus schemes, and revenue goals set by the tax administration should be assessed in order to mitigate potential bad incentives. If tax administration and taxpayer cannot agree on the tax assessment, a tax dispute solution will be started, beginning at the administrative stage and taken to the judicial stage, i.e. to court if necessary. If consensus is found, taxes have to be paid.

Areas for further thinking

How can the problem of outstanding payments can be tackled, especially in cases where companies have left the country and are out of reach of tax authorities?

What measures could be taken on the international level to "punish" companies with outstanding payments?

Would an international agreement tackling this trans-boundary problem be thinkable?

Tax evasion and avoidance in EI

There is a high revenue potential from the extractive sector in resource-rich countries. However, the higher the share of wealth a government tries to retain from extractive industries, the higher the incentives for companies to try to lower the tax burden. Governments have to carefully calibrate two objectives: maximising public revenue potentials, and offering an enabling investment climate. Solid knowledge about the national reserves and economic activity in the resource sector is crucial to strike the right balance. As companies defend their economic interests, there are frequent attempts during contract negotiations but also later during the project cycle to convince the government to lower taxes or grant duty waivers. In the past, international organisations also exerted pressure on developing countries to offer tax incentives, supposedly to compensate for other factors (such as bad infrastructure, low-skilled labour force) impairing the ease of doing business. Governments need to rely on sector and financial experts to thoroughly analyse such requests by the private sector: due to long project cycles in extractive industries, such decisions can be far-reaching.

While requests and agreements regarding tax exemptions between government and companies are legitimate and of no legal concern (if corruption does not play a role), big multinational enterprises have many other instruments at hand, of which not all might be legal, to lower the taxes they pay. The OECD/G20 project on Base Erosion and Profit Shifting (BEPS) addresses a number of these instruments but makes no specific reference to EI. Developing countries are well advised to analyse their country context and the pertinent issues for their economy, and more specifically for the mining or oil/gas sector, before getting involved in the BEPS Process and implementing proposed actions. BEPS Action 8-10 address general transfer pricing issues but tax incentives and the lack of transfer pricing comparable data for certain commodities are common challenges for resource-endowed countries and are not covered by the BEPS framework.

Area for further thinking

Does the extractive sector require special instruments fitted to its specific challenges in order to prevent Base Erosion and Profit Shifting (BEPS)?

Transfer pricing/profit shifting

Conceptually, transfer pricing is the setting of the price for goods and services sold between controlled (or related) legal entities within an enterprise. For example, if a subsidiary company sells goods to a parent company, the cost of those goods paid by the parent to the subsidiary is the transfer price.

Revenue authorities are only concerned if the transfer price that has been set is other than a price that parties would agree to in an arm's-length transaction. In such transactions the buyer and seller of goods act independently, have no relationship to each other, are acting in their own self-interest, and are not subject to any pressure or duress from the other party.

Where related parties transact with each other at other than on an arm's-length basis and the result is less tax paid in the jurisdiction than would be the case if the transaction was at arm's-length, the result is sometimes referred to as predatory transfer pricing, transfer "mispricing", or profit shifting. It is more common to hear use of the otherwise benign term "transfer pricing" to describe this non-arm's-length behaviour.

In the extractives sector in developing countries, predatory transfer pricing is a significant risk because of the large profits which are made relative to other industries.

Areas for further thinking

The fact that such energy has been put into awareness and training of the transfer pricing/profit shifting problem with little audit activity resulting should raise questions about whether there is a better way to address the problem of transfer "mispricing" in resource-rich developing countries.

Could a judicious use of external experts to assist institutions in resource-rich countries in doing audits be explored? That is, targeted interventions over the life cycle (audit preparation, information collection and assessment, adjustment and settlement negotiation and/or dispute through tribunals and courts) rather than just at the initial stages.

Given the complexity of , and reluctance to use it, are there simpler alternatives to transfer pricing law? Could the recently UK enacted "diverted profits tax" (available as PDF) be explored?

Donor agencies have done much to train and otherwise make revenue authorities in these countries aware of the risks of transfer pricing and the methodologies to determine arm's length prices. However, for a variety of reasons this awareness and increase in knowledge has not translated into many transfer pricing audits or adjustments. Some of those reasons include short term revenue demands made by the government which preclude the lengthy investigations and research necessary to determine an arm's-length price, and frustration at stonewalling tactics to information requests or the fact that after lengthy investigations and an adjustment to taxable income, an even more lengthy judicial review has to be endured.

Areas of intervention

- Training for risk-based planning/differentiation frameworks
- Support for extractives tax policy and administration inclusive of tax auditors (e.g. on transfer pricing mechanisms)
- Digitisation and data exchange between tax authorities
- Interconnection between sectorial cadastres and linking cadastres with tax authorities
- Inter-agency dialogues (common understanding and better communication)

Revenue Allocation and Budgeting

To achieve sustainable development, EI revenues need to be managed and allocated according to good governance principles.

Open and transparent budget planning is key to minimising the risks of revenue mismanagement.

Well-designed models help governments to appropriately react to commodity price volatility and form the basis of long-term planning; modeling and forecasting skills are essential.

Local authority capacities for budget planning and accounting need to be strengthened; local civil society organisations should be enabled to ensure social oversight over the expenditures.

Introduction

As highlighted in Chapter 4.1. on Resilience in Sector Dynamics, EI revenues are volatile in nature. In resource-dependent countries where the EI revenues make up a large proportion of domestic revenue generation, this translates into spending volatility (unless the country relies on debt financing to smooth expenditures, although this may not be sustainable). Spending volatility is problematic, because it is inefficient. Starting and stopping construction work or hiring and firing government employees, for example, is often not viable and will also reduce the positive impact of such spending (and can contribute to Dutch Disease as outlined in Chapter 4.1). Furthermore, because extractive resources are finite, there is a strong argument that future generations should also benefit from the extraction of these resources, which in most jurisdictions belong to all citizens (with the US being the exception where the individual owning the land also owns the assets underground). Another particularity of EI revenues is that large amounts often originate from a small number of projects and are not directly paid for by the population, making them prone to mismanagement.

These characteristics mean that EI revenues require special attention and careful management in order to contribute to sustainable development. Ensuring GFG in the allocation and budgeting of EI revenues is thus of great importance.

Planning on how to allocate resources

Deciding on what a country should do with its resources is a sovereign decision. Some countries may place greater importance on compensating communities living nearby to the extraction project more than those living further away. Other countries may place greater importance on saving for future generations the revenues generated today. While priorities and interests may vary, the important aspect when planning how to allocate the revenues from extractive industries is that it should be an inclusive process. Two important factors that need to be considered when making this decision are:

1. the relative size of the revenues expected from extractive industries: if it is only a relatively small proportion compared to total domestic revenue, it may not make sense to set up mechanisms to try and smooth consumption (given that overall spending

volatility will also not be that large and the capacity of the economy to absorb additional expenditures is likely going to be higher); and
2. the level of development of the country: if the country is less developed with low infrastructure and human capital standards, investments in these areas are likely to have a higher return than in developed countries. (Some jurisdictions such as Alaska have chosen to directly pay out revenues to citizens rather than channelling them through the budget, which is likely going to result in higher personal spending rather than public investments).

Once the country has decided on how it wants to allocate the revenues, there are several mechanisms through which it can channel the revenues. These include spending the revenues through the budget cycle (including sub-national distribution), the creation of funds to address volatility and inter-generational aspects, direct distribution of funds to citizens, and spending through the state-owned extractive industry company. More detail about the first two is found below.

Budget planning and execution

In order to plan budgets, governments require the capacity to forecast revenues. A lack of organisational and individual capacities for forecasting EI revenues limits the ability of governments to decide on how to use the revenues and adequatly deal with revenue volatility. This is also the case for realistic and credible budget planning, particularly in the medium term. Ideally, revenue estimates from the extractive sector feed into medium term budget projections. Therefore relevant capacities to be developed include commodities pricing expertise. However, even with accurate modeling capacities, price setting is mostly a political decision, therefore up to the discretion of policy makers and part of the prevailing political economy. This implies a certain risk of setting prices for models too low or too high according to political opportunity. Well-designed models can help governments to react quickly and appropriately to drastic price changes in commodity markets.

Ideally, EI revenues should be part of the regular budget process, follow fiscal rules, and be openly reported on. However, in some resource-endowed developing countries, state revenues generated from EI are handled off-budget and managed by a variety of institutions. This has negative implications for accountability and transparency since oversight by Parliament and financial control is limited and scattered. It also makes the assessment of the overall contribution of the EI sector to the tax base, national budget, and thus to development in general, a difficult task. The effective management of EI revenues might also be weakened by supplementary budgets.

To limit the risk of political opportunism, it is crucial to ensure that budgeting procedures are transparent and open. Therefore, not only the parliament needs to be involved but also sector ministries and relevant government bodies need to actively participate in budget planning. In resource-endowed countries, all these stakeholders need to be aware of the challenges of resource abundance (such as high price volatility, long project life cycles). State-owned enterprises (SOEs) operate or take part in extractive projects in some countries, and may additionally to extraction assume broader revenue collection tasks. Even though SOE profits should be part of the budget, many countries apply dif-

ferent arrangements, which makes their contribution to state revenue opaque. Thus, transparency and distribution regarding revenues generated by SOEs remains a huge challenge.

Natural Resource Funds

Natural resource funds can be setup for several purposes. These include: (1) smoothing expenditures from volatile revenue sources, whereby revenues are saved in stabilisation funds in years when revenues from the EI are high, and revenues from the fund are used in years when the revenues from the sector are low; (2) saving revenues for future generations; (3) mitigating the negative impacts from Dutch Disease by investing revenues abroad; (4) earmarking public investments from extractive industries to particular sectors such as infrastructure and human capital (with the argument that EI revenues should be used for investment rather than spending); (5) ring-fencing revenues to increase transparency and accountability (as related to other revenues); and (6) increasing autonomy to avoid countries having to rely on borrowing.

As shown in the Ghanaian example below, countries can chose a combination of funds. Disregarding of the objective, natural resource funds add to the complexity of EI fiscal regimes and represents a challenge for transparency and accountability: such funds must be well designed and managed according to good governance standards. Clear objectives and criteria are required to be successful. Fiscal rules need to be put in place that define when money should be paid into the fund and when money can be taken out of the fund. Investment rules that define how and where the money in the fund is invested also need to be put in place. To ensure accountability and oversight, there should be a clear and independent structure governing the fund.

The Ghanaian Case

In order to ensure sustainable management of the petroleum revenues, the Government of Ghana enacted the Petroleum Revenue Management Act (PRMA). The PRMA has instituted a set of mechanisms through which petroleum revenues are allocated and accounted for. These include transfers to the state owned Ghana National Petroleum Cooperation, allocations to the Annual Budget Funding Amount (ABFA) that serve as a source of the annual budget, and transfers to the Ghana Petroleum Funds which is made up of two Sovereign Wealth Funds which are held separately from Ghana's consolidated fund. The Ghana Stabilisation Fund can be used to cushion the effect of oil price volatility on the budget, and the Ghana Heritage Fund provides an endowment to support development for future generations when petroleum reserves have been depleted. Borrowing using petroleum reserves as collateral has been prevented by an amendment of the PRMA in 2015.

The ABFA is allocated to the Government's annual budget for the execution of government programmes. Funds are earmarked for priority areas selected by the Minister of Finance. Over the last four years (2011 – 2014), road and other infrastructure made up the largest amount of ABFA, followed by the expenditure and amortisation of loans for oil and gas infrastructure, agriculture modernisation, and capacity building.

Parliament is required to approve certain issues pertaining to the management of the Ghana Petroleum Funds. As part of the transparency requirements of the PRMA, the Minister of Finance submits an annual report on the Petroleum Funds as part of the annual presentation of the Budget Statement and Economic Policy to Parliament. To assess compliance with the provisions of the PRMA, Government instituted the Public Interest and Accountability Committee (PIAC), a multi-stakeholder body which issues biannual reports, which are published and submitted to Parliament. The Auditor General is equally entitled to audit the financial statements of the Ghana Petroleum Funds.

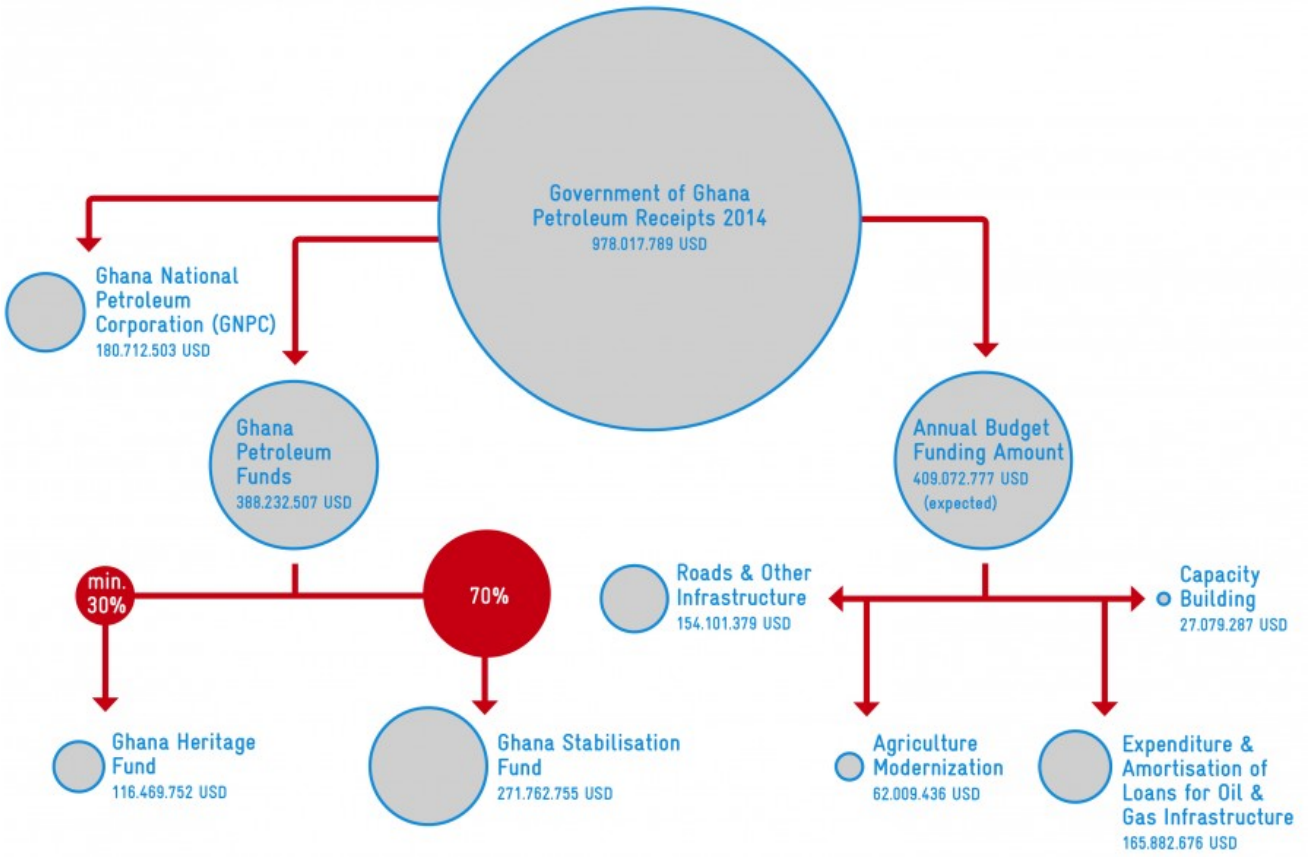

Figure 11: Allocation of Petroleum Revenues in Ghana (2014)

Since 2010, Ghana has produced commercial quantities of crude oil. Although the production and reserves of oil are modest as compared to the global share, the revenues generated through taxes and payments (mainly income tax, oil entitlements, profits of the Ghana National Petroleum Company, and royalties) contribute significantly to Ghana's domestic revenue base. In 2014, oil and gas contributed 7.2% of total GDP and 13.5% of total government domestic revenue (Ghana Ministry of Finance 2014: Final GHEITI report on the oil/gas sector). As a result of the price drop, in 2015 Ghana only collected around one third of the projected petroleum revenues, putting pressure on the national budget and public spending. Ghana has adopted a unique model for the management of petroleum revenues, drawing together government agencies, the private sector, civil society, and parliament. The importance of transparency has steadily increased and as the country continues to make

more oil and gas finds, it is becoming even more compelling to create robust structures for accelerated economic and social development.

Sub-national revenue allocation and expenditure management

Resource extraction takes place at the community level. Therefore, the local population is most affected (negatively and/or positively) by mining and extraction activities. Positive effects can result from employment creation, infrastructure provision and consumption linkages, while land grabbing, pollution and environmental degradation can negatively impact local communities (in many developing countries, the skills needed to work and/or service the EI sector are not developed, which can reduce the positive impacts). The latter calls for compensation, such as financial benefits allocated to or even collected at the local level. EI policies may encompass schemes whereby revenues are redistributed according to where they originate with a certain formula for redistribution. However, such incentives need to be carefully designed and reviewed, and a scheme should avoid increasing regional disparities by overcompensating communities near oil, gas and mining projects.

On the spending side at the sub-national level, one needs to take into account low capacities regarding budget planning and accounting and often defunct accountability mechanisms. The problems outlined above for the national level are often exacerbated at regional or community level. Revenue volatility, for example may lead to high inflation levels at the regional level. Sub-national stabilisation funds can be put in place to manage such volatility if it makes up a large proportion of total revenues. While local authorities are closer to the citizens and therefore could be, in theory, better held accountable for spending of public funds efficiently, traditions or customs may prevent their decisions and actions from being questioned. Local civil society organisations can play a vital role in controlling sub-national expenditure. However, such organisations are often weak and/or absent in rural areas.

Apart from funds collected and redistributed by state authorities, governments should take companies' spending on Corporate Social Responsibility (CSR) into account in order to provide coherent and demand-driven public services. CSR spending usually takes place at the sub-national level and is directed towards communities close to the extraction site. Often this is set between local communities and the companies in Community Development Plans. A company might implement certain activities (such as building a school, health centers, roads) itself or fund them through local civil society organisations or authorities. In some cases, neither of these channels inform national or regional budget institutions nor systematically consult sub-national authorities about CSR spending. This limits the government's ability for coherent budgeting and provision of public services, and also circumvents established decision and accountability mechanisms.

Area for further thinking

Given the importance of good sub-national financial governance in resource-endowed countries, GIZ needs to strengthen its portfolio in that area. A beneficial leverage point can be the large GIZ portfolio in supporting decentralisation and sub-national governance.

Areas of Intervention

› Support to strengthening PFM reform processes and systems with a focus on EI revenue management

› Advise on fiscal transfer mechanism of EI revenue on the sub-national level

› Advise on inclusive processes for revenue allocation and design of instruments (e.g. SWFs)

› Establish systematic consultation mechanisms for mining communities and reporting standards for CSR spending

› Train local civil society on basics of the extractive sector and the fiscal system

Contracts

Contracts for individual companies or projects are commonly used in EI to clarify government and company fiscal and non-fiscal obligations.

Many developing country governments lack appropriate expertise, skills and information to analyse a project and maximise the negotiation outcome for their country.

Contractual schemes can cause major difficulties, additional work and expenses for tax authorities, especially if deviating from existing legislation.

Contract transparency is vital to hold negotiators accountable.

Introduction

Its is very common for industrial production in the extractive sector to require negotiation and signing of contracts between the national government and mining and oil/gas companies. These contracts complement the legislative framework and provide more detailed regulation for the extractive project in question.

Negotiation of such contracts in developing countries is often a major challenge for the government. In many cases, there is a low negotiation capacity in government and imbalance in the level of information held by government and EI companies. While the EI companies usually have a better-qualified team of experts to prepare for negotiations, including geologists, mining engineers, tax and law experts, on the other hand, the governments often lack:

a. all necessary relevant people at the negotiation table (for example tax officials or experts)
b. all relevant information
c. all the relevant skills. The main skill missing is the ability to create and analyse financial models.

Content of extractive industry contracts

EI contracts are sector-specific (oil, gas or mining). In mining, licences for exploration, exploitation, and operating permits can be found. In the oil sector, concession agreements, production-sharing agreements, and risk-service agreements are used.

The issue of tax exemptions is vigorously discussed. Governments should question why a tax concession is necessary and how the tax concession being requested will affect the project model so they understand the effect of tax concessions on project profitability. This questioning will ensure that the government understands the impact of each concession given and that they can make informed decisions about the type and length of the tax concession given away. For instance, imagine a project which has a lifetime of 25 years and which will become profitable after 10 years of operation if the normal tax law is applied, for which the investor is asking for more tax concessions to be put in place for 25 years. If the investor is requesting a number of tax concessions which make the

project profitable in 3 years, the government should ask why the 25 year tax concession period is necessary, and whether a shorter period is more appropriate to mitigate the perceived investment risk.

Another area of contention is stabilisation clauses. Due to high sunk costs and the long-term nature of extractive industry investments, stabilisation clauses have long been included in contracts to assure investors that the state will not change the contract requirements, in particular the fiscal terms, over the life of the project. Especially in countries that are perceived as politically risky, investors demand long-term, sometimes indefinite, stabilisation clauses. While these clauses act as a risk-management tool for investors, they curtail the sovereignty of the state to adapt the terms if and when there is a change in circumstances, and the need to act in favour of the public interest.

Model contracts can help to standardise provisions of contracts and can serve as a starting point of negotiation. However, model contracts always have to be adapted to country-specific needs, and negotiation parties are well advised to start negotiations on basis of the same model.

Area for further thinking

The length of the stability clause should reflect the riskiness of the country and project context. Could a tool be developed that helps governments negotiate the length of the stability clauses, based on a comparative assessment regarding how long stabilisation clauses are in different jurisdictions?

Breach of contract

Another point is that the government sometimes cannot deliver on the agreed terms of the contract, for example providing electricity for the production. In such cases the EI companies often try to claim further tax concessions as compensation for the government's failing to provide the agreed infrastructure. If governments are properly advised on the potential and limits of their resources before making such claims, the issues of non-compliance might be avoided and the risk of losing tax revenues as compensation measures may decrease.

At the outset of contract negotiations, the government should consider the need to include provisions in the contracts requiring a shared use of infrastructure, as it is much more difficult to renegotiate the contracts when the shared infrastructure becomes necessary.

Areas for further thinking

Governments in some developing countries have recently tried to enforce compliance of EI companies with tax law and contractual obligations entailing long judicial processes. What are government's options when companies do not comply to law or contractual arrangements? What are good practices? How could government avoid reaching this stage of escalation?

Support for contract negotiation

One way to achieve better contract negotiation outcomes is direct support for negotiations through a pool of experts with relevant industry, technical and country/regional knowledge. These experts must be able to advise the governments not only on legal and mining technical issues, but also deliver expertise on fiscal issues and project modelling. Nonetheless to avoid a long-term dependency on external experts, there is a necessity to strengthen negotiation capacities directly in the government structures of resource-rich countries. It is advisable to have a coherent strategy for capacity building and ensure enabling conditions for national experts to contribute and feed in their knowledge. An issue remains that high level politicians involved in contract negotiations may refrain from seeking advice and recommendations from lower ranking technical experts. So apart from relying on international experts, governments should ensure that they make

use of the expertise available within their own structures and systematically build up this expertise.

GIZ offers a long-term solution for strengthening of negotiation capacities by offering training on contract negotiations within the framework of the CONNEX initiative. The initiative was launched by G7 in 2014 and aims at supporting developing countries in negotiations of complex commercial investment and infrastructure especially in the extractive sector. The training includes modules for negotiations preparation and strategy as well as for monitoring and implementation of the contracts. More information can be found at the Negotiations Support Portal.

Contract transparency

Contract negotiations are held in a closed door environment. Given the large stakes being negotiated, the risk of corruption is high. To hold the negotiating team accountable, the contracts should be made public. resourcecontracts.org to date has collected and published 1116 contracts from 73 countries. However, there are still many jurisdictions where contracts are not public. Even in countries where the trend is moving towards contract transparency, the more controversial ones that have been negotiated in the past are kept secret. Only by moving towards contract transparency can the negotiation team be held accountable. This will also help to manage expectations (see Chapter 4.2. on Expectation Management).

Areas of intervention

› Capacity building for areas relevant to contract negotiation (project modelling, taxation, geological, engineering)

› Organisational development to ensure technical experts can influence negotiations e.g. clarifying areas of expertise, roles and mandates; possibly introduce standard processes and formats for experts' recommendations

State Ownership

Governments can take ownership interests in resource projects either directly (via government ministries) or through State Owned Enterprises (SOEs).

Equity participation in extractive projects can take many forms, ranging from minority to full state ownership. The form of ownership defines the level of risk and of influence over project activities and profits.

So-called free equities rarely come at no cost for the government, usually they go hand-in-hand with tax reductions and other trade-offs.

The funding of SOEs tends to be off-budget and fiscally non-transparent. Staff appointments are often politically motivated.

Introduction

There are different forms of state ownership in the extractive sector either directly (usually the Treasury, Ministry of Finance, Ministry of Mines) or through 100% state owned enterprises (SOEs). The ownership form can be:

1. 100% ownership which means the government is completely at risk to the investment
2. Majority ownership (greater than 50%) which provides a strong level of influence and mitigation of risk
3. Minority ownership (for example 10% of shares) which provides minimal influence and minimal risk exposure

Significance of SOEs

While investment can take place directly or through SOEs it is the latter which has significant accompanying issues.

There can be different rationales for resource-endowed countries to set up SOEs. Often it is assumed that through SOEs governments can increase their potential earnings and control. Besides exploration and production, SOEs often have responsibilities in managing the development of the extractive sector by promoting efficient exploration and production, channelling a fair share of revenues to the state, managing the stability of agreements, and monitoring operations and revenue collection. Given their unique institutional status and frequently high levels of authority, SOEs often operate with limited oversight and accountability (see for example: NRGI 2015: State Participation and State-Owned Enterprises).

Issues with state ownership of extractive projects

State owned enterprises (SOEs) can take many forms. An SOE can be the monopoly extractive company, a vehicle for joint ventures with foreign companies, or just one of many companies engaged in extraction. An SOE can also be a regulator for particular investments. A state-owned petroleum company, for example, could be all of the above mentioned and also be the entity that regulates activities in that sector.

Governments can take equity stakes in many forms (e.g. via paid equity, some form of carried equity or free equity carried interest, where the government pays for its equity share out of production proceeds; equity in exchange for a non-cash contribution, for example by the government providing infrastructure facilities; and so-called "free" equity).

This discussion will only comment on paid and carry arrangements.

With paid equity, the state pays a market rate for its shares and may have to meet cash calls for project development expenses, as any private partner would. With carried equity, the private-sector mining partner finances the operation up front and the government pays for its equity via foregone dividends. With free-carried equity, the government pays nothing for the equity. However, none of these "free-carried" arrangements comes without costs to the state and, where instituted, typically obligates states to make trade-offs elsewhere in the revenue system in order to attract the investor (e.g. via lower income taxes or mineral royalties).

Carry arrangements, depending on the form in which equity is held and the consequent dividend stream, mean that the government shares some of the project risk. If the equity is in the form of ordinary shares, the board of the company determines how much of the profits (if any) should be distributed by way of a dividend, and how much should go into debt reduction or into retained earnings and be used to support future operations.

The problem that often occurs with minority ownership (e.g. a 10% share in a company) is that minority share does not give the country a decisive influence about what to do with profits, for instance, whether to invest or declare a dividend. If the company decides not to declare a dividend and, instead, reinvests that profit, the government gets no return on the investment.

The company can still get the benefit of those profits however. For instance, by paying interest on company loans to an offshore related entity. Despite not paying the dividend, the mining company can still take some profit out of the country through intercompany loans where the interest rate is above the arm's-length rate. Using debt rather than equity as a method of investment in a country is often referred to as thin capitalization and countries often have special rules to limit the amount of debt a company can have.

An additional problem for the country is that the amount of revenue generated by dividends is unpredictable and may change from year to year making it difficult to rely upon such revenue for budgetary purposes.

Other free-carry arrangements may potentially include the state taking a share of the net cash flow from a project in lieu of dividends. While this still requires the project to generate positive net cash flows before the government receives any revenue from this arrangement, the advantage is that payments are calculated according to an agreed-to formula, and the amount and timing of payments are not up to the discretion of the company board. Indeed such arrangements would also foil attempts to reduce dividends to government by financial manipulations such as debt loading.

Administration of any equity rights and revenue is typically (but not always) controlled by a government department within the jurisdiction's finance ministry. Also, tax legislation in a country typically provides its tax revenue authority with the right to directly audit a company's accounts, so government can be reasonably assured that a proper statement of profit is declared.

Good Financial Governance challenges of SOEs

The funding of the SOEs tends to be off-budget and fiscally non-transparent. Some SOEs take on roles that would typically be carried out by Ministries responsible for government expenditures, such as the Ministry of Finance or Transport. Instead of transferring the revenues to the Treasury, the SOE directly pays for projects in infrastructure or for social issues. This avoids the usual review of the national budget process and therefore infringes accountability and transparency standards (see NRGI 2015).

In developing countries where institutions are weak and roles often not well defined, SOEs can face but also create challenges. A significant governance issue within SOEs is often a lack of accountability, sometimes resulting in corrupt activities. In states inclined to cronyism and nepotism, heads of SOEs are often politically appointed by the government. Badly managed and not effectively supervised, SOEs can become vehicles for public officials to steer valuable contracts toward their own interests, or to create bloated bureaucracies that do little to advance broader development (NRGI 2015). This can result in a slow down in project development and significantly reduce state revenues.

Remedies

Where SOEs exists, certain measures may prevent negative effects. Clear definition and limitation of the tasks and role of SOE *within the sector* may increase transparency and uncontrolled political influence over the sector. Political interference may also be limited by a clear separation of roles *within SOEs themselves*. As the case for private enterprise, standards of transparency and accountability should be set and enforced in order to prevent the above-mentioned problems.

Areas of further thinking

How effective is it to train government representatives on company boards to strategically influence company decisions based on government priorities?

Areas of intervention

› Support Supreme Audit Institution (SAI) to audit SOE in the extractive sector, including profit-making oil trading.

Artisanal and Small Scale Mining

ASM operations often operate in an informal setting, resulting in governments being unable to collect fees, taxes and royalties from these activities. In many countries the potential of ASM value chains for revenue generation have not been tapped into.

Decentralising revenue collection to the local level is one avenue to address formalisation and enforcement.

Background

The overall share of Artisanal and Small Scale Mining (ASM) production of high-value minerals (such as gold, tin, tantalum, tungsten, and gemstones) compared to global production is significant. ASM also occurs in jurisdictions with low-value commodities (such as sand, stones, clay and salt). The sector employs significantly more people than the large scale mining sector and plays an important role in many developing countries regarding the livelihoods of rural populations and the local economies. Considering fees, taxes and royalties applicable to the sector in most developing countries, the overall revenue potential of ASM and its related value chains is significant.

Given that ASM operations often operate in an informal and opaque setting, governments are often unable to collect fees, taxes and royalties from these activities. At the same time, government agents and security forces (police, military) may benefit from the opacity of the sector and demand informal payments from artisanal miners. This results in a complex set of interests that prevent the ASM sector from formalisation.

Additionally, the sector is often plagued by environmental, safety and health problems, human rights violations, social tension, and corruption. In many cases there are also tensions between large-scale mining operations and ASM, which have resulted in mine stoppages and violent conflicts (also having an impact on revenue generation from large scale mines).

Challenges of collecting revenues from ASM

The difficulty of collecting revenues from the ASM sector can be traced back to (a) informal operations and (b) under-reporting. In the case where the ASM occurs in an informal setting, the government loses out on revenues in the form of licence fees, surface rental fees, royalties and other taxes related to production. Even when officially registered, ASM operations have an incentive to under-report production and employees involved in order to avoid employee withholding taxes, Pay-As-You-Earn, royalty payments and/or any other taxes related to production.

Given that ASM operations primarily occur in rural areas in remote regions, the licensing and revenue collection authorities often do not have the capacity to enforce and monitor regulations. Here it is worth distinguishing between artisanal miners that may not be bound to a particular area, and small-scale mining operations with a licensed concession. The former can move around easily and thereby avoid government agencies looking to enforce the rule of law. Gold-producing countries, for example, experience 'gold rushes' whereby word-to-mouth news about a gold find lead to numerous artisanal

miners rushing to the area. By the time the regulator hears and acts upon such news, the artisanal miners have already moved on.

The latter group (small scale mining operations with a licensed concession) is easier to identify by the regulator. However, tax payments are based on self-reporting. Given that it is very difficult to audit these reports without constantly being present at the mine site, there is a strong incentive for these operations to under-report revenues. As a result, only sufficient production figures are reported that will guarantee the continuation of the licence.

Given the limited resources of the government, the difficulty of regulating and auditing the ASM sector, as well as the relatively small revenue contribution by each individual mine (as opposed to a large scale mine) poses the question as to whether it is worthwhile for the government to channel more resources into oversight and monitoring of this sector. If the costs related to hiring more inspectors to audit individual mining pits are more costly than the benefits being generated from this activity, it might not be worth it (benefits should not only include revenues, but also other externalities such as reduced pollution).

While the recovery of taxes and other legal fees in the sector is a major challenge, another challenge is eliminating the practice of government agents requesting payments without any legal basis. Miners, especially those in remote areas, may not know which taxes and fees they are obliged to pay according to current law and regulations and which of the many governmental agencies is allowed to collect those payments. Government agents might take advantage of this ignorance and uncertainty about fiscal obligations and charge illegal fees and payments for mining activities. While these illegally raised payments may drive miners into poverty, they may also incentivise miners to operate in the informal sector, hoping to pass "unseen".

Opportunities for collecting revenues from ASM

Cases where small-scale mining and related revenue collection are well managed by government, such as in Rwanda, where the government collected a total of USD 228 million of combined export revenues for tin, tantalum and tungsten in 2013, indicate the potential of the sector. However, it has to be acknowledged that ASM management is highly context-specific and sucessful approaches are not necessarily replicable.

Formalisation is one of the main avenues for taxing ASM and is a means to enhance transparency of the sector and related mineral supply chains. This can be incentivised by supporting licensed ASM operations with access to financial services (such as loans and grants), machinery leasing schemes, and technical support (such as providing geological information and educational programmes about how to reduce the health risks of using mercury). Some countries create additional incentives for ASM to obtain a licence by increasing peer pressure and tying benefits for the community to the number of licences and official production in it. Certification schemes have been rolled out in order to distinguish which goods are produced by licensed operations responding to predefined criteria as opposed to having been smuggled. For certification initiatives to be successful, neighbouring and importing countries need to recognise these certificates.

Area for further thinking

Which practices for ASM incentivisation and enhanced revenue generation have proven successful?

Given that the central government is often too far removed from ASM operations, some countries have delegated the licence fee and tax collection of ASM to the sub-national level or established specific sub-national structures for doing so. In countries where ASM revenue collection makes up a significant proportion of total government revenues, there may be reluctance to give up control over this revenue stream. There are also concerns that the capacity at the sub-national level is often not sufficient to be able to manage these resources efficiently.

Due to the difficulty of collecting revenues at the mine-site level, many governments target dealers and exporters (see figure below for a typical ASM value chain). These buy the product of several ASM operations before selling it onto larger dealers within the country or exporting it abroad. The idea behind targeting dealers and exporters is that these need to pay the royalty and will then pass on this cost to the miners (by discounting the royalty in the price they pay). In order to become an official dealer or exporter, these operators need to obtain licences, which are only renewed if the appropriate revenues are paid. However, there is still an incentive by licensed dealers and exporters to under-report the quantities of product bought and smuggle out the difference. Furthermore, there are unlicensed dealers that smuggle the product out of the country. This is more common with commodities that have high-value-to-weight ratios such as gold and diamonds. A related issue with precious minerals is that dealers report and get taxed on the comparatively low prices they pay to individual miners but receive much higher prices on their sales, without their profit margin being taxed. Therefore, a few countries have established decentralised points of sales or public centres for ASM producers where prices for e.g. gold and diamonds are estimated by government agents.

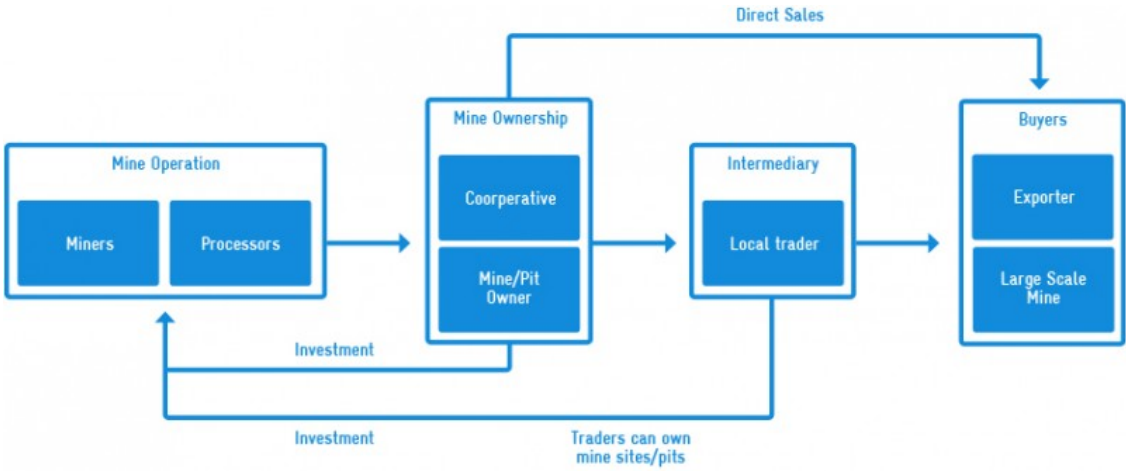

Figure 12: Generic ASM value chain

Areas of intervention

› Advice on integrating the ASM sector into EITI reporting, support to the pooling and publication of data from other initiatives such as mineral certification mechanisms

› Support to governments to simplify the ASM licensing and taxation regime

› Support to sub-national government entities to collect and manage ASM revenues

› Support for increased government inspection and monitoring of ASM activities

› Support to ASM operators for better book-keeping and record tracking

› Conduct trust-building exercises with ASM stakeholders and government institutions and the licence holders

› Organise information campaigns for ASM producers about commodity prices for export products and on international markets

Data Availability

Data availability is a precondition and contribution to good governance in the extractive sector and enables full participation of key actors.

A lack in common standards for data creation undermines their usefulness for the management of extractive resources and bears the risk of increasing the costs of production.

A main challenge for the pooling and sharing of data is trust building between different agents.

Introduction

As in all sectors of the economy, more and more data is being generated by the extractive industries sector. Large-scale mining, oil and gas companies produce increasing amounts of data to optimise production processes. Rio Tinto's mine of the future in the Pilbara, Australia, with the automation of mining trucks, rails and ship loaders is leading the drive in automation. Ultimately the idea is to control mining operations from a control room in order to increase efficiency and reduce the health and safety hazards for in-pit mining staff. On the other hand, increasing pressure by civil society and governments to monitor the sector's activities has led to an increase of reporting requirements for extractive industries.

Generally speaking, data availability can fulfil two functions:

- increasing transparency and thereby contributing to greater oversight and accountability, rule of law and citizens' participation in the management of extractive resources
- increasing efficiency and effectivity of management of extractive resources

Several global and regional initiatives have created and encouraged debate and action around data availability: the voluntary reporting initiative EITI (which becomes obligatory for companies operating in a country that takes part in EITI) has been adopted by 51 countries. The new EITI standard will require more sophisticated data reporting. At the same time, EITI should be mainstreamed, meaning that data would be created and pooled by other national institutions and only shared through EITI reports.

Home-country regulations, which require listed companies to publish data on payments to different governments on a project-by-project basis in all countries of operations, have been implemented or are in the process of being implemented in the EU, UK, Norway, USA, Canada and Australia (which represent a large proportion of where extractive industry companies are listed). Certification schemes such as the Kimberley process for conflict minerals require companies to report where exactly mining products are extracted.

Data generation and data availability are an important precondition to the implementation of technical instruments for sustainable revenue management. Data availability contributes to broad and informed participation of all involved stakeholders, which is essential in often highly politicised resource-related decision making and administrative processes.

Areas for further thinking

Need to establish a shared understanding of what "mainstreaming EITI" means and how this would influence the implementing of individual country technical secretariat roles.

What other criteria and conditions, apart from data availability, need to be met in order to ensure effective oversight, accountability and rule of law?

How much and which type of civilian participation (information, consultation, decision-making) is useful and desirable in EI management?

Key aspects of data provision

The trend to increased data requirement results in the fundamental questions of what information should be collected, in what form, who should create and collect the data, how this data should be shared, and who are the ultimate users. Of course, these questions are inter-related. The paragraphs below address each question in more depth.

Agreeing on what to collect and why

Data collection comes at a cost. If the expected cost of collecting data is larger than the welfare benefits of making this data available, it does not make sense to collect it in the first place. Below is a non-exclusive list of data points that have become available and the reasons for why we might want to have access to the data.

- **Cadastre:** Many resource rich countries have made information from the mining cadastre public. This helps governments and civil society to monitor which concessions belong to whom and whether there are overlapping concessions. Cross-checking information with other sector-specific cadastres such as environment, property can enhance the use of these data and help to detect irregularities.

- **Beneficial ownership:** The new EITI standard requires the publication of beneficial ownership, so governments and civil society can better assess who the ultimate owners of licences are. This will reduce the scope for entities that are trying to hide their assets.

- **Contracts:** An increasing number of countries are making their resource contracts public. The website resourcecontracts.org hosts an ever increasing number of contracts. Contracts allow citizens to see what agreements have been made between the government and the extractive industry sector. It can also help governments to better understand industry best practice.

- **Financial payments:** Financial payment transparency was first driven by the EITI process at the country level, with the idea that total payments from extractive industries should be publicly known so citizens can hold their government accountable. Today the trend is moving towards project-by-project level reporting. This allows oversight of individual projects.

- Given that EI companies do not only pay royalties and taxes, additional data related to payments in kind is also collected. This can include physical data such as ore, oil and gas, infrastructure payments or production sharing with state-owned companies.

- **Employment:** With the increasing push towards local content, companies have started to report employment and procurement figures.

- **CSR investments:** This is particularly relevant for communities around the EI project. A clear definition of CSR investments and their publication allow for better coordination and control of voluntary and non-voluntary contributions.

- **Environmental impacts:** Given that the EI sector usually implies a bad environmental record, there is increasing pressure by civil society to monitor emissions, water consumption and water discharge.

Agreeing on a data collection standard

After agreeing what data should be collected, it is important to agree on a standard according to which the data will be collected. If each company is left to report the data as they please, they will not be comparable. For example, if it is decided that local procurement data should be collected, it needs to be agreed upon what local procurement means. Does it mean a supplier based in the country, or that a certain percentage of local value addition is set to qualify as "locally procured"? These questions have to be dealt with at the country level by governments but also at the international level, for example, by the Statistical Commission of the United Nations or the OECD Statistic Departments. Using their expertise and calling on international best practice may help reach agreement on a data standard suitable and acceptable to EI companies and countries.

Areas for further thinking

Who is responsible for data creation? Are companies, the government or civil society responsible for collecting and creating the data?

How should it be captured? Does data capture require going into the field and/or monitoring? Can technologies be used for automated data exchange?

Streamlining data collection processes (efficiency): there should be a clear timeline as to what data should be collected and when. It is costly to have multiple data collection initiatives. How can one ensure coherence?

Cost/benefit of data collection: if the costs related to making the data available are larger than the social benefits, it may not make sense to pursue this endeavour. How can costs and benefits be easily assessed?

Data creation

Even if a lot of data is generated by different stakeholders at different levels around the extractive sector, in most countries there is no clear division of roles and responsibilities regarding data, and stakeholders involved rarely have a comprehensive strategy for data generation that takes into account further sources and initiatives.

Compilation of data

Very often, data is collected but not compiled, making it difficult for actors to base their decisions on existing and commonly known data. In order to ensure the usefulness of compiled data, it needs to be structured and categorised in a standardised way. Very often, standard categories do not exist and this makes the compilation difficult and costly. In many resource-rich countries, EITI is the only process by which data from extractive industries is systematically compiled and shared.

Data sharing

Data sharing describes mechanisms and processes of making data available to other stakeholders or actors. Data sharing allows for other actors to base their work on the same data.

Data sharing strengthens transparency and accountability across the sector. When it comes to good financial governance in extractives, a major problem lies in the unwillingness of actors to share existing data. As data collection is costly and complicated, actors tend to base work on incomplete information.

To improve data sharing, data needs to be presented in agreed-upon and open formats which allow for the integration of data into other databases. Excel spreadsheets, for example, are a more useful format for data than PDF.

The following questions need to be addressed when deciding how to share data:

- **Public vs. private**

Data made available to the public can be used by civil society and advocacy groups and thus strengthen transparency and accountability, while some data can only be shared between state authorities and would be subject to confidentiality clauses. Governments need to decide on the level of transparency prescribed to actors of extractive industries.

- **Format (user friendly)**

The formats through which data is shared needs to allow for easy use and integration into different actor systems.

- **Access**

Very often, data is available but difficult to access as it must be collected from different places and in different formats. An example would be contracts with operators in the extractives sector, which would have to be collected from different websites, sometimes only available in one language (e.g. Chinese) and incomplete.
Pooling of data strengthens accessibility: the same can be said for the provision in different formats, languages, electronic versions and hard copies as well as short versions or versions in “plain language".

Areas for further thinking

Considering that the extractive sector, legal and other framework conditions of each country differ, how can a common (international) nomenclature (classification) for reporting and standardisation of units be developed? Which actors should drive this process?

Who should be responsible for the compilation and sharing of data? What kind of minimum standards could ensure the accessibility of data in terms of language and format?

Data use

In order to make data meaningful, it needs to be analysed and presented according to the real needs of potential users. The question of how much effort should be put into data collection, pooling and sharing, depends on which actors can make use of respective data.

The following actors may use the data for different objectives:

- **Parliament**

Parliaments can use information on all issues related to the value chain and revenue management in their parliamentary session, in order to question authorities or to prepare parliamentary commissions and audits.

- **Civil society**

Civil society can use data in order to interrogate, hold different actors accountable or to prepare advocacy campaigns around the management of extractive resources.

- **Government**

Different actors within the Government will use data from the extractive industry sector. Currently, a major concern is the lack of data sharing between line ministries such as the Ministries of Minerals (MoM) and the Ministries of Finance (MoF) and revenue authorities. For example, the cadastre needs to share information about licences with other sections within the MoM, and if customs agencies or the cadastre does not share information with tax authorities, it may become difficult to detect fraud. Another example would be countries where production figures are not systematically shared, resulting in incomplete information for tax auditors.
Data can also be used by other actors such as the supreme audit institutions (e.g. for risk based audit planning) and the reform commissions (especially public finance reform commissions).

- **Academia**

Academia can use data for in-depth studies about the sector and its impact on economic development. As such, these actors are likely to require highly granular and disaggregated data. Resulting reports can then be used by civil society and governments.

- **International institutions**

If more data was available, international institutions could base their reports (often a source for policy decisions in partner countries) on the data collected by resource-rich countries for their own use.

Data literacy

The use of accessible data is often limited by lacking capacities of actors to read, interpret and analyse data. Resource-rich countries suffer from asymmetric information between governments and civil society and EI companies, generally resulting in uninformed decision making by government agencies.

Data tools facilitate the use of data and allow for standardised and comparable analysis of developments in the sector. Open fiscal models, for example, are increasingly being made available (such as those by the International Monetary Fund (FARI), the Columbia Center on Sustainable Investment, the Natural Resource Governance Institute, and Open Oil). These can be used and adapted to interpret data.

However, these tools do not directly address data literacy of the respective user because they focus on the provision of data but not on their interpretation. Special training for relevant data users in different stakeholder groups can help to overcome the lack of capacity to read and interpret such data with a sophisticated understanding.

Areas for further thinking

What are the skills stakeholders need in order to read and interpret data? Are these country- or commodity-specific? Can "data literacy" be taught independently of sectors and focus more on target groups (civil servants, civil society)?

Could an open data standard be developed for extractive resources (see Global Open Data Initiative) which would allow for PFM institutions and Ministries of Mines, Oil and Gas to exchange data more easily?

How could data availability be measured?

Areas of intervention

› Support for creation and implementation of (publicly available) information management systems, digitisation and data sharing

› Use of data training

› Peer learning to accelerate the spread of innovation

› Trust-building measures between stakeholders preparing data for sharing

› Support to the application of metadata standards

› Data creation, pooling and sharing via EITI, certification mechanisms and indices

Transparency, Oversight and Accountability

Strong and independent oversight in public financial management of EI revenues and the overall management of the sector ensures that governments comply with a country's own rules and obligations, follow its development objectives, and channel funds in line with its own planning.

Parliaments, Supreme Audit Institutions (SAIs), courts, the media, transparency initiatives and civil society play a key role in holding governments to account and in ensuring Good Financial Governance in the EI sector.

Introduction

Public Financial Management of EI revenues is often associated with a lack of accountability and transparency regarding contracts and payments between private companies and governments and the tax revenues that governments are receiving from those companies. It is important that transparency and accountability apply to the area of natural resources to support good governance. Transparency is an essential part of this equation. It allows parliamentarians to determine whether the country has secured a fair share of the resource revenues, and empowers citizens and their representatives to ask questions about how the government is using the revenues. During the last few years the transparency movement has made big strides in pushing for the disclosure of data about revenues generated by oil, gas and mineral extraction. Another powerful stakeholder can be the Supreme Audit Institutions. If they are well managed and fulfil their role and mandates, they can further increase accountability for the extractive sector.

Extractive Industries Transparency Initiative

An initiative which tackles the striking non-transparency of many countries' resources sectors and which has gained a lot of attention in recent years is the EITI. It was founded in 2002 by a number of governments of resource-endowed countries, extractive companies and civil society - the constituencies of which now form EITI's 'multi-stakeholder group'. The initiative's goal is to shed more light on public and private resource management and to involve civil society in making natural resource governance a subject of public debate.

While EITI can act as a diagnostic tool pointing fingers to technical skills and solutions needed in a country's specific context, it also provides room for the participation of key stakeholders in the debate about the management of often highly politicised sectors in which high expectations amongst the population are often disappointed.

Governments, companies and civil society have agreed that EITI will focus on the third of five links in the resources value chain, namely the disclosure and audit of payment flows between the government and extractive industries.

Figure 13: EITI value chain

While EITI makes a valuable contribution to financial transparency in the extractive industry sector, the concentration on this link means that it does not contribute to comprehensive resource governance along the entire value chain. For example, with revenue transparency, the accountability and development-oriented use of EI revenues is not yet assured.

Oversight of EI by Supreme Audit Institutions

The highest, and in the best case, most independent oversight function of a state is exercised by a country's SAI (equivalent to the Auditor General, and responsible for external audit). Oversight by SAIs is an important tool in safeguarding the effectiveness and efficiency of government action, and also its compliance with previously set agendas.

Figure 14: Role of SAI

One of the core mandates of SAIs is to provide budget oversight including EI revenues in the budget. Furthermore, SAI mandates typically include audits of the criteria used by government bodies to grant production and exploration licences to private and State Owned Enterprises (SOEs) as well as clauses established in those agreements. The audit can also look at compliance by private and public sector companies with a country's legal basis and/or agreements as well as how the government monitors and regulates compliance. Thus, in theory, SAIs have the mandate to exercise oversight over the en-

tire EI value chain in contrast with initiatives, such as the EITI, which focus on transparency of specific aspects only.

Licence fees, production royalties, taxes and dividends from the private companies and SOEs accrue to public accounts and thus fall under the core mandate of SAIs. According to international standards, the mandate of SAIs typically also extend to activities and financial practices of SOEs bearing a significant potential for oversight of extractive revenues managed by the state. The SAI examines whether revenues are in accordance with agreements, the royalties ordinance and any profit transfer agreements, and are entered properly in the budget, duly received and reflected in the public accounts. If the use of Extractive Industries revenues is earmarked for investment in programmes or priority areas related to sustainable development (e.g. channelled through natural resource funds), the SAI can control the achievement of programme goals through performance audits.

In order to fully perform their mandate, SAIs must have unrestricted, direct and free access to all records and information about public natural resources management. For SAIs to fulfil their oversight functions with regard to the overall management of the EI sector and public funds generated by respective activities, the SAI's technical capacity and a deep understanding of the EI sector is of utmost importance. An independent status within the state structure and protection against political influence are also essential to ensure that SAIs can autonomously carry out their audits of EI sector management and report on their audits and recommendations.

The SAI informs the administration, government, parliament and the general public on their findings. Published reports by the SAI on management along the whole value chain can close gaps in information which EITI currently leaves unfilled. The multi-stakeholder group (MSG) of national EITI branches may monitor and give feedback on the implementation of the recommendations intended to ensure orderly, efficient and effective management of natural resources. This may not only prompt dialogue between SAIs and EITI but may also stimulate a public debate about the management of revenues from state reserves of natural resources.

Areas for further thinking

How can measures supporting supreme audit institutions and measures aimed at increasing transparency in the natural resources sector be more strategically linked?

At the organisational level, could cooperation between SAIs and EITI be supported by promoting stakeholder dialogue on coherent audit and transparency standards? Support by technical assistance could also be conceivable in establishing a working group on natural resources governance at International Organisation of Supreme Audit Institutions (INTOSAI), developing audit standards and planning and carrying out joint training by EITI and the INTOSAI Development Initiative. By promoting policy dialogue and knowledge, shared norms and standards could be developed.

Parliamentary oversight

Parliaments have three core functions: representing citizens' interests, legislating, and overseeing the executive and thus contributing to ensuring balance of interest. In resource-rich countries, parliamentary participation in the management of extractive resources can have huge impact on a country's overall economic and social development.

When performing its legislative function, Parliament enacts laws on Public Financial Management and Mining laws.

When performing its financial oversight function, Parliament focuses on: (1) how public finance management and related legislation are approved and implemented; (2) how budgets have been applied; (3) whether government bodies at national and sub-national level are being effectively managed; and (4) whether government has done what it set out to do in the budget.

The oversight functions performed by the Legislature in the planning and implementation stage of the budget are a key precondition for Good Financial Governance. More specifically, Parliament exercises control and approves public expenditures by exercising

its authority to review, amend and authorise national budgets. This also applies to EI revenues, which are channelled through the government's budget. On the one hand, EI revenues often represent a large share of government budgets in resource-endowed countries and therefore deserve special attention. On the other hand, EI revenues managed off-budget represent a major source of concern as legislative oversight can not be performed and the management of revenues often solely relies on the discretion of the Executive, thus limiting control over government action. In some countries, mining, oil and gas contracts, such as production-sharing agreements, are subject to parliamentary scrutiny before being entered into by government, thereby fostering transparency.

Furthermore, the specifics of the EI sector require sector-specific technical knowledge for the Legislature to effectively perform its oversight functions. I this regard, internal capacity and access to independent research capacity on the EI sector, including revenues, budget analyses and expenditures, are essential.

Possible oversight tools are question periods, committee hearings, parliamentary scrutiny by committees (e.g. Mines, Energy, Finance and Public Accounts) and the provision of recommendations for reform.

More specific information can be found in the World Bank Institute document *Parliamentary Oversight of the Extractive Industries Sector* (see the PDF Document here) which outlines the role parliaments can play, describing the stages of the extractive industries value chain, including the link to the national budget, with possible action steps for members of Parliament for each stage.

Oversight through civil society organisations and the media

Since resource extraction mainly affects local communities, stakeholder consultation and engagement with communities before licences are granted is critical to ensure Free Prior and Informed Consent (FPIC) is taken into account and to inform citizens amongst others on financial implications of mining, oil and gas projects. In this regard, community-based monitoring is a complementary instrument. This is mostly implemented by local NGOs, which aim to mobilise communities to monitor extraction processes to avoid negative social and environmental impacts and to ensure socioeconomic development of local communities around extraction areas. NGOs also create demand for more transparency and accountability.

The media play a critical role in providing citizens with information about EI sector management by governments and companies and in uncovering corruption and mismanagement and thereby promoting transparency and accountability.

Areas of intervention

- Capacity development in national EITI secretariats.
- Capacity development for EITI stakeholders.
- Strengthening SAI's capacities for auditing the management of the EI sector.
- At organisational and individual level: capacity development for SAIs, introducing them to international norms and standards in the resource sector.

› Training for parliamentarians in resource governance, international standards and use of data in order to ensure qualified participation in the management of the sector.

› Media training on extractive resource governance.

› Training of civil society and communities to encourage social monitoring and participation in strategic debates.