# REVENUE MANAGEMENT IN THE EXTRACTIVES SECTOR IN AFRICA

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CABRI POSITION PAPER

2016

## Overview

The discovery of mineral resources promises to bring prosperity in the form of higher tax revenue, increased employment, improved infrastructure and trade, greater growth and wealth creation for all. For many resource-rich countries, these expectations have not been met. Even where the extraction of natural resources has led to economic growth, it has not necessarily been translated into better human development outcomes. Transforming the revenue that accrues from natural resources – in the form of taxes, production shares, royalties and dividends – into higher living standards for citizens has been a major policy challenge for governments. This is because large revenue injections from the extractives sector can increase both prices and the exchange rate (the 'Dutch disease'), such revenue is temporary, and high commodity price volatility makes planning difficult.

In the light of this, the Collaborative Africa Budget Reform Initiative (CABRI) organised a policy dialogue on revenue management in the extractives sector on 26 and 27 April 2016 in Accra, Ghana. The dialogue, attended by senior government officials from Côte d'Ivoire, the Democratic Republic of the Congo, Ghana, Liberia, Mali, Nigeria, South Africa and Zambia, as well as development partners and industry experts, examined how ministries plan and manage revenue in a manner that promotes sustainability, equity, poverty reduction and economic growth. Officials from finance, minerals and petroleum ministries attended the dialogue.

The Ghanaian deputy minister of finance, Ato Forson, opened the policy dialogue. He emphasised the need for countries to ensure that revenue accruing from natural resources benefits all citizens. He also underscored the importance of reducing dependency on natural resources by diversifying economies.

Countries need to ensure that revenue accruing from natural resources benefits all citizens.

This position paper on revenue management in the extractives sector draws on the deliberations at the policy dialogue and from two keynote papers that were prepared to facilitate the dialogue.[1] The points elaborated below represent the policy position of CABRI.

## The role of natural resources in the broader development vision

Natural resources should be a means to achieving the developmental objectives of a country, provided the necessary linkages are made between the extractives sector and the broader economy. If this is done successfully, it can enable a low-income economy to jump to a path of higher and sustained growth, catching up with middle-income peers and creating a diversified economy. This requires policy, legislative and regulatory frameworks

1 Keynote paper 1: Extractives industries and their linkages with the rest of the economy.
Keynote paper 2: Revenue management in the extractives sector

that are not only pro-growth but also pro-development. Mobilising human, financial and technical resources, often through public-private collaboration, enables other economic sectors to leverage opportunities created by a growing extractives sector.

Governments, as the custodians of natural resources, have the responsibility to develop approaches to maximise linkages with the rest of the economy. To achieve a 'natural resource jump', it is necessary to secure the investments in human capital, and physical and economic infrastructure, required by the extractives industries, and to increase trade in the commodities and services produced. These linkages, all of which are important and necessary, are elaborated in Box 1.

**Box 1: Extractives industries and their linkages with the rest of the economy**

There are five linkages that can be closely integrated with the broader national effort to achieve sustainable economic development:

- *Spatial linkages:* Extractives companies typically need to invest in infrastructure, such as pipelines, electricity generation plants, roads and ports. Such investments can be designed to maximise benefits to other economic sectors (e.g. electricity generation plants that also serve local villages, or roads that improve the functioning of local markets).
- *Backward linkages:* These involve extractives companies employing local people and procuring goods and services from local companies, which entails the development of local skills. Utilising local content can result in significant social and economic benefits, with the multiplier effect of wages and revenue spent locally providing a further boost to local economic development.
- *Forward linkages:* These involve boosting the broader economy by processing the natural resources extracted and using them to produce finished goods, rather than exporting them in their raw state. This can help to retain more of the wealth created by natural resource exploitation in the country, as well as promoting employment, industrialisation and economic diversification.
- *Knowledge linkages:* New technology, innovation and research and development introduced to the country by foreign extractives companies can become an essential item on the country's industrial growth agenda, if mechanisms are put in place to transfer the technology and related skills to the host country.
- *Fiscal linkages:* These are concerned with how governments capture revenue from natural resource commodities (through a fiscal regime) and the strategic use of such revenue for economic development. Fiscal linkages look carefully at taxes, royalties and production share agreements. The government must balance its interest in maximising revenue with the investors' need to be confident of realising a worthwhile return in a risky environment.

## Managing extractives revenue volatility through the budget process

Revenue volatility is a major concern for most countries that are dependent on extractives industries. Volatility makes the planning and budgeting of government expenditure inherently difficult: there is a risk of overspending on poorly planned projects in boom times, and of harsh cuts when prices or production fall. Volatility in government spending can damage long-term economic growth by causing instability in exchange rates, inflation, investment patterns and private sector activity levels. The primary challenge for revenue managers is to determine the value of the revenue that should be anticipated (in other words, revenue forecasting). However, the long-term volatility of prices renders the viability of resource extraction unpredictable, and this is compounded by technical issues such as geology and extraction technology.

Countries need to find the balance in setting fiscal rules that are not too restrictive but also not too flexible. Enforcement is key.

Revenue managers in ministries of finance, therefore, need to take a long-term and generally conservative view on revenue forecasts, treating unexpected revenue as a windfall and avoiding the temptation to channel it into short-term spending. This can be done by adopting fiscal rules and entrenching these rules in national laws. Countries need to find the balance in setting fiscal rules that are not too restrictive but also not too flexible. Enforcement is key. No amount of control is of much use without visible enforcement; breaches of the rules should attract severe penalties, and it is incumbent on ministries of finance to ensure a basic level of transparency by way of robust accounting and auditing procedures.

Various instruments for managing volatility are available to governments whose budgets depend on resource revenue. These include different forms of hedging against commodity price swings, the use of commodity-price-linked borrowing and the introduction of various fiscal or budgetary rules that help to place limits on budgetary expenditure in response to identified changes in commodity prices or in revenue from commodities. It bears repeating that the most feasible approach for most governments is to use fiscal policy in a counter-cyclical manner, saving revenue in boom times as a buffer against shocks.

## Should revenue from the extractives sector be earmarked?

In principle, revenue earned from natural resources could be earmarked within the budget for specific purposes, such as health and education services, infrastructure investment or cash transfer programmes. Firstly, earmarking can ensure minimum levels of funding for high-priority spending items. Secondly, where public financial management systems are dysfunctional, earmarking may be a way to improve the quality of spending decisions. Thirdly, where democratic institutions are weak, earmarking may help to reduce mistrust of the government by more transparently demonstrating the direct benefits of exploiting natural resources. On the other hand, earmarking reduces budgetary flexibility; earmarked funds can simply be offset by shifting resources to other areas, leaving the overall pattern of expenditure unchanged; and earmarking can reduce the role of democratic institutions in determining the overall budget, thereby reducing accountability for the use of funds. Countries may consider the application of earmarking in the context of a weak institutional environment. However, it is necessary to bear in mind that even with earmarking, resources will eventually run out. It is important that programmes funded from resource rents do not suffer when the resources have been exhausted.

## Spend now or save for later? The pros and cons of sovereign wealth funds

Once revenue begins to flow, the government needs to decide how much to spend immediately on pressing economic and social needs and how much to save for the benefit of future generations, who would then presumably take ownership of how saved funds are spent in the future. There are no hard rules for deciding on the exact proportion of revenue to spend now versus saving for the future. The challenge for the government is to assess the rate of additional spending at which the effects of the Dutch disease begin to materially offset the economic and social benefits gained from increased public expenditure. This is not an exact science; rather, it is a judgement call involving political processes and societal preferences. With regard to long-term savings, a rule of thumb is that if the returns on the sovereign wealth fund (SWF) are lower than the interest paid on debts, then it is rational to reduce debt levels instead of accumulating reserves.

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SWFs need to be considered in a time perspective: in the short term, an SWF can be used for stabilisation purposes and in the long term for intergenerational savings. Several resource-rich countries have established, or are in the process of establishing, SWFs. Countries need to consider carefully whether the size of the fund is large enough to justify its operational costs, whether robust governance checks and balances have been put in place to safeguard the fund and how the establishment of the fund impacts on the budget process.

Given the socio-economic needs of developing countries, there is a strong inclination to spend for immediate priority development needs; consequently, absorptive capacity must be strengthened. Some countries with SWFs have opted to save a small percentage of extractives revenue for future generations and spend the larger portion on development needs.

## Transparency and accountability: for what and for whom?

One of the reasons why many resource-rich countries have not translated their extractives industries' wealth into development for their people is a lack of transparency and accountability. The usual channels of public accountability are often missing in resource-dependent countries, compared to countries where the government relies on taxes for its revenue. The monetisation of natural resources is difficult to monitor and, hence, is more susceptible to appropriation and misuse. Transparency in the extractives sector is important for the following reasons: it improves trust and the management of expectations within and outside the government; it helps to mitigate against corruption and investments that are not in the public's best interest and, therefore, fosters accountability; and it sends a positive signal to quality investors and adds pressure for good fiscal terms. Lack of transparency and accountability has a tremendously negative impact on the management of revenue and the use of revenue to deliver social services. There is some concern about the legal frameworks governing extractives. For instance, some laws include provisions that allow for direct contracting on the discretion of the minister or for decisions to be made on case-by-case basis. This warrants a review of certain laws and, in some cases, a review of the implementation of the law rather than the law itself.

Resource-producing countries with weak institutional frameworks should consider appointing an independent external auditor, in addition to the usual audit conducted.

Transparent decisions are needed across the policy chain of the extractives industry. Information on the following, inter alia, should be disclosed in an accessible manner: bidding processes, contractual terms, fiscal regimes, how much revenue is collected from the sector, how much is used for current and capital spending, how much goes into debt and stabilisation, and how much is saved. To ensure transparency and accountability, resource-producing countries with weak institutional frameworks should consider appointing an independent external auditor, in addition to the usual audit conducted by the country's supreme audit institution. International initiatives, such as the Extractive Industries Transparency Initiative, may have a valuable role to play in complementing the government's own mechanisms.

## The political economy of managing extractives revenue

During times of high commodity prices, governments are under pressure to spend heavily on social programmes, especially where pressing developmental imperatives are at the forefront of public opinion. The 'boom-times' are also renown for wasteful expenditure and the expansion of the public sector.

Fiscal rules are important tools that can impose constraints on ill-informed discretionary expenditure. They have proven to be valuable in times of political and economic turmoil, when pressure to spend has been resisted. The challenge with any rule is the extent to which it can be enforced. To guard against the political pressures that create temptations to break these rules, meaningful enforcement mechanisms should be implemented and the rules should be publicised widely and applied transparently.

## Moving beyond the extractives sector

A heavy reliance on natural resources, without taking measures to diversify, renders a country highly vulnerable to shocks, and less capable of sustaining growth as resources become depleted or unviable for extraction in low-price scenarios. The exhaustibility of natural resources has placed the need for diversification on the continental agenda for some time now. This has become even more important with the end of the commodities 'super cycle' and record-low commodity prices. The call for diversification, therefore, rightly features prominently in the 50-year plan (Agenda 2063) of the African Union.

> Many African countries make the mistake of failing to innovate in times of plenty.

Many African countries make the mistake of failing to innovate in times of plenty. The commodity boom period was a missed opportunity to use surplus revenue from the extractives sector to industrialise and transform our economies. Natural resources can still accelerate growth by leveraging the five linkages referred to in Box 1 above.

## CABRI's continued engagement

Future work on revenue management in the extractives sector will be undertaken on a demand-driven basis. CABRI is in a position to carry out in-country dialogues, which include peer countries, to help identify problems and blockages in effective revenue management and to offer policy recommendations and related action. CABRI will continue to facilitate dialogues between finance ministries, ministries responsible for the extractives sector and other key stakeholders, with the objective of improving revenue management and moving beyond our reliance on extractives.

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This position paper has been funded by UK aid from the UK government; however the views expressed do not necessarily reflect the UK government's official policies.