



THE ROLE OF PARLIAMENTS IN THE EXTRACTIVE INDUSTRIES

List of Acronyms

1. **CBO** - Congressional Budget Office (US)
2. **CPA** - Commonwealth Parliamentary Association
3. **CSO** - Civil Society Organization
4. **CSR** - Corporate Social Responsibility
5. **EI** - Extractive Industries
6. **EITI** - Extractive Industries Transparency Initiative
7. **GDP** - Gross Domestic Product
8. **IMF** - The International Monetary Fund
9. **LEITI** - Liberia Extractive Industries Transparency Initiative
10. **MP** - Member of Parliament
11. **MTEFs** - Medium-Term Economic Framework
12. **PBO** - Parliamentary Budget Office
13. **RRDC** - Resource-rich developing countries
14. **SAI** - Supreme Audit Institution
15. **SOE** - State Owned Enterprise
16. **SWF** - Sovereign Wealth Fund
17. **UJV** - Incorporated Joint Venture

Note: In this document, the terms ‘parliament’ and ‘legislature’ are used interchangeably, as are ‘parliamentarian’ and ‘legislator’.

暴殄天物

*“To waste natural resources is to squander
the blessings of heaven”*

- Chinese Chéngyǔ Proverb

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INTRODUCTION

The enormous potential that responsible management, oversight, and stewardship of natural resources can yield for uplifting people out of poverty and contributing to sustainable development has long been recognized. However, translating those resources into actual benefits in practice has been more elusive, and today two-thirds of the world's poorest people live in countries that in fact are rich in natural resources.

Therefore, it is regrettably stated that natural resources are at best a mixed blessing for developing countries, with many of them indeed suffering from the *Resource Curse*, because resource revenues can feed large-scale corruption, underdevelopment, and in some case fuel conflict and war. Nonetheless, the extractive industries¹ (EI) which convert these resources into economically consumable products can indeed play a positive developmental role through various functions: direct and indirect job-creation; transfer of technologies, knowledge and skills; income generation; and providing governments with a financial base both for social service delivery and for infrastructure development.

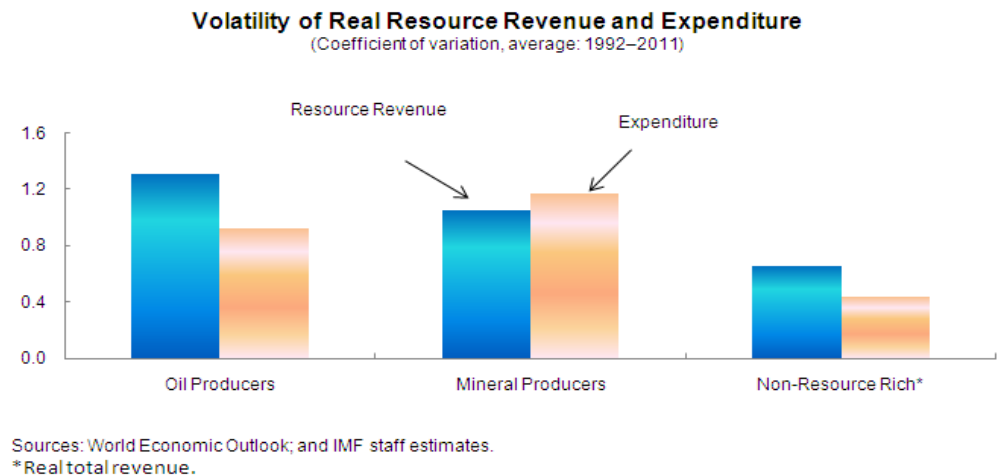
The ill effects of the resource curse can be attributed in part to the absence of transparent and accountable institutions in many Resource Rich Developing Countries (RRDCs). In these RRDCs, large monetary windfalls and unregulated inflows of funds into government treasuries have created incentives for considerable corruption, which in the long-run gravely undermines the relationship between citizens and governments. In these environments, policy makers are tempted to seek out short-term solutions to long-term social and economic problems in return for remuneration, and over time, these economies depend less on productive sectors and the revenues from taxes of non-extractive sectors.

There are some important considerations for extractive resources that one must be mindful of. First, extractive resources are **nonrenewable** and largely finite, which makes the sustainability of their usage highly crucial because the consumption of these resources precludes future generations from reaping their benefits. In other words, extractive resources

¹ Extractive Industries is defined here as comprising the oil, gas, and mining sectors

are a choice that countries need to view across a multi-generational time horizon.

Secondly, commodity prices are ipso facto extremely **volatile**, being the best-performing investment asset class in one year, only to be relegated to the bottom place the following year.

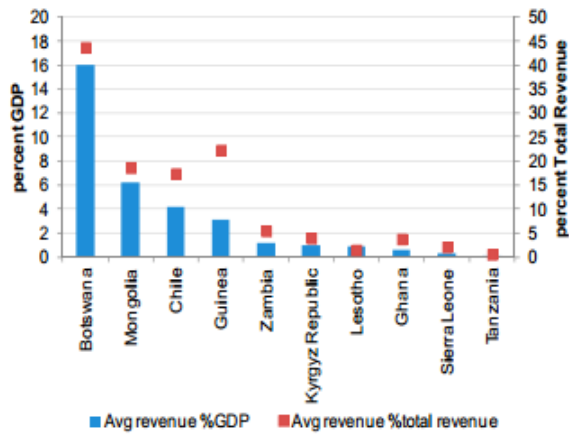


These macroeconomically driven price swings create a tremendous amount of uncertainty which also complicates the conundrum for states wishing to decide how much of a resource should to be extracted. Historically speaking, forecasts of the world oil prices have been pervasively off-the-mark due to inherent volatility and uncertainty

Thirdly, in economics parlance, natural resources give rise to “**economic rents**” because they are not “produced” per se, yet they provide an income to their owners simply through possession of the resource base, and this creates economic inefficiencies and a rentier economic actor, i.e. one which derives a substantial portion of national revenues from the rent of its indigenous resources to external clients. Therefore, weak democratic institutions may be “captured” by usurping agents wishing to siphon these economic rents for their personal benefits.

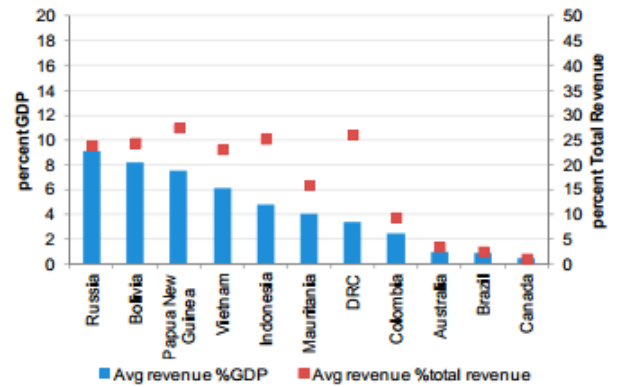
Fourthly, the importance of extractive revenues may be extraordinarily high for certain **governments** because of the significant percentage of the inflows that these revenues may comprise in their national budgets. Oil, gas and minerals often provide the vast majority of state fiscal receipts in many resource rich countries such as Brunei, Iraq, Saudi Arabia, Equatorial Guinea, Azerbaijan, and Angola.

Mining: Government Revenue by Country, 2001–10

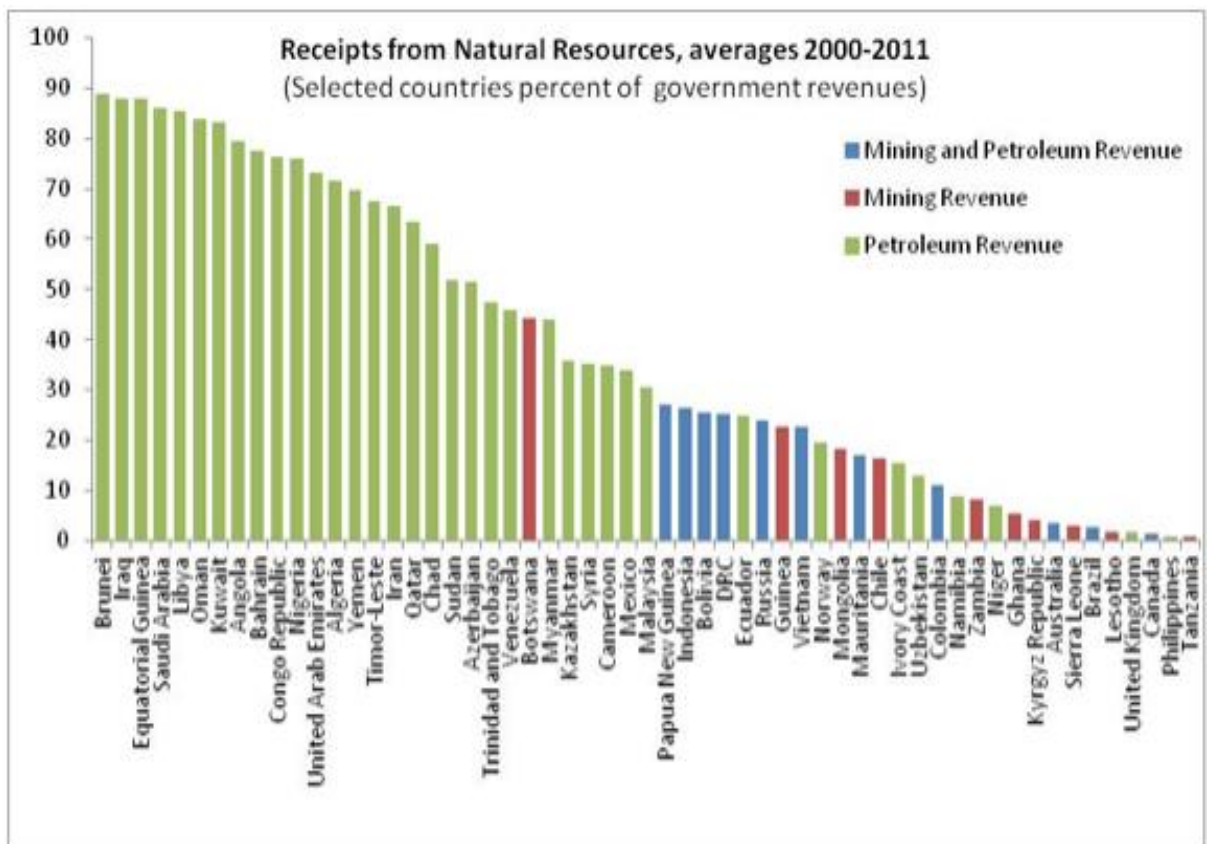


Source: IMF staff estimates.

Mining and Petroleum: Government Revenue by Country, 2001–10

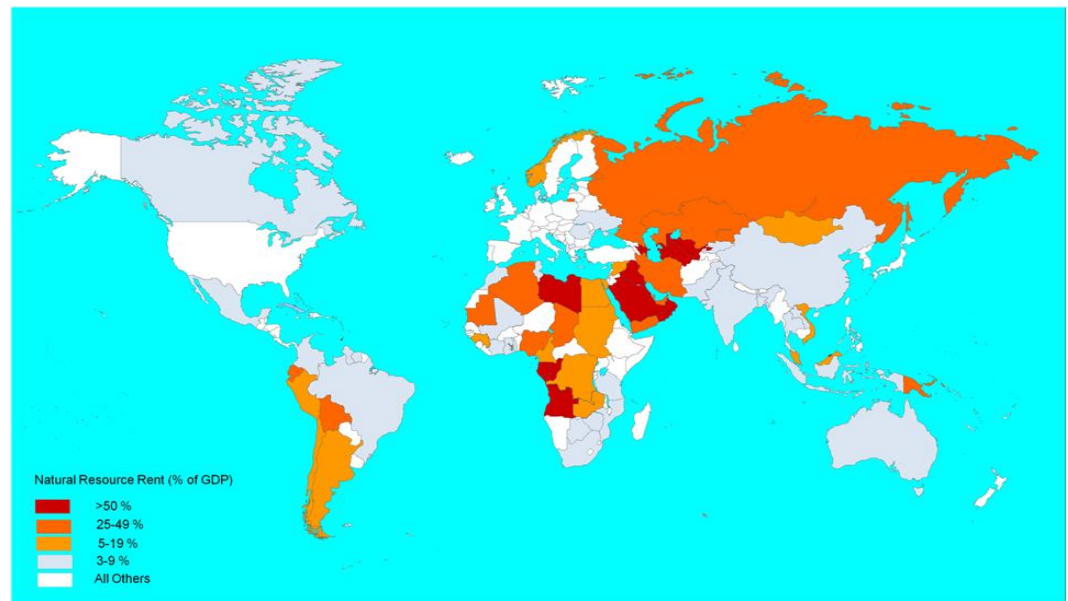


Source: IMF staff estimates.



Source: IMF

Figure: Natural Resource Rents as a % of GDP



Source: IMF

Fifthly, in the world of extractive revenues, particularly under democratic arrangements, there are numerous important **stakeholders** with differing, and sometimes conflicting, agendas that require appeasement: environmental organizations; commercial interests; government agencies; small-scale local enterprises; and in certain cases indigenous peoples; among other stakeholders.

INSTITUTIONAL CAPITAL

In addition to the commonly known ideas of *human capital*, physical capital, and technological capital, there is another economic idea that is pertinent to mention – *Institutional Capital*, which refers both to the governance capabilities as well as the transparency & accountability in institutional frameworks. Many of the policy and institutional factors that enable countries to manage resource wealth well are equally important for their ability to diversify into other sectors, and the two types of capital that can be seen as complementary to natural resources are human capital and “**governance or institutional capital**”. Without these, the country is more likely to fall prey to the resource curse (IMF 2010). This document attempts to guide legislators on their role in extractive industries precisely because of the need for developing greater **institutional capital**.

TRANSPARENCY

A necessary prerequisite for good governance in vibrant democracies is **transparency**, which requires that information is available, timely, accurate and released regularly, in addition to being useful and

readily comprehensible to the public (World Bank Institute 2010). With transparent access to information, citizens are able to participate in the broader discourse on public policy and on the allocation of society's resources, including extractive natural resources. A citizenry with access to information about its mineral wealth will be able to make informed decisions about the judicious use of those resources.

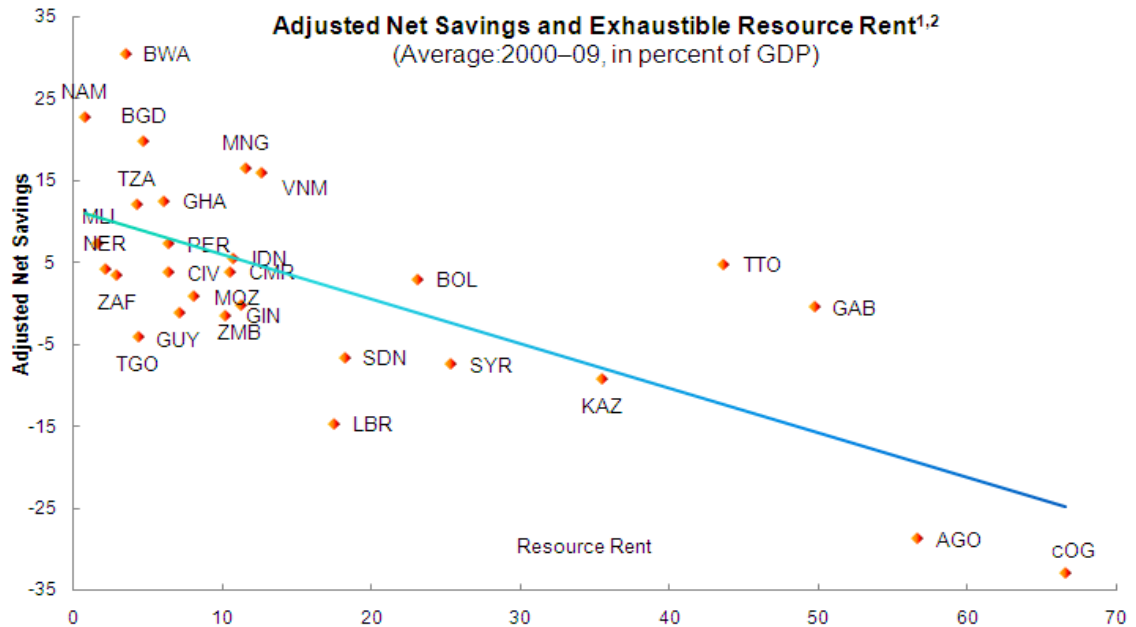
Yet, the level of transparency is generally low when it comes to extractive revenues, and the quality of decision making is thus hampered. There is neither intrinsic reason for ineffective and non-transparent administration of EI to continue, nor for it to be harder for EI than for other industries. After all, EI are simpler than other industries (such as finance and telecoms) in that they involve physical operations with outputs that can be analyzed, weighed, and measured, with prices in most cases quoted on international exchanges; and the vast bulk of revenues is often paid by a few large taxpayers, with a high stake in maintaining government goodwill (IMF 2012).

Thus, the World Bank has been working closely with governments to support transparent, sustainable management of their mineral and hydrocarbon resources to maximize development gains, reduce poverty, and avoid the following “curses” which stem from EI mismanagement: the resource curse, the voracity effect, and Dutch disease.

THE CURSES: THE RESOURCE CURSE, VORACITY EFFECT, AND DUTCH DISEASE

THE RESOURCE CURSE

The IMF describes the fundamental challenge for resource-rich developing countries (RRDCs) as the imperative to “transform depleting resource wealth into a portfolio of other assets to support sustained development” (2012), and this includes human capital, domestic public and private capital, institutional capital, and foreign financial assets. The record of such countries in building a wider, more comprehensive capital base, however, is generally poor; and instead of building a broad base of wealth, RRDCs have been associated with lower investment bases and lower “genuine” savings rates (which adjust savings rates for the rate of resource depletion). Economic performance in RRDCs has typically been weak, suffering both from low savings rates and extreme cycles of booms and busts.



Graph: Resource-rich developing countries tend to have lower savings rates, especially when adjusting their savings rates for the depletion of their resources (Net Savings). Source: IMF

In the minds of legislators, therefore, the resource curse should represent an umbrella term for the range of ills that can plague a country, including poor savings rates, extreme boom-bust cycles, corruption, violence, inequality, and a myriad of other maladies. On the other hand, the other two curses, the voracity effect and the Dutch disease, refer to specific consequences of abundant resources, and deserve the attention of legislators wishing to improve the use of natural resources.

THE VORACITY EFFECT

The Voracity effect, discovered by Tornell and Lane (1999), refers to the overaggressive redistribution by the elites of a windfall of resources which actually reduces a country's rate of economic growth. In the absence of strong institutions, if there are too many competing groups within a developing country simultaneously vying for power, a large resource windfall will cause these groups to voraciously redistribute an amount of wealth *in excess* of what was actually received from natural resources. The competing groups will squander this wealth and will slow the economic growth rate below what it would have been, had the resources not been present.

Due to its institutional nature, the damage of the voracity effect should not be lost on legislators from RRDCs. They should be highly conscious of this phenomenon because it reflects (1) the absence of strong

institutions and large, ‘voracious’ interest groups, and (2) the responsibility thereupon to strengthen institutions such as the legislature to avoid an overzealous redistribution of extractive revenues and assets that might, in the long run, actually slow the economic growth rate.

THE DUTCH DISEASE

Dutch disease occurs when the use of natural resources destroys other non-resource sectors of the economy such as the manufacturing and agricultural sectors. This usually happens because the export revenues from EI (such as oil) lead to an appreciation of the resource-exporter’s currency. The appreciation of currency then makes other exporting industries within the country, such as manufacturing, less competitive in international markets, because they become more expensive relative to manufacturing elsewhere. Overtime the competitiveness of these other industries diminishes to the point that the country begins to depend nearly exclusively on its natural resources, thereby destroying other economic activity.²

The lamentable effects of the resource curse, the voracity effect, and Dutch Disease point to the difficulties that will be faced by nations that do not channel their extractive resources through robust, transparent, and accountable institutions. It is with this premise that parliamentarians must begin the understanding of their engagement with the extractive sector, as the following section elucidates.

DIFFERENCES BETWEEN EXTRACTIVE SECTORS

While aggregating the mining, oil, and gas sectors into the overarching term “EI”, it is still important to take note of key differences between these sectors that will consequently impact countries with differing endowments of each resource in differing ways (IMF 2012).

1. Costs of Extraction

a. **Exploration** is often costly and riskier for petroleum (a deep water well, for instance, can cost over US\$100 million, and the chance of success in a new basin may be less than 5 percent).

b. However, the risks in the ‘**development**’ phase (bringing a discovery to extraction), and of failure during the extraction phase, may be greater for mining. Mining may also involve greater political and environmental risks, being typically based on land rather than offshore, and so more disruptive of communities.

² For Dutch disease, economic diversification is a necessary medicine, as shall be discussed in the management of EI.

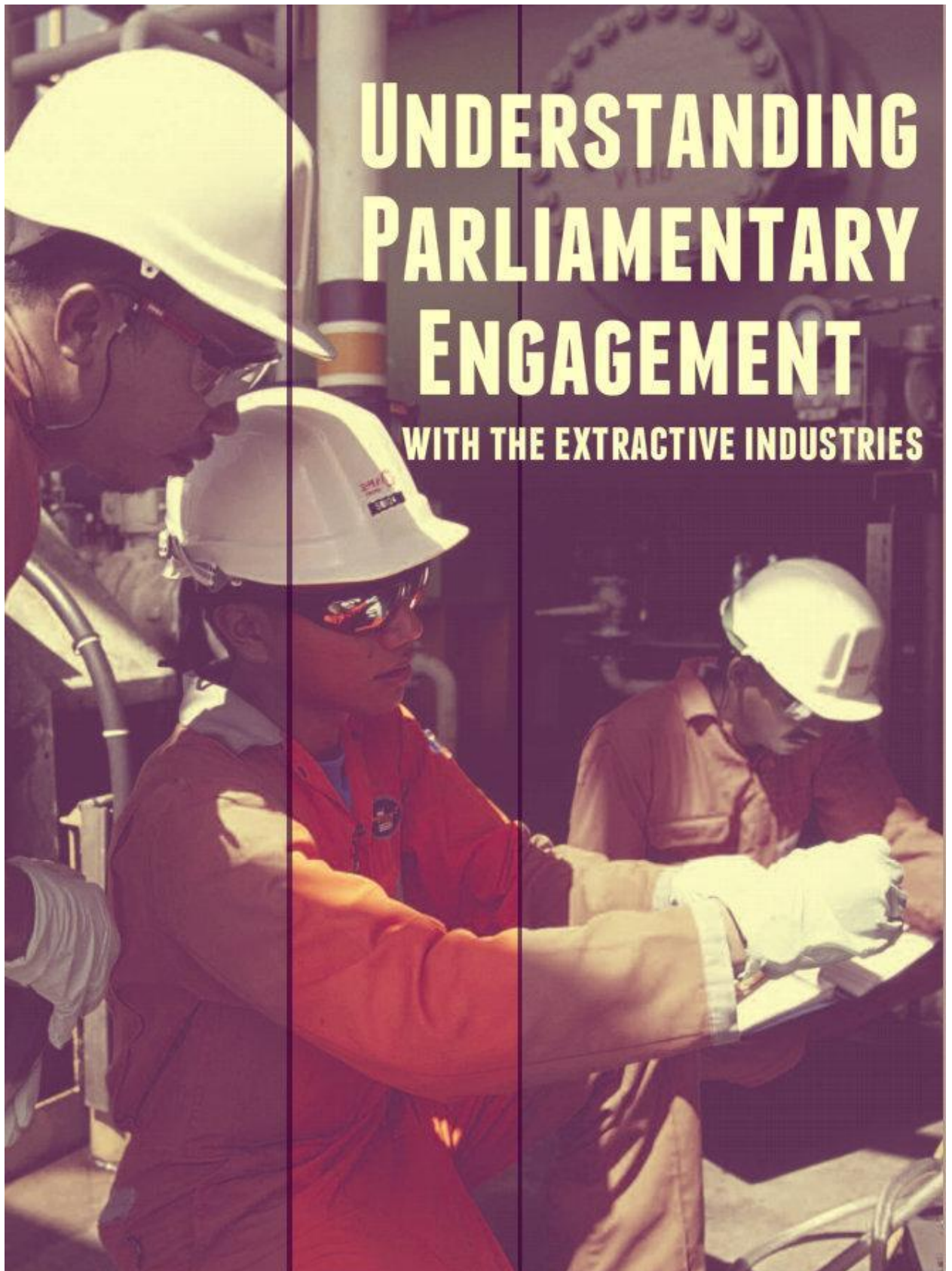
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2. **Commercial structures** tend to differ between petroleum and mining. For tax, financing, or sometimes technological reasons, unincorporated joint ventures (UJV) have been common in petroleum projects, with capital separately provided by the partners and production shared. This sets up conflicting interests from which tax authorities can benefit in controlling costs. UJVs have been much less common in mining, with major companies owning majority stakes in locally-incorporated vehicles.
 3. The EI sectors, especially oil and gas, are entering **a period of change**. ‘Fracking’, (hydraulic fracturing), becoming viable at current prices, enables fuller exploitation of onshore unconventional oil and gas, making their extraction more similar to conventional. In copper mining, production has continued to accelerate despite declining grades of ore mined, as development of new techniques has markedly increased processing efficiency. And the transparency agenda is transforming both the openness of many private EI companies and what is expected of host governments.

Therefore, EI is a term encompassing sectors that are slightly different in their composition, and legislators should be aware of the breakdown of the resource base in their country by commodity type.

THE WAY FORWARD

Having already mentioned (1) some of the key features of EI, (2) some of the curses that come along with mismanagement of EI, and (3) some of the differences between the components of EI, this document now guides legislators on how to contextualize their unique and important role within the ambit of EI. The World Bank Institute (WBI) has prepared this document in order to elucidate precisely what role parliaments can play in channelling natural resources towards the greater good of nations. First, it will discuss the potential scope for parliamentary engagement in EI. Thereafter, it will present the parliamentary responsibilities in light of the extractive industries value chain, going step-by-step through the five phases of the chain and elaborating on the specific functions and degree of involvement within each link in the chain. The value chain will cover the entire extraction process: beginning with the decision to extract and parliamentary representation, followed by the duty to “get a good deal” through contract law and parliamentary legislative function, thereafter transitioning into publishing & analysis of payments and the oversight role of parliament. Finally, the value chain will cover management of revenues and conclude with a discussion on the sustainable investment of these revenues. As such, this document will follow a logical progression that mirrors the pattern of

the natural resource extraction, and is constructed to aid in a firmer understanding of the preponderant themes in parliamentary oversight of the sector.



UNDERSTANDING PARLIAMENTARY ENGAGEMENT WITH EI SECTOR

Historically, democracies have established parliaments to represent and give voice to the interests of their citizens. If properly conducted, they can provide opportunities for more open and participatory governance. Against this background, it is important that parliaments be in a position to play their constitutionally assigned roles. The challenge is for parliaments to use their responsibilities to ensure that the needs of citizens, including the poor, are not only heard, but also met through the delivery of well-designed government programs and services.

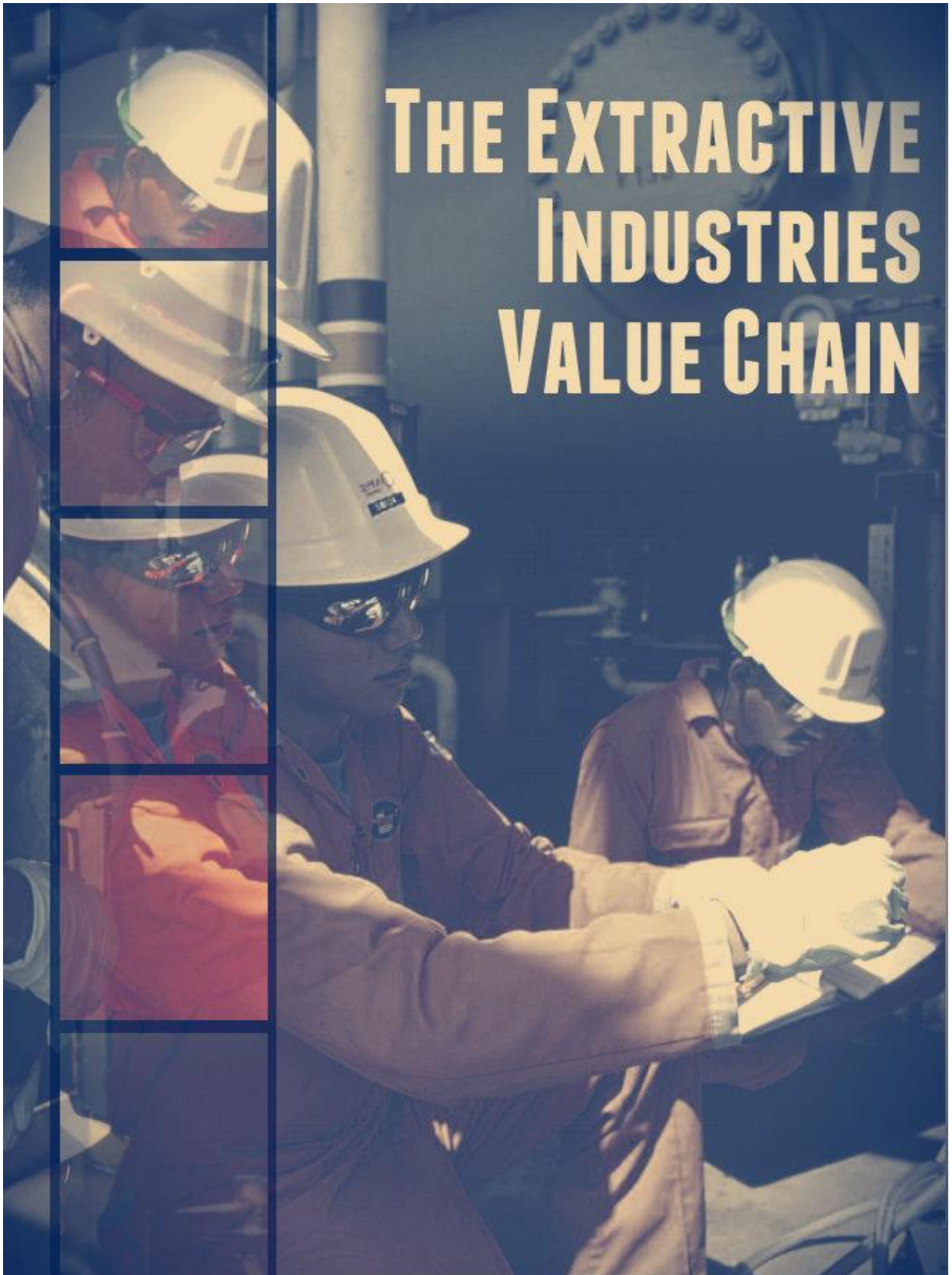
Parliaments perform three functions - representative, legislative, and oversight. First, they perform a **representation** function in that they represent the will of the people, which is the legitimate source of authority in democratic countries. Secondly, they perform a **legislative** function because, in addition to introducing legislation on their own, they have the power to amend, approve or reject government bills. Thirdly, they perform an **oversight** function, ensuring that governments implement policies and programs in accordance with the wishes and intent of the legislature. They undertake this oversight function in two ways: they oversee the preparation of a given policy (ex ante oversight) or oversee the execution and the implementation of a given policy (ex post oversight). In addition to these three core functions, parliaments play a key role in the formulation of the **budget**, and have a significant participatory purpose in all stages of the budget process.

For the purposes of understanding parliamentary engagement with the EI, each of these functions can be synchronized with a distinct purpose within the extractive process. For this reason the functions can each be combined with a step of the Extractive Industries *Value Chain*, which is why an exact dissection of their role is postponed until the following section of this document which analyzes this value chain. For the moment, the following table is provided as a prima facie look into how these parliamentary functions coordinate with the steps of the value chain.

Table: Parliamentary Functions and Value Chain Steps

Function	Explanation	Value Chain Step
Representation	Voicing the concerns of major stakeholders	Step 1: Deciding to Extract
Legislation	fair and transparent legal frameworks and contracts	Step 2: Getting a Good Deal
Oversight	Transparency and Accountability in the collection of revenues, and a thorough analysis of the extractive revenue inflows	Step 3: Publishing & Analyzing Payments
Budgetary Process	Managing the revenues so as to attain national development goals in the context of the overall budget	Step 4: Managing Revenues
Audit Committees	Investing in sustainable projects with long-term, broad based benefits	Step 5: Investing in the Sustainable

This sequential process allows for an understanding of parliamentary engagement in EI as a process that mirrors the extraction of natural resources itself, from the raw resource to the refined consumables and from there to the revenue for attaining present and future development priorities. As this document shall elucidate, there is an unassailable logic in favour of greater legislative engagement in extractive industries, which is predicated on the basis that a strong, credible, independent, well-informed and committed legislature can help to channel the extractive revenues into benefits for the people.

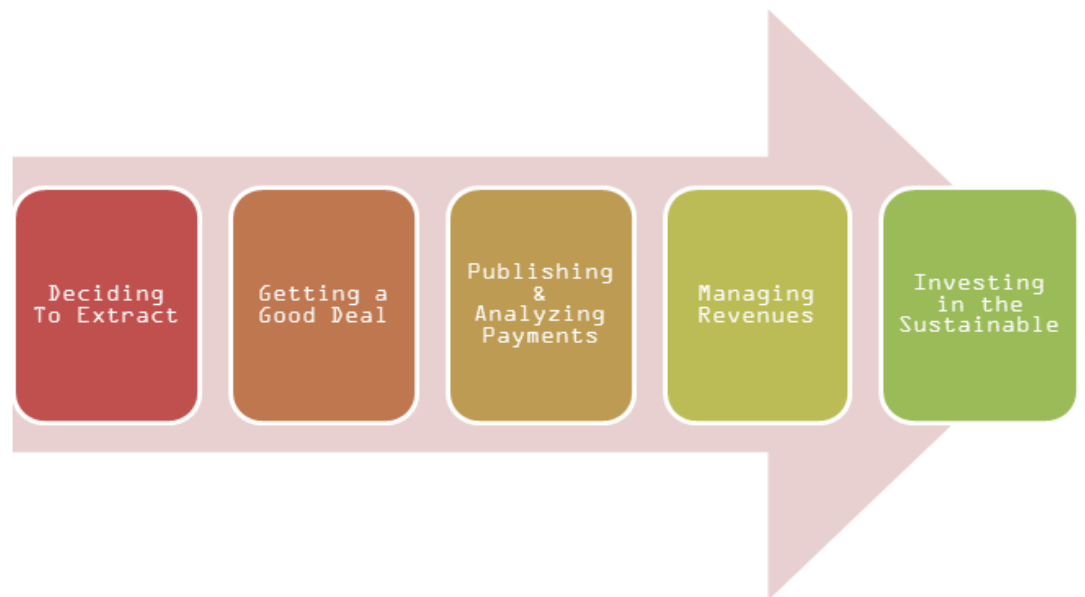


THE EI VALUE CHAIN

A value chain is a way of describing the stages by which the full value of a product is managed and ultimately realized. The process of improving transparency in extractive revenues can be contextualized through this framework, which begins with the decision to extract revenues and follows through to the management and disbursement of revenues, and finally to the reinvestment of these revenues in a sustainable manner.. With this framework in mind, the management of resources along the value chain should feed into an RRDC's long-term economic aspirations, social goals, and poverty reduction strategies (World Bank Institute 2010).

The World Bank, with other development partners, is stepping up its efforts to provide a more integrated and comprehensive approach to managing the full EI value chain, including all the steps of EI development and impact.

Figure: The EI Value Chain



Stage 1, Deciding to Extract: The first decision faced by a government or community is if and when to begin extracting their natural resources and convert them into monetary or other benefits. During this stage, governments may take the opportunity to get prior informed consent from the local communities, to designate environmentally or culturally significant areas as off-limits to exploration and production, or even to reserve certain areas for particular methods of extraction. The government's chief task at this stage is to undertake a cost-benefit analysis that makes every effort to weigh all the costs, benefits and risks over the expected timeframe of extraction and beyond. From a Parliamentary perspective, the

representation function is most important at Stage 1 because voicing the legitimate concerns of major stakeholders is most important in this early phase. Parliament must make a deliberate attempt to broaden its representativeness of all significant stakeholders, including local communities, environmental groups, CSOs, multinational corporations, the media, and political parties, among others.

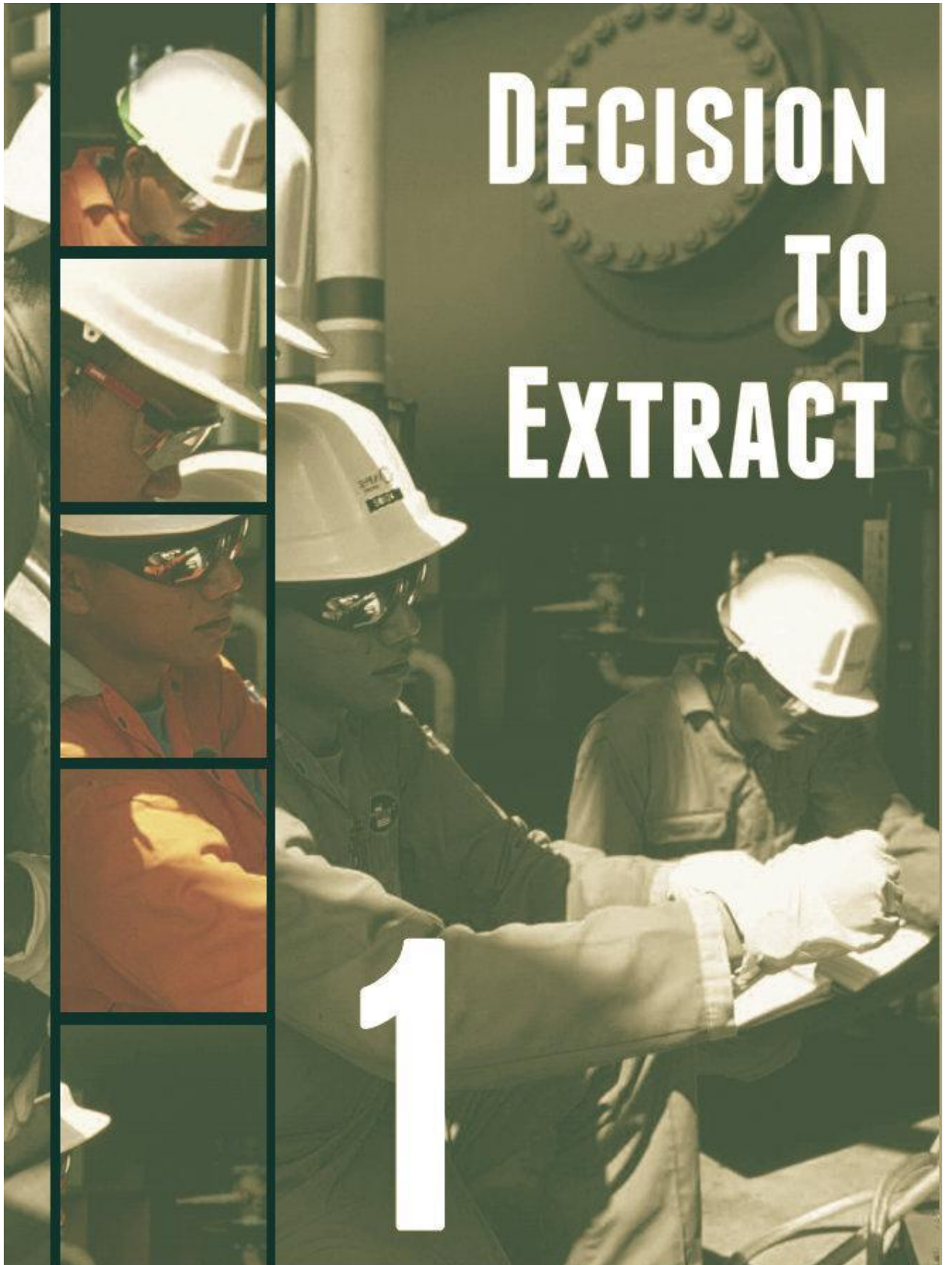
Stage 2, Getting a Good Deal: After a decision is made to extract, the government must decide on a framework for awarding rights to explore and extract, and it must establish the legal and financial terms governing those rights. Exploration and extraction rights may be awarded in a variety of ways, and the legal and financial arrangements governing the extraction process may result from licensing rounds (in which specific terms are left for bidding and the bulk of the arrangement is enshrined in general law) or they may be negotiated on a more ad-hoc basis. In either case, the end result is typically a written contract of some form, complemented by a bevy of generally applicable laws and regulations, the goal of which, for the country, is generally to give it the best deal possible (Revenue Watch, 2009). RRDC's are often at a disadvantage when negotiating with multinational oil and mining companies – particularly where terms subject to negotiation are not tightly constrained either by the terms of a licensing round or other rules – and consequently get less revenue than they should. Therefore, it is at this juncture that the legislative capacity of parliaments comes to the fore, to set up a legal environment that is conducive to fairness, transparency, and prosperity alike.

Stage 3, Publishing and Analyzing Payments: Once the legal framework and contracts have been put in place, and the extraction process has been set in motion, the payments from this process will begin to flow into government treasuries. It is at this time that transparency will be paramount, which is why open publishing of what is paid will be necessary, through mechanisms such as those endorsed by the Extractive Industries Transparency Initiative (EITI). Additionally, due to the complexity of the payments, contracts, duties and responsibilities, the aid of an impartial, technically-oriented office, otherwise referred to here as the PBO, will be important. Both of these initiatives, EITI and PBOs, have specific sections dedicated to them in this document.

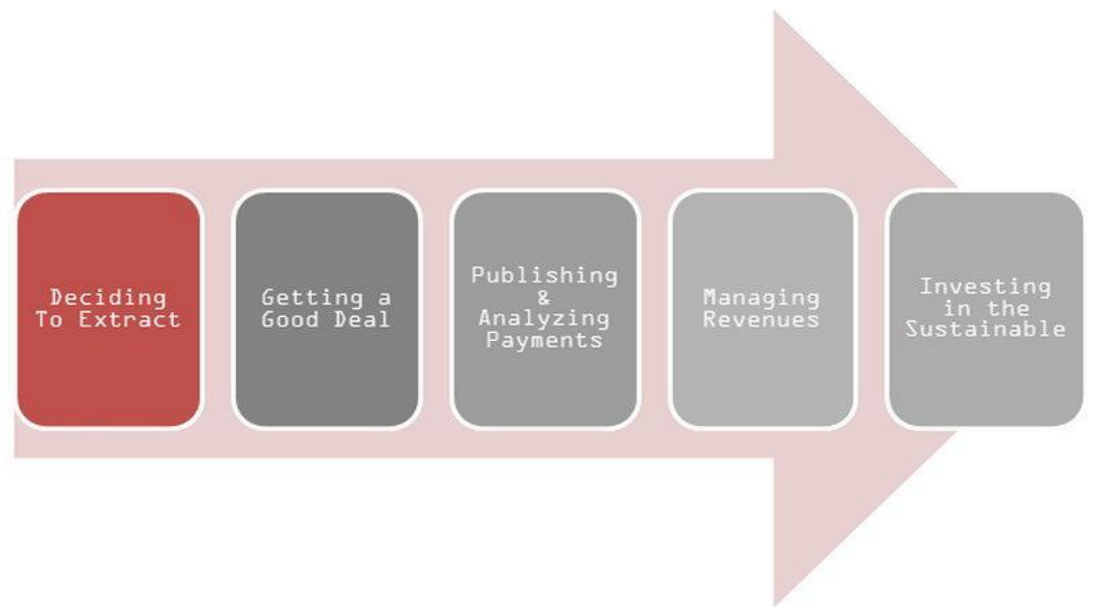
Stage 4, Managing Revenues: As the revenues begin to arrive, the government and communities must decide how to make effective use of the revenues notwithstanding the four constraints mentioned in the introductory portion of this document: nonrenewability, volatility, economic

rent, and significance to government inflows. Stage 4 requires deciding how much to save and how much to spend to mitigate against the adverse effects of dependency on natural resource revenues. It also encompasses long and medium-term planning, as well as the important annual budget instrument. The annual budget, with its four stages: drafting, legislating, executing, and audit; has a special role for parliamentarians. Additionally, some countries use special instruments to deal with the special challenges of managing natural resource wealth, such as natural resource funds and sovereign wealth funds.

Stage 5, Investing for Sustainable Development: The IMF describes the fundamental challenge for resource rich developing countries as the imperative to "transform depleting resource wealth into a portfolio of other assets to support sustained development" (2012), and this includes human capital, institutional capital, domestic public and private capital, and foreign financial assets. Developing countries must lay an emphasis on spending efficiently and practicing integrity in investment execution, and requiring systematic and rigorous monitoring and audits of public investment programs by independent organizations (including civil society groups). Therefore, the ultimate objective of the extractive process is comprised of the parliamentary initiatives in channelling resource revenues towards the long-term, broad-based benefits for the peoples in an economically and ecologically sustainable manner.



STAGE 1: THE DECISION TO EXTRACT



BEFORE TAKING THE FIRST STEPS

It is not a foregone conclusion that a country must extract its natural resources in the immediate present, and policymakers should be circumspect and critical when determining whether or not it is in the interest of the country to extract its resources in the first place. The postponement and smoothing of resource revenues can be achieved by limiting the **rate of resource depletion** (World Bank Institute, 2010). The primary casualty of irresponsible extraction processes is the environment. A great deal of contemporary research points to the harmful effects of improper extraction in damaging landscapes, producing waste, and polluting air and sea, river and drinking water. Therefore, the initial decision to extract should take into account the possible environmental consequences of development through an environmental assessment. If the decision is made to extract, the government should account for the environmental consequences in the development plan of the area. Throughout the life of the project environmental and social assessments should be executed, accompanied by a plan to minimize or mitigate possible adverse environmental and social consequences specific to the project (The Natural Resource Charter, 2009).

Other than environmental effects, extraction may also adversely affect certain income and social groups. Due to their **greater vulnerability**, special attention has to be paid to the effect on low-income groups such as women, indigenous peoples and artisanal miners. Understanding the impact

of policy interventions on different groups is critical to designing effective policy strategies. When making the decision to extract, the effect of extraction on the welfare of different groups must be thoroughly studied, with a specific emphasis on the poor and vulnerable.

Legislative committees can take advantage of local or **international expertise** on extractive industries by consulting with experts from universities or civil society organizations to conduct research on key issues. Such studies could examine the potential consequences of extraction on the poor and the environment.

THE ROLE OF REPRESENTATION

In fulfilling its representation role, the parliament is acting as an instrument for the electorate to voice their concerns, and to do so for all major stakeholders, however disparate their views may be. Parliament must make a deliberate attempt to broaden its representativeness of all significant stakeholders, including local communities, environmental groups, CSOs, multinational corporations, the media, and political parties, among others.

In this role, parliament is broadening the **participation** of society, where participation can be defined as that process by which citizens can **influence** and **share control** over government's priority setting, policy making, resource allocation, and access to public goods and services.

It is harder for citizens to monitor their government when the government is funded by resource revenues: the revenues typically arrive through non-transparent channels, and contracts are often kept secret. For example, some revenue may be channelled through state-owned enterprises, which are difficult for citizens to monitor.

Therefore, participation is important because it allows engagement of citizens and organization in public policy. Parliament is in a position to play a leadership role in promoting greater participation by opening up its practices and procedures to the public.

BUILDING A PARTICIPATORY RESOURCE-RICH SOCIETY

The following recommendations are proffered to make parliament bolster public participation:

1. Constituents learn the opinions, decisions and actions from policymakers through the media. The media can be a platform that provides space for political negotiations. In countries where the media is vibrant and functions independently or relatively independently from government, parliament can spark greater citizen participation in the extractives by using the media as an outlet to inform citizens about developments in the sector.

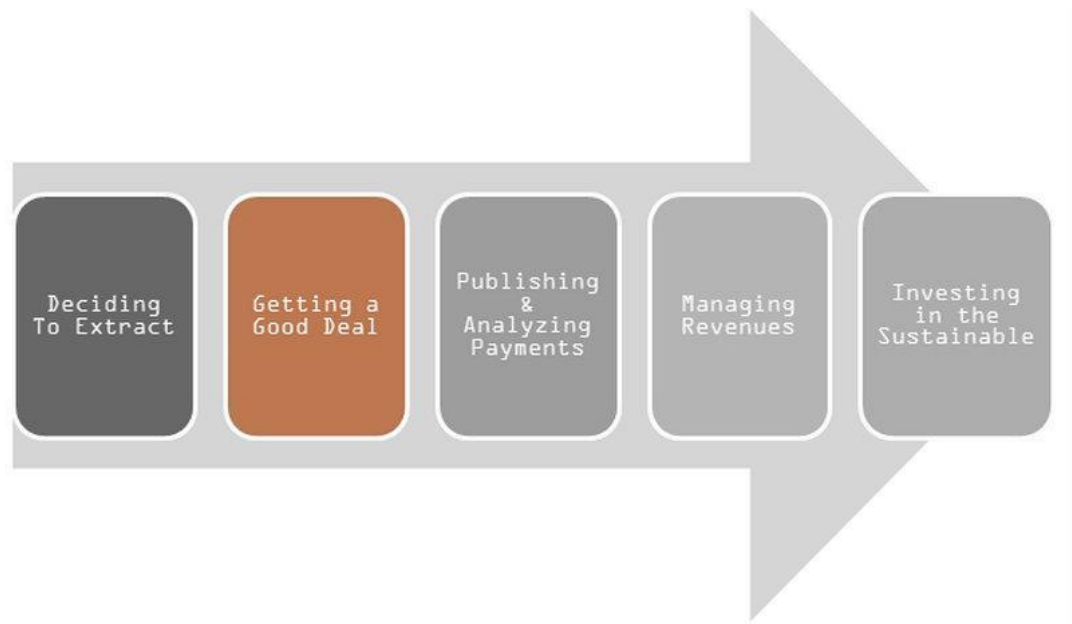
2. Incorporate extractive industries into constituent communication: Citizens often care deeply about whether the natural resources in their country are benefitting them, but know little about what the government receives from extractive industries, or how it spends the revenue. Legislators can transmit this information through their regular contact with constituents.

3. Parliament can play a role in assuring that information is disseminated and accessible to the community. There are several ways to do this:

- a. Publishing the legislative record after each session in Hansard, congressional record, or official daily.
- b. Newsletters and other publications reporting on legislative and member activities.
- c. Public participation offices that responds to citizen inquiries and conducts participatory outreach to citizens.
- d. Open committee meetings, publishing meeting times and agendas in newspapers and on the internet. Public hearings as an opportunity to listen to citizens and for citizens to see their MPs in action.
- e. Internet, TV or radio, broadcasting parliamentary sessions, and posting information on parliamentary websites.
- f. Meeting with constituents: physical space to meet with constituents.



STAGE 2: GETTING A GOOD DEAL



Research by Revenue Watch has shown that transparency in extractive revenue contracts is critical to improving the management of resources and bringing stability in contracts in an industry which sees its contracts renegotiated more than any other (Rosenblum and Maples 2009). In the short term, **contract transparency** helps in the various arms of government, including the legislature set up the **good deals** for future benefits; and in the longer term the learning curve of governments will allow for the negotiation of systematically better deals because the information asymmetry between governments and companies will close. With contracts publicly available, government officials will have a strong incentive to stop negotiating bad deals, whether it be due to misinformation, previous inexperience, corruption, incompetence, or otherwise.

Secrecy in the extractive industries has been such a well-entrenched custom that it was only until very recently that governments and companies felt the need to present arguments in defence of their secrecy (Rosenblum and Maples, 2009). Citizens will better understand the complex nature of extractive agreements if they are out in the open and explained by the contract parties. Governments and companies may not be hiding anything meaningful, but so long as **contract disclosure** is scattered and leaked materials suggest hidden failures, that perception will persist—providing easy fodder for demagogues and politicians to make calls for expropriation and renegotiation in cases where it is not merited. For countries, it may be embarrassing to disclose a “bad deal,” but it is not destructive in the long term. A number of recent disclosures appear to have had only neutral or

positive effects (Revenue Watch, 2009). Moreover, the existence of contract databases, sporadic publication of contracts and ad hoc leaks and disclosures do not appear to have created any lasting harm for companies or host states.

Contract transparency will result in more stable and durable contracts, both because they are less subject to the population's suspicions and because the incentives for governments and companies to negotiate better contracts will be increased. In sum, contract transparency is a necessary element of any effort to promote the responsible management of natural resources for growth and economic development.

INFORMATION IN PRIMARY CONTRACTS

Please see the Appendix: Information in Primary Contracts for a list of information that is to be contained (as well as not contained) in extractive sector primary contracts.

THE MODEL CONTRACT

Some countries have adopted model contracts that aim to improve the stability and uniformity of extractive contracts by limiting the number of contract terms that are open to negotiation. Model contracts are generally established through specific legislation or administrative regulations, and their main purpose is to establish clear rules to promote investment in the extractive sector of a country. These contracts are most commonly used in the petroleum sector, but are increasingly being used by governments to regulate the mining sector as well. While they are not a substitute for a clear and effective mining code, model contracts offer potential improvements to the stability, transparency, and equity of a country's extractive sector.

There is considerable variation in the way that these model agreements are drafted, and their role in the overall regulatory scheme of a country. In countries where the mining sector is well-regulated by a thorough and effective mining code, a model contract can be a short licensing document which provides a few project-specific terms and reaffirms the existing fiscal and dispute resolution mechanisms. At the other end of the spectrum are countries whose model contracts are lengthy documents that spell out every detail of a prospective mining or drilling operation. Because they uniformly establish many of the important terms of an agreement, model contracts can

aid efforts to monitor mineral projects even where the actual contracts are not publicly disclosed.

Additionally, the way in which model contracts are incorporated into a legal system varies from country to country. Most model contracts are established through specific legislation that introduces the model agreement and lays out the rules and requirements for its use. The relationship between the model contract and the existing mining code and other regulations varies as well, though ideally the implementing legislation will specify when it explicitly overturns existing provisions. Generally, the model contract will deal only with certain aspects of the regulation, and will work in combination with the existing mining code to propound a complete regime. Some countries' model contracts can add confusion to the regulatory regime by making no reference to the previous Code and neglecting to clarify any ambiguity between the old and the new rules.

FISCAL TERMS

Please see Addendum: Fiscal Terms of Contracts for an explanation of the key fiscal terms applied to contracts.

MONITORING OF CONTRACTS

Please see Addendum: Monitoring Contracts for a nine step contract-monitoring scheme formulated by the World Bank Institute.

RECOMMENDATIONS FOR CONTRACTS

This section draws on the work of Rosenblum and Maples of Revenue Watch Institute (2009)

Natural Resource States (Host)

- Host states should incorporate contract transparency into law and practice. One effective practice employed by some states has been to adopt and publish a model contract that is vetted by the legislature. Some states require the legislature to approve major contracts. A full public vetting would include approval of both model and final contracts by the legislature.
- Host states should create robust legal regimes to govern relationships with investors instead of individual contracts. Model contracts with as few variables as possible should be adopted, and the allowable modifications should be specified. This reduces suspicion about contracts and simplifies individual contract review by civil society. It reduces transaction costs by reducing the number of costly negotiations. It further reduces the technically

difficult and costly regulatory oversight required for states to fully benefit from natural resource endowments.

- Future confidentiality provisions in agreements should be carefully tailored in scope and duration in order to privilege public access to the contract and the information that it generates.
- With regard to existing contracts, states should consider options for disclosure. States should give notice to investing companies and give them the opportunity to propose redactions. But states should use their leverage to limit any such redactions. Companies are not likely to resist, as the DRC and Liberia examples demonstrate, particularly since many claim that secrecy is for the benefit of the state party.

Home States of Extractive Companies

- Home states should implement disclosure requirements through securities regulation and anti-corruption laws. Anti-corruption laws have been an important tool for countries like the United States in regulating the conduct of their companies abroad. Securities laws have played an important role in this as they have in protecting investors through rules of disclosure. The major stock exchanges and home states for extractive companies (particularly the UK, US, and Canada) already have significant disclosure rules that apply to major contracts. In some cases, companies are required to disclose the contracts themselves, though the circumstances vary and typically leave considerable discretion to the company.
- States should review their disclosure rules with a view to strengthening the requirement for contracts.
- At a minimum, the rules should clarify the circumstances for contract disclosure, favoring disclosure where already required by the laws of the host country in addition to contracts that represent material investments or risks. Ideally, future securities laws will track the IMF Guide and require systematic disclosure. Home states should demonstrate leadership by disclosing their own contracts involving public assets, and by taking immediate steps to change the confidentiality clauses in those contracts. With the exception of Denmark, most home states with domestic extractive industries have nearly identical confidentiality clauses as host states. Home state confidentiality clauses should be narrowly tailored and recognize the public interest in access to information as well.
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clauses should be narrowly tailored and recognize the public interest in access to information as well.

FURTHER READING FOR THIS SECTION

1. The Natural Resource Charter. 2009. [Link Available Here.](#)
2. World Bank Institute. *Contract Monitoring Roadmap*. [Link Available Here.](#)
3. Rosenblum, Peter and Susan Maples. *Contracts Confidential - Ending Secret Deals in the Extractive Industries*. Revenue Watch. 2009. [Link Available Here.](#)
Revenue Watch Institute. Oil, Gas, and Mining Fiscal Terms. Revenue Watch Online Resource Center. [Link Available Here.](#)



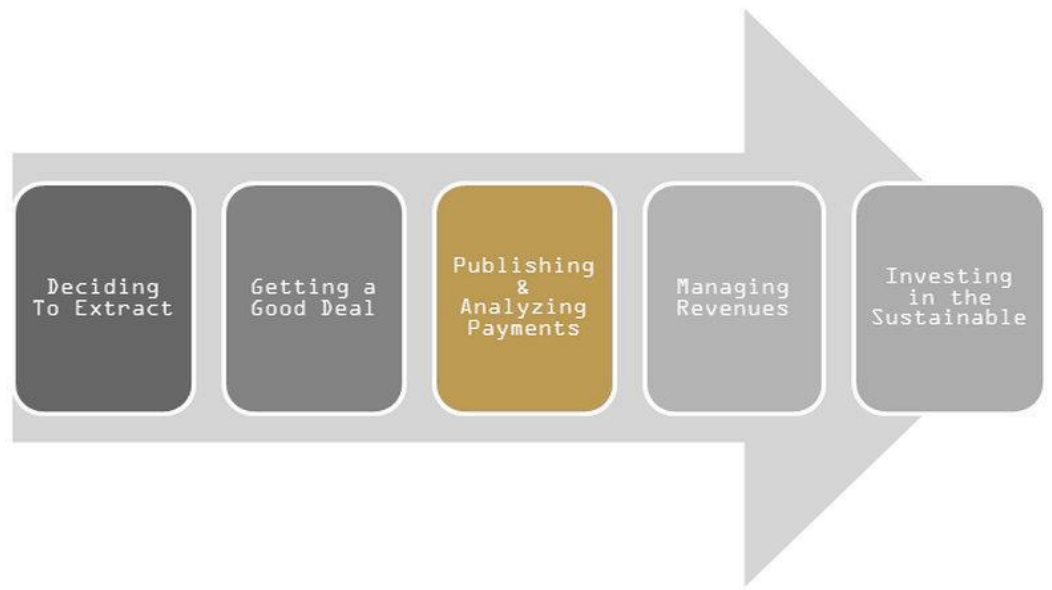
PUBLISHING AND ANALYZING PAYMENTS

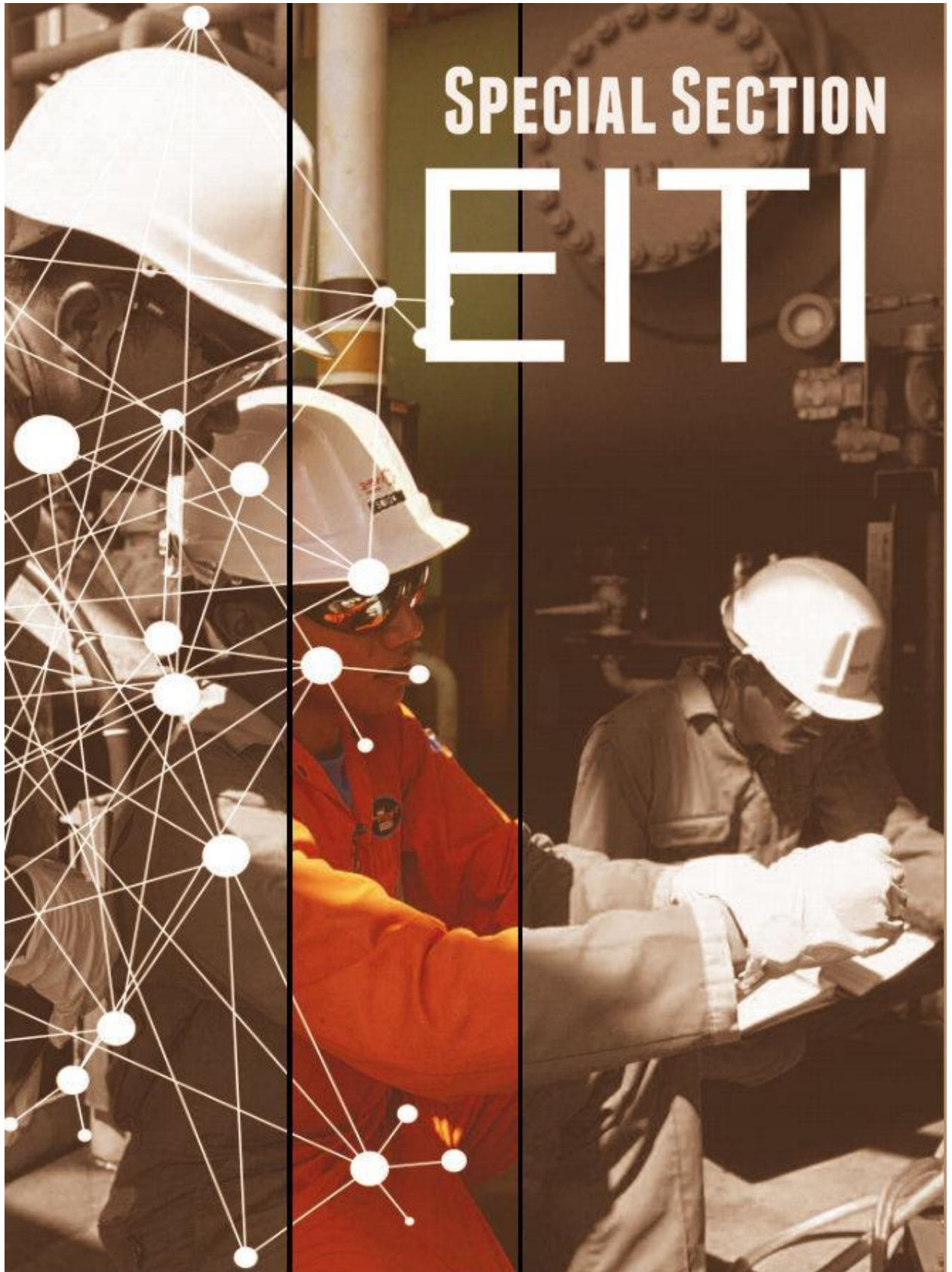
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STAGE 3: PUBLISHING PAYMENTS

The following section is the broadest in the value chain because it covers at least three major subtopics:

1. **EITI**
2. **Revenue & Macroeconomic Considerations**, which in itself contains:
 - a. Taxation
 - b. Fiscal Decentralization
3. **Parliamentary Budget Offices (PBOs)**. In light of the significance that each of these segments deserves, they have been qualified as “special sections” for the purposes of this document.





3.1 THE ROLE OF EITI

There are several important initiatives currently being undertaken at the global level, among which the Extractive Industries Transparency Initiative (“EITI”) particularly stands out. Its global mandate and its comprehensive stakeholder platform - encompassing governments, companies, and civil society - make it especially important to improving governance in extractive revenues on a worldwide basis.

EITI, in its bare essence, is an international project to encourage and facilitate the publication of company payments and government receipts from the extractive sectors. It is a voluntary engagement that promotes greater disclosure through a simple bilateral mechanism of (1) asking companies what they pay, and (2) asking governments what they receive, for the exploitation of extractive resources. Thereafter, any discrepancies that arise between the two numbers raise a red flag - a simple yet elegant underlying logic - which is why EITI is the global standard for best practices in the extractive sectors (World Bank Institute 2011).

Companies publish what they pay and governments publish what they receive in an EITI Report.



Source: EITI FACTSHEET 2012

BENEFITS OF EITI

However, EITI’s strength derives not just from the simplicity of comparing two lists, but also from the comprehensive criteria that it implements to enhance its effectiveness. For example, EITI requires an independent audit of revenue accounts by a ‘credible, independent administrator’ along international auditing standards, with publication of the administrator’s opinion regarding the reconciliation of accounts,

including discrepancies (Johnson 2009). Civil society is also explicitly drawn into the design, monitoring, and evaluation of the process, and the EITI framework explicitly covers State-Owned Enterprises (SOEs) and multilateral institutions under this framework as well.

EITI will confer benefits (1) at the national level, (2) at the company level, and (3) at the level of civil society as well. There are two types of benefits accruing at the **national level** to the countries that commit to EITI. Firstly, harmonization with EITI can be seen as part of, or as a foothold for, broader efforts to improve governance (including legislative oversight), with a view to the positive effects of good governance on economic and political stability, which in turn can mitigate conflict based around the oil, mining and gas sectors (Johnson 2009). Secondly, implementation of EITI will also bode well for national investment climate, as both foreign and local investors and financial institutions will receive a positive investment signal from government policies conforming to EITI standards.

There are similarly two types of benefits for **companies** from the implementation of EITI. Above all, EITI will help to mitigate political and reputational risk: a lack of transparency in the extractive revenues sector hampers commercial investments, as investors fear any scandals may tarnish their hard-earned reputations; and the capital-intensity of extractive industries means that investors require strong assurances before exhibiting a willingness to invest. Additionally, a second benefit from EITI to companies stems from the possibility of a more “level-playing field” for all companies, because the openness of information will help to eliminate advantages that companies may create based on information asymmetry rather than on operational performance.

Finally, as an important stakeholder, **civil society** will also benefit from EITI because of the increased amount of information in the public domain about those revenues that governments manage on behalf of citizens, therefore allowing for allocations of resources that will enhance the welfare of society rather than see the wealth squandered and siphoned away. The resource usage of citizens will also be enhanced due to the

improved energy security that will result from conformity with EITI standards, because the practices endorsed by the transparency initiative will help improve the stability of the energy grid and the reliability of supply (Johnson 2009).

THE CASE OF LIBERIA & EITI

This section draws heavily upon the work of Rich and Warner (2012).

Citing the case of Liberia, Rich and Warner describe the capacity of the EITI to meaningfully transform the extractive revenue situation for the better in an erstwhile war-torn nation. As part of a national reconstruction effort, Liberia adopted the localized version of the initiative, *LEITI*, to foster transparency in the extractive sectors that were often at the center of the conflicts afflicting the country, where "corruption, mismanagement and distrust played a part in fueling the war" (Rich and Warner 2012). There are three main positive takeaways from the case of EITI in Liberia.

1. Firstly, the initiative informed the public about the scope and importance of extractive industry deals, and in the case of a \$24 million ArcelorMittal contract, the transitional government of Liberia was forced by the people to forego its short-term vested interests and accept the deal that was consonant with the national interest, and a significant deal was concluded that led to \$7 million in direct transfers to Liberian municipalities, because the LEITI provided an independent confirmation of the nature of the deal that would inform the Liberian public about key decisions impacting extractive revenues (Rich and Warner 2012).
2. Secondly, the LEITI showed the discrepancies between company payment accounts and government receipt accounts, and one stark incident showed the value of this mechanism when \$100,000 was found to be unpaid to the government by a certain AmLib United Materials, thereby leading to the company compensating the government as well as strengthening its internal controls.(Rich and Warner 2012)
3. Thirdly, the LEITI helped create a forum for local-level debate in which citizens brought forth complaints and raised questions about suspicious activity in the extractive sector, and the heightened citizen participation in

improving accountability in the extractive sectors of Liberia.(Rich and Warner 2012)

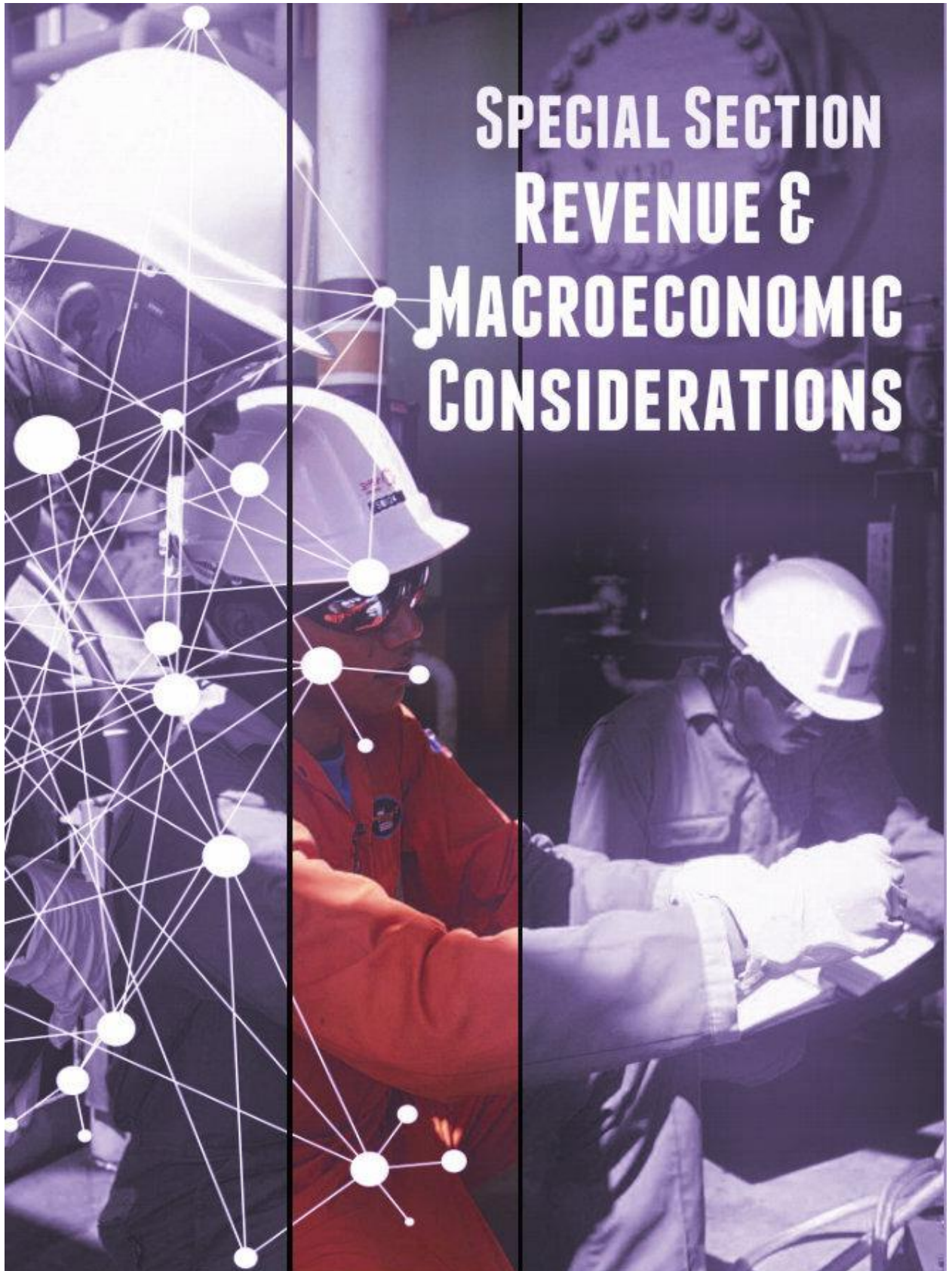
In sum, Liberia's adoption of the EITI was an important step towards transforming the national extractive industries, and it provides an example which other resource rich countries can draw from.

World Bank Group Support: With WBG support, the Extractive Industries Transparency Initiative continues to have a positive impact on the transparency of oil, gas and mining sector payments to governments. As of June FY2012, there were thirty-six EITI-implementing countries, of which fifteen have completed their first EITI cycle, including an external validation, and have been declared EITI-compliant. The World Bank supports the initiative through: (a) administration of the EITI Multi-Donor Trust Fund (MDTF) that provides support to governments to implement EITI; (b) support to civil society to enable effective participation in the multi-stakeholder process; and (c) global knowledge work, including assistance to the EITI Secretariat in its coordination function and serving as an observer on the

LIMITATIONS

The EITI, however, does not cover all the challenges that the EI bring to resource- rich countries. Public reporting of EI revenue, though extremely valuable, represents only one step in improving sector governance and maximizing development outcomes throughout the EI value chain. How these resources are actually developed and how the revenue generated ultimately is spent will determine a country's success in achieving long-term growth and sustainable development. In the words of the WBI:

The EITI, however, does not cover all the challenges that the EI bring to resource rich countries. Public reporting of EI revenue, though extremely valuable, represents only one step in improving sector governance, [oversight] and maximizing development outcomes throughout the EI value chain. How these resources are actually developed and how the revenue generated ultimately is spent will determine a country's success in achieving long-term growth and sustainable development.



3.2 REVENUE & MACRO CONSIDERATIONS

Revenue & Macroeconomic conditions is a special section encompasses two subtopics:

- A. Taxation and Fiscal Regimes
- B. Fiscal Decentralization and Revenue Sharing

3.2.A. TAXATION AND FISCAL REGIMES

Taxation of EIs is a complex issue, because a high level of tax will dissuade investors from coming, but a low level of tax will give the government insufficient compensation for EI resources. Characteristics of EIs that give taxation an unusually high complexity include the following:

1. **Asymmetric information.** Private investors undertaking exploration and development, for instance, are likely to be better informed than host governments on technical and commercial aspects of a project; the host government will be better informed on its own future fiscal intentions.
2. **High sunk costs.** EI projects commonly involve very substantial upfront outlays by investors that cannot be cashed in if the project is terminated. The balance of negotiating power thus shifts dramatically from investor to host government once these costs are sunk. Even the best-intentioned government has an incentive to offer attractive fiscal terms before a project is begun, but afterwards— as the tax base becomes much less elastic—reset the regime in its own favor; and investors' awareness of this can discourage investment (the "hold-up" problem), to the detriment of both sides.
3. **Extensive involvement of multinational enterprises** in many countries raises complex tax issues (with multinationals likely more expert than most developing country administrations) and sensitivities on sharing the benefits from national resources.
4. **Extensive involvement of state-owned enterprises (SOEs)** in others, potentially easing asymmetric information issues but also raising concerns on the efficiency of operations and allocation of taxing responsibilities.

5. **Producers may have substantial market power** where they control a significant part of global deposits. In mining, for example, most internationally traded supplies of iron ore are shipped by just three companies.

The type of tax infrastructure or system that a country puts in place is known as its *fiscal regime*, and includes of tax and contractual arrangements, including signature bonus payments, royalties, income tax, production-sharing, resource-rent taxes, and state participation, among others (Smith 2012). Historically, governments have adopted various combinations of these instruments, which has lead to a diverse and potentially confusing array of distinct fiscal regimes. No two countries tax extractive resources in quite the same way—which leaves researchers to ponder which type of regime is best (Smith 2012). Depending on its fiscal regime, even when resources are abundant, the government’s share may be large or small depending on how provisions of the fiscal regime impact extractive industries.

The fiscal regime touches many aspects of an investor’s plan of exploitation, including the scope of exploration and discovery, the timing and scale of initial development, the rate of production and decline, the timing and scale of enhanced recovery operations, the overall resource recovery factor, and the timing of final abandonment (Smith 2012). The pervasive impacts of the fiscal system, on the investor as well as the government, magnify the importance of designing and implementing a sound fiscal regime.

FURTHER READING ON TAXATION AND FISCAL REGIMES

1. Smith, James L. *Issues in Extractive Resource Taxation: A Review of Research Methods and Models*. IMF Working Paper. 2012.
2. Cotarelli, Carlos. *Fiscal Regimes for Extractive Industries: Design and Implementation*. Fiscal Affairs Department. IMF Working Paper. 2012. [Link Available Here](#).
3. Daniel, Phillip. Natural Resource Charter Workshop. International Monetary Fund. December 2012. [Link Available Here](#).

3.2.B FISCAL DECENTRALIZATION AND REVENUE SHARING

A significant consideration in the administration of revenue is how to share it between the central government and local government, an issue that is generally established in a country's constitution, by law, or both. Fiscal decentralization affects the way in which a nation **empowers** various parts and levels of its government to impose and collect taxes from the private sector. It is often argued that greater control by subnational governments over fiscal policy means that it will be more amenable to local stakeholder input. Others assert that central governments are better able to implement countercyclical fiscal policies. Further, because they will invariably have more diversified revenue bases than subnational governments, central governments are also better insulated from the effects of mineral revenue volatility.

To support the sound implementation of fiscal decentralization, especially where regional and subnational authorities do not have sufficient capacity, the role of the ministries of economy and finance and civil society organizations is to provide assistance, supervision, and scrutiny at the regional/subnational level to ensure that this revenue is properly utilized. The **matching principle** that should be followed is that, whenever possible, revenue assignments to various levels of government should match their respective expenditure capabilities and responsibilities.

BENEFITS FOR LOCAL COMMUNITIES IN MINING AREAS

The allocation of revenue between different tiers of government is attracting increased international attention. Centralist tendencies are still common in low income mining countries, but there have been various moves towards fiscal decentralization. The report shows that both the theoretical and the practical evidence is inconclusive as to whether fiscal decentralization improves the benefits of mining to local communities. So there is no clear cut recommendation for or against fiscal decentralization and the assignment of mining revenue to subnational tiers of government. **The broad observation is to not overemphasize relations with either national government or subnational government entities.**

Improvements in administrative capacity at one level are unlikely to render long term benefits to local communities, if they are not complemented by equal improvements at other levels.

Countries take different views on how to strike the right balance between utilizing benefits for the whole country and for specifically affected communities.

Where fiscal decentralization is introduced as a political strategy to divert attention from the failures of a central government, there is also the danger

that the mining sector's fiscal contributions and its fiscal burden across the different tiers of government will be overlooked. The impact on the long-term sustainability of the sector may also remain inadequately assessed. If companies demonstrate their willingness to help with local social and economic development agendas, they furthermore risk the danger of becoming a *de facto* parallel local government. This is uncomfortable for the companies concerned and is often deeply resented by the *de jure* local governments who see their positions as partly or wholly usurped.

FURTHER READING ON FISCAL DECENTRALIZATION

1. International Council on Mining & Metals. *Minerals Taxation Regimes: A review of issues and challenges in their design and application*. The Challenge of Mineral Wealth: using resource endowments to foster sustainable development. Analysis Publication. 2009.
[Link Available Here.](#)
2. Daniel, Philip. *Oil Revenues and Fiscal Policy*. Fiscal Affairs Department, International Monetary Fund. The PRMPS/COCPO Training Workshop, The World Bank. 2007.



3.3 OVERSIGHT, TRANSPARENCY AND INDEPENDENT ANALYSIS

WHAT IS LEGISLATIVE OVERSIGHT?

Oversight is the major area where legislative influence is most noticeable in modern states (Stapenhurst and Pelizzo 2008). They have a constitutionally mandated responsibility to oversee any aspect of governance, including extractive industries. The rationale for conferring this mandate to legislatures is that it enables these representatives of the people - as legislators are expected to be - to expose corruption, inefficiencies, and malpractice in the execution and administration of laws passed by the legislature itself (Fashagba 2009).

3.3.1 OVERSIGHT IN EXTRACTIVE REVENUES

Legislatures can make a valid and multifaceted contribution through their oversight function. Some key beneficial facets of legislative oversight are discussed in the table below.

BENEFITS OF LEGISLATIVE OVERSIGHT

This table draws on the work of Anderson, 2005.

Oversight Benefit	Extractive Revenue Example
Preventing Resource Misappropriation	Extractive revenues can be misappropriated, such as for the private gains of politically powerful individuals, and for funding political patronage. Legislative oversight can help ensure that revenues from extractive industries are not diverted towards such undesirable ends.
Sustainability and Long-term usage	Legislative oversight can help to ensure that the long-term and sustainable plans for the extraction are adhered to, so that resources are not exhausted prematurely for short-term benefits.
Budget Context	Legislative oversight can help consider extractive revenues within the broader context of the national budget, as this falls under the purview of legislative decision-making. Resources are thereby treated as a component within the broader perspective of other sources of revenue for the government, such as taxation.

Ex-ante policy oversight	Prior to (1) government investment in new assets for resource extraction, (2) investment for expanding current asset base, or (3) allowing local and foreign companies to engage in resource extraction; legislative oversight can consider the feasibility and sustainability of policy decisions prior to setting aside government resources for these projects.
Ex-post policy oversight	Legislative oversight can help ensure that currently undertaken projects in the extractive sector are being responsibly conducted, and plans and commitments are being adhered to. Unwarranted deviations from established plans and laws can be detected and remedied.

In light of these abovementioned benefits, the oversight role of legislatures should be given due endorsement, promotion, and support.

3.3.2 BARRIERS TO EFFECTIVE LEGISLATIVE OVERSIGHT

Given these multifaceted benefits to extractive revenues from legislative oversight, it would seem a foregone conclusion and a natural tendency for countries to bolster their legislatures so that this oversight function can be judiciously effectuated. However, this has not been the case, and there are several serious impediments to legislatures in the implementation of their oversight function in the extractive sector, as is indicated in the following table.

Barrier to Oversight	Example in Extractive Revenues
Lack of Information	Legislatures may not receive complete, timely, accurate information about the receipts from extractive revenues; and therefore may not be able to make informed decisions on extractive revenue policy.
Incompetence and Inexperience	Members of Parliament may lack the requisite experience in energy policy, mineral policy, or other extractive revenue issues. They may also lack the necessary competence for dealing with the sector, and may thus shift their attention to “simpler matters”. (Fashagba 2009)

Domination by an assertive executive branch	In many resource rich developing countries, there may be a history of domination by an assertive executive, and the executive might interfere in the internal business of the legislature. This may be due to past military rule or simply tough civilian rule. The executive branch may also use the 'non-release of funds' weapon to twist the arm of the legislature. Extractive revenues may thus fall under the purview of exclusive executive control in their opinion, and legislatures become rubber stamping organizations.
Lack of confidence in Parliament	<ol style="list-style-type: none"> 1. Resource rich countries transitioning from other forms of government such as military rule may not express confidence in parliaments and their "stamina to withstand adversarial politics" in multi-ethnic or multicultural environments. 2. The idea of a "dual-leadership" between equally strong legislative and executive branches may be an "alien idea" to national political culture. (Fashagba 2009) 3. Parliaments may have a sullied reputation of integrity, perhaps due to MPs trying to squeeze money from government departments for personal gain.
High MP turnover	Political fragility may mean that MPs are frequently replaced, weakening their commitment to causes such as extractive industries. A high turnover of MPs and the laws barring rejoining the legislature for MPs once their term is over means that self-interested MPs may spend more time maximizing their personal benefits and squeezing the system, and gaining personal benefits for the short time that they would have in office. (Fashagba 2009)
Conflicts of Interest, Internal Conflict, and Patronage	If MPs are hand-picked by powerful agents such as the executive branch, then there are debilitating conflicts of interest that can hamper the legislature's judgement and commitment to improving transparency in extractive revenues, which be a main source of the patronage funding their posts. Conflicts of interest can create a dependency relationship between legislatures and executives, as those MPs brought into office through the patronage of the executive branch will not readily "bite the hand that feeds" (Fashagba 2009). There may also be factionalism between MPs, and internal conflict may paralyze the workings of parliament by polarizing the institution.

Therefore, the following section examines a potent solution for overcoming these barriers, in the form of the Parliamentary Budget Office, and considers the advantages that this office can confer onto legislatures.

3.3.3 WHAT IS A PBO?

A Parliamentary Budget Office (PBO) is an institution that is publicly funded and staffed by non-elected professionals who provide unbiased and non-partisan analysis, oversight, guidance, and advice on key issues that affect the government budget (Staddon 2010). A PBO's scope is therefore rather broad, as its "analysis" can extend across many disciplines and policy issues - not least of which are the extractive industries. Given the aforementioned barriers to oversight, the following table demonstrates how PBOs can serve to overcome these barriers, and provide an example from the Extractive Revenues.

Barrier to Oversight	PBO Solution	Example in Extractive Revenues
Lack of Information	a) Provides Rapid Responses b) Promotes Transparency c) Eliminates Executive's <i>Informational Monopoly</i>	a) PBOs can help keep the debate relevant by rapidly providing solid analysis that is pertinent to the debate-at-hand. The timeliness of PBO analysis can positively impact the decisionmaking of extractive industry-related issues. b) The bidding of contracts, deal-making, and the parameters of contracts (the size, duration, and terms etc.) can be laid bare for public viewing via PBOs. c) PBOs may help mitigate the <i>information asymmetry</i> with the executive branch by unveiling the details of extractive revenue projects to the public, and by conferring onto the public any information that can assist in better decision-making.

Incompetence and Inexperience	Simplifies Complexity	Even when information is made available, the sheer complexity of budget information can severely mire the legislature. A PBO can use its budgetary expertise to simplify information about extractive revenues, such as project costs, feasibility, and so forth, for the legislature (as well as other parties such as academia and the media).
Lack of confidence in Parliament	<p>a) Enhances Credibility and Promotes Accountability</p> <p>b) Improves Budget Process</p>	<p>a) PBOs do not rubber stamp the numbers of other agents, and can instead offer independent and credible analysis that parliamentarians and other parties may refer to. They can also assiduously scrutinize budgetary items, such as those pertaining to extractive industries, thereby ameliorating the level of accountability in the budgetary process.</p> <p>b) PBOs can help to improve the process of budget making through recommendations on the allocation of budgetary resources.</p>
High MP turnover		Even when MPs face high turnover, the PBO can add a layer of consistency to the budget analysis that outlasts the short terms of MPs and the frequently changing composition of parliaments.
Conflicts of Interest, Internal Conflict, and Patronage	Serves All Parties	Extractive sectors often have long-lived projects and therefore often encompass the reign of more than one political party. The nonpartisan nature of the PBO can impartially

n o		assist each and every political party that rules during the operating lives of extractive resource projects.
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table PBO initiatives have

3.3.4 WHAT EXACTLY SHOULD A PBO DO WITH EXTRACTIVE REVENUES?

The PBOs overarching responsibility is to bolster the capabilities of the legislature, especially in the oversight domain (Calmfors 2009). This means that an effective PBO can help with all five of the factors previously discussed in Table 1: Benefits of Legislative Oversight, including: ex-ante analysis, ex-post analysis, sustainability analysis, preventing fund misappropriation, and looking at the broader budget context. Table 5 below restates those core functions, then defines them, and then provides examples specific to extractive revenues, as follows:

PBO FUNCTIONS WITH EXTRACTIVE REVENUE EXAMPLES

Core Function	Definition	Extractive Revenue Examples
<i>Ex-post</i> evaluation	Has fiscal policy met its targets?	<ul style="list-style-type: none"> - Has government taxation of extractive revenues been in-line with set targets? - Have government projects to harness extractive revenues respected their announced budget targets?
<i>Ex-ante</i> evaluation	Is fiscal policy likely to meet	<ul style="list-style-type: none"> - Do projections of extractive revenues make sense? Do they overstate (for campaigning reasons) or

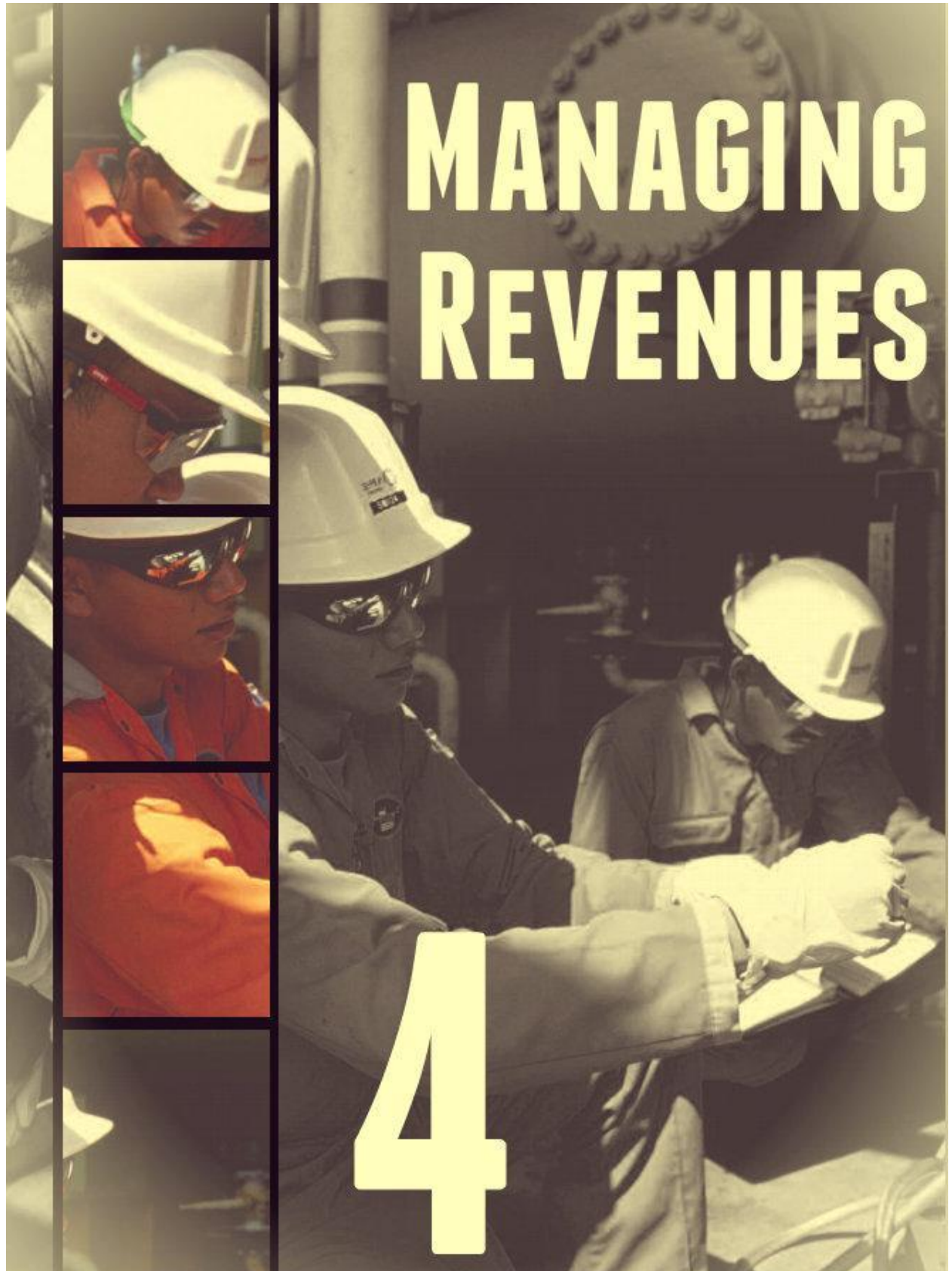
	future targets?	understate (graft) the potential revenue? - What are the proportions of extractive revenue that will stem from the three main sources: ³ taxes, royalties, and dividends?
<i>Sustainability</i>	What is the long-run sustainability & optimality of the fiscal policy?	- Can the tax rates imposed on extractive revenues be maintained indefinitely? What is the optimal tax rate? - Can the extraction lifecycle be smoothed out by postponing the level of activity in certain periods?
<i>Misappropriation of funds</i>	Where is the money going?	- Can the cash flows from extractive industries be accounted for? Are there any 'red flags' in the data?
<i>Overall Budget Context</i>	What is the role of Extractive revenues as a component of the overall budget?	- What is the current and future importance of extractive revenues to the overall budget? - Is the government balance sheet too dependent on extractive revenues, at the expense of other sectors? (Dutch Disease) - In light of the entirety of the budget, should the government invest less of its time and resources, or more of these, in extractive revenues?

As this table amply demonstrates, the PBO can be applied towards all of the possible benefits of legislative oversight: ex-ante policy analysis, ex-post policy analysis, fighting the misappropriation of funds, gauging the sustainability of policies, and contextualizing the overall budget context.

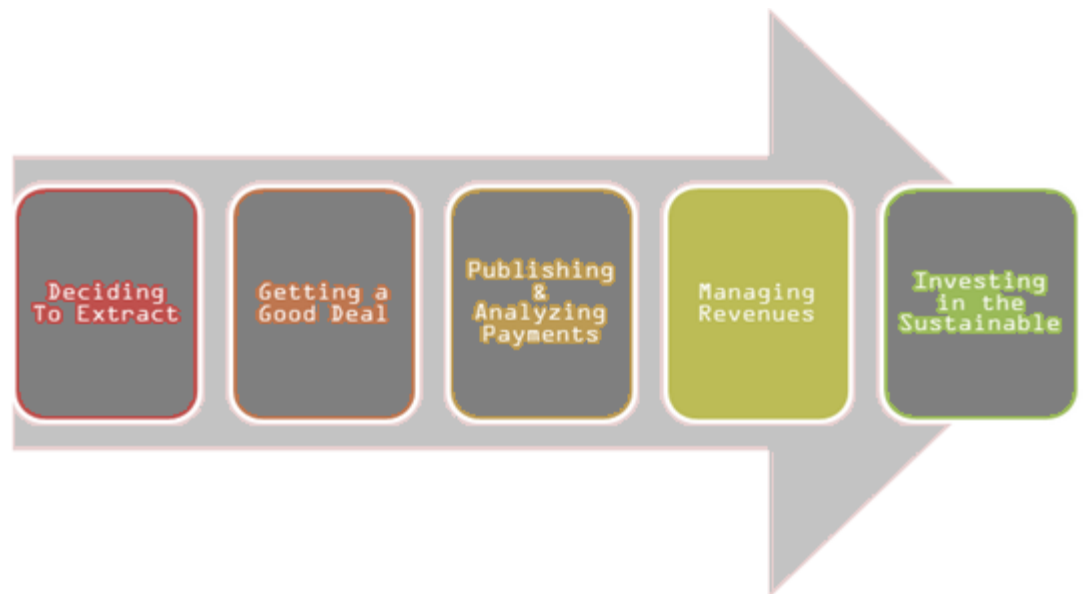
Therefore, the PBO is therefore a highly pertinent tool for improving

³ World Bank, 54

legislative oversight, and this oversight will indeed translate into enhanced transparency and good governance in extractive revenues.



STAGE 4: MANAGING EI REVENUES



EI resources and revenue need to be managed at the macro-level in ways that recognize the nature of extractive revenues as mentioned in the introductory chapter of this document, including: exhaustibility, volatility, importance to government, and so on. Decisions need to be made on how much revenue should be used for current and capital spending priorities and debt reduction, and how much is to be set aside for revenue stabilization, expenditure smoothing, saving for future generations, or other specific needs. It is important to design revenue saving mechanisms—including institutional arrangements—that foster transparency and sound governance.

In this section, three important topics managing revenues are to be considered:

1. The budget: where a very significant role can actively be played by legislatures in all four phases of the budget process, as well as through more elaborate Medium-Term Economic Frameworks (MTEFs) which sustain annual budget policies beyond their one-year constraints.
2. Sovereign Wealth Funds (SWFs) are an important mechanism for managing revenues which parliamentarians must be made aware of.
3. Civil Society Organizations (CSOs): which legislators must be aware of and engage as part of a multistakeholder approach to managing EI.

THE BUDGET

The budget is the key economic policy tool of the government, and constitutes arguably its most comprehensive statement of priorities. One of

the main avenues of engagement between parliamentarians and EI will be via the budget, and by getting involved in the budget process legislatures can direct the allocation of revenues in ways that alleviate poverty and promote social and economic development. Legislatures can help to ensure a balance of views and inputs into budget decisions and thus provide a platform for establishing broadly based consensus with regard to difficult budgetary trade-offs. The legitimacy of legislative involvement in budget preparation is based on the principle of the Power of the Purse, which is an incontestable democratic fundamental (Wehner 2004). In developing and transition countries, a substantial number of legislatures are moving towards budgetary activism. Perhaps the primary reason for this development is that democratization and constitutional change have opened up possibilities for legislature participation in many previously closed systems, notably in parts of Latin America, Africa and central Europe (Wehner 2004).

Parliamentary reforms are showing that parliaments are able to adapt to become more independent actors. Effective legislative participation provides essential checks and balances, enhances openness, facilitates public debate, and provides a platform for broadly based input that can help to deepen consensus about budget choices. This also means that there is an obligation on the legislature to ensure that the revenue and spending measures it authorizes are fiscally sound, match the needs of the population with available resources, and that they are implemented properly and efficiently.

It should be kept in mind, nonetheless, that public resources are always limited and inevitably fall short of meeting all the needs of society. A well-functioning budget process, therefore, helps to assess competing claims on the budget and facilitates difficult trade-offs. Meeting this challenge successfully requires that budgeting achieves: Affordable budget totals, Strategic prioritization of public funds, and Sound operational management.

REVENUE

In terms of the types of revenues which may be collected, modern-day governments can use a variety of sources: Taxation (Direct, Indirect, Progressive), Royalties, Revenues from State Owned Entities (including State-Owned Enterprises, “SOEs”), investment income, charges for certain services, and sovereign wealth funds (SWFs). From the extractive industries specifically, revenues may be collected in three distinct ways: taxes, royalties, and dividend income.

1. **Taxes:** governments earn income through various kinds of taxes. The most common ones are taxes on profits, corporate tax, local income tax,

value added tax, import and export tax, excess profit taxes, windfall revenues, and dividend withholding tax.

2. **Royalties:** royalty refers to a sum of money paid by a holder of a concession to the government. It is a revenue-based tax, but the actual definition of what revenue is taxed can vary. The definition of 'revenue' should be explained in the contract or legislation, and the amount payable is calculated through a formula set out in legislation or in the contract itself. It is usually based on a percentage of the value of the oil or mineral extracted. Royalties usually constitute a major source of income for the government and can be paid in cash or in kind. If a government chooses to be paid in cash, then the company sells all of the production and pays royalty on all of it. When governments choose to be paid in kind, a portion of the physical oil derived from the total production is delivered to the government's representative. Governments often decide to take royalties in kind when there is a need to supply local refineries or consumers. The contract should clearly state on which production the royalty is levied.
3. **Dividend:** a dividend payment is a distribution of profit to shareholders of the development company. When a government is a shareholder in the company, it can be entitled to dividends. The procedure for declaring and paying a dividend will be found either in the corporate law of the country or local jurisdiction, or in the corporate bylaws and other organizational documents of the company itself.

EXPENDITURE

On the expenditure side, the budget facilitates spending for the fulfillment of government obligations, generally by issuing a check or disbursing cash. The three types of classifications of government expenditure types are:

1. Capital expenditures are investments in physical assets, such as roads and buildings that can be used for a number of years.
2. Current expenditures reflect spending on wages, benefit payments, and other goods or services that are consumed immediately.
3. Functional classification: According to various activities and policy objectives, such as healthcare, education, defense or justice.

OBJECTIVES AND PRINCIPLES OF GOOD BUDGETING

Please see Appendix: Objectives and Principles of Good Budgeting for an enumeration of the key principles that good budgeting should follow, and key objectives it should strive to attain.

TRANSLATING OF RESOURCE PRIORITIES INTO THE BUDGET

A country's strategic vision for resources should be reflected, explained and safeguarded in the country's annual budget, medium term economic framework and mechanisms for fiscal discipline. By getting involved in the budget process legislatures can direct the allocation of revenues in ways that alleviate poverty and promote social and economic development. In many countries the power to amend or change budgetary line items is severely limited. Furthermore, legislators are often under pressure to pass budgets within timeframes that do not allow for thorough review. Expected and realized government revenues and expenditures are documented in a country's annual budget. The budget should also explain how expected and realized revenues fit into its long term strategic vision. The government also must explain how it is going to cope with increases in the world price of natural resources, avoid boom-bust cycles, and coordinate the spending of natural resource revenues.

DEVELOPMENT FRAMEWORKS AND THE BUDGET

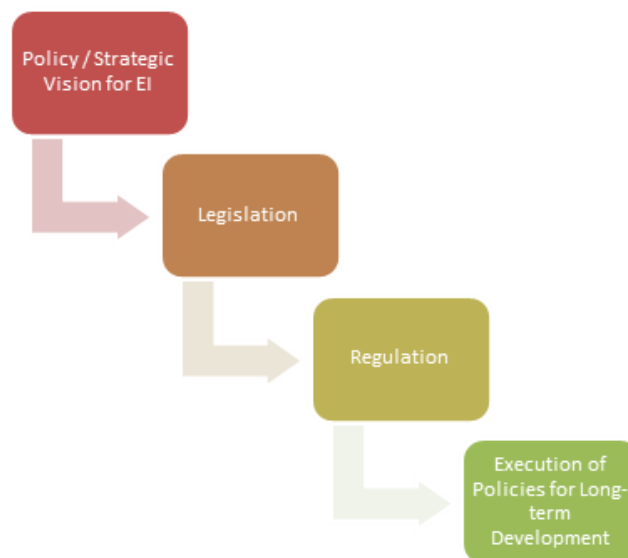


Figure: Relationship between the strategic vision, legislation, and regulations

The management of natural resources along the value chain should feed into the country's long term economic and social development goals and poverty reduction strategies (the Natural Resource Charter, 2009). This ensures the development of natural resources facilitates the maximum benefit to the citizens of the country within the framework of its long-term development goals.

A country's long term economic and social development goals should be clearly outlined in a strategic framework that uses social and economic planning scenarios to reach the country's long term goal. A strategic framework involves the development vision for a country, clarifying the role of the extractives sector within it and establishing the legal framework to serve it. The overall aim must be to maximize the benefits to the citizens of the country, at present and for future generations. A strategic framework should reach beyond the annual budget and include a medium-term budget, strategies for consumption, investment and expenditure smoothing. It should also enable resource-revenues to contribute to the country's economic and social development and poverty reduction.

Before depletion of the resource begins, policy makers have to think through why depletion is the right decision to make. In so doing, they should assess the costs and benefits of depleting, and not depleting. Once the decision to extract is made, contracts have to be awarded to companies that will execute the extraction. Operations of these companies have to be constantly monitored. The state also has to collect revenues in the form of taxes and royalties from these companies. Finally, when revenues are collected, they should be spent in ways to conform the country's development strategic framework. Meanwhile, the effects of the revenue extraction on the macro-economy have to be monitored, and policies have to be put in place to counter negative side-effects such as the Dutch Disease and deteriorating government finances. The country's legal framework should incentivize the prevention of environmental damage; make awarded contracts public; establish sufficient health and safety requirements, etc. Governments must create a business climate that attracts private investment, a necessary precondition to the development of the extractive industries. They must also ensure an equitable distribution of revenues to all citizens.

Because of the multidisciplinary nature of the regulatory process and legal framework, close coordination among different government entities is necessary to avoid regulatory gaps. National investment opportunities should not simply bubble up from within each sector ministry, but should be coordinated within an agreed framework.

Policy and laws regarding extractive industries must then be reflected in legal and regulatory frameworks that govern minerals and revenue management. Therefore the legal framework and regulations should be fixed to a clear vision for development and poverty alleviation.

THE BUDGET PROCESS

Please see Appendix: The Budget Process for an elaborate breakdown of the four steps involved in the budget process (drafting, legislating, evaluating, and auditing), and how legislators can contribute to each step of the process.

MEDIUM-TERM ECONOMIC FRAMEWORK (MTEFs)

Many aspects of budgeting, especially large-scale capital expenditure projects such as those in the extractive industries, stretch well beyond the time horizon of annual budgets. MTEFs for fiscal and expenditure policy are planning tools that help connect the annual budget to longer term policies such as poverty reduction and sustainability objectives. They also enhance analysis of risks, a positive feature given the need for EI producing countries to offset shocks and to facilitate less disruptive adjustment processes (IMF 2013).

A MTEF should provide a clear statement of the revenue and expenditure effects of maintaining current government policies. The MTEF also creates a clear and distinct allocation of funds to long-term strategic priorities, instead of existing policies carrying out a short-term view on development. The MTEF should track the budget implementation of these new policies in the years following the annual budget.

The budgets of many governments in resource-rich states continue to be too dependent on volatile and exhaustible resource revenues in the short-term and would benefit considerably from introducing a medium-term to longer term perspective. MTEFs for these states would typically incorporate estimates of future resource revenue earnings, giving important weight to uncertainty through evaluation of a range of possible future external scenarios and their impact on revenues. Additional relevant considerations would include macroeconomic stabilization, medium-term expenditure priorities, and absorptive capacity. They would also usually be formally linked to the annual budget cycle in order to be implemented properly.

Moreover, an MTEF can be designed in a way that takes the stage of development of the country and also the level of administrative capacity. An example of an MTEF is the Fiscal Responsibility Law introduced by Mexico in 2006. This requires the annual budget to be presented to congress with quantitative projections of the next five years and explicitly costing for new fiscal measures. Other measures were included to smooth expenditures, strengthen management, promote transparency and encourage performance-based budgeting.

MTEFs need to have teeth in order to guide medium term expenditure planning. Without this element, they cannot be an effective response to revenue volatility, and will remain merely medium term projections; their budgeting (and especially the capital budgeting process) would also remain in effect annual in character.

SOVEREIGN WEALTH FUNDS AND STABILIZATION FUNDS

One increasingly popular option for dealing with the resource curse is the commodity-based **sovereign wealth fund** (SWF), which is a state-owned investment fund that invests in both real and financial assets. By investing some of their resource revenues into an SWF, countries hope to smooth resource price volatility, make long-term fiscal policy, manage currency appreciation, facilitate intergenerational savings, and, perhaps most importantly, minimize corruption and tame the political temptation to misuse the newfound wealth (Center for Global Development 2011).

SWFs exist, at the most basic level, to underwrite and sustainably improve living standards within sponsoring countries and the mechanism through which SWFs achieve these lofty objectives is finance. In the simplest terms, a commodity-based SWF converts sub-soil assets into financial assets, which means that SWFs are, ultimately, just a point for governments to access the power of global finance. SWFs can help to stabilize the macro-economy by keeping some assets offshore, and can smooth resource revenues to make budget allocations more predictable, all while offering countercyclical resources for the economy following an economic shock. As a storehouse of financial assets, SWFs can help maintain a balance between current expectations and long-term commitments. Through all of these functions, SWFs are capable of dampening or, at the very least, managing the negative consequences of resource wealth.

In the coming decade, Africa will become the largest sponsor of sovereign wealth funds (SWFs) on the planet. The number of funds in Africa that currently fit within the International Monetary Fund's (2008) typology of SWFs range from the low- to mid-teens, with sponsors from Algeria and Botswana to São Tomé & Príncipe and Sudan. African countries see in SWFs a potentially powerful tool for managing resource revenues.

For a SWF to achieve its objectives, it has to be effective at asset management. This, however, is not a simple feat, as countries set up new SWFs precisely because the functions that these institutions perform are not easily integrated into existing government agencies. Indeed, the complexity and sophistication of financial management necessitates an innovative approach beyond the traditional government apparatus. In this regard, the SWF is a purpose built institution, designed specifically to operate in financial markets. It will thus have distinctive characteristics that separate it from government agencies and departments, and these differences are what make SWFs (in theory) able to compete against the private sector investors that populate global financial markets. In a manner of speaking, then, a SWF

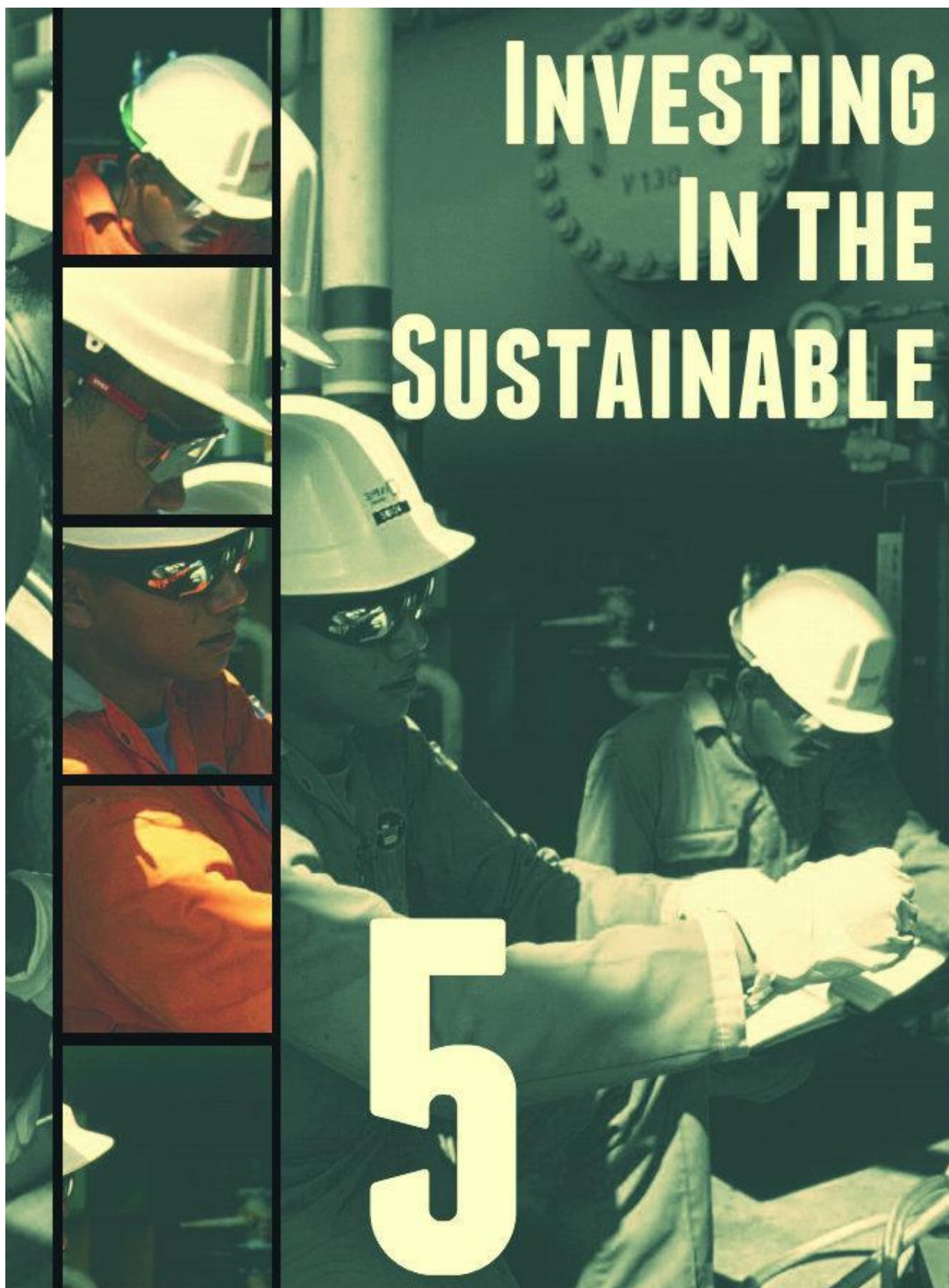
is a 'special purpose vehicle' because it has a truly special purpose: to successfully invest government assets in global financial markets.

FURTHER READING OF SOVEREIGN WEALTH FUNDS

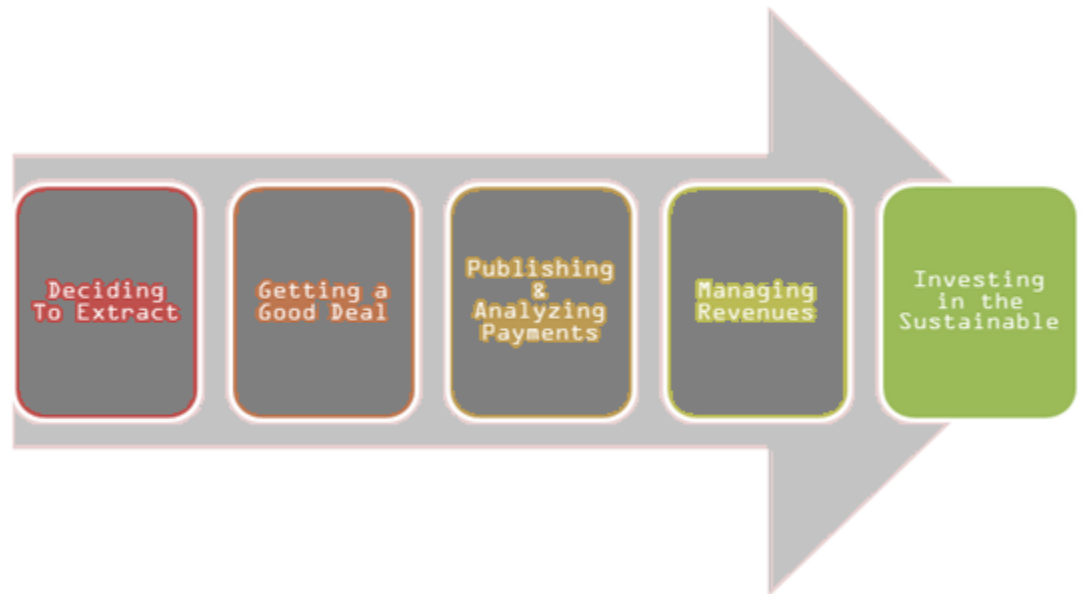
1. Fondo Latinoamericano de Reservas (FLAR). *Sovereign Wealth Funds - Global Overview*. FLAR Seminar Presentation. August 2013. [Link Available Here](#).
2. The Center for Global Development. *What Role for Sovereign Wealth Funds in Africa's Development?* Oil-to-Cash Initiative Background Paper. 2011. [Link Available Here](#).

CIVIL SOCIETY ORGANIZATIONS (CSOs)

Civil Society Organizations play an important role in the management of revenues.



STAGE 5: INVESTING IN THE SUSTAINABLE



Sustainable development requires long-term commitment to reforms and a political system that embraces good governance and transparency. Optimal expenditure and saving decisions are made within the context of an overarching multi-year fiscal framework that recognizes the cyclical nature of commodity prices and the exhaustibility of oil, gas, and mining resources.⁴ Public expenditure needs to be developed in accordance with, and in support of, the priorities expressed in the country's poverty reduction and development strategy. That standard is best maintained by ensuring strong scrutiny and appraisal of public investment choices.

Sustainable development at the regional/subnational level is about rational spending choices that communities and regions make through informed consultation, including with the most vulnerable including women and youth groups, and local participation. Good spending choices rely on good governance reinforced by improvements in public expenditure management, transparent reporting and regular auditing of expenditures, and public accountability.

First, the actual use of the government revenue in sustainable projects, including capital or recurrent operating and maintenance expenditures, must take place within the framework of the **national budget** (see Stage 4: Managing Revenues for an elaboration of Medium-term economic

⁴ see Stage 4: Managing Revenues for an elaboration of Medium-term economic frameworks

frameworks). Sustainable economic development occurs when it “begins with the end in mind.” Thus oil, gas, and mineral resources are best used to support widespread economic development that would last beyond their depletion. This requires a clear plan and implemented measures to diversify the economy and avoid overdependence on EI revenues.

Secondly, projects and infrastructure developed in the EI-producing regions merit special attention and should take into consideration the need to **diversify** the economy develop non-EI activities to avoid overdependence on the EI (Dutch disease) and to support the local and regional economy once the EI resources are depleted. In a similar vein sustainable investing of the resources must be undertaken so that political interest groups in RRDCs do not overdistribute the windfalls from EIs (the voracity effect), thereby hampering future economic growth.

Thirdly, **tripartite partnerships** (government, industry, and civil society) partnerships, especially in producing regions and at subnational levels, play a key role in forging sustainable action-oriented organizations. Governments, state-owned and private EI companies, and civil society each have a role and responsibility to ensure that all efforts are made to devise and implement appropriate and sustainable development policies based on good practice and international standards. By focusing on an integrated approach to improved governance and transparency in the oil, gas, and mining sectors the value chain is a crucial step toward achieving sustainable development. Two ideas which bolster the generation of the Development Dividend are (1) Environmental Impact Assessments, and (2) Corporate Social Responsibility (CSR).

ENVIRONMENTAL IMPACT

Optimal evaluation of EI projects will include an estimate of their environmental impacts, as well as expected socioeconomic benefits and their long-term sustainability. At the same time, the evaluations will address the need to utilize existing government and nongovernment implementation capacity and strengthen such capacity where needed. Of particular importance is to have in place: (1) a clear closure – decommissioning policy for old oil fields and mines and post-closure monitoring of the needed mitigation measures; and (2) a policy that will take care of the technical, environmental, social and economic issues related with the ending of the life of mines and oil and gas fields; a situation that will impact severely local populations.

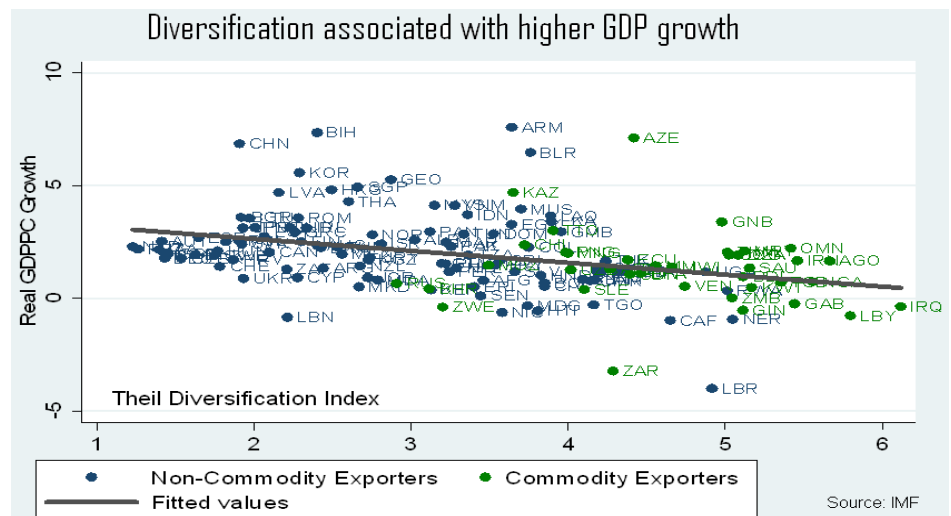
CORPORATE SOCIAL RESPONSIBILITY

Corporate Social Responsibility (CSR) projects, implemented by private companies, should be complementary to public investment projects. To this end, coordination among government, regional authorities, and EI companies is important for the design and implementation of sustainable projects. Special attention is needed to make sufficient provisions for the maintenance of infrastructures and adequate preparation for the handover of useful infrastructure and assets from the EI companies to local governments and organizations.

ECONOMIC DIVERSIFICATION

Resource-rich countries must diversify their economy in order to be less vulnerable to volatility in resource prices and revenue. Also, the pernicious *Dutch disease* mentioned in the introductory chapter of this document can be effectively alleviated through diversification of the economy.

The problem is that many developing economies are very poorly diversified. These countries should aim to diversify their economic base because countries that have diversified economic drivers have faster economic growth rates



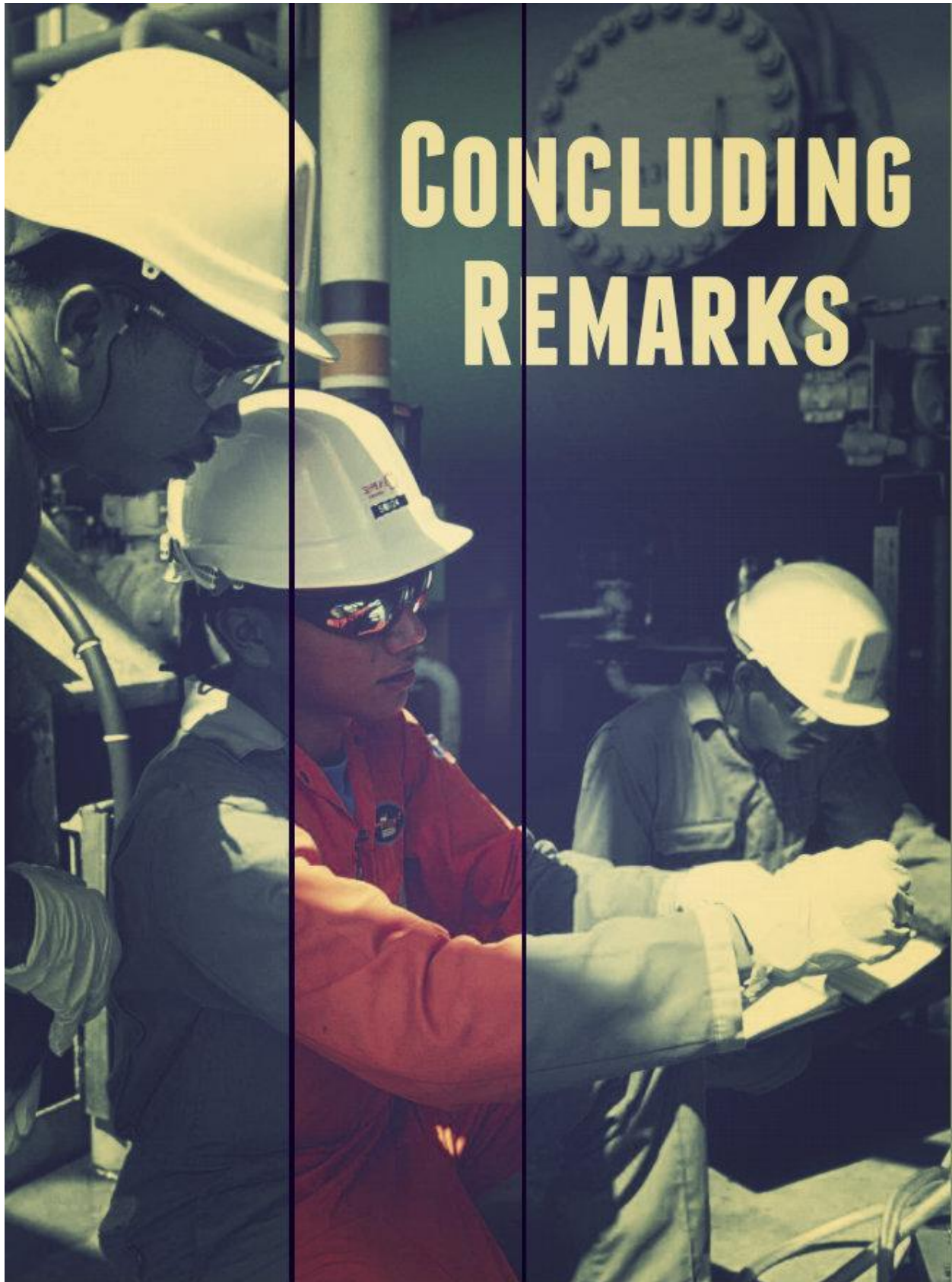
The benefits of economic diversification include the following

- There are *learning-by-doing* gains that raise national productivity and income (IMF 2010).
- Diversification hedges against the cyclical headwinds of various industries.
- Diversification sets up an alternative economic driver once resources are exhausted.

- Diversification exposes producers to a wider range of information, including about foreign markets, and so raises the number of points for potential “self-discovery”.
- Capability in one sector can open the way to others, especially those that use related knowledge.

FURTHER READING ON ECONOMIC DIVERSIFICATION

1. Diop, Ndiame. *Natural Resources Wealth and Diversification, Creating Jobs and Sharing Prosperity Widely*. The World Bank. Presentation. 2013. [Link Available Here.](#)
2. Ghura, Dhaneshwar. *Macroeconomic Policy Frameworks for Resource-Rich Developing Countries*. Global Seminar on the Role of Parliaments and Extractive Industries. 2013. [Link Available Here.](#)
3. Gelb, Alan. *Economic Diversification in Resource Rich Countries*. IMF Working Paper. 2010. [Link Available Here.](#)



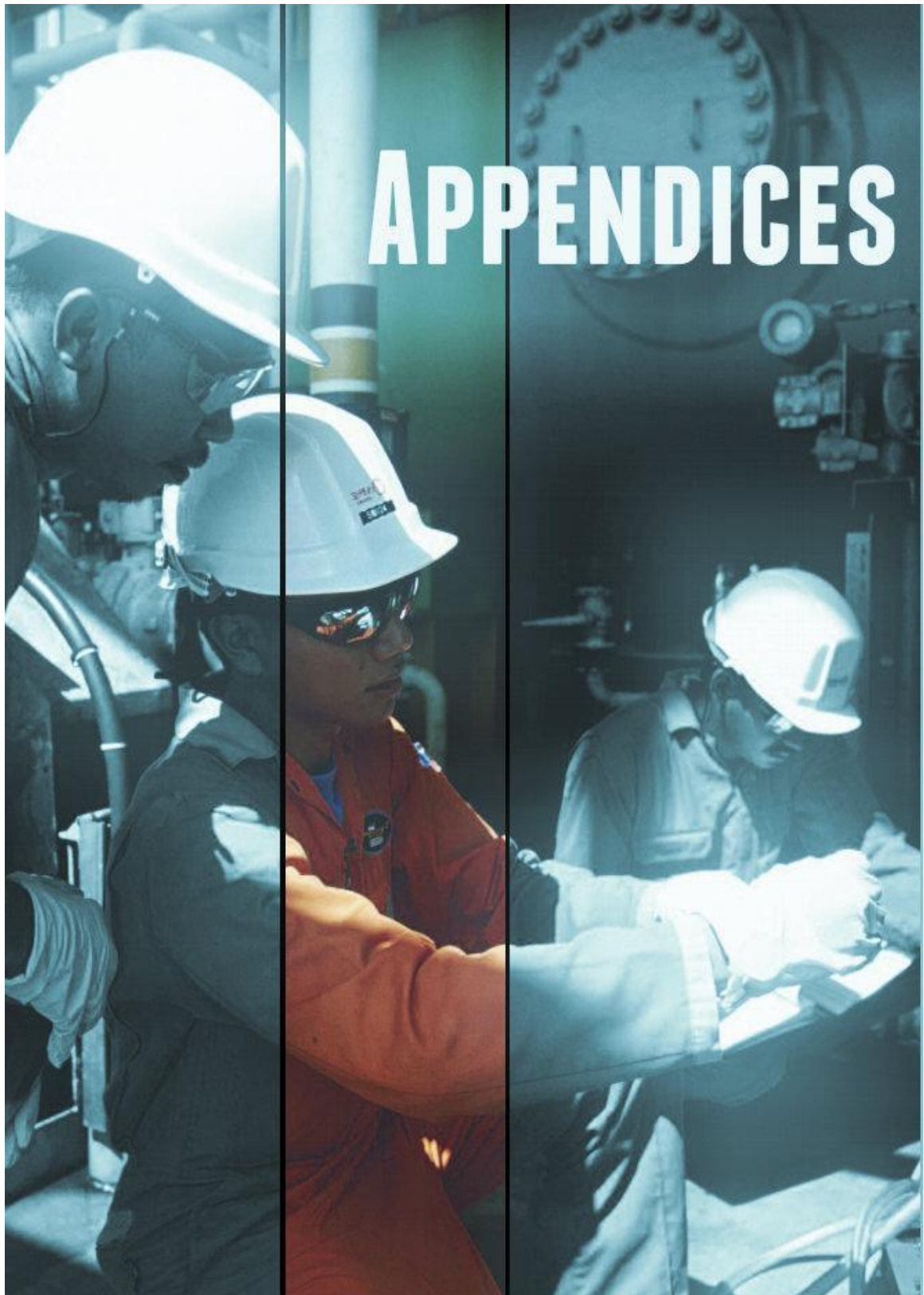
CONCLUDING REMARKS

It has been regrettably noted that natural resources are at best a mixed blessing for developing countries, with many of them indeed suffering from the Resource Curse, wherein resource revenues have fed large-scale corruption, underdevelopment, and in some case fuel conflict and war. Nonetheless, the extractive industries (EI) which convert these resources into economically consumable products can indeed play a positive developmental role through various functions. However, a strong institutional framework is necessary for the conversion of extractive revenues into concrete and positive dividends for ordinary citizens, and Parliaments form an extremely important part of this equation, as has been duly acknowledged through this document.

The World Bank Institute prepared this module in order to elucidate precisely what role parliaments can play in channelling natural resources towards the greater good of nations. It has discussed the potential scope for parliamentary engagement in EI, and has presented the parliamentary responsibilities in light of the extractive industries **value chain**, going step-by-step through the five phases of the chain and elaborating on the specific functions and degree of involvement within each link in the chain. Three special sections have also been included: EITI, Macroeconomic Considerations, and PBOs (Transparency).

This module has followed a logical progression that mirrors the pattern of the natural resource extraction, and is constructed to aid in a firmer understanding of the preponderant themes in parliamentary oversight of the sector.

Given the power of capable and judicious parliaments in improving the management of extractive industries, and thus the prosperity of the people, it is fervently hoped that key stakeholders, not least parliamentarians, will bear in mind the profound importance and transformative capacity of parliaments in the realm of extractive industries.



APPENDIX: INFORMATION IN PRIMARY CONTRACTS

This section draws on the work of Rosenblum and Maples of Revenue Watch Institute (2009)

Discussions with various stakeholders (government, civil society and industry) indicate confusion about the breadth of information that is typically in the primary contract between the state or state-owned company and the extractive company. This confusion could be a barrier to contract transparency, as individuals may believe that certain information is in these contracts when in fact it is typically not. All primary contracts tend to have a similar form and include the following information. How much detail is included in the contract is generally a result of how much is already established by law.

1. Recitals/Preamble: The beginning of the contract typically describes the parties involved, the effective date, and the general purpose of the contract. It summarizes, generally in slightly less legalistic language, the main reasons for entering into the contract.

2. Definitions: Early in the contract, there will be a section defining the key terms used in the contract.

3. Grant of formal legal title: Formal legal title is granted from the state to the company.

4. Oversight: Contracts may include provisions on how decisions regarding operations will be made by the government and the company. These provisions may set up a technical committee, advisory committee or other body empowered to make such decisions, and may provide information about how this body will operate (voting rights, quorum, etc.), what decisions are under its jurisdiction, when it will meet, and other details concerning its powers and responsibilities and how they will be fulfilled. If the state has equity participation in the project, a contract may specify the structure and level of financing of the participation, resource allocation (i.e., how much of the commodity the state will receive in-kind pursuant to its share in the project), operational control, and provisions on how decisions will be made, much as described in the above paragraph (voting rights, allocation of seats on the board, minority shareholder protections, etc.).

5. Rights, Duties, and Obligations:

This section may contain provisions on:

a. Obligations: work obligations or expenditure requirements; infrastructure, local and foreign employment requirements; training, health and safety standards; reporting and accounting standards; environmental standards and harm mitigation measures; how and when public and private land can be acquired; compensation to local communities; and community development obligations.

b. **Fiscal Provisions:** license and area fees; taxes; royalties; signing bonuses; exemptions from taxes and levies; and definitions of the nature and calculation methods of taxes, royalties and other payments.

c. **Fiscal Considerations:** foreign exchange arrangements; dividend and capital repatriation; provisions for debt repayment and debt-to-equity ratios; revenue distribution requirements; and criteria to regulate intercompany transactions.

6. **Confidentiality:** Near the end of the contract, there will usually be a confidentiality clause that lays out which information is confidential and for how long, and describes various exceptions to the confidentiality obligation.

7. **Termination:** Also near the end of a contract will be provisions laying out the term of the contract as well as the triggers for termination prior to the contract's stated end. These provisions describe when a breach is forgivable (e.g., force majeure) and whether and how a breaching party may have the opportunity to cure the breach prior to termination. Renewal provisions are generally found near the end of a contract as well.

8. **Dispute Resolution:** Often adjacent to or combined with the termination clauses, these clauses deal with the consequences of a dispute between the parties. Extractive contracts commonly require resolution through arbitration. Remedies for a breach may be detailed. Frequently associated with dispute resolution provisions is a "choice of law" clause.

APPENDIX: FISCAL TERMS OF CONTRACTS

Fiscal Terms refers to the terms that are laid out in contracts through which the government will receive payment. If managed successfully, petroleum and mining projects can generate large revenue streams for the state. The right set of fiscal terms enables a government to strike a balance between attracting the best investors and getting a good deal for the country (Revenue Watch Institute 2012). A fiscal regime that does not provide sufficient incentives for investors can result in production or revenue levels that fall short of government goals. But a fiscal regime that fails to distribute enough revenue to the host country can fail to effectively compensate the country for the value of its depleting resources, and can foster citizen dissatisfaction and national instability.

The fiscal terms influence not just theoretical assessments of expected national revenue under various scenarios, but also the enforcement of extractive agreements. The success or failure of a legal system to provide benefits for the country depends on the state's ability to manage its commitments and ensure that all parties are adhering to the rules (Revenue Watch Institute 2012). Thus, an analysis of any system must consider how effectively it empowers the government to enforce the terms that capture benefit for the state. Good terms will enable governments to minimize the risk of corruption, non-compliance, and over-use of loopholes. Among the most common tools that states use in varying combinations are the following (Revenue Watch Institute 2012):

- Bonuses. A one-time payment made upon the finalization of a contract, the launch of activities on a project, or the achievement of certain goals laid out in the law or contracts. Sizes vary, ranging from tens of thousands to even hundreds of millions of dollars for a few large petroleum projects.
- Royalties. Payments made to the government to compensate it for the right to extract (and purchase) a non-renewable natural resource. Most royalties are either ad valorem (based on a percentage of the value of output, e.g., 5% of the value of the minerals produced) or per unit (based on a fixed amount, e.g., \$10 per ton). When examining the likely financial

impact of a royalty, it's important to consider not just the percentage or per-unit value, but also the base against which that figure will be applied. The system in place for measuring the value or market price of the mineral plays an important role in determining the impact of royalty rules.

- Income Tax. In some cases, oil, gas and mining companies are subject to the general corporate income tax rate prevailing for all businesses in a country; in other cases, there is a special regime for these extractive sectors. Because petroleum and mining projects require heavy capital and operational investments, rules on how the tax system handles costs and deductions – the deductibility of interest payments, the depreciation of physical assets, the ability to count losses from one tax year to offset profits in a future tax year, etc. – play a major role in determining how governments and companies benefit.
- Windfall Profits Taxes. Some countries have set up special tax instruments designed to give the government a greater share of project surpluses, through additional tax payments, when prices or profits exceed the levels necessary to attract investment.
- Government Equity. In some cases, petroleum and mining projects are set up as locally-incorporated entities for which shares are divided between a private company and a state-owned company or another public body. Holding these equity stakes can give the state access to a portion of dividend payments.
- Other Taxes and Fees. Additional sources of fiscal revenues for the state include withholding tax on dividends and payments made overseas, excise taxes, customs duties, and land rental fees.
- Production Sharing. Many oil and gas contracts entitle the state to a share of the physical quantities of petroleum produced. These systems typically allocate such resources as reimbursements on production costs, then split control over the remaining “profit” oil or gas between the operating group of companies and the government. The government either sells its portion on its own, or takes cash payment from the operating companies in lieu of physical delivery of the commodity.

Since each country is characterized by variations in economic priorities, administrative capacities, mineral/petroleum endowments, and levels of political risk, it is impossible to identify one type or mix of fiscal instrument as best for all countries across the board (Revenue Watch Institute 2012).

But there are certain considerations that governments should include in the design of fiscal regimes:

- The fiscal regime for mining or petroleum should be clearly established by laws and regulations that should be readily accessible to the public. Minimizing parties' discretion to alter fiscal terms in individual contracts facilitates contract enforcement and the application of a coherent sector-wide fiscal strategy, and reduces the risk of corruption in negotiations.
- Fiscal regimes are most stable when they contain progressive elements that give the government an increasing share of revenues as profitability increases. This can be achieved using a variety of instruments, including progressive income taxes, windfall profits taxes, and variable-rate royalties.
- When developing a fiscal regime, it is important to consider not only the total value over the life of a project, but also the timing of the expected revenue flows. Some fiscal instruments – bonuses and royalties, for example – generate revenues to the state at an earlier stage than instruments such as profits-based taxes. Governments should develop their fiscal regimes so as to generate revenues on a timeframe that corresponds with national development plans.

When analyzing the impact of a country's fiscal terms on revenue generation, there are several potential loopholes that bear close monitoring (Revenue Watch Institute 2012).:

- Transfer Pricing. An integrated international company may use sales among various subsidiaries as a means to reduce its fiscal obligations within a particular country. A sale of mineral or petroleum output from one subsidiary to another at a price under the fair market value may serve to reduce the revenue the company reports to the government and thus limit the royalty or tax payments it owes. Similarly, by purchasing a good or service from a related company at an inflated price, a company can raise its reported costs, thereby increasing deductions and decreasing income tax liabilities. In order to limit transfer pricing abuse, a government should put in place a firm policy for the valuation of transactions between related parties, linking the prices utilized for revenue-collection assessments to objective market values wherever possible.
- Debt-to-Equity Ratios. Interest payments on loans are often deductible for income-tax purposes. Integrated international companies sometimes

finance subsidiaries in extractive-rich countries with extremely high levels of debt in the form of related-party loans, which means that interest payments made from the subsidiary to its parent company are deducted, limiting the subsidiary's tax liability. Governments can combat this problem by capping the level of debt that an extractive subsidiary can take on in relation to its total capitalization, or by mandating that interest payments made on debt exceeding a certain debt-to-equity ratio will not be deductible for tax purposes.

- Ring-Fencing. Companies that have multiple activities within one country sometimes use losses incurred in one project (say, exploration expenses from a new mine that has not yet begun production) to offset profits earned in another project, thereby reducing overall tax payments. Governments can overcome this situation through ring-fencing, the separate taxation of activities on a project-by-project basis, which facilitates the government collecting tax revenue on a project each year that it earns a profit.
- Loss Carry-forwards. Many tax systems allow a taxpayer to deduct losses generated in one year from income earned in a subsequent year. Such a system takes into account the heavy up-front costs necessary to get a project off the ground. But in an effort to prevent unfettered carry-forwards from overwhelmingly reducing long-term revenue generation, some governments have placed limits on them, restricting either the period of time that a loss can be kept on the books or the amount of income in any given year that can be offset by past losses.
- Stabilization Clauses. Petroleum and mineral contracts often have clauses that establish that the law that exists on the day that the contract is signed will govern the agreement, and that subsequent legal changes will not have any effect on the contract. These clauses offer investors some assurance that they will not be subjected by legislative action to a drastically different fiscal regime than the one on which they based their decision to invest. But in order to protect the interests of citizens, preserve state sovereignty, and remain flexible to changing economic and political circumstances, stabilization clauses should be narrowly drafted and limited to major revenue streams such as royalties, taxes, duties, and major fees. Stabilization clauses should not freeze environmental, labor or other similar rules.

APPENDIX: MONITORING OF CONTRACTS

The World Bank Institute has designed a nine step contract-monitoring scheme, as follows:

An interactive version of this roadmap can be found at

<http://contractroadmap.org/>



APPENDIX: OBJECTIVES AND PRINCIPLES OF GOOD BUDGETING

OBJECTIVES

In order to execute the budget process properly, legislators must be mindful of the following interrelated objectives:

1. **Fiscal discipline:** ensuring the appropriate balance between what is earned and spent, budget totals should be the result of explicit, enforced decisions; they should not merely accommodate spending demands. To maintain fiscal discipline, parliament has to resist the temptation to add new spending without cutting back elsewhere in the budget. A description of major expenditure and revenue measures and their contribution to policy objectives should be provided, as well as estimates of their current and future budgetary impact and their broader economic implications (IMF, 2007). Budget discipline requires clear descriptions and costing of both continuing government programs and new policy proposals. As part of the budget documentation, countries should always include a statement describing any important fiscal policy changes and their expected effects. This will allow an overview and understanding of the factors that may cause budget outcomes to diverge from planned spending (IMF, 2007).
2. **Allocative efficiency:** Because resources are limited, budgeting forces a government to consider the merit of competing claims on the public purse and to negotiate tradeoffs between them. The achievement of allocative efficiency or strategic prioritization requires government capacity to allocate resources and select programs and projects in conformity with its objectives. This process is supported where the policy basis of the budget is stated clearly on the basis of a strategic framework. Expenditures should be based on government priorities and on effectiveness of public programs. Allocative efficiency is threatened where spending departments are bailed out when they overspend, because poor budget execution can introduce substantial ad hoc realignments that distort stated priorities. Such distortions often divert resources away from the poorest and most vulnerable groups in society to cater for the interests of bureaucracies and strong interest groups.
3. **Operational efficiency:** Agencies should produce goods and services at a cost that achieves ongoing efficiency gains.

PRINCIPLES

While engaging in the budget process, legislators should attempt to incorporate principles of good budgeting, including:

1. **Comprehensiveness:** The budget must cover all the fiscal operations of government.
2. **Predictability:** Spending agencies should have certainty about their allocations in the medium term to enable them to plan ahead.
3. **Contestability:** No item in the budget should have an automatic claim to funding.
4. **Transparency:** Accurate, timely, reliable and comprehensive information.
5. **Periodicity:** The budget should cover a fixed period of time, and follow a clear schedule. However, should seek to achieve medium term objectives
Budgets should be comprehensive and transparent and ensure funding predictability for government departments. The budget process is used to assess competing claims on the budget and to facilitate difficult tradeoffs. Meeting this challenge successfully requires that budgeting maintains fiscal discipline and prioritizes strategic public funds. Fighting the resource curse requires a public financial management system in which budgetary allocations are open and transparent.

THE BUDGET PROCESS

Budgeting is a process rather than an event, and budget cycles are ongoing and interconnected. The budget process is governed by a timeline that typically can be separated into four different stages:

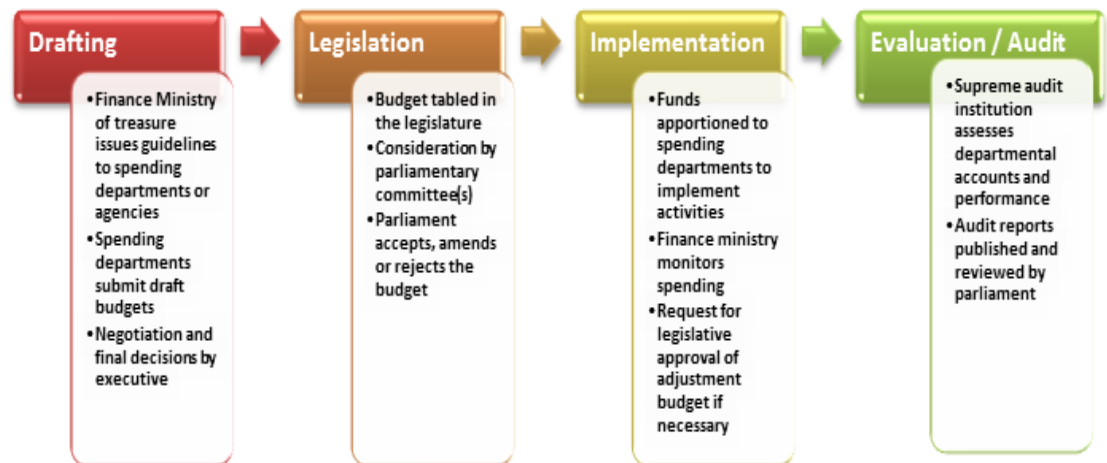
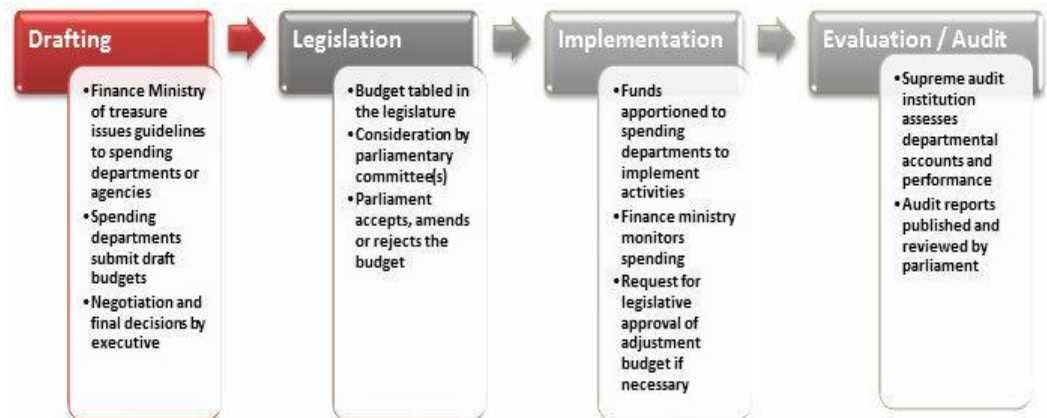


Figure: The stages of the budget process

DRAFTING

The drafting stage compiles a draft budget that can be submitted to the legislature. Although this stage is mostly internal to the executive, it is not necessary for this stage to be secretive or opaque. The first step is to set fiscal policy and estimate available revenues in order to establish the total resource envelope that will be available for spending. Based on the policy framework of the government the finance ministry issues indicative expenditure ceilings for each department. This is followed by negotiations between spending departments and the finance ministry about the allocation of funds across different functions. A consolidated draft budget has to be reviewed and approved at the highest political level, such as the president or cabinet, which will also make final decisions on especially contentious issues that could not be resolved prior to the submittal of the draft.



As mentioned in the introductory chapter, the discovery of new extractive resources can tempt governments to engage in excessive public spending that is founded on the fallacious assumption that their natural resources represent a permanent rise in incomes. Over-optimism causes governments to “promise the world” to citizens. Also iterated in the introductory chapter, the extractive sector presents difficulty in budgeting because commodity prices are extremely unpredictable—which creates volatility in revenue streams. Therefore, to avoid overly optimistic forecasts, best practices include taking an overly cautious prediction of oil, gas, or minerals prices, and construct the annual and medium term budget with those precautious revenues.

To be transparent, government should publish the macroeconomic assumptions and projections upon which the budget is predicated. It is a good test of government’s budgetary foundation to consider whether its growth forecasts are substantially more optimistic than those produced by the private sector and international organizations. Assumptions regarding natural resource prices and production should be made transparent.

All countries, and especially resource-rich countries, are exposed to fiscal risks inherent in a continuously changing economic environment and even with high quality forecasting many new and urgent pressures on public spending are impossible to anticipate and can emerge suddenly. Successful management of public investment thus needs to accommodate volatility, both by smoothing out expenditures, and by using periods in which investment is relatively low to prepare projects to be implemented when revenues become available. This requires that domestic expenditure is built up gradually and spread out over time to take account of revenue volatility. Contingency reserves, which set aside an amount for adapting the budget to changing circumstances or emergencies are often used as well. However, contingency reserves need to be clearly accounted, decisions about their use

should be a transparent and approved by the legislature, and they should not be excessive in size. Otherwise, they can easily deteriorate into ‘slush funds’.

The following Decision Matrix helps to illustrate the choices that different countries have to face, depending on the size of their resource base, their goals, and their level of capital scarcity:

Decision Matrix		Natural Resource Revenues			
		Long-lasting		Short-term	
		Objectives	Examples	Objectives	Examples
Capital Scarcity	High	Macroeconomic Stability Managing Volatility Development	Iraq Nigeria	Macroeconomic Stability Sustainability/Exhaustibility Development	Ghana Bolivia
	Low	Macroeconomic Stability Managing Volatility	Saudi Arabia Canada Kuwait	Macroeconomic Stability Sustainability/Exhaustibility	UK Netherlands Norway

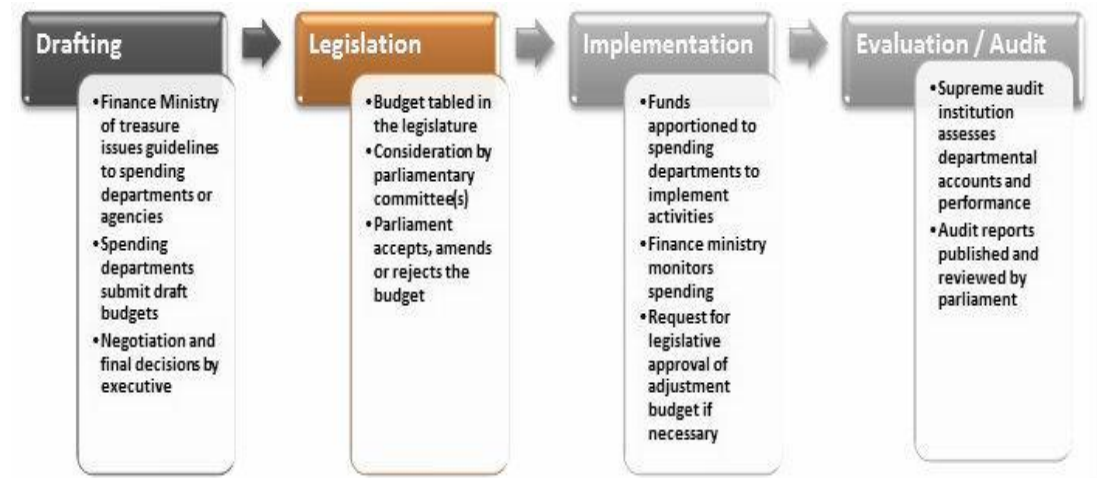
Source: IMF, 2013

Parliament should consider the following actions at the Drafting phase of the budget process

1. **Use conservative budgetary oil prices:** One way to help overcome extractive industries related challenges is to use conservative budgetary oil prices. This is a way of playing it safe. When oil prices turn out to be higher, the windfall revenues can be used to improve government finances. When oil prices turn out to be low and/or lower, the damage to the economy will be only minimal.
2. Related to this is the need to encourage or develop a **non-extractive industries budget:** Because oil, gas and minerals prices are so unpredictable, a budget that does not include any revenues from the extractive industries sector can serve as a worst-case baseline budget. *Dutch Disease* (see introductory chapter) is the fundamental problem being addressed here.
3. Use the **committee system** to evaluate estimated revenues from the extractive industries sector for the upcoming budget year: In some countries, this is the task of the Estimates Committee, which usually examines whether the money is well laid out within the limits of the policy

implied in the estimates; carries out regular examination and scrutiny on budgets, estimates and management thereof; conducts budget hearings; and makes recommendations and report to the House for formulation and implementation of future budget estimates.

LEGISLATIVE



Once a comprehensive budget has been drafted, it needs approval from parliament to come into effect. At this second stage, the revenue and expenditures proposals of the executive branch are scrutinized. The options available to the parliament are to (1) approve, (2) reject, (3) amend, (4) or substitute the draft with its own budget (a special case). In some countries, the legislature passes separate legislation for appropriations and changes to the tax code; in others it considers a unified budget bill.

Countries differ markedly in the duration they allot for the legislative stage. The scrutiny of the budget is a time-consuming and laborious process, which is why the inference about the potential influence of legislatures can be made from the amount of time it has to review the draft budget. In general, an adequate amount to time for a national legislature to scrutinize a budget should be three months at a minimum.

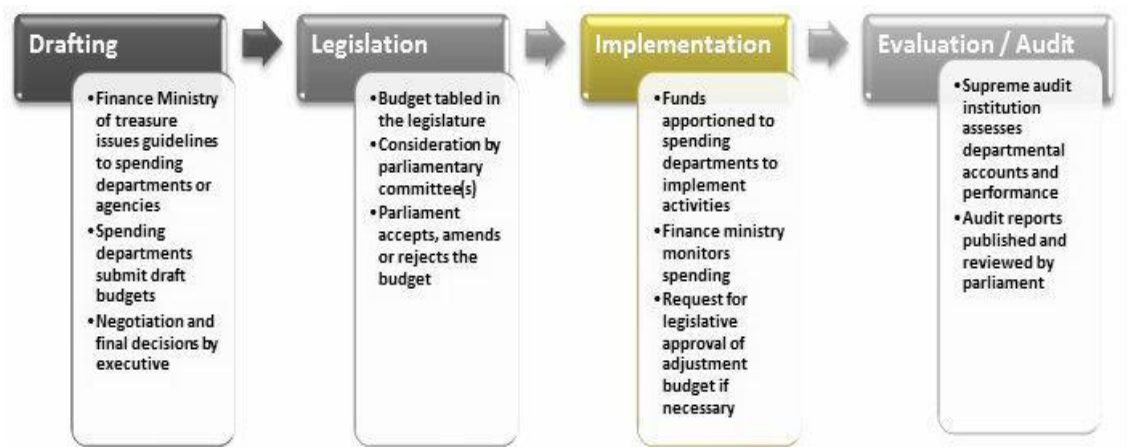
As it engages in the scrutiny of the draft budget, the priority of the legislature should be to **exert a positive influence** on the budget, and try to influence the elements of the budget so as to reflect the national priorities and a judicious use of its revenues and expenditures to achieve these priorities. This applies wholeheartedly to the ambit of natural resources as well. Some recommendations for parliaments in this aspect include:

1. If the allotted time for review of the draft budget is less than 3 months, members can introduce a proposal for reform to parliament's standing orders and the constitution to allow parliament more time to review the

budget. This could be done by lobbying the parliamentary reform or *modernization committee*, members could use the media to advocate for this and inform the public about the constraints it faces in reviewing.

2. Capacity should be developed for astute analysis of the national budget. Wherever this capacity has been wanting, the budget has not been able to fully reflect the national priorities from the point of view of the legislatures. Above all, a Budget Committee, which is typically in charge of spearheading the evaluation of the draft budget, should be prepared and empowered to conduct a robust evaluation
3. A common shortcoming for parliaments wishing to be more effective in the budget process is lack of budget expertise. Executive budgets are large, complex and difficult to understand. A Parliamentary Budget Office (*See section: PBOs of this document*) should be established to assist the legislature. The importance of PBOs in assisting legislatures is so crucial as to warrant its own section in this document.
4. Legislatures can conduct public hearings on the budget, which will invite more stakeholders to insert their inputs into the evaluation process in a structured manner. Outside experts can be invited at this time to give evidence and provide analysis.

IMPLEMENTATION



After the legislation phase of the budget is completed, funds are apportioned to departments in order to implement their activities. The funding of the budget is monitored typically by the Finance Ministry.

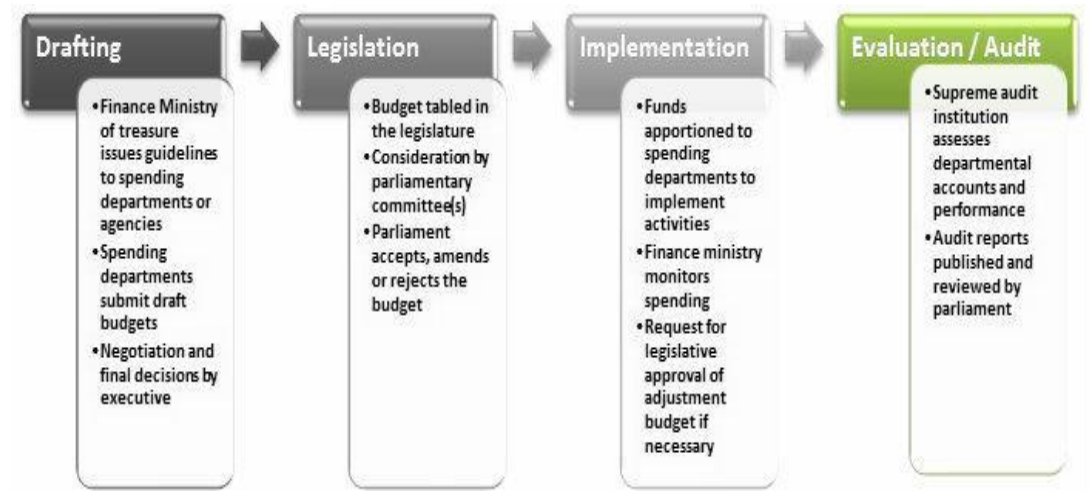
It should be kept in mind, however, contemporary national and global economies are susceptible to continuous change and possibly economic shocks. This is why contingency reserves are necessary for any governmental regime. However, beyond just “rainy-day” funding, adjustments might be necessary in the budgetary scenario during the year itself. For such budget adjustments, requests for legislative approval can be

made if such a situation proves to be necessary. However, such in-year adjustment decisions should be transparent and thoroughly scrutinized.

The OECD makes the following recommendations for the implementation phase:

1. **Projections:** comprehensive budget includes performance data and medium term projections.
2. **A pre-budget report** states explicitly the government's long-term economic and fiscal policy objectives, and its economic assumptions and fiscal policy intentions for the medium term.
3. **Monthly reports** show progress in implementing the budget, including explanations of any differences between actual and forecast amounts.
4. **A mid-year report** provides a comprehensive update on the implementation of the budget, including an updated forecast of the budget outcome for the medium term.
5. **A year-end report** should be audited by the audit institution and released within six months of the end of the fiscal year.
6. **A pre-election report** illuminates the general state of government finances immediately before an election.
7. **A long-term report** assesses the long-term sustainability of current government policies.

AUDIT AND EVALUATION



Audits of the budget are necessary to ensure that they conform with the predetermined agenda of the budget. The main institution in this ambit is the Supreme Audit Institution (SAI) assesses departmental accounts and performance. The independence of Supreme Audit Institutions has been recognized as a core fundamental of effective audit. The reports that the SAI

produced should be published promptly and reviewed by parliament. The type of audit and audit office differs depending on jurisdiction.

ROLE OF SAIs IN EXTERNAL AUDIT:

1. External audit and parliamentary scrutiny of audit findings are fundamental for holding government to account.
2. SAIs have evolved according to different traditions. The audit court and auditor general models are the two main types, but there are variations and hybrids.
3. Parliament can engage with audit findings most effectively through dedicated committee capacity.
4. Devising sound review and follow-up mechanisms is important for parliament to ensure that recommendations are actually implemented to improve public spending and administration.



APPENDIX: RECOMMENDATIONS OF THE COMMONWEALTH PARLIAMENTARY ASSOCIATION ON THE ROLE OF PARLIAMENTS AND EXTRACTIVE INDUSTRIES.

THE ROLE OF PARLIAMENTS AND EXTRACTIVE INDUSTRIES

Government revenues from mineral and petroleum extractive industries should benefit the people of the jurisdictions which own them. It was recognized that mineral and petroleum resource development is a highly complex, technical and volatile field. The resources themselves are non-renewable and consequently finite. Transparency and accountability are therefore essential to re-assure all stakeholders that expectations are reasonable, developments are fair and benefits are spread equitably throughout society. The group therefore encourages all Parliaments and Parliamentarians to support efforts to enhance the transparency of the sector, including projects such as the Extractive Industries Transparency Initiative and contract monitoring. The group stressed that the provision of processes to ensure

transparency and proper scrutiny is only the starting point. Governments, Parliaments and other stakeholders must have the capacity and the will to use the processes fully and vigorously.

THE FOLLOWING ARE SOME OF THE MAIN PROPOSALS THAT EMERGED FROM THE DISCUSSION:

Enabling Parliamentary Engagement

1. Parliament must approve clear and well-considered policies on extractive industries which are part of a comprehensive development plan.
2. Parliament must scrutinize government institutions, administrative processes and regulatory agencies involved in extractive industry development.
3. Parliament must have access to the contracts, licences and other agreements between the government and resource developers and investors, including provisions on changes in ownership of projects and the arbitration of disputes.
4. Parliaments and parliamentary committees must have clearly defined roles in the approval of contracts, the oversight of regulatory agencies

and the scrutinizing of income and expenditure of revenue emanating from resource development.

5. Scrutinizing Extractive Industry Agreements: Provided the selected fiscal process or processes are run efficiently and transparently, revenue from extractive industries can be obtained equally effectively through the sale or auction of contracts including production-sharing regimes, through taxes and royalties including the licensing of exploration and exploitation areas and through direct state ownership either as a majority or minority shareholder.
6. A combination of revenue processes can be beneficial if there is a need to obtain revenue early in the development of extractive industries.
7. Stabilization clauses seeking to shield companies from future political and legislated changes are inappropriate and generally ineffective.
8. Commercial confidentiality should be kept to a minimum and should be time-constrained.
9. Parliaments should be provided with the information and the resources necessary for effective oversight, including where possible the provision of expert technical advice.
10. Parliaments, parliamentary committees and individual Parliamentarians should work with civil society groups, both local and international, to obtain information and expert advice on the operations of resource projects, the effectiveness of their regulation and the monitoring of revenues.
11. Parliament should consider supporting or encouraging the creation of multi-stakeholder groups, possibly including some Parliamentarians, to give civil society a formal role in monitoring extractive industries.
12. Parliament must maintain the highest standards of propriety among its Members through strict adherence to codes of conduct, codes of ethics and asset disclosure rules so its performance in the oversight of extractive industries is beyond reproach.
13. Parliament must make full and effective use of all its oversight practices and procedures to monitor the performance of extractive industries, including: public accounts and audit reviews, approval of the budget, questions to Ministers, departmentally related committee reviews, requests for the production by ministries of persons and papers, special parliamentary committee inquiries and debates on policies and motions.

OVERSEEING THE BENEFICIAL USE OF REVENUES

14. Government must report to Parliament fully on its use of the revenues and in-kind benefits, including social development projects, received from extractive industries.
15. Parliamentary budget scrutiny should ensure that public expenditure levels distribute the benefits from extractive industries sustainably over time to

avoid excessive short-term spending when revenues are high and excessive borrowing when revenues are low and to retain equitable benefits for future generations.

16. The revenues from resource assets should be used to finance social and infrastructure development, economic diversification and the development of human resources to help reduce future dependence on revenues from extractive industries.

The Parliamentarians offer these proposals to assist Commonwealth Parliaments and Legislatures, the Commonwealth Parliamentary Association, the World Bank Institute, the International Monetary Fund, the Revenue Watch Institute, the Parliamentary Centre and the wider global community to address the issues around the development of extractive industries. They recognize that the responses to the issues will vary in each jurisdiction to reflect local circumstances. However, the Parliamentarians see great advantages in strengthening parliamentary oversight of the development of publicly owned natural resources and suggest that Parliaments consider the proposals to increase transparency and public confidence in this sector. The participating Parliamentarians and organizations extend their thanks to the Joint Vienna Institute for facilitating the seminar.

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