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Managing Resource Rents

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The Special Challenges in Postconflict Countries

Resource flows from extractive industries can be a lifeline for postconflict countries, helping to fund critical reconstruction needs. But these resources present issues not found elsewhere in the economy and need to be well managed. Sector governance principles that apply to oil-producing countries in general are even more important in postconflict countries. This Note discusses these principles and shows how they apply in two cases, Timor-Leste and Sudan.

Conflict within countries has often been associated with the presence of substantial natural resources, as different parties attempt to gain control of the revenues from these resources (Collier and Hoeffler 2005). The attempted secession of Biafra in Nigeria, the civil war in Angola, and the conflict in Sudan are all cases where resource revenues played an important part.

Most such cases share common features in the immediate postconflict period: The country tends to have severely damaged physical infrastructure, poor economic performance, and a weak civil service. There is great need for public spending and for job creation. And developing natural resources appears to offer a base for economic recovery. This is especially true where the natural resource is oil, because the price includes considerable economic rent.

Since many postconflict countries have low income levels and limited government revenues from other sources, the resource revenues can account for very large shares of GDP, government revenue, and exports. In Chad during the first full year of oil production, the petroleum sector accounted for about 30 percent of GDP and 60 percent of government revenue. Such a dominant resource sector offers enormous potential benefits for the country, but its special characteristics require careful management to obtain these benefits.

Distributing resource revenues

These benefits can be divided among members of the society in different ways. Three decisions in their allocation have proved important.

Compensate producing regions?

Oil, gas, and minerals are typically "point source" resources, produced in specific locations. Groups living near the resource tend to feel that it is theirs (especially if they controlled it during the conflict period) and that they suffer from local impacts of production. In the postconflict era the government may therefore decide to put in place a revenue sharing arrangement that ensures that some of the benefits go directly to the producing region. In federal states direct revenues from oil production are normally shared between the federal government and the producing state (as in Argentina, Bolivia, and Nigeria).

In Chad, though not a federation, the constitution provides for transferring a share of the benefits from oil production to the producing regions as compensation for its social and environmental impact. In Sudan revenue sharing has been a crucial part of the negotiated settlement between the north and south. In Bolivia opposition to a recently proposed gas export pipeline stemmed in part from the desire of producing regions to ensure that more of the benefits accrued to them.

Another channel for delivering benefits to local populations is international oil companies, which in developing countries are sometimes asked to assume some of the responsibilities of government institutions. Local populations may take advantage of the presence of oil installations by obtaining from the oil companies services that the central government should otherwise provide. That increases the risk for the oil companies, forcing governments to provide incentives for them to invest by lowering resource taxes and royalties.

Spend now or save for the future?

The eventual exhaustion of resources creates a tension between the need for substantial public spending in the present and the need to provide for future generations. Governments also need to show progress to citizens, who may have high expectations after the end of hostilities. To balance these concerns, several oil-producing countries have introduced oil funds for saving part of the resource revenues for future generations. The funds may also be used to stabilize public expenditure, with the government paying more into the fund when oil prices are high. For such a savings policy to be most effective, governments need to be transparent about where the resource revenues are going, how big any resource fund is, and how the fund is performing—to give citizens some assurance that the money not being spent now is indeed being saved for their future interests (Bacon and Tordo forthcoming).

Distribute directly to citizens?

Even where there have been large needs for infrastructure investments and social spending, some governments have considered distributing part of the resource revenues directly to citizens, as a way of achieving an equitable distribution of benefits and obtaining popular support for their general policies. But doing so requires a means of identifying all citizens and an economywide mechanism for distributing cash benefits (such as banks), both of which are lacking in many developing countries. Moreover, the lack of an efficient banking sector often leaves the beneficiary citizens no alternative but to use the extra cash for immediate consumption, limiting the impact on economic growth.

Managing resource revenues

Postconflict countries with a weakened and inexperienced civil service, especially those with no experience with the resource sector, face three main problems in managing resource revenues.

Understanding the government's entitlement

Contracts between private companies and the government, as ultimate owner of the resource, are often complex. Moreover, if negotiated during the conflict, they may be on terms that (viewed in the postconflict period) are unfavorable to the government, in order to persuade private companies to take the risks during a period of much uncertainty. In addition, revenues typically do not accrue smoothly over the lifetime of a natural resource project. A lack of understanding of these issues can cause popular resentment against the resource that will eventually bring benefits for the country. It also makes it difficult for the government to plan its future expenditures.

Building a better understanding starts with developing competence in the sector ministry. Also an important step in ensuring sound revenue management and accountability is to establish and publish independent audits of resource revenues. The government needs to be sure that it is receiving the tax revenues to which it is entitled, and the public needs to have confidence that these revenues are going to the treasury and other appropriate bodies. The Extractive Industries Transparency Initiative provides a relatively simple transparency framework, in which governments, companies, and civil society form a voluntary partnership to collect and publish information on all sector payments made to and received by the government.[1]

Managing volatility

Because natural resource prices tend to be volatile, governments can face large and unpredictable swings in their resource revenues. The use of stabilization funds is a well-tested approach to managing this volatility (see previous section). By contrast, governments rarely use financial techniques such as hedging to provide systematic protection against future fluctuations in oil prices. There are several reasons for this: Hedging is expensive. It requires deep knowledge of the oil and financial markets that is normally lacking in the civil service. And it rarely fully offsets the basis risk.[2]

Planning expenditures

Presented with resource revenues, governments need to construct a useful and sustainable expenditure plan. When revenues are high, governments may be tempted to undertake projects intended mainly for show (such as a presidential palace) or ones without a sound economic foundation (such as a steel mill where there is no local market for its output). In addition, the availability of what may appear to be "easy money" can lead to poor contracting as governments fail to ensure that they obtain value for money. For all these reasons strict expenditure planning and control is critical in countries with large resource revenues. This function is supported by the International Monetary Fund's macroeconomic framework and the World Bank's public expenditure reviews.

Two cases of resource dominance

Many countries that have earlier experienced conflict are now producing exhaustible resources. Among these are two that can serve as recent and contrasting case studies of the problems these resources bring: Timor-Leste and Sudan.

Timor-Leste

Timor-Leste became a republic in 2002, following independence from Indonesia. Its infrastructure was largely destroyed, and its per capita income was only about US$300 a year. But three oil and gas fields have been identified in the Timor Sea, and the first was brought into production in 2004, bringing in revenues of US$129 million in that year (by comparison, other central government revenue amounted to US$75 million and GDP to less than US$350 million).

Since the oil and gas reserves were not the reason for the independence struggle, there are no rival factions laying claim to shares of the revenues. The revenues will fund the large immediate needs for infrastructure to rebuild the country as well as provide future financial revenues.

The new president and Parliament approved a comprehensive plan to develop the sector and to involve the country's population. The plan has three main pillars:

- *Public information and education campaign.* Information on oil and gas sector and public finance policies was widely disseminated, and there are frequent interactions between the prime minister's office and local constituencies.
- *Savings and stabilization mechanism.* The Timor-Leste Petroleum Fund is aimed at coping with revenue volatility and ensuring revenue sources for the country when the resource is depleted. The so-called Norwegian model was chosen for the fund because of its flexibility and because of the key role played by Parliament.
- *Capacity building in the sector ministry.* An extensive training program was devised, and on-site foreign advisers were brought in at an early stage after independence.

The Timor Sea Office, funded by the World Bank, was created to coordinate these efforts.

Sudan

The 20-year internal conflict in Sudan appeared to have reached a negotiated settlement in 2005, so that the country could finally enter a post-conflict phase. Sudan has been producing substantial oil since 1999, with output reaching more than 500,000 barrels a day in 2005.

A large share of the oil is produced by fields in southern Sudan, but until now the control of the oil sector has been in the hands of the central government, located in the north. The substantial oil in the south compounded the difficulties in arriving at a negotiated settlement. The agreement finally reached has several key features: Fifty percent of net oil revenues from fields in the south will be paid to the government of southern Sudan. There will be a stabilization account for the central government. And if production reaches 2 million barrels a day, payments will be made into a fund for future generations.

The agreement means that substantial funds will flow to the government of southern Sudan to finance reconstruction in the region. But managing these flows poses some large problems. The government of southern Sudan must build up its civil service from a small base, and unlike the government in Khartoum, it lacks experience in dealing with the oil sector. Understanding oil contracts and entitlements to revenues, and participating in the future development of the sector in the south, will require substantial training and capacity building. Transparency in the revenue flows for the entire sector is likely to be very important to allay suspicions that one side or the other is obtaining more benefits than entitled to under the revenue sharing agreement. Finally, with oil prices high and production surging, both the north and the south may find it difficult to spend all revenues effectively. They may need to consider how to manage the revenues for stabilization purposes, and to put more emphasis on the fund for future generations.

Conclusion

Sector governance principles that apply to oil-producing countries in general are even more important in postconflict countries: oil may have been one source of conflict, and in early postconflict years the risk of returning to conflict is high. Ensuring that the resource provides economywide benefits, that a fair share accrues to regions affected by the conflict and by the presence of the resource, and that there is general awareness of how the resource revenues are being used will contribute to a sustainable recovery program.

- Whether or not a federal system is involved, revenue sharing can provide a good mechanism for ensuring political stability.
- Where a banking infrastructure is lacking, distributing revenues directly to citizens may lead to inefficient use of resources.
- Care in planning expenditures is required, to prevent volatility in resource prices and revenue flows from creating volatility in public spending and to provide some public saving where the resource revenues exceed immediate spending needs.
- Developing suitable legal and institutional frameworks for managing the sector is crucial. A lack of management capacity, normally amplified by long-lasting conflicts, calls for creating simple, clear, and transparent legal and institutional arrangements.
- The complexity of contracts and resource payments to the government in the extractive industry requires capacity building in the sector, to produce a full understanding of the flows and their likely development by both the government and the public at large. This effort will help in managing the population's expectations about the benefits and impacts of the sector.
- Transparency in the revenue stream flowing to the government is key in building trust.

Notes

1. See http://www.eitransparency.org/.

2. Basis risk is the possibility that the price of the proxy used in a hedge (normally a widely traded crude oil like the Brent blend or West Texas Intermediate) does not behave exactly like the price of the item being hedged. Although crude oil prices are correlated, there are bound to be discrepancies between regional prices and between different types of crude.

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