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AT A GLANCE

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Policy framework for extractive industries' performance

TOPIC: Reports
By: Miguel Schloss
October 7, 2015

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The imperative of social acceptance and economic contribution

It is hardly a coincidence that those countries blessed with the greatest natural resources in general, and mining in particular, also are seen to have the highest levels of corruption and poor economic performance.

In fact, Transparency International's Bribers Payers Index, which ranks the leading exporting countries and sectors in terms of the degree to which their companies are perceived to be paying bribes abroad, indicates that corruption is widely seen as playing a significant role in international trade. Particularly disturbing is the high corruption associated with extractive industries – the economic bedrock for many developing countries. It should thus not be too surprising that mining has a poor connotation, and is seen as contributing to this sorry state of affairs.

With the exception of Namibia or Chile, all other countries whose mining sector exceeds 5 percent of their GDP are rated in the lower 50 percent of World Bank Institute governance indexes in the rule of law (or for that matter, others, such as control of corruption). See figure 1

Globalization and transparency are magnifying these societal shifts, going to the heart of long-term profitability, the license to operate, and the social contract. Moreover, some bracing international data, including the 2005 Gallup and 2006 GlobeScan, when put together, suggest that nearly half of respondents think that business has "too much power," and that international corporations have the highest negative ratings of any global economic actors. The key challenge to the extractive industry in the 21st century is thus to operate in an increasingly globalized, competitive and integrated world.

The era of enclave projects and sheltered existence has come to an end, and the industry's activities are subject to ever-closer scrutiny. Inevitably, host countries' corruption and poor development performance impairs the industry's reputation, increases shareholder risks, impedes efficient use of resources, and can even lead to social unrest.

A way must be found to ensure that extractive industries benefit societies that host them, while responding to the fiduciary responsibilities to their shareholders, thereby inducing stable business development and growth, lower risk, and sustainability. This can only be achieved if their activities are embedded in the host society and their institutional setup.

To put matters differently, most foreign investment in developing countries takes place in extractive industries such as mining and petroleum. Revenues from such investments make their way to governments in the form of taxes, royalties, fees and other payments.

If such revenues were effectively and transparently managed, they could provide a basis for successful growth and poverty reduction. However, all too often, the state and other institutions managing these resources are unaccountable to ordinary citizens and become a vehicle for embezzlement, fraud, misappropriation and corruption. In more extreme cases, access to such resources intensifies regional conflict and the resulting political, economic and social disorder may be exploited to facilitate large-scale misappropriation of state assets.

Inevitably, mining and petroleum companies operating under these conditions are seen to be complicit in the disempowerment of the population of the countries to which the natural resources belong.

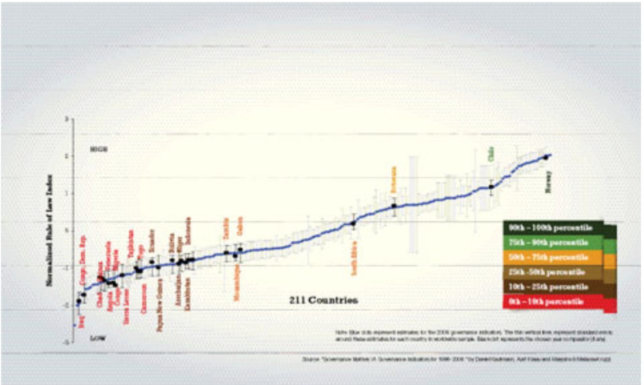
The time has come for governments, civil society organizations and extractive industries to examine the task that lies ahead of them. Despite deep vested interests, nearly 30 mining companies representing the bulk of world minerals production, and leading stakeholders around the world agreed in Mining, Minerals and Social Development project (MMSD) that the industry needed to do much better, particularly in balancing economic, transparency, environmental and social goals. Similar efforts and studies have been undertaken by regional bodies and the International Council on Metals and Mining (ICMM).

It would be naive to believe that the sole awareness of dealing with such issues will be sufficient to overcome the problem. The sheer complexity of the issues, the sparse availability of skills to address such issues, the deep vested interests explaining the current states of affairs are some of the important obstacles to be overcome.

By the same token, it would be foolhardy of executives to regard the governments and people affected by the industry as an inconvenient irritant - rather than the ultimate stakeholders and beneficiaries of mining activities.

The public increasingly expects business to deliver the goods and services it desires not only at a price it can afford but also in a manner it finds acceptable. The OECD Convention on Combating Bribery of Foreign Officials in International Business Transactions, which came into force in 1999, and similar Conventions that have been since enacted throughout the world reflect this new reality and exposes multinational firms to new rules of the game that criminalize corruption, even if undertaken in third countries.

Extractive Industries Countries Governance Performance. Rule of Law - 2006
(Chosen comparator also shown for selected countries)



More than most industries, mining relies on a high level of public consent in order to be able to continue its activities since either the states or their citizenry tend to exercise a significant degree of control over access to, and exploitation of, mineral resources. Leading mining companies now accept that the industry's continuing access to resources on viable terms - its "license to operate" - is dependent upon demonstrating that the industry has the will and the capability to operate within transparent and sustainable development principles.

To this end, the industry needs better governance structures to help manage the resources generated by the sector.

The way forward

To be effective, however, the go-it-alone practice that has prevailed in the sector will have to give way to developing alliances and the empowering of stakeholders. Some initial steps have been taken, such as the debarment of corrupt companies in World Bank financed projects, and the development of statistics on corruption in various countries. The mandates of the ICMM and other global mining associations have been broadened to deal with sustainable development and governance issues – but much more concerted action is needed.

At the local and intergovernmental level, multilateral development banks need to address the public governance implications of extractive industries-based economies to help make governments accountable for the effective collection and investment of such resources by shifting their technocratic and state-driven approach to a more holistic and empirically anchored approach to problem-solving noted below.

Similarly, there is ample evidence that discretionary powers in the public sector are a major factor in creating conditions for corruption, which produce "saints in the courts dispensing favors based on all factors other than performance," to use the words of a former minister of mines in Chile. Clear rules, meritocratic (rather than bureaucratic) public administrations, increased transparency and competition are strong antinodes for effective governance structures that facilitate mutual obligations and performance between stakeholders concerned – including governments and enterprises.

At the collective mining companies sector level, improved anti-corruption standards on the part of all major players; better "intelligence" gathering, so that relevant developments in countries are better known to all concerned; development of mutually agreed and binding industry-specific principles; as well as commonly agreed independent monitoring and verification arrangements.

In the area of individual company practice, head-office management should issue corporate guidelines and codes of conduct, and reinforce them with appropriate internal control arrangements and training. The knowledge gap on how to resist corruption in the field – at the "sharp end" – needs to be addressed not only within the company, but extended to partners as well, while codes of conduct must filter down to the field level.

The idea of user-friendly "help-lines" can enable staff to deal with concrete situations, and international recording mechanisms, such as global databases of financial flows, could provide an invaluable way of monitoring and comparing incidents of corruption within the sector.

Of course all this needs improvements in the level playing field for civil society level participation, to enable proper monitoring to ensure that benefits accrue to stakeholders. There is more to improved governance than the fight against corruption, which if anything is symptomatic of broader dysfunctions leading to poor performance.

In general countries that have succeeded in generating a vibrant mining sector that has begun to contribute to the sustained economic development of host countries have tended to flourish where there has been:

- Solid mining sector policies and strategies have been enacted that provide incentives for investment and generation of a fair share of resources for the host countries concerned, particularly through the adoption of legislation and regulations that are competitive internationally (including the establishment of open, efficient and transparent access to mining properties);
  Establishment of a mining tax regime that is reliable, predictable and competitive;
- Strengthening of government oversight institutions so that they can act on solid technical grounds, and independent vehicles of contestation and adjudication to assure fair treatment of all concerned; and
- Buildup of a reliable and wide range system to technical data on the resource base of the countries concerned to facilitate generation of interest in further exploration and eventual production investments.

In fact, countries that have been adopting such policies, some since the mid 80's, have been rewarded with significant increases in foreign exchange earnings, fiscal revenues, investments and even levels of reserves resulting from increased exploration activities, as can be seen in the table below:

RESULTS BEFORE AND AFTER MINING SECTOR REFORMS
(millions of US$)

Country	**Exploration**		**Production**		**Exports**	
	Before	After	Before	After	Before	After
Argentina	<3	150	340	1.310	70	700
Chile	15	250	2.400	7.500	2.300	6.900
Peru	10	200	2.000	3.900	1.900	3.600
Tanzania	<1	35	53	350	53	350
Ghana	<1	N.A.	125	700	125	650
Mali	<1	30	<1	242	<1	230

The unfinished agenda; issues and actions for the future

Much has been written about the resource curse, the Dutch disease and other problems afflicting countries relying on extractive industries. Yet surprisingly, little attention has been focused on what has differentiated well from bad-performing resource rich countries. Sustained economic development outcomes have varied notoriously from countries as varied the U.S., Canada and Australia on one hand and DRC (Congo), Zimbabwe and Zambia on the other.

Perhaps the one most striking differentiating factor separating one group from the other is the governance performance among them (as can be seen in the graph at the beginning of this paper depicting rankings according to rule of law performance).

Over half a dozen resource-rich countries succeeded in transforming their natural resources into other forms of capital by effectively redeploying such resources into the social infrastructure for sustained development. This has resulted in continued GDP growth, including non-mineral GDP, and improvements in social factors such as child mortality and poverty reduction over more than two decades.

Performance thus requires minding the governance gap – it's a pre-requisite, not an option. The generation of added resources in and of itself does not generate development. Key in generating a commensurate absorptive capacity is to develop accountabilities for results that are embedded in the public sector budgeting and management practices.

Judging from the experience of countries that have succeeded in making a better use of extractive industries resources, overall performance can be enhanced with greater attention to the interface between enterprises and governments, particularly transparency arrangements to facilitate public oversight; public involvement to provide legitimacy and demand for accountability; checks and balances to help create conditions for corrective actions; depolitization, to enhance technical and non-discretionary rules of surplus and public sector expenditure management; and integration to help calibrate resource management with the country's absorptive capacity, thereby avoiding the recurrent Dutch disease normally associated with extractive industries that crowd out other sectors with greater difficulties of reaching international competitiveness in short order.

The common thread between these factors is the facilitating role they play in enhancing the prospects of social demand for accountability. In this regard, most donor-supported programs and initiatives, including the Extractive Industries Transparency Initiative (EITI), the Highly Indebted Poor Countries (HIPC) debt reduction program, the Poverty Reduction Strategy Program (PRSP), and others tend to have a technocratic and state-driven approach to problem-solving, with limited appreciation of the role of civil society, transparency, scrutiny, contestation, and the way of holding accountable countries' administrations.

This may inadvertently perpetuate the temptations of managing the surpluses generated so easily by extractive industries as if they were the product of loot, buying favors through arbitrary budgetary allocation process creating particularly difficult barriers to reform, by generating an entitlement mindset in the population while freeing states from the need to tax their citizens - thereby removing an important incentive for accountability and transparency.

As a result, actions supported by such Initiatives, particularly when added together, tend to rely heavily on information; and institutionally-intensive control vehicles, which are difficult to manage, and fairly nominal "consultation processes" that keep stakeholders un-empowered. Meanwhile, mediating and empowering organizations, institutions with proper oversight arrangements, and checks and balances most of the time play only marginal roles in the arsenal of aid interventions.

In practice, these types of interventions tend to isolate the countries' leadership, whether in the government or private sector from their citizenry, rendering them in fact accountable to donors rather than in-country stakeholders.

This can be observed in such basic methods of budget construction and execution and other vehicles of public sector management, where "consultation" with stakeholders is fairly nominal, and where information is gathered mostly to report aggregates with little tracking and responsiveness to ultimate beneficiaries. In the end, judging by the poor performance in much of Africa, as reflected in strongly differing outcomes compared with World Bank projections and periodic debt crises, suggest that borrowing has not been effectively used for the intended goals.

There has been a natural tendency to consider extractive industries largely as sources of foreign exchange and fiscal revenues. While an important element of their contribution to economic development, such resources can easily be deflected in corruption or misallocations through "gold plating" mining production costs, price transfers abroad, misappropriations, misconceived public projects serving particular interest groups, or rent-seeking.

Nothing of this can easily be detected through the monitoring of tax payments as is the purpose of EITI, or public investment programs underpinning PRSPs, unless the enhanced surplus generation is channeled through strengthened financial and public sector management, and the build-up of proper oversight and enforcement vehicles to ensure the necessary self-discipline in resource use.

Of course, moving beyond the broad principles mentioned above means getting to know the specific institutions, the way they interact at the different stages of mining development (i.e. at project preparation, investment, operation and closure), and assessing their leadership and authority; culture and incentives; policies and processes; organizational structure; and resources and capacities.

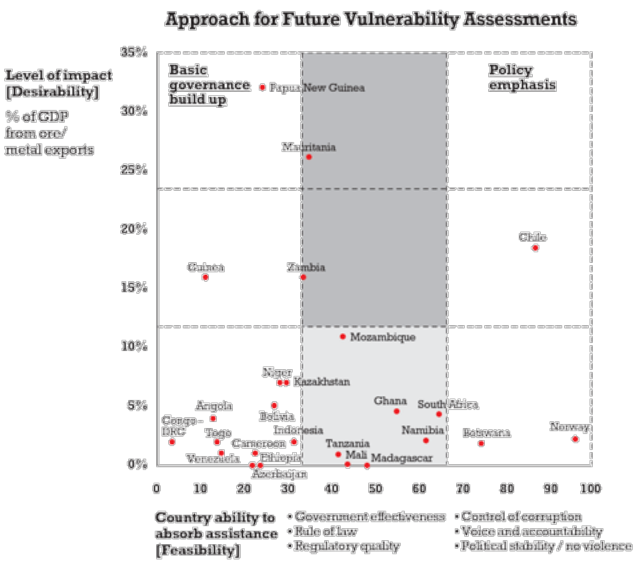
Only once there is a clear understanding of the strengths and weaknesses of the institutions, one can then develop a program to overcome specifically identified shortcomings. This means that the search for "best practices," which has been so prevalent, especially among multilateral development institutions, has to give way to tailor-made "good fits" that address the specific vulnerabilities and weaknesses, which vary from country to country.

A more situation-specific approach, such as the one adopted by the more developed countries, should facilitate the adoption of corrective actions in a manner that is compatible with the institutional capabilities, legal set-up (whether in the formal or traditional law, which coexist in many places) and other characteristics of each country.

The graph below could illustrate the manner one could address differentiated approach.

Seen in this light, countries in the lower tier of institutional development could be approached by building up the basic bodies of governance, such as independent judiciary, oversight agencies, such as National Controller's, the development or accounting and auditing standards, and the like. In the second tier, where such bodies are generally in place, but may not be fully operative, the emphasis could shift towards applying the above-mentioned principles to sectoral agencies and their interaction with national bodies and private enterprises, such as the licensing agencies or those beyond the sector, such as customs, taxation authorities with which the sector operates.

For countries in the third tier, attention could shift to broader concerns, such as systemic or policy issues affecting local mining enterprises, mainly small and mid-tier ventures, such as sustainable development, accessing to capital markets for exploration and mine development, and evolving from an exploration to operating company, as well as the development of clusters to widen the impact of mining beyond the sector through local suppliers and the like.



Trade-offs and conclusions

This approach has the potential of addressing in a more deliberate manner the differentiating roles and responsibilities of government, companies and civil society in each country situation. In this regard, there has been a natural and often held view that companies, after having paid their taxes cannot be held responsible for the lack of delivery of public sector expenditures.

Such views are premised on the notion that governments are precisely set up to deliver social and related services; deal with externalities (the environment, social justice, etc.); mediate different interests; attend demands for public goods and collect taxes to pay for them; establish collective priorities and allocate resources accordingly. In many areas, including large parts of Africa and the less developed areas in Latin America and Asia, governments are either unable or unwilling to carry out this role or, worse still, misapply, misspend or simply steal the means by which they are to carry out the task.

It may not be the responsibility of extractives industries to develop functioning societies with attendant infrastructure and services, but it too often becomes their problem for operating effectively in such environments.

In response to this situation, there is on the other hand an equally strongly held view that business must become engaged in the country's development agenda, bringing with it the full weight of its core competencies. The response to such views has been a proliferation of corporate social responsibility (CSR) activities, including codes of conduct, certification processes, and voluntary initiatives (by World Bank count numbering some 142 today), as well as on-the-ground community projects addressing social and/or environmental problems.

These approaches have improved the standards and quality of life of many people, but they cannot accomplish a long-term agenda for development that goes much beyond mining areas or is sustainable for a country at large.

There is thus a fine line that needs to be properly reconciled to neither disenfranchise shareholders nor stakeholders. Resolving this tension, which is almost inherent in extractive industries, cannot depend on government or private sector actions alone. Extractive industries must be able to respond to economic and market conditions rather than political decisions, if they are going to be able to mobilize resources for high risk and long term investments.

A more nuanced understanding of enterprises, government and civil society's respective core competencies and motivations is essential to developing proper, but differentiated partnerships in the development challenge.

Only a concrete and in-depth review of what each party can "bring to the table" and their institutional capabilities can be an appropriate basis for developing a sustainable and mutually acceptable approach needed to reassure investors; build legitimacy around sensitive decisions; and reduce corruption and enhance economic performance.

That being said, private-public civil society partnerships, important as they are, can be fraught with the same complexity that compromise rule-based prescriptions against any illegal activity.

Such partnerships often fail to breed laws and enforcement vehicles that successfully get resources where they are needed, or can end up with government capture by private interests or vice versa. Success of such efforts thus hinges on a proper calibration of actions to the institutional capabilities of the agents concerned, and the genuine existence of resort to more formal social controls.

Where this is compromised by corporate or official gaming, regulatory laxity, capture of government by special interest groups, effectiveness cannot be assured. The adoption of clear and visible expressions of intolerance with poor performance and/or corruption, independent verification of all parties' actions, including secure channels for reporting violations and whistle-blowing are critical features to assure successful programs.

Once such balance between government, enterprises and social society has been properly developed, a more sustainable and mutually supportive environment can emerge for sustained extractive industries can be fostered for broader economic development.