Public Spending of Revenue from the Mining Sector: Legal and Practical Challenges

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1. INTRODUCTION

The African continent is home to a vast array of natural resources ranging from rivers, arable land, forests to non-renewable mineral resources such as gold, iron ore, aluminium, diamond, uranium, zinc, copper and cobalt. Major exporters in the region include Mali, Mauritania, Ghana, Tanzania, Zambia, Mozambique and Namibia.

Natural resources create linkages between industrialization, economic growth and development, thereby highlighting the need to ensure sustainable exploitation and management of resources, particularly with regard to energy and non-renewable resources. Further, natural resources have played a fundamental role in steering economic growth in the region, which fact is attributed to the extraction and exportation of non-renewable natural resources such as minerals and petroleum. Estimates indicate that over 30 % of the world's minerals and more than 20 % of undiscovered crude oil are contained in SSA.[1] 28 countries in SSA can be classified as being resource-rich, meaning that more than 25 % of their exports are comprised on minerals, oil and gas.[2]

Africa's top five exports are mineral related, and half of African economies being are commodity dependent. The bulk of these commodity exports are minerals, thereby demonstrating the pivotal role that minerals play not only in revenue generation but also in the larger economy of different African states.[3] Even though the heavy resource endowment and reliance on mineral exports, poverty and underdevelopment underlie the narrative of many resource-rich countries that constitute Sub-Saharan Africa. Further, the potential presented by the mining sector as a gateway to development and economic stability notwithstanding, different issues such as Dutch disease, asymmetrical distribution of revenues accruing from mineral wealth, resource-based conflicts over control, access and use of mineral resources as well as poor legislative and institutional frameworks continue to plague the sector.

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1 Nikolaj Thorborg & Morten Blomqvist. *Report on Sub-Saharan Africa.* IBIS & Natural Resource Watch. July 2015.

2 *Ibid.*

3 Africa Centre for Energy Policy & the Ford Foundation. Reviving the Sleepy Vision: An Evaluation of the Implementation Status of the Africa Mining Vision.

1.1. Governance Issues in the Mining Industry

Over the past decade, concerted efforts have been engaged at global level to strengthen governance of petroleum and mineral resources. Key focus areas include transparency and accountability, fiscal regimes and taxation, revenue management, sustainable environmental practices, occupational health and safety as well as local content creation in the extractives industry. Notable global governance initiatives in the extractives sector include Extractives Industries Transparency Initiative(EITI), Publish What You Pay (PWYP), Responsible Minerals Development Initiative, Open Contracting Partnership and the Kimberly Process Certification Scheme.

The synergy between economic development and resource governance underscores the relevance and need for sound policy and legislative frameworks in the sector. At the Continental level, efforts to cement mining reforms culminated in the formulation and adoption of the Africa Mining Vision. The Africa Mining Vision was first adopted in 2008 by the First Africa Union Conference of Ministers in charge of Mineral Resources and Development. African Heads of State then adopted the Vision in 2009. The Vision is the product of several initiatives and efforts made across different levels of governance to develop a policy and regulatory framework that would maximize development outcomes from the exploitation of mineral resources in the continent.[4] The Vision takes cognizance of the role regional integration plays in reducing the costs of transaction, enhancing competitiveness, fostering intra-regional synergy and realizing economies of scale, and reiterates the need to expedite harmonization of rules, regulations and fiscal regimes.[5]

The AMV seeks to entrench mining reform while integrating the mining sector with other areas of the economy in order to foster development. Ideally, mineral endowment in any state should culminate in tangible or otherwise visible rewards and economic strides for the country concerned. As such, the focus on streamlining and reforming governance in the sector is a clear illustration of the potential that well-managed mineral resources have as far as economic transformation and development is concerned.

2. TAXATION IN MINING

The economic value of mineral resources is measured by resource rents. These are the economic returns earned from the sale of minerals, over and above the costs of extracting the mineral and the opportunity cost of capital. How a country harnesses this potential is wholly dependent on the fiscal regime a country puts in place to govern its mineral sector since the fiscal regime is the set of instruments that determines how the often vast sums of money generated from oil, gas and mining projects will be shared between the state and

4 The Africa Mining Vision. At p. 1.

5 The Africa Mining Vision. *Ibid.* At p. 5.

investors.[6] Fiscal instruments in any regime are ordinarily established through legislation or through specific contracts between host county governments and investors in the mining sector.

Whereas the parameters of what a fiscal regime are fairly well defined, it is worth noting that there are various peculiarities unique to the extractives industry generally and to the mining industry specifically, which have a significant bearing on the overall design of fiscal regime and other governance structures designed to regulate the mining industry. The mining sector is characterized by; complexities of capturing fair share of resource revenues, to be shared between states, host communities and industry investors; managing the expectations of the public, especially the State and host communities; market volatility; balancing financial incentives in a manner that is able both to attract and retain foreign direct investment in the sector; ensuring stability and predictability in the tax framework; project cycles wherein different taxes apply depending on the stage at which the mine is (exploration, development, production and closure).

Other factors that come into play as far fiscal regime design is considered include;

a. High sunk costs and long production periods
b. Prospects of substantial rents from resource exploitation
c. High level of uncertainty at all stages from exploration, development, extraction and mine closure
d. The international nature of the industry with multinational companies operating across multiple tax regimes
e. Asymmetric information between policy makers and investors
f. Complexity in enforcing transparency, accountability and oversight at all stages of the minerals value chain

The taxation framework should ideally not be focused solely on ensuring that governments of the host country get a reasonable share of the rents. Rather, it should also achieve three main objectives; providing guidance on revenue sharing between stakeholders; properly monitor and factor in all costs incurred at the various stages of the mineral value chain and ensure that administration and compliance are simplified both for the taxpayer as well as for the responsible tax authority.

3. REVENUE MANAGEMENT IN THE MINERAL SECTOR

It is impossible to discuss expenditure of mineral revenues without factoring in revenue management. It is through this system that revenues and profits accruing from resources exploitation are able to translate into tangible economic and development gains for host countries. Revenue management is intricately connected with the fiscal regime as well as the overall tax administration framework, and as such, institutions involved in revenue

6 N. Woodroffe. Fiscal Regimes in Mining. Africa Mining Legislation Atlas Training, University of Cape Town, September 3, 2015.

administration and management are critical to the overall process of transforming resources into national wealth. When well managed, resource revenues are able to spur growth in other non-mineral sectors of the economy, leading to an overall improvement in development, growth as well as living standards in a host country.

Poor management of resource revenues on the other hand, can result in drastic economic shocks, wasteful spending, poor public and private investments, over-borrowing and the creation a potential debt crisis.[7] The mining industry has, among others, three defining features. One is the finite nature of resources. Mineral resources are essentially non-renewable. As such, mines have a lifespan which also translates into impacts on revenue streams accruing from mining activities. The finite nature of mineral resources necessarily means that revenues not only deplete as the minerals deplete, but are only guaranteed to be generated for a defined period of time. This therefore calls for strategic investments and long-term policy strategies on how to harness and effectively spend resource revenues.

The second feature of the mineral sector is the possibility of generating unprecedented volumes of revenue. This comes with a significant risk of shifting concentration from non-mineral sectors of the economy, leading to high inflation, appreciation of the exchange rate, and factors of production, capital, labor and even investments shifting from the non-mineral sector into the mineral sector. This phenomenon in economic terms is commonly referred to as the Dutch Disease and is characterized by deindustrialization in the economy of the affected state, as well as the overall detrimental effects that lead to a decline in other sectors of a country's economy.[8]

Finally, the mineral sector is also characterized by market volatility. As such, commodity prices are subject to unpredictable changes which often take time before resuming to normal. As such, if states model expenditure without adequately factoring in the dynamics of volatility, then outcomes as far as economic growth and poverty can be quite drastic, particularly if expenditure remains unchecked.[9] With this in mind, the need for policy and legislation on revenue management being tailored in a manner that is adequately responsive to these features becomes paramount.

In addition to the features discussed above, there are various other factors that come into play when assessing the structure and effectiveness of revenue management in the mining sector. These include; political economy generally; complexities in determining and obtaining fair share; tax administration; legal framework regulating expenditure of mining revenues; transparency and accountability; handling resource-based conflicts and a disconnect between regional and national obligations and interests occasioned by haphazard policy and legislative reforms. These factors, taken collectively or individually, exert

7 Natural Resource Governance Institute. Natural Resource Charter Benchmarking Framework. At p. 79.

8 Jason Gould and Katen N. Kapadia. *Dutch Disease in Africa: A Case Study of Nigeria and Chad.* University of Michigan.

9 Natural Resource Charter Benchmarking Framework.

influence in one way or the other on revenue management and public spending of resource revenues accruing from the mining sector as discussed below.

Political Economy generally pertains to the relationships between individuals and society, and between markets and the state. In the simplest terms, it is the study of how a country is governed, while taking into account both the political and economic factors that shape its governance.[10] Taxation is a key revenue generator for all governments, and as such, has a central role in the overall political economy landscape. As far as it relates to minerals and to natural resources generally, the abilities and strategies used by the government to enforce agreements as well as the extent to which the political system is inclusive play a major role as far mining revenues are concerned.

Specifically, coordination by political forces in the formulation and implementation of laws and policies as well as the mechanisms available to ensure full compliance with agreements is of essence as far as taxation of the sector is concerned. The better the ability of government institutions to enforce policy, the more stable the environment in which to do business. This not only helps to promote predictability but also encourages investors by giving them a sense of security in the host country. Stable institutions by and large also enhance efficiency as far as revenue generation and expenditure are concerned.

Obtaining Fair Share is important to any host government actively exploiting its mineral resource for revenue. Fair share in this case is considered within the context of the multiple actors that have a stake in reaping the benefits of mineral exploitation. These include foreign investors, host countries and local communities surrounding the area where minerals are extracted. Unfortunately, sharing of the benefits of mineral exploitation isn't as straight forward as one would imagine. Benefit sharing as a whole is widely accepted as a way of spreading resource utilisation benefits across the economy, catalysing broader-based growth and supporting social equity policies.[11] The key challenge however, lies in making sure that there is fair and equitable sharing of benefits and in converting resource wealth to permanent wealth.[12] This conundrum is accentuated by the fact that there is no generally agreed-on scale as to what amounts to a fair share,

It would be incomplete to assess revenue management without factoring in the aspect of tax administration, because poor tax administration can in and of itself also intensify existing challenges. The scope of tax administration extends to procedures, institutions and government functions and as such must be adequately captured in law and policy, in a manner that sets out the respective roles and duties of every actor involved, including taxpayers and tax administrators alike. Where there is a poor tax administration framework, several issues may arise. These include; inability or failure by tax authorities to account for all revenues received throughout the mineral value chain; complexities arising from ad-

10 Britannica Encyclopedia. https://www.britannica.com/topic/political-economy.

11 Initiative on Sustainable Hydropower. *Knowledge Base on Benefit Sharing*. Volume 1 of 5, 2011. At p 4.

12 Collins Odote. *Benefit Sharing in the Extractive Industry.* Mombasa 2014.

ministering different types of taxes at different stages of the mineral value chain; challenges associated with filing different types of taxes, all due at different times of the year as well as poor coordination between multiple agencies collecting tax and non-tax revenues.[13]

Transparency & Accountability remains a critical governance concern in a sector that is characterized by opacity. Transparency is a characteristic of governments, companies, organisations and individuals that are open in the clear disclosure of information, rules, plans, processes and actions. It entails application of procedures that are visible, understandable, and which promote public participation. It is argued that transparency does not merely seek to make information available, but rather, manages and publishes information so that the information is relevant and accessible and timely and accurate.[14]

Whereas emphasis on transparency tends to lean towards contract disclosure, the need for transparency and accountability at all stages of the mineral value chain cannot be underscored. The thread of transparency and accountability should ideally weave across the entire process from negotiation of contracts, awarding of licenses and concessions, resource exploitation, production and sale, the declaration of revenues generated and usage thereof.[15] It is argued that corruption and lack of transparency and accountability in the management of revenues generated from resource wealth has exacerbated poor governance, fuelled cycles of conflict and poverty, undermined opportunities to spur economic growth and hindered social development.

The economic importance of natural resource wealth has been previously illustrated all through this work. A resounding theme across the board is that of wealth creation for the host countries. This is typically an institutional function, because it is institutions that are involved at all stages of the governance process. It is argued that there is a correlation between natural resource under-development and weak institutions. Where institutions that deal with natural resource exploitation and rents have the capacity to use these endowments to promote economic transformation, economic diversification, poverty alleviation and accountable governance, then a country is better able to benefit from resource wealth.[16]

4. RECOMMENDATIONS & BEST PRACTICES

Having highlighted the various challenges surrounding the public spending of mineral revenues, it is beneficial at this point to propose best practices that can be put in place to counter

13 Jack Calder. *Resource Tax Administration. Functions, Procedures and Institutions* in *The Taxation of Petroleum and Minerals: Principles, Problems and Practice*. Edited by Philip Daniel, Michael Keen and Charles McPherson. Routledge, Taylor and Francis Group, London 2010 at p 344.

14 Sefton Darby. Natural Resource Governance. New Frontiers in Transparency and Accountability. Open Society Foundation, 2010.

15 This is the typical sequence of activities in the resource value chain.

16 Laars Burr, Ole Therkildsen, Michael W. Hansen and Mette Kjaer. *Extractive Natural Resource Development: Governance, Linkages and Aid*. Copenhagen, Danish Institute for International Studies, 2013.

the potential and existing adverse effects. This section proposes recommendations related to; fiscal regime design; use of fiscal rules; investment of mineral resources; Sovereign Wealth Funds (SWF) and general practices related to governance and revenue management.

a. Fiscal regime design

The fiscal regime arguably forms the backbone of the system through which host countries share proceeds from the exploitation of minerals with other stakeholders including companies involved in mineral extraction as well as the local communities and general population of the host state. As such, the regime should not focus its entire emphasis on capturing profits for the host state but also on ensuring that all costs incurred in the entire value chain are captured and properly reflected.[17]

In addition, the fiscal regime should be designed in a manner that responds to and accommodates the fluctuations that arise from variations in commodity pricing or decline in production. The administration of the tax regime should also be both simplified and predictable for all actors, i.e. the tax revenue authority as well as relevant taxpayers from whom revenues are due. The fiscal regime, in addition to being easy to administer, should provide strict sanctions for non-compliance with statutory and regulatory provisions. It is also recommended that the fiscal regime adopted for the mineral sector in a host country be buttressed on appropriate macroeconomic policy.

b. Adoption of Fiscal rules

Fiscal rules can be put in place as a measure to control expenditure and ensure that mineral revenues are sustainably invested. Fiscal rules not only ensure that a country's economic objectives are achieved, but also ensure that all budgetary decisions entered by the state are in compliance with established rules. Fiscal rules are defined as multi-year numerical constraints on government finances,[18] government spending or on accumulation of public debt.[19] The use of fiscal rules is useful in jurisdictions that generate large, temporary cash revenues from exploiting non-renewable resources, particularly minerals and petroleum resources.[20]

17 International Monetary Fund: *Fiscal Regimes for Extractive Industries: Design and Implementation.* IMF, 2012.

18 Thomas Lassourd & Andrew Bauer. *Fiscal Rule Options for Petroleum Management in Uganda.* Revenue Watch Institute, April 2014 Policy Paper.

19 Andrew Bauer. *Fiscal Rules for Natural Resource Funds: How to Develop and Operationalize an Appropriate Rule.* Natural Resource Governance Institute & Columbia Centre on Sustainable Development.

20 Official Norwegian Reports. *Fiscal Policy in an Oil Economy. The Application of the Fiscal Rule.* Official Norwegian Reports NOV 2015.

Fiscal rules are categorised into four core groups depending on the function they are designed to serve; debt rules limit public debt as a percentage of the GDP; revenue rules limit the percentage of mineral revenues that can be injected into the host state's annual budget; expenditure rules place limits on current spending and balanced budget rules which limit non-resource current budget deficits.[21] be set out in clearly established policy, regulatory or legislative instruments;[22] Fiscal rules should be structured in a way that sets out clear objectives;[23] enjoy political consensus as far as their suitability is concerned, to ensure that there are strong enforcement and oversight mechanisms[24] and allow flexibility to mitigate the uncertainties that characterise the mineral industry.[25]

Fiscal rules play a key role in the management of resource revenues by discouraging overspending and encouraging accountability by governments to mitigate the side effects of resource volatility, promote economic stability and encourage private investors in the mineral sector. Fiscal rules also improve government performance as far as public financial management is concerned, and serve as an effective method through which to define the parameters for deposits into and withdrawals from Sovereign Wealth Funds.

c. *Sovereign Wealth Funds*

Development in a mineral dependent economy is only sustainable when revenues derived from the exploitation of non-renewable resources are reinvested in other assets that will generate future incomes when mineral resources are exhausted. As such, revenues generated from resource exploitation should go into financing investments in other assets. The requirement to invest mineral revenues can then be entrenched in both policy and law. Mineral revenues can also be saved or reinvested in developing economic, social or human capital. A predetermined proportion of resource revenues should be set aside for long term investments.

Sovereign Wealth Funds are also an effective vehicle to ensure that mineral resources are invested in a sustainable way. Resource funds insulate economies from oscillations prevalent in the mineral sector, serve as vehicles for states to set aside savings for future generations and provide a buffer in the event that uncertainties arise with regard to future mineral reserves or the ability of the economy to absorb effective spending.[26] A resource

21 Lassourd & Bauer, *Op Cit.*

22 *Ibid.*

23 Andrew Bauer, *Op Cit.*

24 *Ibid.*

25 Official Norwegian Reports, *Op Cit.*

26 Kamiar Mohaddes & Mehdi Raissi. *Do Sovereign Wealth Funds Dampen the negative Effects of Commodity Price Volatility?* Federal Reserve Bank of Dallas. Globalization and Monetary Policy Institute, Working Paper No. 304.

fund that has clear structures and a framework for transparent management mitigates against wasteful expenditure and corruption.[27]

d. Other General Recommendations

States should ensure that they take ownership of and play a leading role in the extractives industry. This can be done through joint ventures with foreign companies, building technical capacity at the national level, promoting local content at all levels of the mineral value chain and adopting a gradual and pragmatic approach towards exploitation of mineral resources, which promotes trans-generational equity and guarantees income for future generations.

Transparency and accountability are also essential as far as ensuring sustainability of public spending of mineral reserves. Transparency is a characteristic of governments, companies, organizations and individuals that are open in the clear disclosure of information, rules, plans, processes and actions. It entails application of procedures that are visible, understandable, and which promote public participation. Transparency should not merely seek to make information available, but rather, manages and publishes information so that the information is relevant and accessible and timely and accurate.[28] By so doing, government spending and investment of mineral revenues is subject to scrutiny and oversight and therefore less likely to be mismanaged or otherwise misappropriated.

Alignment of the mineral sector with other sectors of the economy is essential, especially when such alignment is carried out within a framework that does not compromise spending. This not only helps to cushion the economy as a whole but also ensures that resource revenues are injected into to other sectors of the economy thereby mitigating against the adverse effects that can be occasioned by over-emphasis on the mineral sector at the expense of manufacturing and other non-mineral sectors of the economy. Mainstreaming the mineral sector into economic and development strategies at the national level also helps to create local opportunities, enhance value additions and develop local enterprise.

Transgenerational benefit sharing of resource revenues is another approach that governments can adopt as a strategy against wasteful spending of resource revenues. Benefit sharing is of itself a dynamic process, and requires the state to continuously offer improvement and build capacity at the local level. As such, states should strive to diversify benefit sharing to include such measures as; creating awareness among all stakeholders; undertaking pilot projects aimed at building confidence and stakeholder consensus on suitable mechanisms for the delivery of benefits; introducing appropriate legislation to promote transparent sharing of all resource benefits; careful selection of the financial sources for

27 Philip Daniel. *Petroleum Revenue Management. An Overview.* World Bank Group, ESMAP Program.

28 Sefton Darby. Natural Resource Governance. New Frontiers in Transparency and Accountability. Open Society Foundation, 2010.

sharing of benefits; making use of appropriate institutional arrangements and ensuring participatory approaches to benefit sharing.