



On Solid Ground: Toward Effective Resource-Based Development

Lisa Sachs | Tuesday, Aug. 6, 2013

The small island-state of Timor-Leste exemplifies the challenge of resource-based development for a poor country well-endowed with a valuable natural resource. Timor-Leste, which gained its independence in 2002, has accumulated \$13 billion in its petroleum fund in less than a decade. Some of the largest multinational oil companies are operating in the country, and the revenues continue to flow. And yet, while Timor-Leste has seen very notable improvements in its development indicators in the past few years, it continues to face a massive challenge of converting financial wealth into economic development. There are also heated debates about how to spend the oil revenues, or whether to spend them at all as opposed to accumulating them in an overseas fund.



Oil wealth by itself does not end a poor country’s problems. Timor-Leste’s malnutrition and stunting rates remain among the highest in the world. The electricity grids are incomplete. Many roads are in disrepair. The education system is in need of massive upgrading, and many of those seeking higher degrees now go to Indonesia or elsewhere to get them. The government is committed to transforming its economy into that of a middle-income country in a short time. In 2011, it produced a 20-year strategic development plan that laid out the priorities for public investment in a number of key sectors. While Timor-Leste has made and continues to make great progress in its development trajectory, the country illustrates the basic fact that resource-based development is extremely challenging, even for a small, democratic and financially well-resourced country.

At the core of economic development for a poor country is a successful strategy for multidimensional capital accumulation: human capital, infrastructure capital, business capital, natural capital, and technological capital. One obvious complication is that these various types of capital are complementary: The benefit of one depends on the presence of the others. A government shouldn’t focus first on roads and then on schools, for example. Without roads, it may be impossible for children to get to school. Without education, the economic benefit of roads may be very small.

These various kinds of capital are accumulated through a combination of public investment, especially in human

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harnessed to finance key public investments. Many extractive industry projects have the potential to be profitable for investors while generating billions of dollars of revenues for the host government, offering the country an unprecedented and perhaps the only chance to finance human and infrastructure capital.

There are other features of extractive industries that make them particularly beneficial for sustainable development. They are long-term investments—once a company invests, the sunk costs are not mobile, and the profitability of the investment relies on its long-term operation. This creates a unique partnership between the investor and the government, in which both have an interest in the stability and profitability of the investment over the long term.

Extractive industry projects are also capital intensive, with major infrastructure and supply chain needs. Investments in infrastructure—such as rail, ports and power—not only bring in additional capital and potential employment but also have the potential to help close the critical infrastructure gap in poor or remote settings. The supply chain needs of the investments can create spillover benefits to the local and regional economy; moreover, the long timeframe of the investments means that there is sufficient time to invest in local supply chains and skills training. In some cases, the resource itself can be used domestically, as in the case of natural gas or thermal coal, or processed downstream.

Special Obstacles to Resource-Based Development

However, there are several features of extractive industries in developing countries that make resource-based development particularly challenging, and which in the worst cases give rise to the infamous “resource curse.”

First, the vast asymmetry of information and skills between the negotiating teams of developing countries and those of international investors often leads to unequal deals that are, at best, unfavorable for the government relative to the investor, and at worst, unconscionable from a public policy perspective. Negotiating a good deal requires an advanced understanding of contracting terms, fiscal models, market conditions and projections, corporate finance structures and other technical aspects of the industry; in most cases, the investor’s access to information and skills, both in-house and externally, vastly exceeds that of developing country governments.

Second, many industry contracts last for decades, so the terms negotiated at the outset encompass the entirety of the benefits to the government. This is especially the case in contracts with stabilization clauses, which freeze the fiscal terms in place at the time of negotiation for the duration of the investment. If the terms are later realized to be unbalanced—either because of a change in market conditions or because the original terms were poorly negotiated—the government may have little recourse to renegotiate the deal short of an outright repudiation of the contract. For their part, investors often have recourse to international arbitration to seek compensation for costs incurred by changes in government policy. Indeed, the number of disputes initiated with respect to extractive industries in the past decade has risen dramatically.

Third, the asymmetry of information and skills between host-country governments and investors is exacerbated by

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It creates a cloak of secrecy that shrouds terms that are counter to public policy, whether the terms were included because of the asymmetry of bargaining power or because of corruption. It means that the balance of risks and benefits are unknown to all other parties affected by the investment, including communities and local governments that, when problems arise, are often caught between investors and national governments disputing who is to blame. And it undermines accountability for how revenues are to be allocated and managed, since the amounts owed are generally unknown.

Fourth, fluctuations in both the market price of the commodities and lending rates mean that projects stop and start abruptly, at times being put on hold for many years until either prices or other market conditions improve. Even when operations run smoothly, price fluctuations mean that associated revenues are similarly volatile; revenues may be high in some years, leading to budgetary expansions, only to face a major contraction in subsequent years, either requiring a massive budgetary cut or leading to unsustainable debt accumulation.

Fifth, inflows of foreign capital create the risk of “Dutch Disease” in which the host-country currency is overvalued and the price of nonresource exports increases, decreasing the competitiveness of other tradable sectors. This is especially the case when governments use the rents from the extractive sectors for short-term consumption and budgetary needs rather than investing in infrastructure and human capital, which boost the productivity of the other sectors.

Sixth, oil, minerals and gas are nonrenewable resources, meaning that their eventual depletion is a core reality that has to be planned for. The revenue flows will decrease over time, so governments have to be strategic about smoothing consumption and ensuring that benefits accrue to future generations, whether through savings or through investments in human and infrastructure capital. There is no second chance to recapture rents that are mismanaged.

Seventh, extractive industry projects have traditionally been treated as enclave sectors, with little attention paid to possible linkages between these projects and the rest of the economy. After the construction phase, these capital-intensive projects create few jobs for the longer operations phase. The jobs created often require skills that are not readily available in developing countries and go instead to foreign nationals. Supplies and services required by the industry are often imported, as supply chains are not sufficiently developed or reliable in developing countries; many of the small and medium-sized enterprises (SMEs) that might provide such services do not meet international standards for due diligence, accounting, quality standards and the like.

Importantly, the infrastructure that is built for these projects is often financed by the investors and therefore built solely to service the projects’ needs. The result is that transportation or power infrastructure may be built in regions with a major infrastructure gap—indeed where the lack of infrastructure is a main obstacle to development—with no excess capacity or rights for other users.

Eighth, extractive industry projects often include the acquisition of land rights at concession sites or for right-of-ways for infrastructure, which often entails the relocation of communities. In some cases, there are serious

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recourse when they are resettled. Resettlements are almost always riddled with conflict and tension, and international best practices with respect to engagement or compensation are not yet widely observed; in fact, there is not yet consensus on what such practices include.

Ninth, the potential environmental, health and social impacts of extractive industries cannot be ignored. Historical records of environmental and human rights shortfalls on the parts of both industry and governments have led to distrust among the stakeholders, including the communities that have been most affected by these atrocities. In many cases, when new projects are proposed—even those where the investor has no track record, whether positive or negative, in a particular country—stakeholders are resistant to the investment based on prior trends of mismanagement of environmental, health or social impacts by various industry and government players. At times, such resistance has led to strong, even violent, protests that have the potential to substantially delay or shut down a project altogether.

Tenth, due to the large rents involved, these projects can become highly politicized, both domestically and internationally. Home-country governments often lean on weaker host-country governments in support of favorable conditions and terms for foreign investors. (Home countries are the countries of origin of the foreign investors.) Home-country governments also enable, or at times facilitate, mechanisms for tax avoidance in the host country, turning a blind eye to transfer pricing, tax havens and the like. Domestically, of course, the rents create incentives for corruption and bribery, as host-country leaders can use the revenue to entrench their power, fill their coffers and, at times, fuel conflict.

Eleventh, these mega-projects involve a complex web of stakeholders, which may include national governments, local governments, companies (“junior,” “major” and state-owned) and their shareholders, subcontractors, international financial institutions and regional development banks, development agencies, home-country governments, local communities and global consumers, among others. Each stakeholder has differing interests, time horizons and incentives that are not always compatible and not always conducive to the long-term perspective necessary for resource-based development. The lengthy time horizon of these projects also means that many generations of stakeholders are involved.

Finally, the fact that resource deposits are often in countries with pre-existing governance constraints and major development challenges makes the solutions both more difficult and more urgent to achieve. Resource extraction projects often take place in the poorest of settings, especially in least-developed countries, in which communities are failing to meet even their most basic needs in terms of health, food security, proper hygiene and sanitation, access to clean water, agricultural productivity and infrastructure. Expectations are high, as communities look to the mega-projects for employment and other benefits. Implementing resource-based development requires strong government and societal institutions, for accountability, transparency, planning, coordination and implementation. Yet, many developing country governments are still building—or rebuilding—these institutions and do not have the structures and skills in place to transform the sector for sustainable development.

Pillars for Resource-Based Development

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At the Vale Columbia Center on Sustainable International Investment at Columbia University, we have identified five key elements of an effective resource-based development strategy. For each element, there is an important role for all stakeholders: host-country governments, home-country governments, multilateral and bilateral donors and partners, regional banks, civil society and academia. The challenge is too great for any one stakeholder to manage alone.

The first element is a transparent, robust legal framework governing the extractive sector. Such a framework provides the institutional backbone of the relationship between the host-country government and the investors and is the most critical element to ensure that countries are benefiting from the sector. As a starting point, the basic terms of all contracts and legislation should be publicly available. Long-standing arguments against transparency have been debunked (<http://www.revenuewatch.org/publications/contracts-confidential-ending-secret-deals-extractive-industries>), although many in the industry and in governments continue to advance them. Some governments have taken the steps to publicize all of their contracts, including Liberia, Timor-Leste, Peru and, most recently, Guinea. A new public database (<http://www.resourcecontracts.org>) of these contracts allows citizens, parliamentarians and others to understand and compare the terms of contracts within and between countries. More countries should follow suit, with the technical and political support of international organizations, home-country governments and civil society.

Many resource-rich governments need support in strengthening their legal frameworks, both for individual contracts and, importantly, for the legislative and regulatory frameworks for the sector. Existing weak legislation leaves most terms governing the resource extraction sector in contracts, which increases the risk of corruption or asymmetric bargaining power and also creates a fragmented legal system in which each project is governed by a different set of rules, standards and commitments. Monitoring and auditing such a fragmented network of contracts exceeds the human and financial resources of most revenue authorities and other oversight bodies in poor countries. Some international organizations (<http://www.vcc.columbia.edu/content/negotiation-support-developing-host-countries>), including the African Legal Support Facility and the World Bank's Extractive Industries Technical Assistance Facility, are providing assistance to developing countries. However, the demand for such assistance far exceeds the supply, and securing competent, reliable, comprehensive and timely assistance remains difficult.

Governments also need support in designing and administering their allocation systems; competitive bidding may have some important benefits, but those systems are difficult to design and administer and are susceptible to mismanagement and corruption. In order to strengthen their negotiation capacity, governments need more information about their geological base. Geo-surveys are prohibitively expensive for most governments, but without the knowledge such surveys provide, governments are approaching each negotiation handicapped. The World Bank launched an initiative in 2011 to help finance public geological information, and a new African Minerals Geoscience Initiative seeks to help African governments finance and make use of this data.

Fiscal systems should properly balance the returns investors need in order to justify their investments with the ultimate rights of governments and citizens to benefit from their resources; the regime should be flexible to allow the government to increase its share of the pie when the profits exceed anticipated values but simple enough not

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legitimate cause for concern about political whims or expropriations. Rather than leaning on poor governments in support of their investors, home-country governments should work with poor governments to bring their legal, fiscal, environmental and social legislation in line with international best practices and ensure that home-country investors are not taking advantage of any loopholes to bypass the evolving legal regime or eschew other commitments. Steps that the U.S. and European Union have taken recently to require publicly listed companies to disclose their payments to governments are moves in the right direction, although even these modest steps have been successfully challenged by companies in U.S. courts. Home-country governments and international partners can also help to strengthen the monitoring, auditing and enforcement capacity of host-government institutions; without such capacity, the strength of the legal system as a whole is undermined.

Second, natural resource extraction should be embedded in medium- and long-term development plans, including frameworks and budgetary mechanisms for the strategic allocation of resource revenues into priority public investments. Governments may have these plans yet fail to incorporate the mining sector into them. More often, however, governments lack a basic medium-term framework of any kind.

For decades, developing countries have been advised that allowing—or encouraging—foreign investment in their resource sectors would naturally yield long-term economic growth, both through capital inflows from the projects and through direct and indirect spillover benefits to the host-country economy. Yet, the spillover benefits are far from automatic. Governments should have a strategic vision for how the sector will promote development, how partnerships with the private sector and other stakeholders can support government priorities, how the revenues will be managed and how responsibility for the sector will be allocated among various levels of government.

Resource revenues can fund critical public investment programs in education, health care, nutrition, infrastructure and business development. Governments sometimes have sovereign wealth funds or other investment instruments through which the resource revenues are invested in financial assets, often overseas. This may make sense for countries like Norway, or arguably Chile, that have basic infrastructure and human capital in place and sufficient budgetary resources to fund key public services. However, for low-income countries with huge infrastructure gaps and minimal public systems for basic health, education, nutrition and the like, the economic returns on public investments in these key sectors may be far larger than the returns on financial assets. (Note that even in Norway, and especially in Chile, there are heated debates about using more of the accumulated funds for domestic public investments.)

Development partners, including the World Bank and bilateral donors, can usefully help governments with collecting data, identifying public investment priorities and bringing coherence to national and sector-specific plans. Medium-term expenditure frameworks can help align the budget with the planning process and public investment plans. They can also be instrumental tools for aligning government policy and the activities and investments of external partners—investors, development partners and nongovernmental organizations—with the long-term strategic vision.

Third, governments and companies should work together to identify the potential synergies between national or

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leveraged for the creation or expansion of critical infrastructure. Coordination among investors, governments and other stakeholders, such as regional banks, can reduce costs, improve access, create scale economies and increase opportunities for new investors.

Additionally, the procurement of goods and services for mega-projects presents an opportunity for regional SMEs. Governments can partner with the private sector and with other actors, including banks and development partners, to support local SMEs through training, business support services and access to finance. One of the pervasive myths of extractive industry investments is that they will create many jobs for locals; in fact, very few direct jobs are created, especially during the operational phase of the projects. Helping to build out the supply chain enables the creation of more indirect jobs that might also service other projects in the region. Governments can and should consider local content requirements that obligate investors to source local inputs and to transfer knowledge to local SMEs. In some cases, governments and their international partners can promote downstream processing and beneficiation, or the use of the resource itself, to build local industry.

Fourth, governments should work with their partners to support integrated development at the local level to ensure that benefits are realized on the ground in surrounding communities. Expectations are high for extractive projects to increase the local standard of living through jobs; improved housing, electricity and other infrastructure; improved markets and so on. When these expectations are not met, social unrest and local conflict can undermine both sustainable development and the investment itself. Coordination between the investor and the government is particularly important. When companies build hospitals, schools or other local infrastructure in isolation from public systems, the results are often unsustainable: The hospitals and clinics lack doctors and nurses; the schools lack teachers; and both companies and the government disclaim responsibility for ensuring that electricity and water networks reach the new infrastructure. If, instead, the public and private sector partner on a local development plan, the plan can be integrated into domestic infrastructure grids, budgetary mechanisms, chains of responsibility and so on, with private sector support for the physical infrastructure, teacher or nurse training, supplies or other inputs.

And fifth, governments must understand and manage the environmental impacts of potential investments, in order to preserve the “natural capital” for the joint benefit of the countries’ citizens and the companies’ operations. Because of both their geography and their dependence on favorable conditions for agriculture, most low-income countries are already disproportionately affected by global climate-change-induced extreme weather events, such as droughts and floods, and longer-term changes in temperature or precipitation levels, which can and do cause widespread famine in a number of countries. Extractive industry investments can exacerbate these environmental disruptions, especially in the context of lax environmental standards or failure to adequately consider the cumulative environmental impacts of several distinct but interacting activities in a region. Universities and other partners can help governments manage existing environmental disruptions, anticipate potential new and cumulative environmental impacts over time, mitigate environmental disruptions to the greatest extent possible and adapt to changing environmental realities, such as increased droughts, floods and other consequences of climate change.

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The importance of the resource extraction sector as well as the challenges of resource-based development are increasingly recognized both in host countries and globally. The past decade has seen a number of thoughtful analyses and specific initiatives to help implement sustainable development policies in resource-rich countries. The resource sector is likely to be recognized in the post-2015 Sustainable Development Goals (<http://unsdsn.org/thematicgroups/tg10>) and is already being incorporated in various transparency initiatives of the G-8 and G-20. Attention to the ills of tax havens and other methods of tax avoidance is also rising. Companies, governments and citizen groups have increasingly recognized the potential for win-win solutions and embraced collaborative approaches to address these complex challenges.

Yet the challenges are still extreme. Indeed, with new players and rising scarcity of land, forests and some minerals, the potential for lawless resource grabs is also on the rise. It is therefore especially important for all stakeholders to reach a better understanding and shared framework for action.

Lisa Sachs is the director of the Vale Columbia Center on Sustainable International Investment at Columbia University.

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