

Precept 11. Role of Home Governments

Technical Guide

The *home governments* of extractive companies and capital centers should require and enforce best practice.

1. Introduction: Objectives and Guiding Principles

Resource-producing countries can take important steps to strengthen the governance and economic management of resource wealth. However, without supporting actions by home governments of extractive companies, resource-consuming nations, international capital centers and the international community more broadly, these steps may be undermined. The international community's objective of supporting the development and transformation of resource-rich countries requires the wide proliferation and enforcement of international best practice.

It is in the general interest of the international community to support the development and prosperity of resource-rich countries and their citizens. Actions that help resource-rich countries to realize the transformative potential of resource wealth will generate stability and security of supply, promote a level playing field, and foster sustainable commercial relationships.

Objectives and Guiding Principles

The paragraphs below set out some specific objectives and guiding principles for the international community:

Propagating international best practices. International best practice needs champions. International non-governmental organizations should be in the forefront of direct lobbying and publicity campaigns, as well as playing a crucial watchdog function in monitoring the implementation of international policy directly or developing benchmarks, checklists and metrics to empower civil society in holding governments, firms and capital markets accountable.

Establishing a common, global standard for transparency in extractive operations would reflect the increasing commingling of industry interests across borders and among countries. It will help those countries seeking to follow best practice to better define their policies. A common standard would reduce costs and risks for extractive companies that have to follow different rules, practices and accounting standards in different jurisdictions. It will become easier for investors and lenders to assess the risk and return of investments in extractive companies and resource-rich countries and easier for home and host governments to collect the taxes owed them. Companies that meet the global standard will be rewarded and the playing field for securing concessions will be levelled. The international community, including resource-consuming countries, should seek agreement on a consistent set of minimum standards, applicable to all resource-rich countries, in order to avoid a 'race to the bottom'.

Payment disclosure and reporting requirements. Home governments and international capital centers should enact and enforce rules on the disclosure of company payments on a country-by-country basis. Rules should also require that companies extracting resources from public lands report volumes and costs of production, revenues, profits and payments to the state by type (taxes, fees, bonuses, royalties and payments in kind).

Levelling the playing field. Home governments of extractive companies should seek, through regulation, legislation and diplomacy, to create and support a level commercial playing field amongst extractive sector companies. This should be built upon the guiding principles of transparency, respect for human rights, observance of the highest environmental standards, competitive open access and robustness to changing circumstances. In order to support and encourage governments of resource-rich countries in the use of transparent processes to award contracts home governments should not lobby for special deals for their companies outside of competitive processes. International discussion should be sought about the costs and benefits of individual countries seeking to secure preferential access.

Punishing and deterring the looting of assets. Asset looting is prevalent in many resource-rich countries. Five of the top ten countries suffering illicit financial transfers are oil exporters¹. The common feature of such looting is the taking of

¹ Transfers earned through corruption, the sale of contraband goods, criminal activities, the sheltering of wealth from tax authorities. Dev Kar (2009) and Devon Cartwright-Smith, 'Illicit Financial Flows from Developing Countries, 2002-2006' (Washington, DC: Global Financial Integrity, 2009), p. 29. www.gfip.org.

money that belongs to the state out of the country and placing it in “safe havens”. Illicit capital transfers deprive resource-rich countries of the revenues that could finance public goods, fuel growth, create jobs, reduce poverty and diversify the economy. Notorious instances of such diversions include lavish estates owned by officials whose salaries are not sufficient for such purchases, billions in overseas banking accounts in leading international banks, controlled personally by heads of state without any accounting to the public or the legislature, and dummy companies secretly controlled by public officials and their families “co-investing” in large extractive projects to take a share of the profits. International capital centers should seek to enforce principles of transparency, anti-corruption, anti-bribery, and the restriction of transfers of looted assets.

Minimizing tax avoidance and abusive transfer pricing. This requires coordination between home and resource-rich governments. At present, it remains too easy for extractive companies to arbitrage different rules and standards to avoid taxes in both home and host countries.

Build capacity. The promotion of international best practice will be unsuccessful without the capability to implement it. The absence of capacity should spark initiatives to build it rather than providing an excuse for failing to adhere to best practice. Home governments should support the capacity-building efforts of resource-rich governments. Norway has taken a lead in this area and should serve as an example to others.

Trade-offs

Home governments face significant trade-offs in the decision to support the best practice conditions in resource-rich countries. Applying best practice will impose costs on actors within resource rich countries which they will try to avoid. Unless all home governments apply the same level of standards, this will create an incentive for resource-rich government to deal with international investors whose home government require a lower level of standards. A ‘race to the bottom’ can ensue where home governments face lobbying pressure from their own extractive companies to lower the requirements they place on resource-rich countries. Lobbying pressure may also come from the home government’s financial institutions and other actors that benefit from the current practices outlined above. Third-party actors that campaign for higher standards within resource-rich countries need to be ready to demonstrate how home governments can benefit from supporting best practices, in opposition to such lobbying efforts.

A problem with this advice is that quantifying the benefits and transparency and other best practice standards is not easy, and often impossible. This is also problematic in deciding which strategies to pursue. With less understanding of the consequences, decisions by home governments to support best practice strategies become a risky trade-off.

2. Instruments and Actors

This section elaborates on the initiatives that might be taken, and instruments used, to address the objectives outlined above, and identifies the actors best suited to implement them.

Leading by Example

Many countries that are home bases to internationally active extractive companies are themselves major producers, including Australia, Brazil, Canada, China, India, Malaysia, Norway, Russia, South Africa, the United Kingdom and the United States. Most of these countries are members of the G-20, which is the leading forum for developing reforms for the global economy in the wake of the recent financial meltdown. Commodity markets played a large role in the recent crisis, and they will be crucial to the recovery of the G-20 economies. These countries are well-placed to lead the way to higher global standards for extractive activities. They should implement the Extractives Industries Transparency Initiative (EITI), as Norway has done, and generally increase the transparency of extractive activities at home². In addition, such countries should require companies extracting resources from public lands in their jurisdiction to report volumes and costs of production, revenues, profits and payments to the state by type (taxes, fees, bonuses, royalties, payments in kind) as well as make public the material provisions of extractive contracts covering resources that belong to the state. They should also enforce environmental best practice on all extractive activities in the country, whether on private or public lands; enforce best practice labor and safety standards across the board for all extractive industries in the country; and protect community interests in the process of granting and overseeing extractive concessions.

² The criteria for compliance with EITI can be found at www.eiti.org, along with summaries of individual country experience in implementing EITI.

Transparency and Financial Integrity as Global Standards

The benefits of making transparency and integrity into global standards would be widely shared. Extractive industry interests—resources, investments, supply chains—are increasingly commingled across borders and among countries. Establishing a common, global standard for transparency of extractive operations will:

- help countries that want to follow best practice to define their policies while exposing those countries that do not follow best practice;
- reduce costs and risks for extractive companies that now have to follow different rules and practices, including accounting standards, in different jurisdictions of operation;
- level the playing field for companies competing to secure concessions;
- help investors and lenders assess the risk-return of investments in extractive companies and resource-rich countries;
- reward companies and countries that meet the global standard;
- prevent extractive companies from arbitraging different rules and standards to evade taxes in both home and host countries; and, finally,
- reduce opportunities for asset looting.

Actions to ensure global standardization should include:

Listing and Reporting Requirements. Regulators of major capital markets can make country-by-country reporting the disclosure basis for extractive companies, as the US has already done. As concessions to extract, fiscal regimes, tax payments and the political risk of extraction are all country-based this is a more informative format than aggregation at the regional or global level. Such disclosures should include sales, profits and taxes (royalties, bonuses, payments in kind) paid in each jurisdiction in the audited financial statements and tax returns required for listing on capital markets.

Imposing reporting requirements on extraction companies frees them from potential conflicts with resource-rich governments. Requiring transparency in reporting extraction revenue streams via the EITI, accounting standards and stock exchange listing requirements helps to achieve this.

Accounting Standards. Civil society and investor groups have recommended to the International Accounting Standards Board (IAS) that a new International Financial



Reporting Standard (IFRS) for extraction companies include country-by-country disclosure of reserves, payments to governments, cost and volume of production and revenues. More than 100 countries already use IAS as their required accounting standard. Canada and the United States are migrating from Generally Accepted Accounting Principles (GAAP) to IAS, and many state-owned companies make use of it or are in the process of adopting it. One of the main advantages of IAS is that companies which raise capital in a country that uses the standard would be subject to the reporting requirements, whether their home country required IAS or not. In addition, banks operating in a country that uses IAS would require extraction companies that they finance to make use of IAS.

Government Agency Standards. Contract and payment transparency principles should be embedded in the policies and requirements of government-sponsored lending agencies, export credit agencies and investment guarantee programs that are used to support extraction projects. National agencies such as the Export-Import Bank of the United States, the US Overseas Private Investment Corporation and government-supported investment and export promotion programs should incorporate transparency and other best practice requirements for any guarantee, loan or investment in an extractive project. This should include, at a minimum, disclosure of contract terms with any public entity, disclosure of payments to a public entity (by payment type), reporting of production costs and revenues generated by the project, and the meeting of social and environmental best practice standards.

Leveraging International Organizations and Agencies

Governments should seek G-8, G-20, OECD and UN resolutions and agreements endorsing the principle of the publication of contracts involving the exploitation of publicly owned natural resources. As well as encouraging the proliferation of the norms for EITI participation, listing requirements, diligence in the financial sector, harmonization of predicate offenses pertaining to the looting of natural assets, and on the identification of true beneficial ownership.

Member governments can ensure that the major international financial institutions, including the World Bank Group, the African Development Bank, the Asian Development Bank, the European Bank for Reconstruction and Development and the Inter-American Development Bank all adopt the highest transparency, environmental and social protection requirements for investments, loans or guarantees to extractive projects. This should include, at a minimum, disclosure of contract terms with and payments (by payment type) to a public entity and

reporting of production, costs and revenues by the project. The IMF *Guide on Resource Revenue Transparency*³ has been approved by all its members. Other international financial institutions should, at a minimum, apply the Guide to their own engagement with extractive industries.

The European Commission should develop a common transparency standard for EU members to apply in EU and European bilateral investments, guarantees and lending for extractive projects. Such standards should incorporate these policies in the European Investment Bank as well. Similarly, the OECD should add extractive industry standards to its agenda for the harmonization of export credit guarantee agency practices. Through such organizations, countries can cooperate in developing uniform export credit terms to avoid a race to the bottom. These standards should include best practice in extractive industry projects.

Opening a Dialogue on State-sponsored Preferential Access

Home governments should initiate a debate on preferential access to natural resources by state-sponsored companies and whether this achieves the aims of both those governments seeking preferential access as well as the resource-rich countries themselves.

Home governments need to carefully consider the true costs and benefits of state-supported competition for access to fungible commodities. Gaining preferential access may confer limited economic or strategic gains but at a higher cost than internationally traded prices. A ‘race to the bottom’ has significant risks as a side-effect of such competition for access. International forums, notably the G-20, are the appropriate bodies in which to reach agreement on a consistent set of minimum standards applicable to all resource-rich countries, especially fragile states or those less well-integrated into the international system—such standards can help pave the way to the beneficial integration of such countries.

It is not clear that any perceived preferential access is a real benefit where fungible commodities traded on world markets are concerned and where supply is available to those willing to pay market prices and the product is easily transportable overseas (a possible exception exists in those cases where there are direct pipeline links, such as natural gas). Though ruling elites in resource-rich countries may benefit, the broader populace will not, and the investor is left vulnerable and exposed, if not deterred. In the long-run, ruling elites will be ill-served, either as a

³ IMF (2007)

result of the inefficiency and ineffectiveness of murky investments, or as a consequence of the political backlash such arrangements can promote at home and abroad.

Implementing TFFI Reforms

The Task Force on Financial Integrity and Economic Development⁴ has identified five major reforms that would significantly reduce the flow of illicit monies from developing countries and help curtail tax avoidance:

Identifying beneficial ownership. Making readily available, on public record, the true beneficial ownership, control and accounts of companies, trusts and foundations facilitates effective due diligence. The beneficial owner should be defined as a natural person or listed corporation, not a nominee corporation or disguised trust.

Automatically exchanging tax information. An agreement that all governments collect, from financial institutions, data on income gains and property paid to non-resident individuals, corporations and trusts and automatically provide it to the governments where the non-resident entity is located would be a major step towards making transparency a global standard. This could be taken up by the G-20 working groups on enhancing regulation and transparency or reinforcing cooperation and promoting integrity in the financial markets. In addition, the United Nations Committee of Experts on International Cooperation in Tax Matters could take up the issue and develop a template agreement.

Harmonizing Predicate Offenses. Common standards of what constitutes an illicit transaction would make it more difficult to shelter assets illicitly gained in—and transferred from—one jurisdiction to another jurisdiction. Governments currently allow activities undertaken abroad that would be illegal at home. The G-20 and the Financial Action Task Force (FATF), which leads the Organization for Economic Cooperation and Development's (OECD) efforts to curb money laundering, should agree new standards for illicit transactions and establish regulations to restrict the flow of such funds through the international financial system. FATF could establish a group to specifically address the laundering of the proceeds of corruption and more effectively use its power to name and shame member states where legal systems and enforcement are not in compliance with agreed standards.

⁴ Task Force on Financial Integrity and Economic Development, 'Economic Transparency: Curtailing the Shadow Financial System' (Washington, DC: Feb. 2009).

Requiring due diligence in banking and finance. Commercial banks and other financial intermediaries are subject to strict controls and due diligence requirements regarding transactions and clients that may involve illicit drug operations or terrorist activities. Banks are required to “know their customer” and to report any suspicious transactions that can be classed as such to the authorities. Rules are far laxer for financial transfers possibly involving monies derived from corrupt transactions. Anti-money laundering laws can be strengthened to require due diligence in avoiding the proceeds of corruption and looted assets by identifying the ultimate beneficial owners and refusing to accept funds if there is reason to believe that the proceeds are derived from corrupt transactions. Those institutions failing to carry out such due diligence can be blacklisted by regulators. The success of any such measures can be encouraged by offering support for jurisdictions to maintain public income and asset declaration databases for senior public officials.

Discouraging trade mispricing or abusive transfer pricing. Trade mispricing to reduce revenues subject to taxation is a serious problem for resource-rich countries. Under- or over-pricing of intra-group transactions insulated from market forces provides a means to shift profits and elude taxation. As extractive companies tend to be vertically integrated, it is relatively easy to use transfer pricing to minimize taxes along the value chain. Parties conducting a sale of goods or services in a cross-border transaction could be required to sign a statement in the commercial invoice certifying that no trade mispricing has taken place in order to avoid duties or taxes. OECD and WTO rules could incorporate such a requirement, raising the legal and financial risks of the practice.

Transferring Knowledge and Building Capacity

Assistance for the proper management of the resource sector should be a centerpiece of technical assistance programs.

Donors can fund the provision of legal, economic and geological expertise to governments lacking it. The most successful producing countries can create or fund training programs for officials from less well-prepared resource-rich countries for field management, contract enforcement and monitoring, fiscal management, and the creation of stabilization and savings funds. The major producing countries can also offer expert secondment and mentoring to state oil and mining companies to encourage best practice.

Norway has created the Oil for Development fund under its foreign assistance program in order to transfer its human, technical, legal and institutional expertise in the petroleum sector to developing countries with hydrocarbon resources.



Australia, Brazil, Canada, Malaysia, the United States, Saudi Arabia, South Africa and Sweden, among others, are in a position to do the same, transferring knowledge and technical support to countries striving to strengthen their management of mining and hydrocarbon sectors. These countries can do much more than they do at present to transfer the requisite expertise on regulation, accounting, and the technical, environmental and financial management of extraction.

Key References

Kar, D. and Cartwright-Smith, D. (2009) *“Illicit Financial Flows from Developing Countries, 2002-2006”*. Washington, DC: Global Financial Integrity.

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