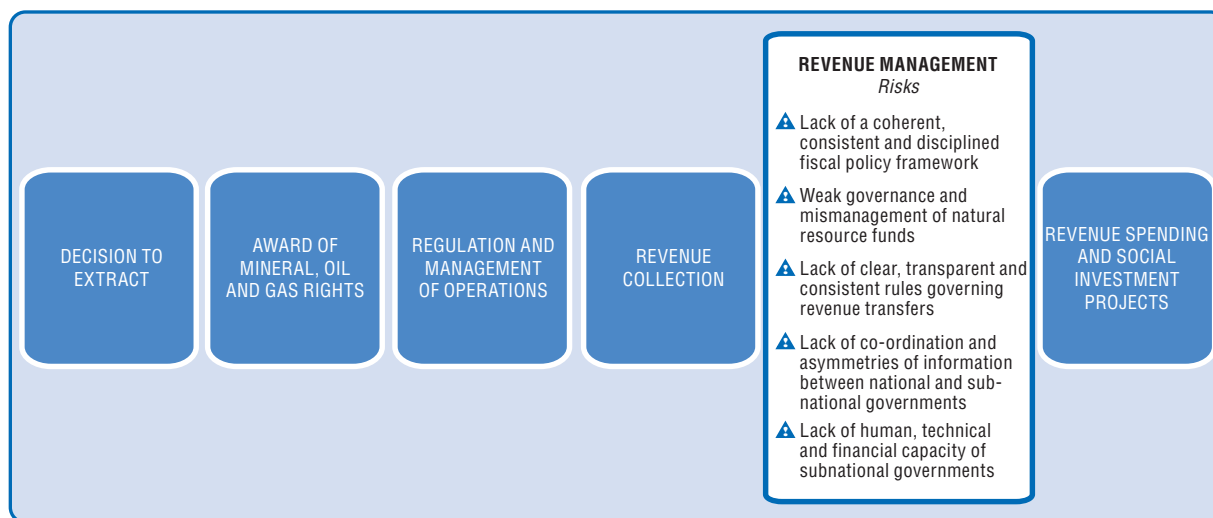


Chapter 6

Corruption risks in revenue management

This chapter looks into corruption risks associated with different types of revenue management and distribution. In particular it covers risks related to the management of revenues through natural resource revenue funds and government transfer schemes for the redistribution of revenues. It further offers practical guidance on recommended mitigation measures to host governments, at central and local levels, and donors.

Figure 6.1. **Corruption risks in revenue management**

Corruption related to revenue management through natural resource funds

Many resource-rich countries have established funds for managing resource revenues. These funds have a variety of different purposes, ranging from stabilisation of revenue flows, sterilisation of exchange rate fluctuations,¹ to saving for inter-generational equity and investment to promote local development (IMF, 2014). The purpose of a fund and the investment mandate that it sets forth for this purpose, imparts different degrees of corruption risk.

Stabilisation funds, for instance, are inherently short-term, low-risk and passive investment funds. They typically hold a portfolio of government bonds in major international currencies (largely US Treasuries and other sovereign debt from developed economies), and occasionally highly rated corporate bonds. There are numerous commercial providers that offer portfolio management services at a reasonable cost. Another approach, as some countries with stabilisation funds have taken involves the central bank providing asset management services. Given that the investment mandate is limited to short-term and low-risk securities and cash, there is limited to no opportunity for funnelling capital to investments that could be of a corrupt nature. But this does not mean that stabilisation funds due to their low-risk nature are free of corruption risk. If third-party asset managers are used, the payment of higher than market-rate management fees could suggest incompetence or potential corruption.

For savings funds, including those with stabilisation objectives, investment options are not, in principle, as restricted. If the objective of a fund is to maintain and increase wealth for future generations, then there is reason to diversify the portfolio across a greater range of asset classes with different risk-return characteristics. With this larger investment

mandate there is a greater risk of corruption either through direct investments or in the use of asset management contracts.

Moreover, some countries have established special-purpose investment vehicles that are charged with fostering local economic development by targeting certain sectors and/or investing in infrastructure. Establishing a natural resource fund with a domestic mandate is not without significant risk, of which corruption is one. For example, there is a risk that these funds invest in industries where the commercial viability is weak or in infrastructure projects that have limited purpose – so-called “white elephants” or “bridges to nowhere”. In effect, they may lack the rigor and savvy to execute investments that produce a better developmental outcome. If such investments derive from corruption, rather than insufficient due diligence, then the fund would reinforce underdevelopment.

Corruption schemes

Fraud, diversion of resource revenues for private interest and embezzlement

In the management of natural resource funds, the transfer of funds from the general budget as well as the disbursement of financial resources are vulnerable to risk of embezzlement and diversion of public funds for private interests.

Political capture, bribery, favouritism and clientelism in investment decisions

Financial flows to and from resource revenue funds may bypass the regular budget process and become vehicles for patronage and discretionary allocations (OECD, forthcoming 2016; NRG, 2014). The press has reported several cases where conflicts of interest and political capture have led to mismanagement, misuse and misappropriation of funds which has severely undermined the performance of natural resource funds. It is common to find government officials or well-connected elite on the supervisory board of these funds. In one particular case, the board was almost exclusively composed of members belonging to the President's inner circle. This resulted in a series of opaque and high-risk investments in hedge funds and complex derivative transactions.

The management of natural resource funds, in particular investment decisions may be marred by patronage and clientelist practices. Corruption can occur either through direct investments or in the use of asset management contracts. Indeed, suspicions of corruption underlie several cases where non-commercially credible or imprudent investments were made in companies affiliated to (owned, managed and/or advised by) well-connected elites. In all cases identified, the amounts of revenues missing from the funds' accounts or lost as a result of mismanagement, misconduct and lack of oversight amounted to billions of dollars.

Similarly, the management of portions of the fund's assets may be entrusted to external managers (e.g. foreign banks) with political ties and affiliations in the country. For example, in one oil producing country, a manager in the national natural resource fund was accused by members of parliament of contracting his former employer, a foreign bank, as an external manager of the fund's assets without following due process (NRG, 2014). In another case, a lawsuit was filed by the natural resource fund against a foreign bank for allegedly bribing key officials and top executives of the fund to influence decisions over the fund's investments.

In some resource-rich countries, in particular oil producing countries, patronage can be a broader feature of the economic and political system under which natural resources are governed and managed (Ramos, 2012).

Parties involved

On the public side, parties involved in corrupt schemes related to mismanagement of natural resource funds may be the fund's board members, managers or staff. Politicians and high-level government officials from ministries or central banks involved in the management of the fund may also play a role in the corrupt scheme through trading in influence, conflicts of interest or embezzlement.

On the private side, foreign or local investment banks and other fiduciary entities acting as external managers of portions of the fund's assets may also be the instigator of the corrupt scheme and may bribe public officials with a view to influencing investment decisions.

Vehicles and mechanisms***Use of shell companies***

In cases of bribery or diversion of public funds, parties to the corrupt scheme may use offshore companies with obscure beneficial ownership to channel and launder the illegal payments or to conceal the proceeds of corruption. For example, one lawsuit case reports the payment by a foreign bank of advisory fees to a friend of the President's son through an offshore company.

Use of offshore bank accounts

The proceeds of corruption or diverted funds are usually transferred to offshore bank accounts pertaining to friends or relatives of the corrupt officials in jurisdictions with lax regulations regarding beneficial ownership.

Fraud and misinvoicing

As illustrated in the example above, illegal payments and bribes may be falsely recorded as advisory or consultancy fees. When external asset managers or investment consultants are used, higher than market-rate management fees or commissions may suggest potential corruption.

Corruption risks***Lack of a coherent, consistent and disciplined fiscal policy framework***

The lack of a coherent fiscal policy framework stating clear medium-term to long-term fiscal objectives and integrating natural resource funds into the general budget may provide ground for corruption in the revenue management phase (IMF, 2007). Overly rigid or inconsistent deposit and withdrawal rules, unclear accounting of revenue flows between the government and the fund, insufficient reporting of off-budget accounts in the general budget and circumvention of the regular parliamentary budget process increase the risk of dual budgeting and encourage corrupt practices to bypass existing rules or take advantage of legislative and regulatory gaps. The lack of transparency and accountability in the use of extra-budgetary allocations and secret bank accounts or deposits outside the national banking system contribute to opacities in the origin and destination of the fund's revenue flows.

Mismanagement of the fund

Shortcomings in the management of natural resource funds may provide opportunities for corruption. Such gaps may include a mismatch between the fund's policy objectives and

its investment function, as well as between the investment function and the organisational and human resource capabilities and expertise of the fund. In relation to the latter, the lack of staff professionalisation and technical capacity may leave room for unchecked and excessive executive discretion in the budget process, increasing the risk that resource revenue funds become a parallel budget managed under the discretion of the executives (Sharma and Strauss, 2013; Collier and Venables, 2011; Gauthier and Zeufack, 2009).

The lack of transparency in the management of the fund may also encourage corrupt practices. Opacity may result from unclear or vague procedural and operational rules governing the management of the fund, internal controls and monitoring systems. It may also result from the lack of public disclosure on natural resource funds activities and governance structures including: its institutional structure; functions; relations with the executive; investment mandates; investment policy; risk management policy; asset allocation; targets, benchmarks and results for asset classes and direct investment assets; external management fees and fees paid to investment consultants (Gelb, Tordo and Halland, 2014). In some countries, information disclosure about natural resource funds is even prohibited by law (NRGI, 2014; Collier and Venables, 2011; Gauthier and Zeufack, 2009).

Weak governance of the fund

Inadequate governance arrangements may foster discretion in decision-making processes and hamper integrity and compliance in the management of natural resource funds. First, the lack of clear rules defining the roles and responsibilities; between ownership and regulatory/supervisory functions of natural resource funds (Gelb, Tordo and Halland, 2014); and/or between board membership and executive management may result in weakening the board's oversight function. It may also allow for the exercise of political discretion in changing the fund's rules and making investment decisions (NRGI, 2014; Collier and Venables, 2011; Gauthier and Zeufack, 2009). Additional risk factors include: the lack of an independent and accountable supervisory board (Collier and Venables, 2011; Gauthier and Zeufack, 2009); the lack of expertise and professionalisation of the fund's board members; as well as the lack of clear behavioural guidelines and codes of conduct requiring board members, executives and staff to disclose potential conflicts of interest (NRGI, 2014).

Finally, the lack of independent audits and the lack of parliamentary and public scrutiny on the management of natural resource funds may further increase risks of political discretion and associated corrupt practices.

Recommended mitigation measures

RISK FACTORS	RECOMMENDED MITIGATION MEASURES
<i>Lack of a coherent, consistent and disciplined fiscal policy framework</i>	<p>What host governments can do</p> <ul style="list-style-type: none"> ● Define a coherent and disciplined fiscal policy framework in which natural resource funds are integrated with the budget through clear deposit and withdrawal rules and procedures. <p>What donors can do</p> <ul style="list-style-type: none"> ● Assist with the development of clear medium- to long-term fiscal policy/fiscal objectives. ● Support the implementation of transparency and accountability guidelines for the management of revenue generated from extractive industries, including whenever relevant considerations for the creation of a sovereign wealth fund or similar arrangements to manage revenues. Help with access to information on the experience of other countries which have used such arrangements.
<i>Mismanagement of funds</i>	<p>What host governments can do</p> <ul style="list-style-type: none"> ● Put in place a robust and stable legal framework establishing roles and responsibilities as well as rules for the accumulation and investment of assets. ● Ensure coherence between the fund's policy objectives, such as stabilisation or saving for the future, and its investment function. ● Establish ethical guidelines to screen companies in which funds are invested. ● Ensure that the degree of allowable investment risk and the scope of allowable investments match the organisational and human resource capabilities available to the fund as an institutional investor (OECD, forthcoming 2016). ● Require disclosure of fees paid by natural resource funds to investment consultants or external asset managers. ● Require natural resource funds to provide comprehensive and timely reports on their transactions and assets (OECD, forthcoming 2016).
<i>Weak governance of the fund</i>	<p>What host governments can do</p> <ul style="list-style-type: none"> ● Establish sound institutional and governance arrangements that limit discretionary behaviours and ensure insulation of the fund from short political cycles. ● Promote merit-based selection of governance board members and operational managers with a remuneration scheme that attracts and maintains qualified professionals, clear procedures for appointment terms and removal (OECD, forthcoming 2016). ● Establish internal integrity measures including requiring governing bodies, managers and staff to disclose any direct or indirect business interests with any activity involving the fund (OECD, forthcoming 2016). ● Where domestic state institutions are weak, consider contracting out management to an independent and professional domestic, regional or international institution (OECD, forthcoming 2016). ● Subject the natural resource fund to parliamentary oversight and independent external audits (OECD, forthcoming 2016). ● Publish reports and audit results. ● Invest in public education and transparent communication on the fund's strategy, objectives and results in order to build and maintain trust among citizens and investors over time (OECD, 2015). <p>What donors can do</p> <ul style="list-style-type: none"> ● Provide capacity-building support to train parliamentarians on issues related to fiscal policy and revenue management in order to ensure effective parliamentary scrutiny over the management of funds.

Corruption in the redistribution of resource revenue through transfers

The redistribution of revenues with transfer of funds from central to subnational entities presents major risks of corruption, in particular risks of revenue diversion and embezzlement and risks of patronage and clientelism.

Natural resource revenues can be transferred from central to subnational authorities through various mechanisms. Revenue-sharing arrangements can be grouped into three main categories: i) devolution or derivation-based transfers; ii) direct allocations from the central government and iii) formula-based revenue sharing arrangements. The purpose of devolution or derivation-based formula is to transfer revenue, or a share of it, to jurisdictions associated with the extractive activity, either producing regions or regions hosting infrastructure for refining, transportation and distribution. This mechanism aims to compensate the producing regions for the extraction of resources or the negative externalities linked to the extractive activity. The second scenario consists of centrally managed allocations whereby the central government consolidates the management of revenues,

allocated through development or regional investment funds on an annual basis from a central budgetary account, or through competitive investment grants aimed at supporting specific types of projects, to promote a more strategic investment of resources and to minimise the fiscal liability of uncontrolled subnational expenditure. Finally, governments can rely on pre-determined formula to distribute resource revenues across all subnational jurisdictions, including non-producing ones, taking into account the different needs and characteristics of each jurisdiction, the size of the population and territory, pre-existing social and economic inequalities, and in some cases fiscal effort. In practice, these criteria can be combined when deciding on reallocation and distribution schemes (Acosta, 2015).

Corruption schemes

Embezzlement and diversion of revenues

Risks of leakages and revenue diversion may affect the phase of calculation of the share of revenues available for transfer. Embezzlement and misappropriation of funds may also occur throughout the revenue transfer process, from intra-governmental transfers through various designated national accounts all the way through to subnational authorities' accounts where the revenues are actually disbursed.

Patronage, favouritism and clientelism

The rationale behind central government revenue assignments to subnational governments may be driven by patronage and electoral clientelism with a view to securing loyalties at the subnational level. This can be facilitated in the case of non-statutory assignments that provide for a certain level of discretion in determining the criteria for allocation as in the case of revenue distribution through specific purpose funds or competitive investment grants aimed at supporting specific types of projects (ODI, 2006).

Parties involved

In cases of revenue diversion and embezzlement, parties involved can be national or local government officials depending on where in the transfer process revenue misappropriation and leakages occur.

In cases of patronage and clientelism, the instigator of the corrupt scheme may be national government officials, or alternatively local government officials bargaining their affiliation and loyalty in exchange for bribe payments.

Vehicles and mechanisms

Miscalculation of the share of revenues available for transfer

The complexity of calculations of the share of total revenue available for transfer and the share allocated to each subnational government may provide an opportunity for fraud, misappropriation and embezzlement. This is true in particular in the case of formula-based revenue-sharing types of arrangements for which criteria for allocation and redistribution might be unclear as well as in the case of derivation-based transfers for which determining the proportion of total resource revenues derived from a particular producing state, province, district or affected community may prove challenging (ODI, 2006).

Use of offshore bank accounts

Diverted funds can be transferred to offshore bank accounts pertaining to friends or relatives of the corrupt officials in jurisdictions with lax regulations regarding beneficial ownership.

Corruption risks

Lack of clear, transparent and consistent rules governing revenue transfers

Corruption risks in revenue redistribution may result from the lack of clear, coherent and consistent rules governing revenue transfers from national to subnational authorities. Revenue distribution schemes may suffer from inconsistency with national fiscal policy and macroeconomic objectives. Moreover, legislation may fail to set clear and transparent transfer rules and assignments of expenditure responsibilities or when a legal framework exists, it may lack stability or not be enforced (Acosta, 2015; World Bank, 2011). Finally, unclear or vague rules and regulations may provide room for unchecked and excessive executive discretion in the budget process allowing for discretionary or *ad hoc* transfers (Bauer, 2013).

Lack of co-ordination and asymmetries of information between national and sub-national governments

Corruption risks may arise from the lack of co-ordination and the asymmetry of information between national and sub-national governments (World Bank, 2011). This may take the form of insufficient tracking and transparency over transfer payments from various “disbursement” accounts at national level (ODI, 2006). Moreover, the lack of disaggregated data disclosure by the central government leaves local authorities with insufficient information (e.g. data on volumes produced, consumed and exported, and on the prices actually realised, and the amount the government receives for its share of production) to verify their entitlements (World Bank, 2011).² This lack of transparency may be due in particular to the confidentiality of contractual clauses on company payments to the national government (Bauer, 2013; Morgandi, 2008). Conversely, asymmetries of information may work in favour of local governments due to the lack of or unclear legal provisions for the reporting of financial accounts by lower levels of government to the central government (NRGI, 2013), as well as weak central government’s control systems (IADB, 2014; Martini, 2012).

Lack of human, technical and financial capacity of subnational governments

Finally, corruption in revenue transfers may thrive where subnational governments lack the human, technical and financial capacity to manage and spend large revenue inflows. In particular, local governments often lack the statistical capacity to measure fiscal performance, model complex revenue streams and verify entitlements (Bauer, 2013). Moreover, local governments may not have appropriate safeguards and transparency mechanisms in place to protect budget levels from potential fiscal volatility (Ushie, 2012; Acosta, 2015).

Reforms towards greater decentralisation have often translated into increased transfers of responsibilities and revenues without transferring the necessary financial and human capacity or investing in building local institutional and administrative capacity to manage these new large inflows of resource revenues. This has led to poor budget execution, difficulties in planning and inefficient resource allocation (ODI, 2006; IADB, 2014; Martini, 2012;

World Bank, 2011). Moreover, the high concentration of revenues contributes to encouraging rent-seeking behaviours and dependency on transfer payments at the expense of tax collection (World Bank, 2011).

Recommended mitigation measures

RISK FACTORS	RECOMMENDED MITIGATION MEASURES
<i>Lack of clear, transparent and consistent rules governing revenue transfers</i>	<p>What central governments can do</p> <ul style="list-style-type: none"> • Structure a revenue distribution scheme which is consistent with national fiscal policy and macroeconomic objectives. • Define and enforce legislation clearly setting transfer rules, assigning expenditure responsibilities and segregating roles in the authorisation process (proposal, examination, approval) to limit executive discretion in the budget process. • Introduce a transparent and clear regulation and accounting system for revenue transfers.
<i>Lack of co-ordination and asymmetries of information between national and sub-national governments</i>	<p>What central governments can do</p> <ul style="list-style-type: none"> • Define clear legal provisions for the reporting of financial accounts by lower levels of government to the central government. • Introduce periodical reconciliation of transfers between the national and subnational levels. • Publicly disclose the revenue sharing arrangements between central and subnational governments as well as the actual disaggregated transfer payments so as to enable local authorities to verify their entitlements and facilitate the identification of any discrepancies. Publicly disclose any further <i>ad hoc</i> or discretionary transfers (World Bank, 2011). • Increase collaboration with local administrations to develop standard systems to model revenue streams, standard reporting systems, etc.
<i>Lack of human, technical and financial capacity of subnational governments</i>	<p>What local governments can do</p> <ul style="list-style-type: none"> • Plan appropriate organisation and staffing and strengthen financial management, oversight and audit functions in local administrations to increase capacity to manage transfers and local revenues (World Bank, 2011). • Develop systems and build capacity to model revenue streams to verify entitlements and facilitate budget planning activities. • Develop appropriate fiscal rules, safeguards and transparency mechanisms to protect budget levels from potential fiscal volatility.

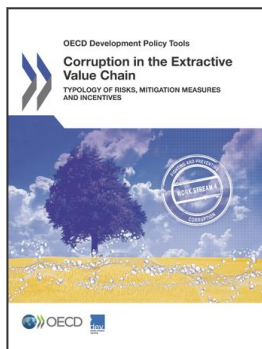
Notes

1. Comments from participants in the Working Group on Corruption Risks further point to risk associated with the manipulation of the exchange rate, when decisions are influenced by third parties' interests such as export industries, in particular in the extractive sector, benefitting from the depreciation of the national currency.
2. See also recommendations contained in the following EITI reports: Democratic Republic of Congo (2012 report), www.itierdc.com/formulaire/Rapport%20de%20Conciliation%20ITIE%20RDC%202012%20-%20Final%20.pdf. Ghana (2012-2013 report), https://eiti.org/files/2012-2013_Final_Oil_and_Gas_Sector_Report_0.pdf. Guinea (2012 report), <https://eiti.org/files/Guinea-2012-EITI-Report-FR.pdf>. Kazakhstan (9th 2013 report), https://eiti.org/files/EITI-2013-Report-Kazakhstan_Annex.pdf. Liberia (5th 2011-2012 report), https://eiti.org/files/EITI_Report_Liberia_2011-12.pdf. Peru (2011-2012 report), https://eiti.org/files/Peru-2011-2012-EITI-Report_0.pdf. Zambia (2013 report), https://eiti.org/files/zeiti_2013_reconciliation_final_report_18_12_14%20%281%29%20%282%29.pdf. Philippines (2nd 2015 report) http://ph-eiti.org/document/EITI-Report/First-Country-Report/PH-EITI_Report_Volume_II_Reconciliation_Report_final.pdf.

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