

# AIDING, TRADING OR ABETTING?

THE FUTURE OF TRADE, AID AND SECURITY

# 1

DESIGNING CONFLICT-SENSITIVE  
TRADE POLICY  
MARKET ACCESS, SUBSIDIES  
AND PRICE VOLATILITY



**IUCN**  
The World Conservation Union



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Institut international du développement durable

## 1. TRADE AND CONFLICT

Designing trade policies that diminish the likelihood or longevity of violent conflict is a critical task for the international community. In theory, trade can be a powerful driver of economic growth and stability: reducing poverty, creating non-military ways to resolve disputes and providing strong economic incentives for stability.

However, in practice, the current system of rules that govern international trade is fundamentally inequitable; biased towards rich countries and their corporations. Limited market access, complex regulations and perverse domestic subsidies in the developed world inhibit the efforts of developing countries to diversify their economies.

At the same time, developing countries are being pushed to adopt uncompromising market liberalization, which can reduce government revenues and undermine livelihoods, serving to increase the prospects for political instability and competition over scarce resources. This is especially the case in the absence of effective domestic institutions capable of mitigating economic shocks and satisfying competing demands for resources.

In effect these policies are locking developing countries into reliance on the export of primary commodities subject to volatile and declining prices, over which they have little or no control. Economic shocks, stagnation or decline in fragile states have caused civil conflict by amplifying social inequalities, undermining governments, producing corrupt elites and placing the heaviest burden of trade liberalization on the poorest and most vulnerable. Statistically speaking, the more reliant a country is on primary commodity exports the higher the risk of civil war.<sup>1</sup>

However, the potential impact of trade policies on conflict has rarely featured in the discussion on global trade policy. This policy brief focuses on four areas of trade policy that aggravate the risk of conflict and undermine post-conflict reconstruction.

First, tariff barriers coupled with complex sanitary and technical standards restrict the access of southern products to northern markets and inhibit efforts to diversify their economies. Second, domestic and export subsidies undermine the ability of southern producers to compete on a level playing field with heavily subsidized northern producers and result in the dumping of subsidized goods. Third, the continuing dependence of many countries on primary commodities leaves them prone to the volatile commodity prices on international markets. Finally, the aggressive promotion of an increasingly globalized trade system reduces the 'policy space' of developing countries to implement policies suited to their national circumstances.

## 2. MARKET ACCESS RESTRICTIONS

OECD trade policy, in effect, constructs a number of daunting barriers for developing country producers. Access to developed country markets is limited by quotas, the exclusion of specific products, tariff barriers (often for goods which developing countries produce more efficiently than Europe, such as dairy products, vegetables, nuts and fruit), higher duties for processed goods, and 'rules of origin' clauses that prevent manufactured goods that require components from outside the region from entering developed country markets.

Tariff escalation is a particularly pernicious measure whereby developed countries typically apply low tariffs to imports of raw commodities but rapidly rising rates to intermediate or final products. In Canada, for example, tariffs on processed food products are 12 times

higher than on raw products.<sup>2</sup> In effect, tariff escalation and tariff peaks (high tariffs designed to block specific imports) prevent developing countries from adding value to their exports, inhibit industrialization and lock them into dependence on exporting price-volatile, low value-added commodities.

Existing schemes trumpeted by OECD countries as improving market access for developing countries tend to be the subject of considerable exaggeration. The EU's *Everything But Arms* (EBA) initiative, which took effect in March 2001, grants duty-free access to almost all products from the least developed countries. However, corporate lobbies successfully diluted the initiative by keeping import duties on sugar and rice until 2009 and on bananas until 2006—among the most important exports of developing countries.

The eleventh hour deal struck at the December 2005 Hong Kong Ministerial meeting of the WTO proposed to extend quota-free and duty-free access to nearly all LDC exports to OECD countries in a package similar to the EBA. However, like the EBA, various exemptions and complex rules of origin requirements will very likely undermine the impact of this admittedly welcome move.

The U.S. *African Growth and Opportunity Act* (AGOA), passed in 2000, gives preferential access to U.S. markets for several products such as textiles and has helped to increase export growth in some countries in Africa. But there are major limitations including limited product coverage and complex eligibility requirements. A recent World Bank study concludes that only a small number of countries receive substantial benefits from AGOA.<sup>3</sup>

### 3. COMPETING WITH RICH COUNTRY SUBSIDIES

However, tariff barriers alone do not tell the whole story. Market access alone is no panacea and import duties are just the

door fee. The real challenge for producers from the developing world is remaining competitive once in developed world markets. Complying with complex sanitary and safety standards can be extremely costly. To compound matters, product standards tend to get stricter with increased processing which discourages industrialization.

And even if developing world producers manage to negotiate the turbulent waters of developed country import regulations, they reach a playing field made grossly uneven by domestic subsidies. Rich countries spend at least US\$230 billion each year in payments to their farmers that subsidize the production and export of agricultural goods.<sup>4</sup> Often the products that are most subsidized, such as rice, cotton, maize and sugar, are the very goods in which developing countries could otherwise be competitive.

Each farmer in the EU is subsidized by a sum many times greater than the average annual income of an African farmer. These subsidies depress world prices for key developing world products like sugar and cotton, deny developing world farmers valuable export markets and undermine growth in the developing world. The UNDP estimates that the real costs for developing countries of rich country agricultural protectionism and subsidies may be as high as US\$72 billion a year—equivalent to all official aid flows in 2003.<sup>5</sup>

**LIMITED MARKET ACCESS, COMPLEX REGULATIONS AND PERVERSE DOMESTIC SUBSIDIES IN THE DEVELOPED WORLD INHIBIT THE EFFORTS OF DEVELOPING COUNTRIES TO DIVERSIFY THEIR ECONOMIES.**

Since the Uruguay Round of trade negotiations started in 1986, annual agricultural support in developed countries has remained at around \$250 billion.<sup>6</sup> The EU and U.S. claim to have cut their domestic subsidies over the years but in reality there has been little substantial reduction, more a re-labelling of existing support to make them more easily defensible in the WTO.

The U.S. Farm Bill of 2002 was widely vilified in the international trade community for actually increasing trade-distorting farm subsidies. U.S. officials argued that a proposal made in October 2005 would substantially reduce domestic subsidies. Yet closer analysis shows that the proposal would potentially allow for negligible cuts to the subsidies paid to farmers. Argentina's ambassador to the WTO suggested that the proposal would mean that U.S. subsidies could actually increase.<sup>7</sup>

Unlike the U.S. Farm Bill, which comes up for renewal every five years, the EU's Common Agricultural Policy (CAP) is fixed until the European Commission proposes legislative change. The last major reform took place in 2003, and in contrast to the U.S. bill, EU farm policy is less trade-distorting as a result. However, a 2005 World Bank study concluded that despite the 2003 CAP reform there are still subsidy incentives for EU farmers to increase production.<sup>8</sup> Recently, division over agricultural spending stalled attempts to reach an agreement on the 2007–2013 EU budget.

Subsidies allow developed countries to produce goods below the costs of production. To compound the problem, many OECD countries still provide export subsidies that enable artificially cheap exports to be dumped on the developing world; flooding local markets and undercutting local production and jobs. In 2003, export dumping by U.S.-based food and agri-business companies meant that wheat, cotton and rice were exported at an average price of 28, 47 and 26 per cent respectively below the cost of production.<sup>9</sup> Imports of cheap subsidized U.S. rice into Haiti, for example, have thrown thousands of poor farmers out of business, and forced many people off their land. Although formally prohibited by the WTO, the dumping of goods below the cost of production is still common and WTO rules make it complicated and expensive for poor countries to establish grounds for anti-dumping actions.

The WTO's Doha declaration of 2001 agreed to a 'reduction of, with a view to phasing out, all forms of export subsidies.' At the Hong Kong Ministerial meeting of the WTO in December 2005, the OECD countries finally agreed to phase out all export subsidies by 2013, in return for some limited concessions on the liberalization of trade in services. However, this phase-out period is much longer than that sought by many developing countries and there is a danger that the OECD countries will funnel the resultant savings into greater domestic subsidies. In short, the tentative agreement's impact on a heavily distorted trading system is both uncertain and delayed.



*Former child soldiers at a transit centre in Kalehe, Democratic Republic of the Congo.  
(c) Amelia Bookstein*

## 4. COMMODITY PRICE VOLATILITY

One of the most serious trade issues facing many developing countries is the volatility and decline in the prices of primary commodities on which their economies rely.

Ninety-five of the world's 141 developing countries are more than 50 per cent reliant on commodity exports.<sup>10</sup> This dependence makes many developing countries highly vulnerable to fluctuations in the price of key commodities.

At the end of the 1980s, over-supply and the collapse of commodity price agreements led to violent price fluctuations on a downward trajectory for many commodities. By 2000, prices for 18 major export commodities were 25 per cent lower in real terms than in 1980; for eight of these commodities the decline exceeded 50 per cent.<sup>11</sup> The UN estimates that for every \$1 in aid received by sub-Saharan Africa since the early 1970s, \$0.50 has been lost as a result of deteriorating terms of trade.<sup>12</sup>

Research suggests that commodity price shocks tend to promote corruption, weaken state institutions and lead to a host of budget and management problems. When prices are high, increased government revenues, coupled with easier access to external borrowing, tends to lead to an increase in expenditure. This can trigger severe deficits when prices decline. There is also evidence to suggest that severe price shocks have a multiplier effect that damages medium-term economic growth. As such, negative price shocks can precipitate episodes of rapid and persistent economic decline that increase the risk of conflict. One study by the World Bank estimates that if 25 per cent of GDP is derived from primary commodity exports, the risk of civil war jumps to over 30 per cent.<sup>13</sup>

Ethiopia and Burundi rely on coffee for between 60 and 80 per cent of their export earnings, so the two-thirds fall in the price of coffee between 1980 and 2000 devastated rural livelihoods, slashed government revenues already strained by debt repayments, and radically undermined health and education programs.<sup>14</sup> It has been convincingly argued that the sinking price of coffee in the early 1990s contributed to the Rwandan genocide of 1994 by halving export revenues, eroding livelihoods and exacerbating ethnic tensions.<sup>15</sup>

There are five broad policy responses to commodity price volatility: (i) price agreements based on producer cartels such as OPEC; (ii) stabilization of producer/consumer prices by variable export tariffs or taxes, marketing boards and domestic stockpiles; (iii) compensatory financing of individual producers by domestic governments or international institutions; (iv) producer government revenue stabilization funds; and (v) the use of risk instruments such as forward contracts to stabilize producer revenue. All have somewhat mixed histories but commodity price stabilization mechanisms have largely fallen out of favour politically since the collapse of many of the commodity price agreements in the late 1980s.

The international community used to have two mechanisms to compensate price shocks: the Compensatory Financing Facility (CFF) of the IMF and the FLEX Facility of the EU. However, neither worked particularly well and both are now dormant. There is a real need to re-open the debate on how the income that countries get from their commodity exports can be made more smooth and predictable.

## 5. TRADE LIBERALIZATION AND POLICY SPACE

Recent years have witnessed a fierce debate about the role of trade liberalization in development. It is important to distinguish two separate issues: whether trade liberalization in the South is good for development and poverty eradication *in the South*; and the debate about opening up OECD country markets to developing country exporters, i.e., liberalization *in the North*.

Greater access to northern markets is a vital issue for developing countries and import restrictions have major adverse impacts on many poor countries, discussed above. Yet the issue of liberalization in the South is equally important for many developing countries, linked as it is to the critical question of developing greater domestic industrial and agricultural capacity and the longer-term ability to compete in global markets.

Despite decades of intervention in their own markets, the EU and U.S. are not supporting developing country initiatives to protect small-hold farmers from unfair international competition.<sup>16</sup> The outstanding cases of successful poverty eradication in the post-war world, Taiwan and South Korea, rejected policies to open their economies completely at key stages in their development. These countries often protected their domestic industries, for limited periods and with clear performance requirements, gave preference to domestic companies on the grounds of promoting long-term industrial development, and actively intervened in their economy through regulation and by financing investment. A key point about successful development in East Asia was that these countries were not subjected to 'big bang' or shock liberalization. These policies were part of a mix that included those of liberalization now advocated by the WTO, but were far from restricted to them.

Despite some concessions to special and differentiated treatment for the least developed countries, the WTO promotes a 'one-size-fits-all' model of economic development in developing countries, reducing their flexibility to pursue possible policies more suited to their local circumstances. For example, the WTO's *Trade-Related Investment Measures* (TRIMs)

agreement covers conditions on investment related to trade in goods and bans many laws and regulations that favour domestic over foreign capital inputs. The *Agreement on Subsidies and Countervailing Measures* also prevents many developing country governments (though not LDCs) from providing subsidies to encourage the use of domestic over imported goods.<sup>17</sup>

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## 6. RECOMMENDATIONS

To enable trade policy to contribute to peace and security rather than conflict:

- Reduce the market access barriers that block poor country exports to developed country markets, and rapidly abolish the export subsidies that undermine economic diversification in developing countries;
- Increase support for developing country efforts to diversify their economies and meet the standards requirements in developed country markets. Specifically, the developed countries need to identify and remove domestic policies, principally trade-distorting subsidies and protectionist import standards, which inhibit economic diversification in the developing world;
- Promote greater trade policy flexibility than is currently available under the WTO's Special and Differentiated Treatment (SDT) provisions. Potential conflict countries could be identified as a special group within the WTO in order to allow for special trade measures;
- Improve and cohere approaches to failed states and engage in better research to design appropriate trade policies and ensure this is incorporated into the design of overall development cooperation packages;
- Provide more capacity-building support to fragile states to enable them to reinvigorate their trading opportunities. More aid could also help support fragile states manage future economic shocks and build their capacity to negotiate effective trade agreements;
- Consider the use of both trade measures and aid resources to compensate for revenue losses that result from the lowering of trade taxes, and to mitigate adjustment costs of liberalized trade;
- OECD states should refrain from negotiating overly-complex trading agreements or ones that seek to deepen trade liberalization commitments on the part of developing countries going beyond those agreed multilaterally.

## ENDNOTES

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- <sup>3</sup> Paul Brenton and Takako Ikezuki, 'The initial and potential impact of preferential access to the US market under the African Growth and Opportunity Act,' *World Bank policy research working paper 3262*, April 2004
- <sup>4</sup> Godoy, Julian, *No End to Subsidies*, Interpress Service, June 25, 2005
- <sup>5</sup> *Human Development Report*, 2005, p.130
- <sup>6</sup> *Ibid.*
- <sup>7</sup> 'US agricultural proposal criticised as inadequate and ignoring SDT for developing countries,' TWN Information service, October 15, 2005
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- <sup>10</sup> Benn, Hilary, *Human and Environmental Security – An agenda for change* (Dodds and Pippard), Earthscan, 2005
- <sup>11</sup> Oxfam, *Rigged Rules and Double Standards – trade, globalisation and the fight against poverty*, 2002, p. 151
- <sup>12</sup> UNCTAD, *Economic Development in Africa: Performance, Prospects and Policy issues* New York and Geneva, 2001
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- <sup>14</sup> Oxfam, *Rigged Rules and Double Standards – trade, globalisation and the fight against poverty*, 2002, p. 150
- <sup>15</sup> Mark Halle, Jason Switzer and Sebastian Winkler *Trade, Aid and Security – elements of a positive paradigm*, International Institute for Sustainable Development (IISD), 2004, p. 13
- <sup>16</sup> Oxfam Briefing Paper, *Europe's Double Standards – how the EU should reform its trade policy with the developing world*, Briefing paper 22, 2002
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Since 2000, the initiative has focused on the way in which trade in natural resources can contribute to violent conflict at the sub-state and international level, and on the role of foreign aid and trade liberalization—in tandem or in isolation—in accelerating or alleviating this downward spiral.

On the basis of this understanding, current research focuses on the options available to domestic and international policy-makers. This series of policy briefs recommends six key objectives that the international community should strive to achieve if trade and aid policies are to contribute to peace and security rather than increasing the likelihood and longevity of violent conflict.

Those objectives are; developing conflict-sensitive trade and aid policies; restricting the trade in conflict resources; spreading 'good governance'; promoting conflict-sensitive business practice; and improving the management of revenues from natural resources and aid.

For more information please visit [www.iisd.org/security/tas/](http://www.iisd.org/security/tas/)

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# AIDING, TRADING OR ABETTING?

THE FUTURE OF TRADE, AID AND SECURITY

## 2

**DEVELOPING  
CONFLICT-SENSITIVE AID**  
THE RELATIONSHIP BETWEEN  
AID AND CONFLICT



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## INTRODUCTION

**'Aid' has not met the ambitions that were set for it when the project was first articulated in the 1950s and 1960s. That is not to say 'aid does not work.' Revolutionary achievements in education, health, agriculture and poverty reduction—patchy and isolated as some have been—demonstrate that aid can be hugely effective. The problem is that aid has been used by donors and recipients for purposes that were either not intended, or not explained to their citizens.**

**In the intervening years, there has been an upsurge in conflict. Many of the investments of the past two generations are threatened, or have been lost. There is, therefore, renewed interest in how aid can be used to prevent conflict, to move from conflict to recovery, and from there to sustainable long-term development. The advertised purpose of aid was to end poverty and, latterly, to do so in ways that are socially, politically, economically and environmentally sustainable. In examining lessons and options, this policy brief emphasizes the enduring importance of this aim.**

## 1. LESSONS OF HISTORY

Critics of development assistance have long argued that aid can make things worse, that it can ignore signs of trouble, and that in supporting bad governments, it can skew resource allocation and help set the stage for conflict. There is no country in recent years more studied than Rwanda, because the violence that erupted there in 1994 was so devastating, and because the outside world did so little to stop it. Many studies have pored over the warnings that were available in the months before the genocide began, but where foreign aid is concerned, it was not so much a matter of ignoring or misreading the signs, but of actively building the capacities of a bad government with murder on its mind.

In reality, the majority of Rwanda's people lived in absolute poverty, with few prospects for improvement. An uneducated, ill-informed public was treated in an authoritarian and oppressive manner by an arrogant government with a solid track record of corruption and human rights abuse. Regional and ethnic inequality was palpable, exacerbated by state-sponsored racism. Author Peter Uvin<sup>1</sup> argues that these factors—exclusion, inequality, pauperization,

racism, structural violence and oppression—all interacted with development assistance to lay the groundwork for the genocide. Foreign aid contributed through action—in supporting and building the 'capacity' of the government—and through inaction, by ignoring unmistakable warning signs and failing to mitigate the worst aspects of poverty, exclusion and violence. Current conditions in other countries that are the recipients of considerable foreign assistance bear uncanny similarities to the Rwanda of 1994.

Today's 130 million Nigerians represent nearly a quarter of all the people living in sub-Saharan Africa. 75 per cent of their land is arable, the country has abundant mineral resources and Nigeria is the sixth largest oil producer in OPEC. And yet Nigeria is a mess. More than 70 per cent of the population lives on less than a dollar day, one out of every five Nigerian children dies before the age of five, and at least four million people suffer from HIV/AIDS. Half of the country's adults are illiterate, inflation is high, growth is weak, and most of the wealth is in the hands of a small and incredibly rapacious elite.

Thousands of people have been killed in the northern states and in the Niger River Delta in recent years as a result of inter- and intra-communal violence, violence between criminal gangs and violence committed by security forces sent to quell disputes. The words used to describe Rwanda in 1994 could as easily be used to describe Nigeria today: exclusion, inequality, pauperization, racism, structural violence and oppression.

Bangladesh, another example, began its life as a kind of 'failed state,' and predictions for its 70 million people were dire. Defying logic and prediction, Bangladesh has today become largely self-sufficient in rice and wheat, even though its population has doubled. Nevertheless, half the population lives in abject poverty, and the prospects for the 240 million people who are likely to live in Bangladesh by 2020 are not hopeful.

Optimistic donors argue that with good public policies, strengthened institutions and sustained levels of growth, some of the Millennium Development Goals could actually be met in Bangladesh by 2015. But Bangladesh does not have good public policies, strong institutions or the level of growth that will be needed to meet these goals. The erosion of what few democratic processes remain is rampant; communal violence is largely ignored as a concession to increasingly militant fundamentalist parties; and Bangladesh, along with Nigeria and Haiti, now finds itself at the very bottom of Transparency International's corruption index. Like Nigeria, Bangladesh bears all the hallmarks of Uvin's Rwanda.

The aid-related question about Nigeria and Bangladesh and a dozen other fragile states is, 'Are aid agencies doing the right thing?' The answer is at least a partial 'no.' Overall aid volumes and the urgency with which problems of governance and poverty are being addressed in fragile states are wholly inadequate. And while donor countries spend billions each year on peacekeeping in Sierra Leone, the DRC and elsewhere, sustained developmental assistance for recovery is negligible.

## **2. GREED, GRIEVANCE AND THE RESOURCE CURSE**

Economic agendas are not a new factor in conflict. Historically, many wars have been fought almost exclusively for economic ends. Managing revenues from natural resources and reducing the trade in 'conflict resources' are the subjects of other policy briefs in this series. From an aid perspective, however, there are important lessons to be learned from the 'resource wars' of the past 15 years.

Some of these lessons may seem at first glance to lie beyond the normal remit of 'aid' policy, but for aid to be effective, other policies, including trade policies, must be a part of the equation. The promotion of good governance; reducing the exposure of poor countries to price shocks; increasing the transparency of natural resource revenues; and attracting reputable resource extraction companies to fragile and recovering economies are essential parts of the mix.

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### 3. CONDITIONALITY AND OWNERSHIP

It is generally conceded that ownership is key to good development. The objects of the development enterprise must also be the subjects; they must feel that they are the 'owners' of policies and projects from change. This is not at all the way it works, not least because many recipient governments cannot be trusted with the full ownership of aid funds, and because even where they can, donors are unprepared to let go.

Conditionality remains, therefore, and it remains problematic. Joseph Stiglitz says of the recent past that, "Those who valued democratic processes saw how 'conditionality'—the conditions that international lenders imposed in return for their assistance—undermined national sovereignty."<sup>2</sup> The net effect of the liberalization and privatization policies set by the Washington Consensus "has all too often been to benefit the few at the expense of the many, the well-off at the expense of the poor. In many cases, commercial interests and values have superseded concern for the environment, democracy, human rights, and social justice."

The issue in the conditionality debate is not so much whether there should be conditions. Donors are responsible for how their money is spent. But conditionality is probably one of the greatest challenges in a business that wants more than anything else to be a 'partnership,' but where large amounts of cash have vanished without a trace, and without effect. The issue is really how conditions are negotiated, and more importantly, how deep, rigid and formulaic they should be.

Years ago the IMF insisted that the Jamaican government remove subsidies on petrol. The government, knowing what the impact would be in several sectors, pleaded—to no avail—for reconsideration, more time and a phased approach. The result: taxi drivers overturned and burned cars in tourist areas, and Jamaica's number-one foreign exchange earner evaporated for three years—the exact opposite of what was intended.



*Food ration,  
Salala Camp, Liberia.  
(c) Amelia Bookstein*

## 4. HUMANITARIAN ASSISTANCE

Humanitarian assistance—the ODA response to man-made and natural disasters—aims to restore countries to a position where long-term development can occur. Humanitarian assistance as a percentage of ODA has grown dramatically in recent years, but much of it is driven by non-humanitarian concerns: geo-politics, growing apprehensions about security, domestic considerations of donor countries and sometimes even commercial concerns. Far too often no provision exists for the longer-term development assistance required to prevent a recurrence of hostilities. And donor ‘priority setting’—a euphemism for earmarking and cherry-picking—fosters competitive scrambles among executing agencies leading directly to a weakening of humanitarian principles, and an ineffective multilateral response.

The most prominent characteristic of global humanitarianism as practised today is its voluntary nature. Donor governments provide assistance—if they feel like it. There are no obligations beyond the moral, no consequences (for the givers) of doing less than enough, or of doing nothing. Of the 31 poorest countries on the 2005 UNDP Human Development Index, fewer than half appear on any donor’s priority list. Many are failed, failing or recovering states—Côte d’Ivoire, DRC, Guinea, Haiti, Liberia and Sierra Leone—and all in tremendous need of assistance. For the victims of calamity, there are no assurances of any kind, and many are condemned to live through what the world has come to call ‘forgotten emergencies.’ Voluntarism is a feature of all ODA, but its negative consequences are more dire in emergency situations.

## 5. SECURITY

Effective and accountable security systems can reduce the potential for conflict, and ‘security sector reform,’ now among the many items on today’s development agenda, is undoubtedly an important element in constructing conflict-sensitive aid. Since 9/11, however, discussions about security have led to concerns about the diversion of long-term development aid and short-term relief assistance—not so much to the security of people in developing countries, but to the new anti-terrorist agenda of wealthy countries.

One way of insulating the ODA budget from security sector incursions is the creation of special funds to deal with security sector reform and related issues. Britain created two such funds in 2001, managed jointly by the U.K.’s Department for International Development (DFID), the Foreign Office and the Ministry of Defence. These apply a development perspective to security reform, and may help to make development interventions more sustainable. The cost, however, in the British case, is charged to the ODA budget only where it conforms to ODA definitions. Similar funds have been created in the Netherlands and Canada.

## 6. MDGs AND OTHER PROMISES

Virtually all of the lessons about conflict suggest that poverty and exclusion are the most fertile breeding grounds for social violence and wider conflict. Historically, ODA has focused its main efforts on economic growth, not in itself a bad thing, but alone, insufficient.

Development assistance is growing again. But as a percentage of the overall gross national income of rich countries, ODA—at a quarter of one per cent—it remains significantly below 1990 levels, and significantly short of the 0.7 per cent target set by the global community.

Donor countries give, but they also take away. Key exports from developing countries—clothing, agricultural products and textiles—remain subject to high tariffs in rich countries. Agricultural subsidies give rich countries an unfair trading advantage and seriously undercut the productivity of farmers in developing countries. It is estimated that free trade in farm products alone would be worth \$20 billion a year to developing countries.

Encouragement can be taken from positive change in Asia, where the people living in absolute poverty (less than \$1 a day) declined from 936 million in 1990 to 703 million in 2004, a remarkable achievement resulting mainly from sustained growth in China and India. But globally, the gap between rich countries and poor countries is growing. In 1960 there were 41 rich countries,<sup>3</sup> 19 of them non-Western. By 2000 there were 31 rich countries, only nine of them non-Western. In India and China, widely quoted average growth rates conceal huge levels of inequality between urban and rural populations.

The Millennium Development Goals (MDGs), successor to a long list of ODA-related pledges, are the most comprehensive set of targets yet. Time-bound and measurable, they are—or at least were in 2000—believed to be achievable. But progress during the first five years has been disappointing. UN Secretary General Kofi Annan maintains, “Let us be clear about the costs of missing this opportunity: millions of lives that could have been saved will be lost; many freedoms that could have been secured will be denied; and we shall inhabit a more dangerous and unstable world.”

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This is not a new lesson, but the message is becoming much more urgent. Historically, many aid pledges have been made, but few have been kept. The cost in lives, freedoms and stability has been enormous.

## 7. RECOMMENDATIONS

If aid policy is to support peace and security in fragile states, then donors (and recipients) need to deal much more urgently with problems of inequality, racism, structural violence and exclusion. In particular:

- Recognize the links between aid and conflict, mainstreaming conflict prevention into development aid, ensuring coordination with peacekeeping forces, military actors and other actors;
- Pay closer attention to the 'resource curse,' harmonizing aid policies with policies on governance, policies to protect poor countries from price shocks and policies to promote responsible foreign investment;
- Build the capacities of institutions and people for conflict-prone countries to benefit from greater trade openness;
- Create stronger and more formal links between humanitarian relief and development assistance. Investments in the transition from relief to development are very much an *ad hoc* affair. The longer-term factors that contributed to the crisis in the first place are often ignored completely. There must be better synergies between the humanitarian and development departments within donor agencies;
- Create a stronger multilateral core, along the lines of the newly-founded UN Peacebuilding Commission, with the capacity, resources, accountability and mandate to meet humanitarian needs in an impartial and effective manner in post-conflict situations;
- Develop funding and programming mechanisms to secure stable and predictable funding for the most needy countries and ensure these 'forgotten emergencies' do not become a permanent blot on the ODA landscape. Donors must focus their efforts on ending poverty, and they must honour their pledges they make in the process;
- Break the link between the strategic interests of donor countries and their aid programs. Principles of neutrality, independence, accountability and proportionality in humanitarian assistance have been diminished by political considerations. An important step would be to devolve aid ministries from the control of the ministries of trade or foreign affairs;
- Recognize that security is important for everyone. Northern security concerns should not diminish efforts to promote security and poverty reduction in the South;
- For their part, recipient countries have a responsibility to put in place checks and balances to ensure that aid is well spent. In particular, recipient countries could publicize the quantity and origin of the aid they receive and create mechanisms for the independent monitoring of aid projects.

## ENDNOTES

<sup>1</sup> Uvin, Peter, *Aiding Violence: The Development Enterprise in Rwanda*, Kumarian Press, 1998

<sup>2</sup> Stiglitz, Joseph E., *Globalization and its Discontents*, Norton, New York, 2002, pg. 47

<sup>3</sup> "Rich" defined as incomes higher than the Portuguese average. Statistics from Milanovic, Branko, *Worlds Apart: Measuring International and Global Inequality*, Princeton University Press, Princeton, 2005

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Since 2000, the initiative has focused on the way in which trade in natural resources can contribute to violent conflict at the sub-state and international level, and on the role of foreign aid and trade liberalization—in tandem or in isolation—in accelerating or alleviating this downward spiral.

On the basis of this understanding, current research focuses on the options available to domestic and international policy-makers. This series of policy briefs recommends six key objectives that the international community should strive to achieve if trade and aid policies are to contribute to peace and security rather than increasing the likelihood and longevity of violent conflict.

Those objectives are; developing conflict-sensitive trade and aid policies; restricting the trade in conflict resources; spreading 'good governance'; promoting conflict-sensitive business practice; and improving the management of revenues from natural resources and aid.

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# AIDING, TRADING OR ABETTING?

THE FUTURE OF TRADE, AID AND SECURITY

# 3

PROMOTING 'GOOD' GOVERNANCE  
AID AND TRADE POLICIES TO  
SPREAD 'GOOD' GOVERNANCE?



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Institut international du développement durable

**“DEVELOPMENT  
CANNOT BE  
IMPOSED.  
IT CAN ONLY  
BE FACILITATED.  
IT REQUIRES  
OWNERSHIP,  
PARTICIPATION  
AND  
EMPOWERMENT,  
NOT HARANGUES  
AND DICTATES”**

*President Benjamin Mkapa of  
Tanzania, November 2004*

## 1. ‘GOOD GOVERNANCE’ AND SECURITY

Autocratic and unaccountable regimes, corruption, wasted public money, environmental degradation, poor provision of basic services, weak legislation and lax enforcement of regulations have contributed to a downward spiral leading to violence in fragile developing states across the world: recent examples include the Democratic Republic of the Congo, Zimbabwe, the Solomon Islands, Nigeria, Angola and Bolivia.

These elements of political and economic (mis)management have been grouped under the catch-all title of ‘good governance.’ ‘Governance’ and more especially ideas about ‘good governance’ have come late to the development agenda, constrained by the Cold War until its unexpected demise in 1989. The concept is problematic, contested and difficult to measure but it is essentially about building effective institutions and rules imbued with predictability, accountability, transparency and the rule of law.

Good governance has become both an objective and a condition for aid and trade policies. This brief asks whether and how the trade and aid policies of the developed world can be used to enhance good governance in developing countries.

## 2. WHAT IS GOOD GOVERNANCE?

The question of whether trade and aid policies can bring about good governance is complicated by the fact that no one agrees on what constitutes the ‘good’ in ‘good governance.’ For some, like the IMF and the World Bank, good governance is about fiscal performance such as levels of government spending and debt. The U.K. Department for International Development (DFID) promotes a broader understanding that incorporates a focus on poverty reduction, the respect for human rights and basic financial management.<sup>2</sup>

In practice, it is notoriously difficult to assess good governance; it’s both qualitative and subjective. There have been various attempts to capture good governance in numerical indicators though none are particularly compelling. In reality there are few countries that can be definitively pigeon-holed as either good or bad performers. Most countries lie somewhere in between.

In the context of this paper we understand good governance as the package of domestic institutions and measures that help to ensure that natural resource and aid revenues are used effectively and equitably. It implies accountability, transparency, sound environmental management, respect for the rule of law, low levels of corruption and so on.

### 3. TRADE, AID AND 'GOOD GOVERNANCE'

Trade and aid are two of the main ways in which countries interact. Trade and aid policies may present tremendous potential to increase transparency and accountability, promote the rule of law and build domestic governing capacity.

However, trade and aid policies can reduce stability and cause resentment if they are misdirected or perceived as heavy-handed. In the past, aggressively promoted 'Western' concepts of good governance, market liberalization, and democratic reform have proved highly controversial and often dangerously destabilizing. Despite getting pulled in many different directions by the policies of the developed countries, responsibility for the quality of governance is often laid firmly at the feet of the developing country governments.

Meanwhile, revenues from aid and natural resources have proved inherently problematic for governance. By reducing a government's reliance on revenues from collected taxes, aid and natural resource revenues tend to weaken the relationship between government and the governed.<sup>3</sup>

History and experience raise three important questions: Should rich countries consider good governance when designing trade and aid policies? If so, what constitutes good governance? And finally, what is the best mix of measures to encourage governance reform in countries reluctant to embark on reforms themselves?

Almost inevitably, this paper deals with the 'tools' or 'levers' available to wealthier, developed countries to encourage the reform they think is appropriate for lesser developed nations. This is not to endorse a paternalistic, top-down approach but rather a recognition that developed country trade and aid policy decisions are highly influential (for good or bad) for governance and security in developing countries.

#### 3.1. Trade and aid policies can have an enormous influence on governance

In Cambodia during the 1990s, carefully applied international pressure helped to move the country past various crisis points toward UN-governed elections in 1998 and encouraged greater control over illegal logging.<sup>4</sup> It is widely believed that trade and financial sanctions (alongside the threat of military action) played an important role in forcing Serbian President Slobodan Milosevic to accept the 1995 Dayton Peace Accords which ended the war in the former Yugoslavia.<sup>5</sup>

In Rwanda in the early 1990s, the international community failed to halt a slide towards the very worst form of governance, state-sponsored genocide, by not applying pressure to a government that was deliberately ramping up ethnic tensions. According to Peter Uvin, "[P]olitical conditionality was never really implemented in Rwanda... we should not forget that aid to Rwanda greatly increased during that period... the aid system did not care unduly about political and social trends in the country, not even if they involved government-sponsored racist attacks against Tutsis."<sup>6</sup>

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## 4. THE PROBLEM OF USING TRADE AND AID POLICIES TO PROMOTE GOOD GOVERNANCE

Policy-makers recognize that aid to or trade with corrupt, unaccountable regimes is less effective than with transparent, accountable governments. Donor governments have a responsibility to use their taxpayers' money wisely. Also it is not unthinkable that some donor governments may have the experience, capacity and resources to help develop well-founded reform of institutions, skills and policies in recipient countries.

Consequently, it is unsurprising that policy-makers often attempt to use the levers of influence at their disposal to encourage what they perceive to be best practice. However, trying to promote good governance is a minefield of problems and dilemmas:

1. **It can be counterproductive**—Over the past three decades, policy-makers in the North have repeatedly arrived at 'the answer' to improve governance, pressuring developing countries into making dramatic and expensive domestic policy changes in line with the latest thinking. This disrupts domestic policies, diverts the attention of recipient governments and can weaken a government's effectiveness.
2. **It can undermine national sovereignty and policy autonomy**—Often condescending and didactic; such foreign attempts at national reform have a hint of missionary zeal about them. Understandably, poor countries have become a little cynical of the earnest prescriptions of Western consultants.
3. **It can be fundamentally undemocratic and unaccountable**—It is ironic that donors try to force norms of good governance on recipient countries which often include respect for the democratic process in a way that can be profoundly undemocratic. Those most affected by the policy prescriptions of international policy-makers, poor people in developing countries, have little recourse against them.
4. **If the reforms are so worthwhile, why 'buy' them?**—If a particular reform is beneficial for a country, then why do policy-makers have to bribe or coerce a country into changing its domestic policies?
5. **Strategic interests crowd out long-term development**—Assessments of good governance have often been tangled up in the short-term geo-political concerns of a donor country. Particularly since 9/11 it seems that a *good ally* is more important than *good governance*.



*Friendship at the transit centre in Kalehe, Democratic Republic of the Congo.*  
(c) Amelia Bookstein

## 5. WHAT ARE THE LEVERS FOR PROMOTING GOOD GOVERNANCE?

Broadly, the mechanisms used by OECD countries are either ‘carrots’—inducements for positive behaviour such as preferential trade access or aid packages, or ‘sticks’—reactive punishments for poor performance such as trade sanctions or the suspension of aid. In addition, capacity-building and technical assistance attempt to transfer supposedly more advanced skills, policies and institutions from the developed to the developing worlds. Finally, OECD countries promote regional integration, often spearheaded by regional trade agreements, as a mechanism to improve governance, develop interdependence between countries, build structural barriers to conflict and create non-military ways to resolve disputes.

### 5.1. Carrots and conditionality

For many years donors have used aid as an incentive to ‘buy reform’ in recipient countries. However, such conditionality has a very mixed record. Developing countries have agreed to conditions even where they have not been convinced of the case for change. Unsurprisingly, such conditions are often ignored. For their part, donors have continued financial assistance when conditions are not met—or conversely, stopped aid for domestic reasons unrelated to whether or not specific conditions were met.

Analysts tend to agree that conditionality can speed up an existing reform process but is typically ineffective at creating reforms out of thin air. While there are positive stories to be told, conditionality tends to make recipient countries accountable to donors rather than their own citizens—which itself undermines governance.

### 5.2. Sticks and sanctions

Aid sanctions or the threat of sanctions are common responses to perceptions of poor governance performance. They are also used for domestic reasons; to show that politicians are ‘doing something.’ Trade sanctions can be more influential than the withdrawal of aid but tend to be politically harder to construct and sustain.

Sanctions tend to be blunt, reactive instruments that affect the poorest members of society most. Moreover, sanctions have a relatively weak record. Decades of U.S. sanctions on Cuba and Iran have helped entrench the very regimes the sanctions

were supposed to displace. The ‘Oil for Food’ sanctions regime in Iraq was widely criticized and has since left the international community with little appetite for future sanctions.

More effective may be the imposition of well-targeted sanctions, such as asset freezes or travel bans, as a way to influence a positive change on the ground without negatively affecting the wider population.

### 5.3. Capacity-building and technical assistance

There is an assumption that the major obstacles in achieving good governance are a lack of skills, experience, structures and institutions in the developing world. While this may be the case, there is the implicit conclusion that all that is required is a parroting of Western institutions. Too often, building accountable, robust states is seen as a technocratic exercise rather than the complex political bargaining process it is.

To this end, aid packages often include a large element of technical assistance, where highly paid Western consultants parachute in to advise on economic management, provision of services and so on. The assumption is that if the necessary institutions are in place, good governance will follow. A 2003 study of technical assistance identified three key problems: (i) programs tend to be driven by donors rather than provided in response to recipients’ priorities; (ii) ownership by recipients has been weak; and (iii) the costs are high while quality is variable.<sup>7</sup>

#### 5.4. Trade integration and good governance

Trade integration is increasingly seen as an effective vehicle for governance reform. Increasingly, a range of non-trade concerns, particularly good governance criteria, are being bundled into trade agreements. Two forms of trade integration are of relevance: first, bilateral trade agreements between developed and developing countries such as the EU's Economic Partnership Agreements (EPAs) with the African, Caribbean and Pacific countries; and second, the promotion by rich countries of regional trade integration across the developing world.

**North-South trade integration.** This is, in effect, a form of conditionality where access to valuable markets in the North is offered in partial return for governance reforms. EPAs exhibit the extent to which aid and trade policies are now seen as interconnected with an explicit objective to improve the quality of governance in partner countries.

**South-South trade integration.** Many developed countries have become enthusiastic proponents of regional integration as a 'hands-off' way to improve governance and promote interdependence between countries. Regional groupings such as MERCOSUR in Latin America can serve as aspirational clubs and provide non-military ways to settle disputes. However, poorly planned regional trade integration can also be divisive and can embed regional tensions.

## 6. CONCLUSIONS

Good governance is elusive. The core challenge for developed countries is to generate constructive influence in countries that are at risk of instability or conflict. Unfortunately, in the past, many of the mechanisms used by the international community have proven neither constructive nor influential.

Too often, policy-makers in developed countries attempt to use trade and aid policies to pursue subjective, changing concepts of good governance without a realistic appreciation of the local context. There are many examples where conditionality, sanctions, capacity-building or trade integration have been ineffective at generating significant changes in governance. Countries in the developing world have become understandably cynical of the prescriptions of developed world policy-makers.

Nevertheless, there have been some important successes. In most poor countries large assistance programs or important trading relationships do at least enable serious dialogue about governance and in some cases this has encouraged reform.<sup>8</sup> Even so, it is difficult to force countries to implement policies they find unconvincing. More often, the best that can be expected is to encourage existing and incipient reform; to 'push a train that's already moving.'<sup>9</sup>

**TRADE INTEGRATION IS INCREASINGLY SEEN AS AN EFFECTIVE VEHICLE FOR GOVERNANCE REFORM. INCREASINGLY, A RANGE OF NON-TRADE CONCERNS, PARTICULARLY GOOD GOVERNANCE CRITERIA, ARE BEING BUNDLED INTO TRADE AGREEMENTS.**

## 7. RECOMMENDATIONS

- **Physician, heal thyself!**—Developed world policy-makers first need to consider the impacts of their existing trade and aid policies on governance by: creating conflict-sensitive trade and aid policies; reducing the economic incentives for war; building markets for conflict-free goods; helping countries diversify their economies; and supporting moves for greater transparency. These are things over which policy-makers in the developed world already have control. Only then will policy-makers in the developed world have any credibility to offer their policy prescriptions overseas;
- **Don't travel blind**—Carefully assess the likely political, economic and social impacts of any intervention before implementation. Assess what the impact of that intervention would be on local incentives and political relationships. This should not be a preparation to 'sell' a pre-determined governance agenda more convincingly but to understand what that governance agenda should be;
- **Learn from past success and failures**—Policy-makers must decide what kind of governance is 'good enough' and they must make a clear link between 'good enough' governance and poverty reduction;
- **Realize that aid and trade policies may not be the most effective lever of influence**—Experience shows that aid and trade policies are rarely effective at manufacturing reforms against the wishes of recipient countries. Often, poorly planned attempts to leverage influence through trade and aid policies backfire. Sometimes doing nothing may be the most effective policy;
- **Build on existing reforms and align external interventions with domestic priorities**—Before imposing pre-fabricated policy solutions, policy-makers need to look at what already works and why. If external interventions can build on existing reforms and incorporate local policies rather than relocating rich country institutions, they are more likely to generate the elusive ownership that is so often the rhetorical objective;
- **Be patient, consistent and realistic**—There are few 'quick wins' when supporting genuine governance reform. Governance reform is a long haul. Institutions can't be transferred; they need to be developed, while building trust and accountability is a political process that takes time;
- **Harmonize, coordinate and target aid**—Focus aid on 'islands of change' within the state structures. Aid to civil society can be an effective means to improve governance;
- **Design trade agreements so that they provide incentives**—Make sure that trade agreements provide appropriate incentives to promote good governance. Regional trade agreements may also (indirectly) encourage good governance and interdependence between countries.

## ENDNOTES

- <sup>1</sup> Benn, H. in *Partnerships for poverty reduction: rethinking conditionality*, DFID Policy paper, March 2005, p. iii
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- <sup>3</sup> Unsworth, S. *Focusing Aid on Good Governance: Can foreign aid instruments be used to enhance Good Governance in recipient countries?*, Working Paper, Global Economic Governance Programme, Oxford, 2005, p. 11
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- <sup>5</sup> Boyce, J. 2002, p. 20
- <sup>6</sup> Uvin, P. *Aiding violence: the Development Enterprise in Rwanda*, Kumarian Press, West Hartford, 1998, p. 237
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# AIDING, TRADING OR ABETTING?

THE FUTURE OF TRADE, AID AND SECURITY

# 4

**RESTRICTING TRADE  
IN CONFLICT RESOURCES  
CREATING MARKETS  
FOR CONFLICT-FREE GOODS**



**IUCN**  
The World Conservation Union



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## 1. NATURAL RESOURCES AND CONFLICT

Natural resource exploitation has played an increasingly prominent role in bankrolling conflict around the world since the end of the Cold War. Previously, many combatants in local insurgencies or low-level nationalistic conflicts were financed by competing superpower blocs. Since such ideological sponsorship is now much harder to come by, and as war remains an expensive business, belligerents have turned to easily accessible wealth from natural resource exploitation.

Precious minerals such as diamonds, emeralds and lapis lazuli have been used to fund conflicts from Angola to Afghanistan, from Burma to Sierra Leone, while tin ore is still being used to fund warring parties in the Democratic Republic of the Congo (DRC). After Chinese support dried up in the late 1980s, the Khmer Rouge in Cambodia turned to logging and gem-mining to fight the Vietnamese-supported government. Timber sales paid for the human rights abuses committed by Charles Taylor's regime in Liberia, while Nepal's insurgent Maoists claim that up to 75 per cent of their income comes from the sale of a rare fungus, highly prized in Asia as an aphrodisiac.

The presence of some commodities, particularly oil, may make the initiation of conflict more likely; the presence of others, for example gemstones and narcotics, may lengthen the duration of conflicts. Revenues and riches may alter the mindset of combatants, turning war and insurgency from a purely political activity to an economic one; conflicts become less about grievance and more about greed.

In all cases, however, the link between natural resources and conflict depends critically on the ability of their exploiters to access external markets. Take away the ability to earn returns from resource extraction and their value to the promoters of conflict falls away, sometimes dramatically. For example, when the Thai and Cambodian governments closed their joint border to log exports in 1995–96, the Khmer Rouge insurgency, which depended largely on logging revenues, began to disintegrate, leading ultimately to the end of the civil war.

## 2. CONFLICT RESOURCES AND ILLEGAL GOODS

The term 'conflict resources' is easy to grasp, but harder to define. An intuitive definition would be 'natural resources whose extraction or trade funds a war.' However, not all conflict is internationally illegitimate—a state has a sovereign right to defend itself against aggression, provided that it obeys the laws of war embodied by instruments like the Geneva Convention. Similarly, there are certain rebellions, for example against a despotic or genocidal government, which could be considered legitimate.

A conflict resource—one that deserves sanctions by the international community—is therefore one that is bankrolling a war that is illegitimate, or where the laws of war are broken. The legitimacy of a conflict is, of course, a controversial subject. However, the crucial point of international concern is not the existence of conflict in the abstract, but the collateral damage to the ordinary population by freebooters who flout the rules of war and who have made violence and pillage a form of economic activity. Thus, we can define 'conflict resources' as:

**Natural resources whose systematic exploitation and trade in a context of violent conflict contribute to, benefit from, or result in the commission of serious violations of human rights, international humanitarian law or violations amounting to crimes under international law.** (Global Witness, 2005)

## Illegal goods

Trade in illegal products shares many of the same characteristics as trade in conflict resources; and sometimes they are the same thing. Over the last three decades national and international frameworks for the protection of the natural environment have evolved rapidly. International environmental crime, or the deliberate evasion of environmental regulations by individuals and companies in the pursuit of financial gain where the impacts are transboundary or global, is a serious and growing problem.<sup>1</sup> The major natural resources traded illegally are wildlife, timber and fish. It is impossible to know their total value, but educated guesses put it at a minimum of US\$30 billion a year, about 7.5 per cent of the size of the global drugs trade, and perhaps up to 25 per cent of the total legal trade in these products.

## Different resources, different policies

Different resource endowments affect conflict (and illegal behaviour) in different ways. If the resources are spread throughout the country, or centred on the capital or offshore, conflict may focus over control of the state. If they are concentrated in one province, then their existence may well lead to a secessionist conflict, as was the case in Bougainville Island in Papua New Guinea. The amount of investment necessary to extract the resource and its portability are other key variables.

These parameters can lead to some conclusions on the best way to address specific resource problems. For example, conflict diamonds are easily smuggled and transported to world markets, but elasticity of demand is probably high, so interventions may best be made in consumer markets. Oil revenues are huge but critically dependent on international financing and capital to access the reserves, so it may be more efficient to target the initial investment stage, i.e., extractive companies and financial institutions. For timber, although access to the resource is easy, logs are hard to transport, so interventions like sanctions may be effective.

## 3. TOOLS: SANCTIONS

One obvious way to exclude natural resources associated with conflict from international markets is to place a trade embargo on the country or countries concerned. The UN Security Council has the right to impose trade sanctions under Article 41, Chapter VII of the UN Charter, which allows the Council to impose economic restrictions to maintain or restore international security.

Before the 1990s, UN sanctions were applied sparingly, a victim of Cold War politics, with the veto being liberally applied to proposed sanctions against client regimes of the superpowers. When sanctions were employed at all, they were used to punish a state economically, as were the sanctions on Southern Rhodesia in 1966, rather than to cut off funding by applying sanctions to a particular resource. The concept of placing sanctions on specific resources has only really taken hold in the past 15 years—and has been implemented with only limited success.

**THE LINK BETWEEN  
NATURAL RESOURCES  
AND CONFLICT  
DEPENDS CRITICALLY  
ON THE ABILITY OF  
THEIR EXPLOITERS TO  
ACCESS EXTERNAL  
MARKETS.**

A UN report on sanctions-busting in Angola, set up in May 1999, reported that Togo, Burkina Faso and Belgium, among other countries, were breaking the sanctions on diamonds exported by the rebel UNITA group. It was estimated that US\$350–420 million worth of Angolan diamonds were smuggled into neighbouring countries in 2000—approximately half Angola’s diamond production.<sup>2</sup> Timber sanctions on Liberia were more effective, as logs are harder to smuggle than diamonds.

Of course, for UN sanctions even to be considered for a conflict, that conflict has to be addressed by the Security Council. Only the most high-profile issues tend to make it there while other conflict resource issues, such as those in Nepal, continue unaddressed and unabated. Where the UN has sought to impose sanctions on belligerents, their implementation has been left to member states. Attempts to enforce the sanctions have only been made sporadically, with no effective means of ensuring compliance. The sanctions committees within the Security Council are only meant to review submissions by member states on how sanctions are being implemented, and despite routine laundering of conflict commodities, there has been widespread reluctance to impose secondary sanctions upon states that violate the original sanctions.<sup>3</sup>

A proxy strategy has developed though, of using *ad hoc* ‘Panels of Experts’—panels of technical experts convened to report publicly on areas specified in their mandate (normally, sanctions violations)—to ‘name and shame’ violating countries. Panels of Experts have been formed for Angola, DRC, Sierra Leone and Liberia, among others, and have provided the Security Council with in-depth information about the situation on the ground. Although their reports have done much to bring the debate about conflict resources to the Security Council, each panel is created as needed and then disbanded, meaning that there is no continuity of institutional knowledge within the UN. Panels are costly and time-consuming to establish, have relatively restricted mandates and unspecified processes. Additionally, there is currently no coordination between the different panels, and thus no means of pooling the information gathered.

UN smart sanctions on natural resources, while not wholly ineffective, are failing to achieve the impact that they could. This is because the machinery involved in applying and monitoring sanctions is *ad hoc*, inconsistent and incoherent, as well as being subject to the whims of the permanent members of the Security Council.

Of course, trading partners do not need to wait for the UN; unilateral trade sanctions (and, to a lesser extent, sanctions imposed by regional organizations) can also be applied. These are often quicker than the UN route and, since they are voluntarily imposed by a trading partner through a sovereign political decision, tend to be better implemented. The wider international community can also encourage bilateral trading partners to take action. The U.S. Congress’ 1995 Foreign Operations Act, for example, threatened to cut off aid to Thailand if it continued to assist the Khmer Rouge and led to the closure of the Thai-Cambodian border to the trade in illegal timber.



Wildlife products in a Chinese market.  
IUCN Photo Library (c) Jim Thorsell

## 4. TOOLS: LICENSING SYSTEMS

Blanket restrictions on trade, such as the UN sanctions on conflict resources examined above, are clearly inappropriate where conflict resources may be smuggled into neighbouring countries, or where the domestic government is struggling to cope with illegal behaviour, and where economic and social development may well depend on the legitimate exploitation of the resources in question. A more targeted solution is to develop systems to identify and license resources produced legally or free of conflict. This allows importing countries to bar entry to unlicensed products, which are presumably conflict-related or illegal. Examples of such systems include the Kimberley Process on conflict diamonds and the EU's Forest Law, Enforcement and Governance (FLEGT) Initiative on illegal logging.

### THE KIMBERLEY PROCESS

The Kimberley Process on conflict diamonds<sup>4</sup> came into operation on January 1, 2003, and now involves 45 countries.<sup>5</sup> The Process was initiated by several southern African countries who decided, in early 2000, to take action to stop the flow of conflict diamonds to the market without jeopardizing the legitimate diamond industry.

The system revolves around the certification of exports of rough diamonds. Participants undertake to establish internal systems to implement and enforce the certification scheme, including establishing suitable penalties for transgressions. The diamond industry has also introduced a system of self-regulation to support the Process, involving warranties for all diamonds, not just rough diamonds. An overall review of the operation of the Process is soon to take place, but early indications are that it has had some success in excluding conflict diamonds from world markets.<sup>6</sup>

Import and export licensing systems such as these are not uncommon in international trade. However, many existing licensing systems suffer from a number of problems: a reliance on paper certificates, which tends to lead to fraud, theft and corruption in issuing them; a lack of independent verification and poor cross-checking of documentation; and the non-participation of key countries. Fortunately the international community has accumulated substantial experience in tackling these problems and developing innovative responses.

Sanctions are most effective when products originating from a limited and clearly defined area—e.g., one experiencing conflict—are to be excluded from external markets. The more limited the area, the easier it should be to apply sanctions. A licensing system is more desirable when a particular category of products originating from many countries—e.g., illegally produced products—are to be excluded. In this case, sanctions are impracticable because they are too blunt a weapon: they would block the export of legitimate as well as illegitimate products and, in any case, cannot realistically be applied against a large number of countries. The two tools are not, however, mutually exclusive, and licensing systems can also be effective as a backup to sanctions.

## 5. TOOLS: PROCUREMENT

The counterpart of excluding illegal products from consumer markets is building markets for verified legal products. This can be achieved through public procurement policy, which covers government purchases, and private sector supply chain management. The public sector accounts for about 20 per cent of purchases in most developed countries, and can therefore exert substantial influence on the market. The EU FLEGT initiative, for example, encourages all EU member states to use public procurement policies to promote markets for legal timber and timber products. Five EU states currently have or are moving towards systems which will require proof of legal origin for central government purchases of such products.

In addition to public sector activities, the private sector can ensure its own supply chains are free of illegal, unsustainable and/or conflict-related products. In the timber sector, many companies and trade associations have already taken action to source legal timber, partly as a response to government regulation and consumer pressure but also out of a growing understanding of the role of illegal logging in undercutting markets for legal (and sustainable) products.

## 6. WTO IMPLICATIONS

Trade controls of the type considered above—sanctions, licensing systems and public procurement policies—may present potential conflicts with World Trade Organization (WTO) rules. Whether a conflict would really arise is entirely speculative—but this has not stopped opponents of trade controls (for whatever reason) raising the spectre of a clash as a reinforcement to their position.

Considering previous WTO jurisprudence, it is possible to reach some tentative conclusions about the design of policy instruments that may affect trade. The less trade-disruptive the measure involved, the lower the chance of a successful challenge under the WTO. Similarly, the more precisely targeted and multilaterally implemented the measure, the less the chance of a successful challenge. An embargo applied against a country's entire exports of a particular natural resource because some of them were believed to be illegal would be more vulnerable to WTO challenge than an embargo applied only against products which could be proved to be illegal, or not shown to be legal.

**THE CONCEPT OF PLACING SANCTIONS ON SPECIFIC RESOURCES HAS ONLY REALLY TAKEN HOLD IN THE PAST 15 YEARS-AND HAS BEEN IMPLEMENTED WITH ONLY LIMITED SUCCESS.**

## 7. RECOMMENDATIONS

Policy-makers need to exclude conflict resources from international trade but also generate demand and build markets for goods produced in a 'conflict-free' way. In particular:

- Develop and strengthen licensing systems that build on current initiatives like those for diamonds and timber. These need clear reporting guidelines, mechanisms for independent monitoring and compliance and ensured compatibility with WTO rules. Additionally, these systems should be broadened to include resource-intensive countries such as China, Brazil, Russia, India, Malaysia and South Korea;
- Seek collaboration between WTO rules, UNEP and key multilateral environmental agreements (e.g., CITES and CBD) targeting trade in natural resources that leads to or aggravates conflict;
- Establish a permanent professional capacity in the Security Council with demonstrable independence and transparent procedures to advise on sanctions related to conflict resources, identify emerging conflict resources, coordinate sanctions with peacekeeping missions and monitor the implementation of sanctions;
- The Security Council, for its part, needs to provide a clear and unambiguous definition of when sanctions should be imposed (i.e., when *"systematic exploitation and trade in natural resources in a context of violent conflict contributes to, benefits from or results in the commission of serious violations of human rights, international humanitarian law or violations amounting to crimes under international law"*). It also needs to show greater resolve in imposing secondary sanctions against countries involved in sanctions busting;
- Improving natural resource governance should be a central task of UN Peacekeeping missions and also part of the UN Peacebuilding Commission's mandate where natural resources have contributed to conflict;
- Ensure that public procurement policies exclude illegal and conflict resources and install time-limited bans ('sin-bins') on access to government procurement for companies that trade in illegal conflict resources.

## ENDNOTES

- <sup>1</sup> For more detail on this topic, see Duncan Brack and Gavin Hayman, *International Environmental Crime: The Nature and Control of Environmental Black Markets* (Chatham House, 2002), available at <http://www.chathamhouse.org.uk/pdf/research/sdp/Environmental%20Crime%20Background%20Paper.pdf>
- <sup>2</sup> Michael Fleshman, "Conflict diamonds" evade UN sanctions, *Africa Recovery* Vol.15 No. 4, December 2001, p.15
- <sup>3</sup> Le Billon, 'Getting it Done: Instruments of Enforcement.'
- <sup>4</sup> The Process defines 'conflict diamonds' as 'rough diamonds used by rebel movements or their allies to finance conflict aimed at undermining legitimate governments, as described in relevant United Nations Security Council (UNSC) resolutions insofar as they remain in effect, or in other similar UNSC resolutions which may be adopted in the future, and as understood and recognised in United Nations General Assembly (UNGA) Resolution 55/56, or in other similar UNGA resolutions which may be adopted in future' – Kimberley Process Certification Scheme Section 1.
- <sup>5</sup> See <http://www.kimberleyprocess.com>
- <sup>6</sup> See discussion of the Kimberley Process in the report of the RIIA workshop on 'Excluding Illegal Timber: Border controls and procurement – making the system work,' October 2003.

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Since 2000, the initiative has focused on the way in which trade in natural resources can contribute to violent conflict at the sub-state and international level, and on the role of foreign aid and trade liberalization—in tandem or in isolation—in accelerating or alleviating this downward spiral.

On the basis of this understanding, current research focuses on the options available to domestic and international policy-makers. This series of policy briefs recommends six key objectives that the international community should strive to achieve if trade and aid policies are to contribute to peace and security rather than increasing the likelihood and longevity of violent conflict.

Those objectives are; developing conflict-sensitive trade and aid policies; restricting the trade in conflict resources; spreading 'good governance'; promoting conflict-sensitive business practice; and improving the management of revenues from natural resources and aid.

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# AIDING, TRADING OR ABETTING?

THE FUTURE OF TRADE, AID AND SECURITY

# 5

**PROMOTING CONFLICT-  
SENSITIVE BUSINESS**  
FOSTERING RESPONSIBLE BUSINESS  
IN FRAGILE STATES



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## 1. INTRODUCTION

The liberalization of global trade and investment has led to an unprecedented upsurge in foreign direct investment (FDI) worldwide. Nearly all international trade is conducted by companies and facilitated by financial institutions; the market actors. Their investment choices and conduct can have a crucial impact on security in the developing world.

At its best, increased business investment in fragile states has been positively correlated with reduced conflict risk: raising economic growth and living standards. However, investment has not everywhere delivered on its much-vaunted promises of improved growth, opportunity and prosperity. Indeed, in some cases, it has caused quite the opposite.

There are five major ways in which companies and financial institutions exploiting and trading natural resources have been associated with violent conflict:

1. Companies have helped violent factions raise money through the sale of conflict resources such as diamonds and timber;
2. Companies have contributed to the likelihood of conflict, however unintentionally, where the income from natural resources has reinforced the power of predatory states, or has disproportionately benefited narrow social or political groups;
3. Poor corporate conduct in countries with weak regulation and limited enforcement has generated grievances over environmental damage and limited investment in host communities;
4. Financial institutions have facilitated the flows of illegal revenues from corrupt officials and conflict economies; and
5. International companies have been the focal points of local grievances over perceived foreign domination, particularly if that company is perceived as interfering in the domestic affairs of a country.

One of the most striking examples of business complicity in violent conflict is the activities of the French national oil company Elf Aquitaine, which financed both sides in the 1997 civil war in Republic of Congo (Congo-Brazzaville). Elf Aquitaine used its assets and influence to provide Sassou Nguesso, the final victor, with military assistance from Angola in return for the future rights to Congo's substantial oil reserves. At the same time, Elf executives also organized an oil-backed loan (mortgaging future oil production at high interest rates for upfront money) for Sassou's opponent President Pascal Lissouba, with which he could purchase arms.<sup>1</sup> Elf's so-called 'Africa System' was thus partially responsible for a civil war where systematic rape was prevalent, thousands died and hundreds of thousands more were displaced.<sup>2</sup>

There can be little doubt that market actors investing in fragile states routinely engage in self-regarding, even predatory economic activities. But to focus only on the behaviour of market actors is to mistake the symptom for the disease. Market actors do not exist in a vacuum but in a web of incentives and risks that define the market context. Changing the behaviour of market actors means changing their perception of value, and, ultimately, this means changing the opportunity structure in which they operate. Here, poor governance at the national level is compounded by a deficit of global governance. In the stark words of one analyst, "governance has not kept pace with globalization."<sup>3</sup>

## 2. THE SPECTRUM OF POLICY RESPONSES: SELECTIVE AND INEFFECTIVE

The current regulatory landscape is a diverse and uneven patchwork of issue-driven initiatives. For example, UN commodity sanctions, the Kimberley Process and EU efforts to regulate the trade in illegal timber were undertaken in response to specific instances of violent conflict, particularly in Sierra Leone and Liberia, in which the unregulated trade in lucrative commodities was identified as a barrier to conflict resolution. By contrast, the current focus on transparency of natural resource revenues, although informed by specific conflicts, has also been shaped by parallel international efforts to tackle the debt crisis, reduce aid dependency and promote 'good' governance.

Often, discussions of regulatory responses to conflict-promoting business activities are cast in terms of a 'voluntary versus mandatory' dichotomy. While the distinction is analytically useful, the dichotomy is not. It obscures a number of promising hybrid initiatives which combine market inducements with legal sanction, such as the Kimberley Process, which though voluntary, has binding effects throughout the diamond trade. More important, however, where the objective is to change the incentives that enable conflict-promoting business activity, then what matters is not whether the approach is voluntary or mandatory, but whether it can effect positive change.

Although voluntary codes do suffer from self-selection and weak enforcement, they have provided important guidance and even a market niche for progressive companies seeking to improve business practice in challenging environments. By the same token, while mandatory regulation is essential to the creation of a level playing field, and to addressing the worst conduct, it cannot remedy the many conflict-promoting, yet still legal, market activities. Because different market actors have varying sensitivities to risk and opportunity, so too their receptivity to different forms of regulation is highly variable. For this reason, efforts to promote conflict-sensitive business need to take advantage of the full spectrum of regulatory options.

**IN FRAGILE STATES,  
TRANSACTIONS BETWEEN  
EXTRACTIVE COMPANIES  
AND UNACCOUNTABLE  
HOST GOVERNMENTS ARE  
WIDELY ACCOMPANIED BY  
BRIBERY OF PUBLIC  
OFFICIALS, MONEY-  
LAUNDERING, TAX EVASION  
AND OUTRIGHT THEFT.**

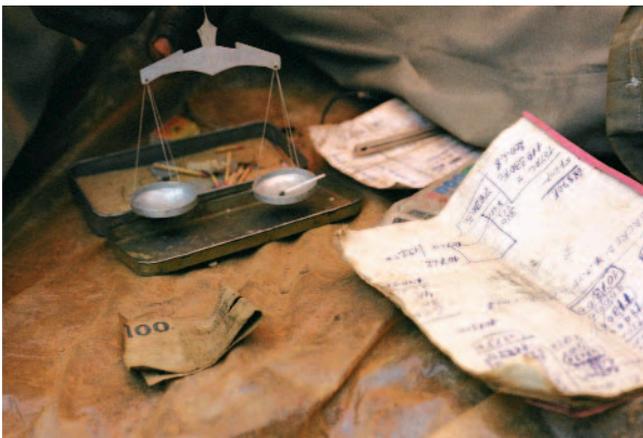
### 3. TOOLS: VOLUNTARY CODES AND INDUSTRY SELF-REGULATION

That one can even speak of progressive companies today signifies an important change. Pressed by advocacy groups, shareholder protests and UN efforts, an increasing number of extractive companies, particularly large multinationals, are embracing the notion of good corporate citizenship.<sup>4</sup> Positive community relations and environmental protection embodied in various codes of conduct have already become standard elements of today's corporate social responsibility agenda. While these codes remain mostly aspirational benchmarks, a few companies have committed resources and personnel to match them with meaningful implementation.

Other forms of voluntary company self-regulation are multi-stakeholder initiatives, such as the *Voluntary Principles on Security and Human Rights*, the *UN Global Compact's Dialogue on Private Sector Actors in Conflict Zones*, and the *Extractive Industry Transparency Initiative*. These initiatives have the advantage of providing sustained engagement of key stakeholders with companies that have helped to build confidence, legitimacy and consensus, and to target attention to practical and policy challenges.

A final type is the *OECD Guidelines for Multinational Enterprises*. While designed as a mechanism to promote transparent and responsible investment by OECD-member companies, the Guidelines now extend to address human rights concerns. Companies are now being challenged to address wider problems of business in weak governance zones, including those that intersect with violent conflict. An advantage of the Guidelines is their extraterritorial reach and their inclusion of a mechanism for dealing with non-compliance complaints.

However, voluntary initiatives suffer several weaknesses, the most apparent of which is the partial, self-selective nature of self-regulation. Smaller companies, state-owned enterprises in non-OECD countries, and independent rogue actors are often insulated against 'naming and shaming' and hence have few incentives to sign on. Second, industry self-regulation has led to a proliferation of voluntary codes, none of which have global reach and authority. Third, self-regulation often lacks transparent reporting, clear performance criteria and reliable monitoring mechanisms. Fourth, voluntary efforts to do good by individual companies may be undercut not just by other less scrupulous companies, but by host governments unconcerned or unable to address issues of corruption, criminality and conflict.



Comptoir, Democratic Republic of the Congo.  
(c) Amelia Bookstein

## 4. TOOLS: MANDATORY REGULATION

Given the many inherent shortcomings of industry self-regulation, there is a strong case for more robust forms of legal regulation, at both the national and international level. A common set of authoritative and legally enforceable rules would accomplish several things:

1. Rigorous sanctions would make accountability of economic actors meaningful and curtail the current climate of impunity;
2. Common rules would reduce the collective action problems that currently impede the extension of improved corporate conduct to the broader set of market actors, while also injecting clarity and predictability into what is currently an unwieldy array of voluntary codes;
3. Rules with global coverage would end the current jurisdictional double-standard that allows companies to conduct themselves abroad in ways that would never be permitted at home; and
4. An international legal framework for responsible business conduct abroad would make companies less vulnerable to retaliation by unaccountable host-country partners, and perhaps, increase their leverage to promote host-country accountability.

The strengthening of mandatory regulation does not, however, rely exclusively on the creation of a full-blown international regime. As several studies have recently demonstrated, there is a range of existing and emerging international norms and national legal instruments that may be employed to deter undesirable activity and hold economic actors accountable for misconduct in fragile states, and that also provide the blocks for building a more coherent global framework. Here the challenge lies in extending their coverage and strengthening their enforcement.

UN Security Council sanctions have helped to curtail some of the most egregious sorts of economic activities that fuel instability and violence. While Security Council enthusiasm for using targeted sanctions has diminished in recent years, UN sanctions nonetheless remain one of the most potent forms of regulation available. However, the progress achieved through targeted sanctions owes more to the creation of expert panels and monitoring mechanisms, and the deterrent effect of their practice of 'naming and shaming' sanctions violators, than it does to robust sanctions enforcement among UN member states.<sup>5</sup>

Under current international law, there are few provisions that directly address economic activities that profit from or promote conflict. While designed for other purposes, anti-corruption and anti-bribery measures offer a second area in which existing regulatory mechanisms could be better deployed against conflict-promoting business activities. In fragile states, transactions between extractive companies and unaccountable host governments are widely accompanied by bribery of public officials, money-laundering, tax evasion and outright theft.<sup>6</sup> Many of these are recognized as crimes, duly codified in domestic law and in a number of international conventions.<sup>7</sup> However, despite several prominent national court cases and a growing number of legal investigations of alleged corporate wrongdoing, convictions have been rare.<sup>8</sup>

Because of the laws of war and international human rights law have been extensively codified and enjoy broad international consensus, they may provide a more reliable basis for concerted action. The Rome Statute of the International Criminal Court, for example, defines pillage, plunder and spoliation as actionable war crimes. While company officials have been prosecuted under these provisions in the past, the

narrow scope and high legal thresholds of these offences will continue to make prosecutions of this sort rare.

Companies can, however, be held accountable where they are complicit in the perpetration by others of war crimes, crimes against humanity, and other grave violations of human rights such as torture, forced detention and slavery.<sup>9</sup> As yet, while there have been no international criminal prosecutions against economic actors for aiding and abetting war crimes and crimes against humanity, both the International Criminal Court and the Special Court of Sierra Leone have signalled that such prosecutions are within their remit.

Holding companies liable for actions that aid and abet violations of international criminal and human rights law is also within the power of national governments. Several criminal and civil cases are now pending in France, Belgium, the Netherlands and the U.S. that seek to prosecute individual businessmen and large multinational corporations for

complicity in offences committed by others abroad. These suits have signalled to companies operating in fragile states that they face expensive and reputation-battering court cases if they fail to exercise prudence in their operational and investment decisions. Paradoxically, more robust legal sanction may have the effect of enhancing the appeal of voluntary codes.

Ultimately, the effectiveness of legal forms of regulation should not be judged by the number of convictions. If an increased incidence of prosecutions was all that was accomplished, the harmful impacts of extractive companies in fragile states would not have been prevented in the first place. The real value of legal prosecution is to clarify minimum standards of unacceptable economic activities and to reduce the incentives for entering into deals where the risk of violating those standards is present and unavoidable. In short, while legal action can have profound reformatory effects on the incentive structure of market actors, these effects are likely to be incremental and uneven.

## 5. TOOLS: MARKET INDUCEMENTS

While voluntary and mandatory forms of regulation have differing strengths and weaknesses, they do share one shortcoming: a lack of positive inducements. Implementing emerging best practices, devoting the resources needed to sustain engagement in the plethora of voluntary initiatives, and tracking the emerging complicity liability risks, are both a costly and uncertain investment. It is particularly expensive for small-scale prospecting companies that are typically the first to enter fragile states, contributing to this category of companies' poor track record of socially responsible business practice.

Here the challenge is to supplement regulatory prohibitions against unacceptable behaviour with economic benefits that reward good business practice. The Kimberley Process and the OECD *Financial Action Task Force Against Money-Laundering* demonstrate that voluntary agreements to implement a core set of regulatory standards can effect positive change when supported by effective oversight, transparent performance assessments and meaningful market inducements.

To date, however, those in a position to proffer such rewards, namely shareholders, and government and international financial lenders and regulators, have not deployed their political, regulatory and financial assets accordingly. There is a pressing need for these actors to come together to provide authoritative public policies that would help defray these costs by providing economic rewards in support of those companies that show a demonstrable commitment to improved practices.

## 6. RECOMMENDATIONS

Given the competitive nature of the global market place, it cannot be expected that improved conduct will naturally trickle down from progressive companies to poor performers. There is a need for new or improved global frameworks that offer real sanctions or rewards, which create level playing fields and overcome collective action problems. There is also a need to establish mechanisms which (a) discourage financial flows which may contribute to or prolong conflict, and (b) promote investment which encourages recovery from conflict:

- Work through the United Nations and other international fora to develop international agreements that establish clear and authoritative norms on the rights, responsibilities and liabilities of companies in weak and war-torn states;
- Develop robust criminal and civil mechanisms to hold companies within home jurisdictions accountable when found complicit in violations of international humanitarian law, anti-corruption conventions, and UN-mandated sanction regimes, and ensure effective enforcement and monitoring. Encourage emerging economies such as China, Brazil, India and Russia to develop and implement similar mechanisms;
- Increase the resources available for the investigation of corrupt practices under the *UN Convention against Corruption* and *OECD's Convention on Combating Bribery of Foreign Public Officials in International Business Transactions*;
- Develop and implement complementary public policies that increase the market rewards for companies that voluntarily adopt conflict-sensitive business practices. In particular: make good practice a requirement of government lending, export credit and overseas investment provision; create 'White lists' that give preferential consideration to the verified best performers in government and international organization

procurement; and add these standards to the listing rules of international securities and exchange commissions.

- Promote the broad adoption of the *Voluntary Principles on Security and Human Rights* by all governments and extended to all companies operating in conflict-prone countries. The Voluntary Principles need to establish clear criteria for participation, transparent and measurable performance and reporting obligations, and enforceable provisions for suspending or expelling non-complying members;
- Strengthen the Specific Instances Process of the OECD's *Guidelines for Multinational Enterprises* by increasing the technical and fiscal resources of national contact points; by creating common, improved standards for the transparent examination of complaints and speedy resolution of disputes; and by using this process to provide explicit guidance to business about the scope of the Guidelines' human rights provisions.

## ENDNOTES

- 1 Global Witness, *Time For Transparency: Coming clean on oil, mining and gas revenues*, March 2004
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- 9 International Peace Academy and the FAFO Institute: *Assessing Liability for Grave Violations of International Law*. Oslo: 2004

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# AIDING, TRADING OR ABETTING?

THE FUTURE OF TRADE, AID AND SECURITY

# 6

MANAGING REVENUES FROM  
NATURAL RESOURCES AND AID  
BUILDING TRANSPARENCY,  
ACCOUNTABILITY AND STABILITY



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**“WE DO NOT WANT THE DUTCH DISEASE PLEASE. WE ARE NOT INTERESTED IN PARADOXES OF PLENTY, CRUDE AWAKENINGS OR ENDING UP IN THE BOTTOM OF THE BARREL EITHER.”**

*President Fradique de Menezes, São Tomé e Príncipe, 2004<sup>1</sup>*

## 1. INTRODUCTION

Natural resources and foreign aid revenues can play a crucial role in improving the security of populations in poor countries. After more than a decade of decline, many commodity prices, especially oil and minerals, rebounded at the end of the 1990s. Likewise, foreign aid flows have begun to edge up again in real terms. Well-managed, these financial flows could dramatically improve the lives of some of the poorest and most conflict-affected populations in the world.

However, when the tiny island state of São Tomé e Príncipe discovered oil in the late 1990s, President Fradique de Menezes was right to be concerned about how his country would manage the sudden influx of oil money. Somewhat paradoxically, many of the world’s most conflict-prone countries possess valuable mineral and agricultural resources. These countries, often highly dependent on natural resources and foreign aid, tend to rank lower on the UNDP’s Human Development Index, suffer higher levels of corruption and worse governance than countries with more diverse sources of wealth. This pattern, commonly referred to as the ‘resource curse,’ links natural resource wealth to stagnation and conflict rather than economic growth and development.<sup>2</sup>

Natural resource revenues are rarely, if ever, the sole source of conflict: identity, ideology and history are all important factors. Nevertheless, natural resources have played a key role in many cases of deteriorating governance, widening income disparities and worsening corruption.

Poorly managed revenues (more accurately called ‘rents’) from natural resources tend to nurture predatory political systems, whose elites have a strong financial interest in staying in power, even if it is by repressive and authoritarian means. In other words, governments find more immediate and lucrative rewards from capturing and redistributing rent (including to themselves) than from encouraging wealth creation and economic growth.

When commodity prices are high, governments face pressure to spend the proceeds from the natural resource windfall quickly—often to satisfy powerful interest groups eager to see tangible benefits. A rise in export earnings during boom times tends to appreciate the real exchange rate (i.e., the local currency becomes more expensive) making other exports uncompetitive. This effect, commonly known as the ‘Dutch disease,’ does not necessarily have a symmetrical effect during price slumps. Meanwhile, large ‘unearned’ natural resource revenues do not automatically trigger re-investment or create employment. This makes the economy even more reliant on that commodity and vulnerable to recessions caused by fluctuations in the prices of commodity exports.

States that are highly dependent on natural resources tend to be unaccountable to citizens demands owing to their reliance on resource rents over tax revenues. Natural resource rents also prove attractive to outside groups, spurring and funding conflict. If natural resources are concentrated in a particular region of a country they may strengthen beliefs among disaffected groups that secession is an attractive option. Aid (another 'unearned rent') can also undermine accountability if governments become more responsive to the demands of donors than those of their citizens. Likewise, aid projects create winners and losers and so can widen inequities and create grievances.

The problem of natural resource revenue management is vividly demonstrated in Angola, where an IMF audit in 2001 confirmed that over \$900 million per year of the country's oil revenues—roughly a quarter of the state's yearly income—had gone missing since 1996.<sup>3</sup> Equatorial Guinea, despite valuable offshore oil deposits which spurred some of the world's fastest economic growth (60 per cent in 2001), has an HDI rating 93 places below its GDP per capita position.<sup>4</sup> In Nigeria, Angola and the Democratic Republic of the Congo natural resource wealth has failed to generate development and has instead helped to entrench deep-seated corruption that retards growth and fuels conflict.

Those countries that have trouble managing natural resource revenues also tend to experience difficulties making the most effective use of aid. Poor management of natural resource revenues and aid

contribute to ongoing poverty and underdevelopment. And poor countries are most at risk of violent conflict. Research indicates that lower levels of GDP per capita are associated with a higher risk of violent and more prolonged conflict. All else being equal, a country with \$250 GDP per capita has a 15 per cent risk of experiencing war in the next five years. At a GDP per capita of \$5,000, the risk of civil war falls to less than one per cent.<sup>5</sup>

With the deadline for the Millennium Development Goals less than a decade away, relatively high commodity prices and current proposals to front-load aid to Africa mean that revenue management is more crucial than ever. The challenge for resource-rich countries is to manage natural resource revenues in an equitable, transparent and accountable way, and to ensure they are carefully invested to meet the needs of the country in a way that breaks the cycle of direct dependence on natural resources. Similarly, there may be lessons from natural resource revenue management for aid policy (and vice versa); in particular to improve aid absorption and utilization.

**THOSE COUNTRIES  
THAT HAVE TROUBLE  
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USE OF AID.**

## 2. IMPROVING REVENUE GOVERNANCE: REVENUE MANAGEMENT LAWS

One way to improve revenue management is through the creation of formalized, legally-codified revenue management procedures. Resource-rich countries around the world have adopted such measures for two key reasons. First, they help to stabilize the income a country receives from its commodity exports—saving when prices are high, spending when they are low. Second, they can isolate resource revenues from short-term political interests and embed structures for the long-term, prudent management of revenues.

Typically, these revenue management laws stipulate that revenues be paid to an international account under the administration of an oversight body and a certain annual percentage be devoted to development projects, transfers between regions, and so on. Specific oil revenue management laws have been drafted, with varying degrees of success, in several conflict-affected countries: Azerbaijan, Iraq, Sudan and Timor-Leste as well as Chad and São Tomé e Príncipe.

After three decades of hostilities opposing northern and southern factions, peace negotiations and the consolidation of President Deby's regime in the 1990s made it feasible for oil companies to develop oil fields in southern Chad. With some prompting from the World Bank, the Chad government passed an oil revenue management law in 1999 that stipulated how it would manage and spend direct oil revenues. However, the project failed to ensure that strong institutions were in place before oil revenues started flowing. The outcry over arms purchases with oil money led the World Bank and the IMF to threaten to exclude Chad from its debt-relief program. There have since been continuing problems over the monitoring of oil revenues as well as government interference in the domestic oversight committee.

With two recent coup attempts in 1995 and 2003, São Tomé e Príncipe's potential oil wealth has raised great concern for the future of the tiny archipelago. The 2004 Oil Revenue Management law provides extensive guarantees in terms of transparency, accountability and governance. The law creates a fund that directly receives all oil revenue, which is held by an international custodial bank. All financial information is to be made transparent, fund withdrawals are done on an annual basis only with a ceiling determined by future production potential, and borrowing against present or future oil revenues is prohibited. Despite this exemplary framework, the Prime Minister and government resigned in June 2005, arguing that the President had negotiated and signed new Production Sharing Agreements without proper consultation.



*A gold miner in the Democratic Republic of the Congo shows his takings.*  
(c) Amelia Bookstein

## Aid trust funds

The level and allocation of aid is an important component of aid effectiveness. Aid trust funds constitute a financial instrument through which funds are collected from donors and allocated to recipients in a supposedly independent fashion. Such trust funds can smooth aid flows, help generate future income and time disbursements to domestic needs rather than donor priorities.

Recovery in post-conflict situations requires large and rising levels of assistance during the first half-decade, rather than the 'boom and bust' often characteristic of 'CNN-driven' crisis management. Part of the donations immediately made after the signature of a peace agreement can be 'saved' for future use. However, in practice, trust funds have often retained close ties with donor interests, such as donor priorities and preferential home-country contracting.

Such mechanisms, which inherently reduce a government's control over its revenues, are controversial among those who see them as an attack on state sovereignty. In Azerbaijan and Chad, the success of revenue management laws has been somewhat curtailed by continuing political control over the revenues and poor transparency. Whilst revenue management funds can be useful they are no substitute for sound management of a country's national budget. Ironically, resource funds seem to work best only where they are not needed; that is, when sound economic policies are already observed and resource revenues represent only a small part of government revenue.

## 3. STABILIZING REVENUES FROM NATURAL RESOURCES

A key element of improving the management of natural resource and aid revenues is to make them more predictable and reliable. In theory, revenue management funds and aid trust funds can help to achieve this by providing a continuous income during lean times. There are also international mechanisms, such as the IMF's *Compensatory and Contingency Financing Facility* (CCFF) and the EU Flex's instrument which help countries ride out slumps in the price of their commodity exports. For reasons explained in the first brief (on conflict-sensitive trade) in this series, neither has proven particularly effective.

Historically, the most common way that governments have tried to stabilize prices was by maintaining buffer stocks that could be expanded or reduced during times of low and high prices respectively. However, speculation by private investors, expensive

storage costs and free-riding by other countries make such policies difficult to sustain.

Another method for stabilizing revenues is price agreements based on either producer cartels or pacts between consumers and producers. Stabilization of prices by imposing variable export taxes or tariffs, marketing boards and domestic stockpiles is also possible. Finally countries can try and use of risk instruments like forward contracts to hedge the future price of commodities. None of these approaches has proven outstandingly successful and price stabilization has somewhat fallen out of favour in recent times. Nevertheless commodity price volatility remains a serious problem and there is an urgent need to reopen the debate on what can be done to tackle it.

## 4. IMPROVING TRANSPARENCY AND ACCOUNTABILITY

The basis of accountability is transparency. A lack of transparency not only increases the risks of corruption and embezzlement, but also of inequity, distrust and false expectations. By contrast, transparency can consolidate democratic debate by providing accurate figures upon which stakeholders can negotiate, plan and ensure accountability.

Transparency can be supported at the international level through corporate revenue disclosure rules, international norms of public and private financial governance, capacity-building assistance, and international auditing and reporting. The IMF and the OECD's Development Assistance Committee (DAC) constitute the two elements of international transparency for resource revenues and aid, respectively. The IMF provides valuable information on resource revenues through its Country Reports, the information for which is mostly provided by the country's central banks. DAC provides aid statistics on aid flows (and other resources) to developing and transition countries.

Three complementary initiatives are now underway to improve transparency in the resource sectors: The *Publish What You Pay* (PWYP) Campaign, launched in 2002 by George Soros' Open Society Institute and Global Witness, aims at mandatory disclosure of all payments to host governments by oil, gas and mining companies. The campaign argues that corporate disclosure is an important step toward comprehensive accountability in the resource sectors and that while voluntary measures are useful, they are unlikely to achieve a global and lasting solution. To achieve comprehensive transparency coverage, PWYP is advocating for a 'double book-keeping' by extractive companies and governments, through revenue disclosure laws in both host and home countries. Specifically, PWYP advocates that developed countries require companies to declare their disaggregated payments to the host country as a condition for stock market listing or export credit.

Second, the British government's *Extractive Industries Transparency Initiative* (EITI) lays out principles of transparency, accountability and prudent management of resources for voluntarily participating countries and companies.<sup>6</sup> It also provides specific revenue reporting guidelines and criteria for participation. In contrast to the PWYP approach, the British government stressed the responsibility of host governments for transparency, while the U.S. government also lobbied hard against EITI following a mandatory approach. Being voluntary, it is incentive-driven and critics have suggested that the main incentive for joining EITI has been for governments and companies to deflect criticism and gain domestic and international legitimacy. That said, adherence to EITI principles is now a criterion to access financing for extractive sectors from many export credit agencies and other international financial institutions.

Third, the IMF *Guide on Resource Revenue Transparency* (GRRT) promotes transparency through its support for clear roles and responsibilities of governments, public disclosure of all resource revenues, open budget preparation, and external or independent auditing of national accounts. Nevertheless, few resource-dependent countries have followed the more general IMF *Code of Good Practice in Fiscal Transparency* and undertaken Reports on the Observance of Standards and Codes that gives it teeth. The same may be expected with the GRRT, in part because large resource revenues insulate governments from IMF conditionality.

## 5. CONCLUSIONS AND RECOMMENDATIONS

Since the late 1970s, some developing economies such as Chile, Indonesia and Malaysia have escaped dependence on primary commodity exports or aid. Three key factors behind their success are: sound macroeconomic management that allowed them to take advantage of increased opportunities to trade; central control of corrupt rent-seeking behaviour; and the pro-poor spending of commodity revenues to improve the competitiveness of labour-intensive activities.

In essence, for revenues to be handled effectively and invested carefully, whether from natural resources or aid, policy-makers need to develop institutional mechanisms that increase the transparency and accountability of natural resource and aid revenues, that ensure they are prudently managed and do not become a 'prize of power.' Civil society has a key role to play as a watchdog of government expenditure and anchoring commitments to better revenue management. In particular:

- Strengthen the Extractive Industries Transparency Initiative and the IMF Guide on Resource Revenue Transparency. Develop them into an International Extractive Sector Transparency Agreement with common standards of revenue disclosure, independent monitoring and effective compliance measures;
- Increase the focus on capacity-building in extractive sector transparency agreements to improve revenue management, resource pricing, accounting, reporting and auditing;
- Build effective revenue management mechanisms that increase the accountability and transparency of natural resource and aid revenues, and ensure long-term income stability for natural resource dependent countries;
- Introduce income stabilization mechanisms that help conflict-threatened areas manage and stabilize revenues from natural resources and aid;
- Reinvigorate the debate on measures for commodity price stabilization, beginning with the IMF's Compensatory and Contingency Financing Facility; and with the voluntary schemes being developed by the fair trade movement.

## ENDNOTES

- <sup>1</sup> Speech by H.E. Fradique de Menezes, President, Democratic Republic of São Tomé e Príncipe, 'Creating a stable base for transparency in São Tomé's Oil Sector.' CSIS Conference 'Promoting Accountability and Transparency in Africa's Oil Sector,' Washington, DC, 30 March 2004
- <sup>2</sup> Palley, T. 'Lifting the Natural Resource Curse,' *Foreign Service Journal*, December 2003
- <sup>3</sup> Global Witness, *Time for Transparency*, 2004, p.4
- <sup>4</sup> UNDP, *Human Development Report 2005*, p.221
- <sup>5</sup> DFID, *Fighting poverty to build a safer world – a strategy for security and development*, 2005, p.8
- <sup>6</sup> See <http://www.eitransparency.org>

This is one of six policy briefs prepared under the auspices of the Trade, Aid and Security initiative: a research project jointly coordinated by the International Institute for Sustainable Development and IUCN – The World Conservation Union, with funding from the governments of Norway and Italy.

Since 2000, the initiative has focused on the way in which trade in natural resources can contribute to violent conflict at the sub-state and international level, and on the role of foreign aid and trade liberalization—in tandem or in isolation—in accelerating or alleviating this downward spiral.

On the basis of this understanding, current research focuses on the options available to domestic and international policy-makers. This series of policy briefs recommends six key objectives that the international community should strive to achieve if trade and aid policies are to contribute to peace and security rather than increasing the likelihood and longevity of violent conflict.

Those objectives are; developing conflict-sensitive trade and aid policies; restricting the trade in conflict resources; spreading 'good governance'; promoting conflict-sensitive business practice; and improving the management of revenues from natural resources and aid.

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