



Blogs Mini-Series

How is industry adjusting to persistently lower commodity prices?

What does this mean for governance prospects?

A silver lining? Impact of Commodity Price Fall on Good Governance in Sierra Leone

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This is the 4th blog from the ***How is industry adjusting to persistently lower commodity prices? What does it mean for good governance prospects?***

From 2002 to 2013, resource-rich countries in Africa enjoyed the benefits of a commodity boom, using increased revenues to embark on major infrastructure projects in roads, rail, ports, and housing. But when commodity prices fell starting in 2011 (see figure below), public sector revenues took a major hit with private sector companies scaling back operations, delaying investment decisions and suspending unprofitable operations. Especially as the number and size of investments in the sector contracted, Governments felt increased pressure to collect, manage and spend those revenues more efficiently. As a result, the fall in commodity prices and mounting economic pressure actually led to opportunities to improve governance of the extractives sector. The result in a number of resource-rich countries has been efforts to improve laws and increase focus on implementing existing laws. There is evidence of some success in reducing corruption in the sector.

Sierra Leone is one such resource dependent country. Minerals, primarily iron ore, account for over 70% of the country's exports. Iron ore prices fell from a five-year average during the boom years of \$140-\$170 per metric ton (depending on the ore grade) to \$40-50 in 2015. London mining, the second largest iron ore mine in Sierra Leone collapsed in 2014 and the larger operator, African Minerals, collapsed a few months later. Total royalty payments from the five largest companies fell from \$31 million in 2014 to only \$9.25m in 2015. The situation was compounded by a raging Ebola epidemic, whose control measures effectively paralyzed significant sections of the economy. Contractors supplying goods and services to the iron ore and mining sector, for example, temporarily ceased operations. Companies embarked in cost reduction measures by cutting down on operating costs through more rigorous controls, delays in recruitment, reducing expatriate staff, cutting corporate social responsibility payments and renegotiating contracts with service providers and suppliers. Without exception, companies also requested concessions to their tax and debt repayment obligations.

These impacts led to an improvement of regulatory quality and government effectiveness due to the following reasons: First, the sharp cut in the budget and correspondingly in public expenditures increased the pressure on the Government to manage its more limited revenues more efficiently. Second, due to the budgetary pressures, the National Revenue Authority (NRA) was asked to meet and surpass its annual

revenue collection targets. The NRA launched a series of actions to collect statutory taxes with an emphasis on the mining sector. A multi-ministerial task force was set up to ensure companies comply with their tax obligations, through greater scrutiny and by closing loopholes through which potential revenues were lost. Issues such as bureaucratic inefficiencies, poor coordination and limited scrutiny of accounts were addressed. The Government also proactively engaged companies to better understand their plans in order to improve revenue projections.

Third, although not a government response, there was a sharp fall in issuance of exploration licenses as a result of the global commodity price downturn. Only 11 new exploration licenses were issued in 2015 compared to 60 in 2011. While this development is a blow to further mineral discoveries, it allowed the Government to increase scrutiny of the fewer new and remaining companies' compliance with statutory obligations in the quest to maximize tax revenues.

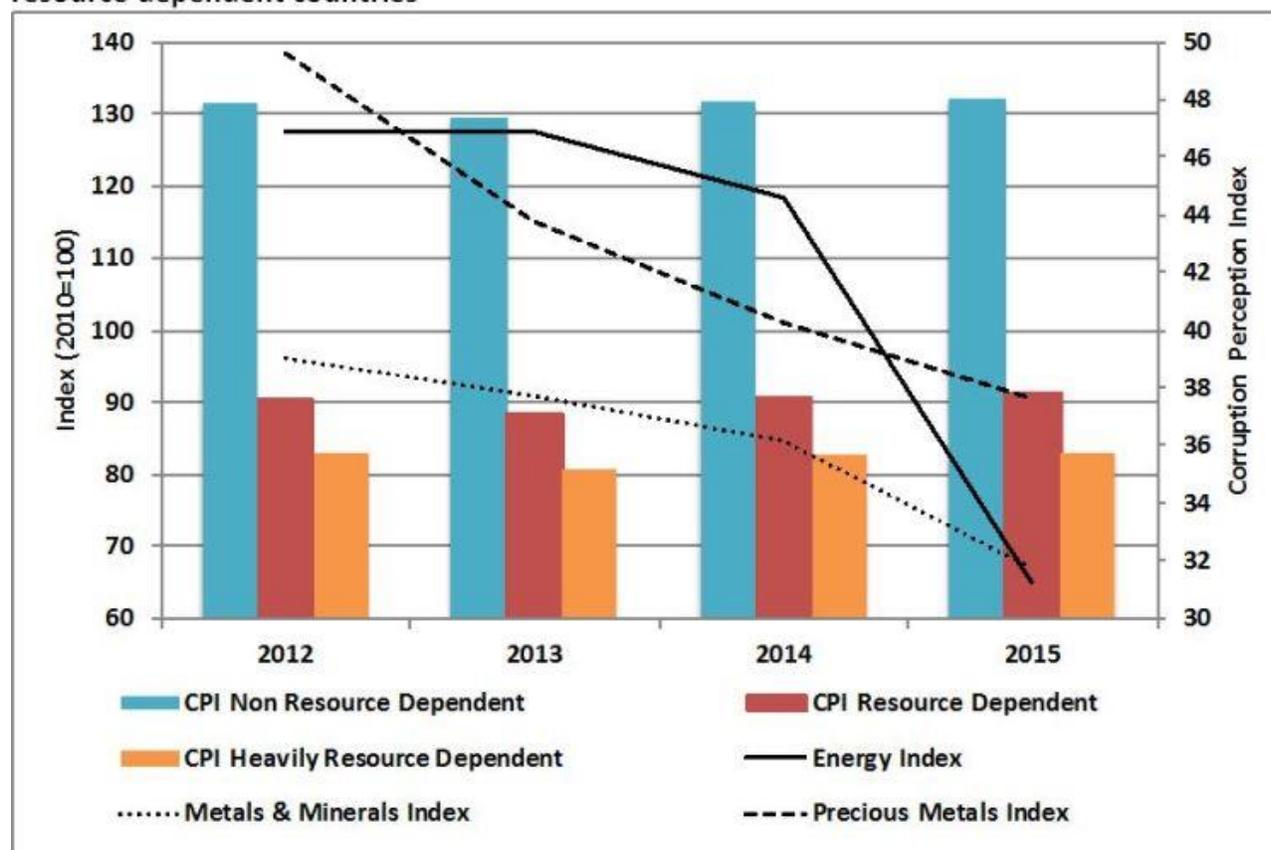
One key obstacle to improving governance in the extractive sector of Sierra Leone has been the absence of effective checks and balances of Governmental authority within the legal framework, which has led to corruption allegations in the past. The country is in the process of revising its mineral policy, that is to address some of these weaknesses. While this policy has yet to be adopted, it is unlikely that during the boom years such changes would have been so easily accepted given that there were stronger incentives by those benefitting from more discretionary power to keep these rules in place. Simultaneously, transparency has improved and now all mining agreements are published on the website of the National Minerals Agency and regular bulletins are issued on the sector's activities.

In sum, the commodity price fall has not led to a fall in good governance in Sierra Leone. On the contrary, there are several factors including greater transparency, improved enforcement of government regulation and enhanced government efficiency in tax collection and spending, which have led to an improvement in governance of the sector.

Sierra Leone is not alone in seeing improved governance during the downturn. We have compared the Corruption Perception Index (CPI) of resource dependent countries at the peak of the commodity prices in 2012 with the latest 2015 data.^{[1],[2]} The figure below shows that while the CPI is consistently about 10 points lower in resource dependent countries as compared to non-resource dependent countries,^[3] the average CPI of the 85 resource dependent countries in our sample has marginally increased by 0.28 points between 2012 and 2015. This compares to a 0.15 increase of the 80 non-resource dependent countries.^[4] The CPI increased in 49% of the resource-dependent countries during this time span, while it fell in 36% of the resource-dependent countries (13% of the sample countries did not see a change in the CPI). This trend persists when isolating the 48 heavily resource dependent countries,^[5] where 46% of the countries experienced an improvement in the CPI and 33% experienced a fall.

This analysis therefore suggests that while the commodity price drop is having a disastrous impact on the finances of many resource rich countries, it has not necessarily resulted in worsening governance in the sector. While the improved governance indicators are likely due in part to factors outside of price levels, including the expansion of EITI participation, the growing internationalization of anti-corruption norms, and other factors, they nonetheless show that countries can and have continued to make advances on good governance regardless of price levels, and indeed that lower prices might provide greater incentives, pressures and opportunities for such reforms. With improved institutions and mechanisms in place, there is hope that these countries will be better equipped to spend the revenues from the next commodity price upturn more efficiently than during the last commodity super cycle.

Commodity prices and average corruption perception index for resource dependent and non-resource dependent countries



Sources: World Bank Commodity Price Data, UN Comtrade Data, Transparency International

References:

Anthonsen, Mette and Asa Lofgren and Kals Nilsson, 2009, "Natural Resource Dependency and Quality of Government", Working Papers in Economics, No 415.

Bhattacharyya, Sambit and Ronald Holder, "Natural Resources, Democracy and Corruption", 2010, European Economic Review, 54, pp 608-621.

[1] A CPI of 0 signifies "highly corrupt" and a CPI of 100 "very clean". The corruption perception index was used as a proxy for good governance due to the availability of the 2015 data point. 2012 was chosen over 2011 as the starting point, because there has been a change in methodology in the way that the CPI is computed, which makes a pre-2012 time-series assessment difficult. It would be interesting to redo this analysis with the updated resource governance index instead of the CPI to focus specifically on the extractives sector. For instance, there was a marginal increase in perception of corruption recorded in the latest CPI for Sierra Leone, but this is largely explained by the Auditor General's report of 2014 on the use of Ebola funds that generated considerable public outcry and not on governance of the extractive sector.

[2] A country is determined to be resource dependent if more than 25% of the total exports are made up of oil, gas and/or minerals. Comtrade data was used to estimate the resource dependence of the countries in 2014. Fuel and mineral exports (SITC codes 3, 27, 28, 68, 667, 971) were divided by total exports for that year.

[3] For an explanation as to why resource dependent countries may be more prone to corruption see for example Anthonsen et. al (2009) and Bhattacharyya (2010).

[4] All countries that had CPI data points for the 4 years were included

[5] Defined as 50% or more of total exports being made up of oil, gas and/or minerals.