

Resource Rich Countries and Weak Institutions: The Resource Curse Effect

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Abstract: The natural resource curse represents an enormous impediment to development. Yet it is important to realize that it is not natural resources that are the problem; rather, it is lack of good governance and democracy. Remedying this institutional failure requires changes of law and practice but does not require huge resource investments. *The most interesting aspect of the resource curse is not that natural resource wealth on average reduces growth, but that the economic and political outcome is so different in different resource abundant countries. To understand the resource curse one needs to study how economic factors shape institutions and how institutions shape economic factors.* By increasing the transparency of resource payments by firms to governments, increasing government transparency in the management of resource revenues, encouraging preventive diplomacy, restricting the trade of high-risk, and conflict-related commodities, income from these natural resources can be used to support growth and development.

One of the puzzling regularities of economic growth is that many countries rich in natural resources have such poor growth performance. This occurs because the income from these resources is often misappropriated by corrupt leaders and officials instead of being used to support growth and development. Moreover, such wealth often fuels internal grievances that cause conflict and civil war. This pattern is widely referred to as the “natural resource curse” -- natural resource wealth creates stagnation and conflict, rather than economic growth and development. *The most interesting aspect of the resource curse is not that natural resource wealth on average reduces growth, but that the economic and political outcome is so different in different resource abundant countries. To understand the resource curse one needs to study how economic factors shape institutions and how institutions shape economic factors.*

The natural resource curse hypothesis maintains that rather than fueling growth and development, natural resource wealth can become the cause of economic stagnation, corruption, and civil war. The possible explanations of the natural resource curse largely fall into two classes: Economic factors and political or political economy factors. The economic phenomenon behind a negative growth effect of natural resource dependence is termed the *Dutch disease*. Named after the negative effects on the Dutch manufacturing sector of Holland’s natural gas revenues from the North Sea, it is the contraction of other tradable sectors as a result of a boom in the natural resource sector (Sachs, 1995). The real exchange rate appreciates as capital flows into a country in response to a natural resource boom. This appreciation renders domestic manufacturing and agriculture uncompetitive, causing lost jobs and higher unemployment. These lost jobs are not compensated for by growth in the natural resource sector, which is capital-intensive. The

decline of manufacturing and agriculture also makes the economy dependent on natural resources, contributing to economic volatility since natural resource earnings are highly volatile (Angrist, 2005).

I. Problems

The natural resource curse undermines governance and democracy. For example, oil generates large streams of foreign exchange, and these flows become the basis for patronage that supports dictatorship and autocracy. Natural resources and oil wealth should be of benefit to countries. The fact that they often are not is because of failures of governance that are connected with failures of democracy and public accountability. Evidence shows that natural resources can drive civil conflict as parties struggle to gain control of over resource revenues (Fearon, 2002). Excluded groups have an incentive to try and wrest control, while dominant groups have an incentive to take a disproportionate share of benefits. Creating a system in which all receive an equal, pre-determined share can alleviate these tensions. Once the resource is seen as belonging to the public, the incentive to wrest government control for personal benefit is reduced as the value of control over government is diminished. Beyond these political economy benefits are also more standard economic gains from such funds.

Firstly, the whole state may be subject to a 'rentier effect'. States with abundant mineral and oil reserves extract their revenues from resources that are concentrated geographically in terms of ownership. This reduces their incentive to develop the governance mechanisms that enable general taxation. On the other end of the spectrum side, since the state sector tends to dominate, citizens have less incentive to form a healthy 'civil society,' an independent middle class fails to develop, and technocratic and

entrepreneurial talent remains captive of state largesse in terms of employment and advancement opportunities (Manzano, 2001). In addition, the government can rely on its resource revenues to repress dissent, either through buying off opposition (often with high-profile infrastructure projects) or through violence. As a result of this, democracy often fails to develop (Karl, 1997; Ross, 2001). More importantly in this context, stifling technocratic and entrepreneurial talent, as well as making unproductive investments, will harm the economy.

Secondly, political elites find it relatively easy to control resources and maintain their wealth in a point resource-led economy, but face the prospect of losing their grip through industrialization and urbanization (Dietz, 2005). It follows that political elites in resource-rich countries resist modernization pressures for as long as possible, especially investment in the manufacturing sector. Again, in this case civil society fails to develop. The main reason for this is that the concentration of capital ownership among political elites, together with production methods that favor the use of expert (foreign) labor and that are capital-intensive (Leite, 1999); reproduce social inequalities between those inside the elite and those outside it.

The effect of resource rents on growth may depend on the strength of institutions, but the institutions may in turn depend on the existence of rents. The works of (Ross, 1999) amply document how the increased magnitude of rents in the two resource booms led policy-makers to do what they could to dismantle institutional safeguards that would protect the rent. Ross calls this *rent capturing* – when rents are large, there are strong incentives to gain control over the process of allocating the rents, which can in turn produced incentives to weaken the institutional framework that regulates the use of public

funds. (Leite, 1999) show in a model how a windfall gain can create this effect, and present econometric analyses suggesting that institutions are indeed negatively affected by natural resource dependence. (Sala-i-Martin, 2003) reproduced (Sachs, 1999) results, and then includes the share of primary commodities in exports in a first-stage regression so that resource dependence can affect economic growth in two ways: Directly, or through its impact on institutions. They find a strong negative effect of natural resource dependence on institutional quality, but only in the case of fuel and mineral resources. Agricultural resources and land had little effect on institutions and direct effect on growth. Interestingly, the direct effect of natural resources on growth disappears when they are allowed to work through the institutional mechanism (Harford, 2002). These large-sample econometric results lend strong support to the political scientists' observation that the effects of natural resource abundance works through a deteriorating effect on the governing institutions of the country, and not in the main through Dutch disease.

One problem concerns fiscal policy and inflation. Oil booms tend to raise expectations, and contribute to unrealistic projections of future income. This in turn leads to loss of control over public spending, including taking on high-cost public infrastructure projects, often financed with foreign borrowing. These projects can also become the vehicle for corruption and influence peddling. The net result is loss of fiscal discipline that contributes to inflation, the build-up of external indebtedness, and the development of cultures of corruption.

1. Corruption

Corruption exerts a significant negative externality by raising overall indebtedness while doing nothing to increase a country's capacity to repay. In effect, corruption dilutes the asset protection available to other creditors, and they protect themselves by raising their required interest rate (Dietz, 2005). By holding creditors responsible for corrupt loans in cases where lenders failed to do due diligence, default loans can be diminished and honest lenders can lower their required interest rate. Part of this problem is due to the sheer volume of resource revenues: governments can only absorb and effectively track limited amounts of money. Resource wealth often floods governments with more revenue than they can effectively manage (Dietz, 2005). Resource revenues also tend to be collected by governments in ways that are unusually difficult for citizens to track, and unusually easy for crooked officials to divert; hence some revenue winds up in off-budget accounts or the pockets of government officials, and is never heard of again (Ross, 1999).

(Ross, 1999) measures both poverty and natural resource wealth each in several different ways, and examines their connections through six different potential politico-economic mechanisms - economic volatility, inequality, slow economic growth, the crowding-out of manufacturing, civil war, and authoritarianism. Like (Sala-I-Martin, 2003), he finds that the culprits are oil and non-fuel minerals, not agricultural and forestry resources. They increase poverty through several mechanisms. But non-fuel minerals tend to work mainly by reducing the overall growth rates of economies, while oil works mainly by crowding-out manufacturing and making polities more authoritarian. The poorer countries are, the greater the cursing effect of an oil or mineral find.

2. Weak Government

Natural resource revenues can, ironically, weaken governments, making them less likely to resolve social conflicts and provide public goods, such as health care and education. There are two ways this can happen. One way is by retarding the effectiveness of a state's bureaucracy. Some scholars have found that when governments are funded through oil or mineral revenues instead of taxes, they are left with weaker governments. Much of a government's "strength" comes from its capacity to extract taxes from the population, a capacity that often takes decades to develop. A government that fails to develop this ability may also be unable to establish the type of bureaucracy that can provide effective public goods, and ameliorate social conflicts. The result may be a heightened danger of civil war (Karl, 1997; Fearon, 2002).

3. Unaccountable Government

Another effect is reduced government accountability. Governments that get their income from natural resources become less democratic, and hence less accountable than countries that rely on other revenue sources such as taxation. One reason for this pattern is that when governments have an abundance of revenues, they use part of their surplus to quell dissent. Sometimes they do this through tax policies: resource-rich governments commonly use their revenues to reduce or eliminate taxes on their populations in the absence of taxes, people are less likely to demand accountability from their government (Mehlum, 2002). Other times they do it through spending: greater patronage can dampen latent pressures for democratization. In some cases governments use their largesse to prevent the formation of independent social groups that might eventually demand political rights (Busby, 2004). It is important to note that, all undemocratic rulers use

their fiscal powers to reduce dissent, and such governments in resource-rich states tend to have extra revenues at their disposal.

II. Solutions

Economic development involves the accumulation of public capital and infrastructure and requires government investment. Economic development, however, requires the accumulation of private capital based on the decentralized decisions of individuals. Putting extra money into the hands of individuals can help this process.

Economic policy is more important than natural resources in driving economic growth. The resource poor countries are less prone to policy failure than the resource-abundant countries because intensifying land shortages reduce tolerance for inequitable land distribution and the resulting social tension encourages the political state to align its interests with the majority poor. Consequently, the governments of resource-poor countries tend to appreciate the need to invest efficiently from a very low per capita income and they are less likely to pursue policies that cause the economy to diverge from its long-term comparative advantage.

The resource poor countries develop through internationally competitive industrialization. Their governments tend to abandon closed trade policies at a low per capita income and, as commodity exports are limited, labor-intensive manufactured exports expand rapidly and soon absorb surplus labor. This causes the economy to diversify into competitive capital-intensive and skill-intensive manufacturing so it is resilient to external shocks and sustains rapid growth. The early elimination of surplus labor combined with incentives from competitive manufacturing for the poor to acquire skills curbs income inequality. Finally, early industrialization accelerates urbanization in

resource-poor countries so that population growth slows sooner and the ratio of dependants to workers falls earlier. This boosts the rates of saving and investment.

(Davis, 2001) conclude that, funds “are, however, not an easy—nor necessarily an appropriate—solution to the fiscal policy problems faced by these countries.” The underlying reasoning is that the conditions that generally thwart sound fiscal policy are likely to undermine the effectiveness of funds. Particularly, where institutional capacity—to monitor and exercise accountability—is weak, there is a very serious risk that Funds will be “raided.” This temptation is likely to be greater the larger the size of the Fund. If the problem with oil is, as demonstrated above, weak institutions and corruption, a fund is more likely to exacerbate the problem than address it.

1. Dividends

Income distribution is highly unequal in many developing countries, and this inequality is bad for growth and democracy. The payment of a dividend to all citizens would constitute a progressive redistribution, helping equalize the distribution of income and providing seed money for poorer citizens to become entrepreneurs. And because the dividend would constitute a regular source of income, it would also provide collateral for ordinary citizens to finance small business investment projects. This, in turn, would stimulate development of credit markets, which are so essential for development (Davis, 2001). This problem frequently afflicts oil-rich countries is that they suffer from economic activity that is skewed toward excessive government, a feature which also promotes corruption. Directly paying revenues to citizens would help rectify this structural imbalance. Finally, on the political side, citizens would have an incentive to

become politically engaged to protect the dividend paid and to ensure that state-owned industries operated efficiently so as to maximize the dividend.

One common objection to distributing revenues is that it would starve developing country governments of money needed for infrastructure building. The goal of development is to build lasting political and economic development, and trade-offs are always present given the scarcity of resources. Directly distributing revenues to citizens may be the best possible development investment, yielding higher returns than infrastructure spending in terms of creating political ownership and economic dynamism (Busby, 2004).

Another economic benefit is that it can contribute to the development of credit markets. The dividend distribution will provide eligible citizens with a steady stream of income, and this income can then be used as collateral to borrow against. In many developing countries lack of access to credit is a restriction on entrepreneurship and development. The dividend entitlement can serve as seed money giving people access to credit. And as people borrow it will stimulate small business, stimulate the growth of credit markets, stimulate financial development, and entrench laws of contract, commerce, and property (Davis, 2001).

2. Privatization

Another solution to the natural resource curse is privatization, For example the sale of state-owned oil industries and oil production rights to private-sector investors. Privatization has been a big part of the development agenda pushed by the IMF and the World Bank over the last two decades. The argument is that it promotes productive

efficiency by restoring the profit motive. It also resonates with political agendas aimed at shrinking state economic involvement.

3. Saving Funds

Saving funds represent another approach. An accounting device is to provide a separate account into which revenues are paid. Their purpose is to shield the government budget from the revenue uncertainty and volatility of natural resource revenues, and to save for future generations given that natural resources are often non-renewable (Davis, 2001). Such funds can make a contribution to improved governance, particularly by contributing to greater transparency of natural resource revenue flows. They can also help guard against the problem of “Dutch Disease” by ensuring that some of the revenues are directed to the accumulation of foreign assets. This helps prevent exchange rate appreciation, which undermines international competitiveness. Finally, to the extent that government spending is tied to fund revenues, they can contribute to fiscal discipline.

However, stabilization funds also have significant limitations. For example, there is no guarantee their revenues will be used for the benefit of citizens. Furthermore, governments can avoid the putative income constraint by borrowing. The bottom line is that to work well, there is need of good governance.

4. Taxable resource revenue distributions

Instead of paying resource rents into the government treasury, they would be distributed equally to all individuals, with government taxes on it, even at a rate for 100%. Letting the resource rents pass through the hands of the population creates two effects: An endowment effect and an information effect. The endowment effect makes

the population more willing to put pressure on the government to abide by principles of good governance, because they now feel the cost of waste and corruption as an out-of-pocket cost. The information effect will make them more aware of the magnitude of the revenue flows, and of the amount of funds at the government's disposal. Both of these effects will increase the pressure on the government and would encourage an institutional development conducive to growth (Sandbu, 2004).

Human beings are prone to care much more strongly about money that has passed through their hands (such as income taxes) than money that they simply never see (such as wasted or diverted natural resource rents). This endowment effect implies that the political pressures on the governments to manage public funds well are stronger when the source of those funds is taxation rather than resource rents. Taxable revenue distributions convert resource rents into tax revenues and thereby bring those stronger political pressures to bear also on the governments of resource-rich states (Ross, 1999).

III. Conclusion

It is a tragedy each time we observe a country fully endowed with bountiful natural resources to go down a path of corruption, conflict, and underdevelopment. The natural resource curse represents an enormous impediment to development. It is important, however, to realize that it is not natural resources that are the problem. Rather, it is the lack of competent, uncorrupt governmental institutions and the absence of democracy which hinders the development and responsible use of natural resources. Remedying this institutional failure requires changes of law and practice, but does not require huge resource investments. Resource-rich countries must simply improve their weak sustainability performance by reforming their corrupt, inept institutions.

Natural resources need not be a curse if institutions are good and stable enough to discourage corruption. (Mehlum, 2002) presents a simple model in which resource abundance has a non-monotonic effect on growth, and in which the threshold for a negative effect increases as institutions become more “producer-friendly” and less “grabber friendly.” (Sachs, 2001) regression model includes an interaction term between institutional quality and resource abundance, Sachs estimates the coefficient to be positive, suggesting that when institutions are sufficiently stable and capable, a larger share of primary commodities in exports is associated with faster and not slower growth.

The natural implication is that a country could alleviate the resource curse by mimicking a non-oil economy, in which the government does not have a free source of revenues. (Sala-i-Martin, 2003) makes the same argument in their analysis of Nigeria: the main problem affecting the Nigerian economy is the fact that the oil revenues that the government receives are regarded as manna from heaven, which tends to corrupt institutions and lower the long-term growth prospects. Thus, if states can maintain secure, stable institutions in terms of resource management, they can use the revenue they generate to further improve their own economies and the lives of their citizens, providing social, economic, and military securities.

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