Briefing Note 7

Reversing the Curse:
Five Principles for Beating the 'Natural Resource Curse'

The 'Resource Curse'

The wholesale prices of oil, gas, metals and mineral commodities continue to be historically high. Seven year crude oil is still trading at over $60/barrel, nickel is selling well above its long-term cycle, and gold, at the time of going to print, had increased to over $500/oz.

Such prices bring developing countries endowed with non-renewable natural resources (NRNR) substantial opportunities. They also bring great risks.[1]

The basic policy mistake in managing NRNR 'windfall' revenues is the use of resource surpluses to relax fiscal discipline.[2] The conventional tax base is slowly eroded, public investments fuel consumption rather than production, domestic inflation is allowed to increase, and other tradable sectors such as manufacturing become uncompetitive. Recovery from such a collapse in the economy can take decades. There is also a body of statistical and anecdotal evidence that NRNR revenues, particular in periods of high commodity prices, pose a risk to the political security of a country, not least in post-conflict states.[3]

Five Principles

Substantial international experience has accumulated on how to manage the risks and realise the opportunities of 'upstream' oil, gas, and minerals development during 'boom' periods. Five emreging principles for policy formulation are as follows:

➔ Principle #1: Upgrade the Regulatory Framework

The higher the proportion of national income dependent upon NRNR revenues, the higher the risks of the 'resource curse'. Many resource-rich countries need to rapidly modify their regulatory environments to manage the current elevated ratios of NRNR revenues to non-NRNR national income. For example, Kazakhstan, Timor Leste, Sao Tome and Cambodia, along with some established oil economies such as Nigeria, are in process of passing new revenue management and fiscal laws, sensitising their populations to the risks and opportunities of NRNR 'booms' and conducting public consultations on how revenues should be managed for the benefit of society as a whole. In some countries, programmes are also being put in place to support parliament to exercise oversight, and to strengthen Ministries of Finance and state petroleum and mineral agencies in budget management and accountability.

➔ Principle #2: Sequence Your Economic Policy

Countries which have managed oil, gas and mineral wealth relatively well – Norway, Alaska, UK, Botswana, Chile, Colombia, Indonesia – paid attention to the way in which revenue management strategies and economic policy 'fitted' with the evolution of their NRNR production sector. For example, in the early investment phase, to varying degrees, efforts were made to develop production sharing, royalties and tax regimes relevant to local circumstances and market conditions, to maximise 'local content' provisions and the positive economic impact of construction and operations, and to build up a capital fund from early revenue streams. As the sector developed, efforts shifted to towards medium and long-term budget stabilisation, investment of revenues to sustain and develop competitiveness in other tradable sectors, and a sharing of revenues with sub-national levels of government.

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The sequencing of industrial and economic policy also has to be sensitive to changes in the external environment, for example: sterilising 'windfall' revenues against 'Dutch Disease' effects as commodity prices surge; responding strategically to new export markets; and balancing national interests for mid-stream developments (power stations, refineries) with the potentially lower costs of importing energy and refined hydro-carbon products.

➔ Principle #3: Customise Your Revenue Management Strategies

Managing NRNR revenues is essentially about deciding 'what to spend', 'what to save', and 'when'. There is a wide array of international experience in establishing natural resource funds (NRFs), whether they be for managing revenue volatility, budget stabilisation, savings, investment, or some combination. The only consensus seems to be that there is no single 'right answer' to their design.

Those who support NRFs believe they help to absorb windfall volatilities, enable budget stabilisation and savings, address intergenerational inequalities, keep funds out of the hands of kleptocracies, and by their very presence, suppress expectations of spending by government departments and the public. Others believe that NRFs are divorced from mainstream national development plans and poverty reduction strategies, and that resource revenues should be handled in the same way as normal fiscal and budget management. In very weak economies, it may also be politically challenging to justify NRFs that, because of the need to build up capital stock, delay the release of income to the national budget.

Whichever revenue management strategy is chosen, it needs to be customised to fit both domestic and international economic, social and political factors, and be constantly re-evaluated as circumstances change.

Principle #4: Strengthen Transparency, Accountability and Democratic Governance

International experience suggests the need to put in place the following elements of democratic governance in order to manage the risks of revenue mismanagement, and the potential adverse impact of this on corruption, worsening poverty and conflict:

- create a visible link between NRNR revenues and improvements in national economic performance;
- surgically address institutional and judicial barriers to effective transparency and accountability in revenue management;
- build capacity in public expenditure management and execution at national, provincial and local levels;
- strengthen oversight of NRNR revenues within parliament, the media and civil society; and
- ensure people who live in resource producing regions benefit economically, but not to the detriment of non-producing regions, nor to the capabilities of central government to execute its fiscal stabilisation and distribution functions.

Principle #5: Re-align Aid

Many resource-endowed, low-income, countries are also recipients of official development assistance. For some, the prospect of sustained, high, NRNR revenues is coincident with increases in aid targeted at the country's persistent development challenges, eg. in employment, health care, basic education, water and sanitation. Other resource-rich countries are destined for 'reduced' aid flows, precisely because of the higher NRNR revenues.

These realities present both opportunities and risks. The opportunity is to redirect more of the aid (or manage the withdrawal of aid) in such a way as to build the institutions and infrastructure required to ensure linkage between NRNR revenues and the achievement of social and economic development goals. It is also to align aid with NRNR revenue surpluses so as to support regional (cross-border) investment and political security, as an alternative to depositing revenues on the global capital markets. The risks centre around i) how to prevent 'big-push' aid strategies from compounding the 'Dutch Disease' effects of NRNR 'booms', further eroding institutional absorptive capacities and fuelling corruption; or ii) how to slow the rate of withdrawal of aid such that key institutions are readied in time to handle the elevated NRNR revenues.

In Summary

Get the choice of industrial and economic policy and their sequencing right. Support this with fiscal prudence, customised NRNR revenue management, and adequate democratic oversight, and NRNR revenues can be a force for sustained economic growth and social development. Get the policies and sequencing wrong, copy revenue management strategies without localisation, and ignore issues of good governance, and international experience tells us that a 'boom' in NRNR revenues can become a 'curse', depressing economic growth, worsening poverty and increasing political insecurity. There is much to learn from the experience of other countries in managing NRNR revenues. But each country is also unique, and external markets and internal realities constantly change. Adaptation is key.

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Selected References

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Dr Michael Warner
programme on Business and Development Performance
Overseas Development Institute
111 Westminster Bridge Road, London SE1 7JD
email: m.warner@odi.org.uk tel: +44 (0)20 7922 0386
www.odi.org.uk/business.html

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