

## **Can governments avoid the resource curse?**

**TO: Workshop on Poorly Governed Resource-Dependent States**

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For some time, there was considerable debate over whether the resource curse existed at all. However, recent findings indicate that the resource curse is a very real problem that mainly affects states with weak institutions and poses important questions for US policymakers. Countries that depend on natural resources experience less growth, less democracy, and more war when they have weak institutions or high levels of poverty. They also experience more failure at post-conflict reconstruction than resource-poor states. In contrast, states that seem to avoid this resource curse—including Norway, Canada, and Botswana—boasted strong institutions when they discovered their resources.<sup>1</sup> I first describe the recent findings and then their implications for US policy.

First, the strength of institutions appears to be a key variable for predicting the impact of natural resources on economic growth according to Melhum, Moene and Torvik (2006). They measure institutions using data from the International Country Risk Guide (ICRG) on surveys of foreign investors on government corruption, risk of expropriation, and repudiation of contracts across countries and find that resource wealth undermines economic development in weak institutional environments, like in the DR Congo and Algeria. But in strong institutional environments, economic growth is robust.

Second, the presence of oil has been found to undermine democracy, but only in poor countries (Ross 2009). Ross' results are tentative because there are few observations of low income democracies. Nevertheless, they are consistent with Jensen and Wantchekon (2004), who show that oil has undermined democracy in sub-Saharan Africa, a region plagued with the world's worst poverty.

Third, Ross (2009) also finds that oil increases the likelihood of war within poor or middle-income states, but not within high-income states. This is consistent with Humphreys (2005), who tentatively finds that weak states with high oil production are more likely to experience conflict than strong states with high oil production.

Finally, my research reveals that among governments emerging from civil war, the vast majority of which administer very poor and weak states, those that are resource poor are more likely to bring about successful post-conflict reconstruction than their resource-rich counterparts.

Put together, these latest findings demonstrate that the resource curse emerges only in states with weak institutions. Poverty and institutions, measured using data from ICRG, are

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<sup>1</sup> See Wright and Czelusta (2004) and Acemoglu, Johnson and Robinson (2003).

highly correlated, as might be expected. What are the mechanisms linking weak institutions to the resource curse? Ross (2009) argues that governments that discover natural resources become overwhelmed by resource windfalls that force them to grow at a much faster pace than the civil service can control. While expanding beyond control, these governments are forced to meet challenges created by exporting natural resources, including declining terms of trade, the weakening of a country's agricultural and manufacturing sectors due to the appreciation of the real exchange rate (Dutch Disease), the volatility of revenues, and future depletion. It follows that states with weaker pre-existing institutions will become even more beleaguered and less capable of addressing the challenges created by natural resources.

Melhum, Moene and Torvik point to a second mechanism. They argue that the resource curse occurs only in weak states because their few entrepreneurs can partake in the rent-seeking that natural-resource discovery engenders only by participating in the existing corruption, generating a vicious cycle. In strong states that are rich in natural resources, entrepreneurs can only seek rents by being strong producers, generating a virtuous cycle.

Third, weak institutions lead to the resource curse because leaders are more vulnerable to being overthrown than in stronger states. They use the wealth generated by natural resources to protect themselves rather than to develop the economy. Robinson, Torvik and Verdier (2006) argue that leaders weaken their own institutions when natural resources are discovered because they benefit more from disbursing the wealth immediately to serve their needs and interests instead of disbursing widely for future development and risking only tangential benefit. Acemoglu and Robinson (2006) argue that vulnerable leaders are less likely to spend on development because citizens who become stronger as a result of such spending may become strong enough to challenge the leader's rule. For example, former president of resource-rich DR Congo, Mobutu Sese Seko, feared that by building effective governmental bureaucracies to offer public services, he might empower elites that would administer them. In turn, elites might have opportunity to develop their own patronage networks around those bureaucracies, which could facilitate coordination against the regime.<sup>2</sup> Mobutu therefore spent on the presidency at the expense of health and education. Similarly, in Angola, since the 2002 ceasefire, defense expenditures increased while expenditures in health and education remained abysmal at 1.9 and 2.4 percent of GDP respectively (IMF 2007, 65), showing no improvement despite the influx of oil revenues. The strategy works: resource rich regimes last for a very long time.<sup>3</sup>

If the resource curse emerges in impoverished countries because they have weak institutions, then improving transparency and strengthening legislatures, courts, the central bank, political parties, the media, and civil society should promote responsible revenue management. But can any donor initiative induce leaders to implement these reforms given that these reforms should facilitate broad-based development and that leaders fear that such development could empower potential challengers? Can any donor initiative induce leaders to address the technical problems associated with the resource curse, such as diversifying exports, controlling spending, or supporting stabilization funds (Ross 1999)? The answer cannot be technical or financial advice since the international community already targets resource-rich governments with such

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<sup>2</sup> See Reno (1998).

<sup>3</sup> See Smith (2004) and Morrison (2009).

guidance. The problem is that donors have no leverage over resource-rich states – the topic I turn to now.

## **EFFORTS TO REIGN IN RESOURCE RICH STATES: 3 INITIATIVES**

An important lesson from recent multilateral and bilateral global initiatives aiming to improve governance in resource-rich states is that donors have minimal leverage. The current thinking in the field has been that aid always encourages post-conflict reconstruction, even in resource-rich states. But in my study of post-conflict reconstruction, I find that successes in UN peacekeeping and postwar development mostly occur in resource-poor states, where leaders are dependent on aid and therefore subject to leverage applied to meet donor conditionality requirements. For conditional aid to assist a resource-rich state, its government must believe that it benefits more from complying with the reform than from forgoing it. My results therefore caution against giving any assistance to resource-rich states. By giving them any aid, donors may increase the value of capturing the government, and therefore force the leader to take even more actions that stabilize the regime at the expense of the rest of the state. It is hard to see how a resource-rich government plagued by weak institutions would ever accept reform and thereby give up access to easy wealth – wealth that ensures the regime’s survival.

To demonstrate the problem, I briefly discuss three examples of global initiatives with, at best, ambiguous results: conditionality by the World Bank and the International Monetary Fund (IMF), Chad’s Revenue Management Fund, and the Kimberley Process Certification Scheme (KPCS).

When offering assistance to resource-rich states, the IMF and the World Bank increasingly include revenue transparency as a condition in their programs. But many resource-rich countries choose not to implement the conditions. I find that, after civil war, resource-rich countries are significantly less likely to comply with conditions on aid. Angola, where the IMF and the World Bank advocated transparency and accountability, serves as an instructive example. After its ceasefire in 2002, the Angolan government discussed reform programs with the IMF, but refused to implement even the preconditions that the IMF required prior to approving the agreement. These preconditions sought to change Angola’s accounting practices. Angola agreed to implement some transparency measures, but did not accomplish enough reform to satisfy the IMF. The World Bank approved several projects, but these failed to bring about results according to the Bank’s own evaluation.<sup>4</sup>

Why not implement reforms prescribed by the IMF and the World Bank? Transparency and accountability could have tied the government’s hands forcing it to spend oil revenue on the country’s development, and this spending could have strengthened weak groups enough to challenge the regime. Instead of following IMF guidelines, the government maintained defense expenditures similar to what they were during the civil war.<sup>5</sup> Angola, also, had no need for conditional financial support. In addition to receiving oil revenues, by 2004, Angola began receiving large and steady amounts of unconditional reconstruction assistance from China in

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<sup>4</sup> See World Bank (2007a).

<sup>5</sup> See World Bank (2007b).

exchange for a guarantee that Chinese firms would receive at least 70 percent of bids for reconstruction projects and in exchange for oil. Natural endowments, and especially oil in cases like Angola, reduce leaders' incentives to comply with conditionality.

Resource-rich states may also find it hard to comply with anti-corruption reforms accompanying Revenue Management Funds because they can do better in the short term by renegeing. One example is Chad, which needed a pipeline to export its oil reserves. The government welcomed the World Bank and other external actors who financed the \$4.2 billion pipeline in exchange for transparent revenue management to implement a poverty reduction strategy. Chad was to deposit royalties in an offshore account, where an independent panel would monitor its expenditures, making sure they contributed to the country's development. Once oil revenues poured in, over \$1 billion a year, Chad reneged, declaring that it would increase revenues in its general budget and increase military spending. The World Bank eventually agreed to a softer version of the program, leaving Chad with much more discretion over its oil revenues than in the previous agreement. In particular, the new agreement allowed Chad to increase military spending and abandon a fund meant to store oil revenues to benefit future generations. But even this program failed in 2008 when Chad declared that it would not comply with the soft conditions. Chad's government seemed to believe that the costs of complying with the agreement were outweighed by the benefit of siphoning rents. Chad is mired in insecurity. It hosted a long civil war and is again embroiled in conflict. Its president, Idriss Déby, has suffered at least five coup attempts. It is likely that the regime senses insecurity about its future, and might fear that if it fails to take advantage of oil wealth and use it to co-opt or repress as needed, one of its rivals may take advantage of the regime and its control over oil revenue.

In contrast to the other initiatives, the Kimberley Process Certification Scheme (KPCS) seems to have had some success. Its purpose is to prevent the sale of diamonds mined in conflict zones and thereby cut off funding to warring groups. Its launch in 2000 preceded the end of several conflicts where diamonds helped pay for the fighting. But it is hard to know how significant a role KPCS played in ending these conflicts. Through the KPCS, governments guarantee their diamonds are not from conflict zones, but the guarantee depends on validation from national diamond industries, which are not transparent. Also, it is unclear whether those who choose not to comply suffer any ill effects.

## **EVALUATING NEW POLICY INITIATIVES**

The assessment done by the Bank Information Center and Global Witness of the World Bank and the IMF emphasizes transparency. Four out of five recommendations for the World Bank and the IMF deal with disclosure issues. However, the case of Angola raises important questions about how far transparency can go at promoting good governance. After coming under a great deal of pressure from Global Witness and other non-governmental organizations, the World Bank and the IMF, and foreign governments, Angola agreed to release information about what revenues the government receives. It now publishes monthly data on the production of and income from diamonds and oil, block by block. The government uploads these data on the website of its Ministry of Finance along with its annual budget. It also allows KPMG to publish

audit reports, some of which are hard-hitting. Despite this achievement in financial transparency, improvement in basic living conditions for most Angolans has been minimal. Africa's leading oil producer still has among the world's highest infant mortality rates. So what does transparency do? Transparency without institutions may only have negligible effects on the resource curse. In regard to Angola's transparency efforts, the World Bank reported that: "resistance to change in other areas notwithstanding, the authorities have moved to enhance transparency in oil revenues, but the improvement has not led yet to a clear decline in corruption, at least as captured by perception based measures" (World Bank 2007a, viii).

Angola might become less corrupt if political institutions hold government officials accountable. According to Humphreys and Sandbu (2008) checks and balances implemented through more representative legislatures correlate with fiscal responsibility in resource-rich states. This implies that donors should promote reforms that bring about free and fair elections and a viable opposition, such as reforms that support electoral administration, that reinforce independent media, and that bolster the legislature's capacity both to research issues related to revenue management and to oversee the executive.

The Extractive Industries Transparency Initiative (EITI) has more potential than existing conditionality by the World Bank and the IMF because it squarely addresses both transparency and accountability. It asks governments to publish all available information on receipts from oil and gas companies and it forms partnerships between governments, civil society and the private sector to promote accountability. Twenty-six countries have become Candidate countries, meaning that they are initiating the process of implementing these programs, but only Azerbaijan has been validated so far. We still don't know if EITI is working and research is needed to find out why some countries decide it's in their interests to comply and others not. Because EITI focuses on both transparency and accountability, it may have the potential to affect good governance in resource-rich countries.

If EITI can't obtain compliance initially, which is what I expect, it may at least succeed at creating a ready alternative in case a resource-rich government looks for a change in the future. Recommendations from the Senate Foreign Relations Committee to strengthen US EITI assistance through US Treasury and USAID commitments, engagement with foreign powers like China, Russia, and India, and support from the G8 seems very promising since these moves should help establish a norm of acceptable behavior that might influence domestic actors in resource-rich states eventually.

Another idea sometimes advanced is to provide oil rents directly to citizens with the aim of governments taxing them in exchange for public services.<sup>6</sup> The idea of direct transfer to citizens is similar to remittances. In a paper I co-authored with Claire Adida, we find that citizens create their own access to public services when provided direct income via remittances. The effects of this dynamic on governance are ambiguous, however: citizens could be freeing up the government to be more corrupt than it was before (Abdih *et al.* 2008), or they could complement its activities.

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<sup>6</sup> See Morrison (2007) and Birdsall and Subramanian (2004).

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